European Stability Mechanism

Completing banking union to support Economic and Monetary Union

This discussion paper depicts recent developments in the euro area banking system and sheds light on institutional and economic obstacles to further integration. Based on those facts, the paper proposes a way forward for further integration and completion of banking union, considering the implication of reforms to foster a safer, more profitable and integrated euro area banking industry.

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We dedicate this paper to our beloved colleague and co-author, Mike Hesketh, our principal banking expert who sadly passed away much too early, in April 2019. Mike was an outstanding professional and friend to us. We appreciated him for his profound expertise and high standards, his truthfulness, and deeply felt empathy for those around him. We sorely miss Mike's sense of humour and wonderful stories, but we draw inspiration every day from his knowledge and dedication.

Disclaimer: The views expressed in this discussion paper are those of the authors and do not necessarily represent those of the ESM or ESM policy. No responsibility or liability is accepted by the ESM in relation to the accuracy or completeness of the information, including any data sets, presented in this paper.

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Executive summary

Banking union was key to overcoming the past financial crisis as well as the most far-reaching step taken in the last decade towards a more complete single market.

During the financial crisis, the monetary policy transmission channel had largely ceased to function given the lack of trust in the banking system and hugely diverging borrowing costs across countries. The tightening of regulation and creation of a banking union with a unified supervisory and resolution structure were decisive steps in overcoming these problems and establishing a level playing field for banking services in the single market. But the process is not complete.

Pushed by regulatory changes introduced since the financial crisis, banks have become much safer but still face a number of structural challenges and could benefit from stronger integration.

Due to new regulation, European banks have built up capital and liquidity buffers. They have made considerable progress in reducing non-performing assets; however, these remain at unsustainable levels in some countries, putting a drag on banks' profits and their ability to lend. Moreover, the sovereign-bank feedback loop persists through the high exposure of banks to their sovereigns. Banks' profitability still lags behind non-euro area banks due to structural and cyclical factors and European banks face rising competition through "intruders" using new technologies. Regrettably, the banking sectors have become less integrated than before the crisis.

The completion of banking union could enable banks to reap the benefits of a single market and help to strengthen the euro area economy.

A balanced approach to regulation and a complete institutional set-up could provide the basis for a safer, more profitable and integrated European banking sector that would effectively serve the euro area economy. Our aim is to propose a well-founded and balanced plan for the completion of banking union. Adding a common deposit insurance scheme as the third, missing pillar of banking union, together with an improved regulatory and resolution framework as a guarantee of on-going risk-reduction could help to address remaining concerns about the free movement of capital and liquidity within banking groups. Dismantling the remaining barriers would in turn help banks address the profitability challenge and alleviate pressure arising from technological innovation and new competitors. Further integration in the banking sector creates new business opportunities. Effective regulation and strong supervision mitigating regulatory arbitrage will act as a continuous safeguard that enhances the private risk-sharing channel and at the same time reduces the need for public risk-sharing in the European Economic and Monetary Union.

Our paper contributes to the on-going policy debate by outlining a step-wise approach for the completion of banking union. The different steps to complete banking union would take place between 2021 and 2027. They are based on proposed stages of implementing a European deposit insurance scheme (EDIS), which entail an increasing degree of loss mutualisation. Additional measures are linked to those stages building on two principles. First, we prioritise measures more directly affecting the operation of EDIS and its potential pay-outs. Second, each step fosters trust-building before the next stage is reached. It does so through institutional safeguards, the building up of experience, and careful stock taking. With these principles we try to define a balanced approach to overall risk-mitigation. Steps towards deeper integration and risk sharing on the one hand, are matched with steps avoiding moral hazard and one-sided benefits on the other hand.

This paper outlines a three-step roadmap for the completion of banking union to foster a safe, profitable, and integrated banking sector.

EDIS is at the heart of the process. EDIS will create trust among savers that they can count on a deposit insurance which is able to cover even extreme failures in a country's banking system. This strengthens financial stability across the entire union. With EDIS, moreover, supervisory and resolution responsibility would better match financial liability: deposit insurance would be performed at the same level as supervision and resolution, dissipating fears of unequal treatment. Increasing European responsibilities also reduces the possible impact of bank failures on sovereigns and weakens the "doom loop". Similar benefits are expected from the creation of a common backstop to the Single Resolution Fund (SRF) that will be provided by the European Stability Mechanism (ESM) as of 2024 at the latest.

EDIS is at the heart of the completion of banking union. It will increase financial stability, reduce the sovereign-bank doom loop, and create a level playing field for banks to operate across the union.

Moral hazard concerns related to uneven distribution of risks and benefits from EDIS can be prevented by a smart design of accompanying regulatory measures and adequate calibration of bank contributions to EDIS. Reducing options and national discretions related to prudential banking requirements can ensure a level playing field. The various insolvency laws across countries treat investors differently and present diverse risks that require the use of European funds in extreme cases. Also, remaining gaps in current supervisory and bank practices can be closed. More harmonisation of regulation and further work on crisis legacies would help to mitigate concerns that common

Further regulatory harmonisation and measures to address local risks can prevent that banking systems in member state benefit in a disproportionate way from an enhanced European safety net.

insurance will be tapped by countries not adhering to European regulatory standards and commitments. EDIS design will be fiscally neutral for taxpayers and be covered by the banking industry. A number of measures can be taken to address the issue of sovereign risk on bank balance sheets, which currently reinforces the “doom loop”. EDIS contributions can also reflect these sovereign exposures. Eventually, direct regulatory changes could reflect the risks linked to sovereign exposures in a banking union. However, taking this step requires sufficient transition time and an integrated banking market so that sovereigns can keep adequate market access during the transition.

Measures to allow banks to operate efficiently across the union and promote integration are equally important for the completion process.

Banking union will only work properly and in line with the idea of a common banking market if banks can operate freely and provide services across the union without concerns about the adequacy of the different national safety nets. In turn, banks should be able to efficiently design their cross-border operations without additional capital and liquidity requirements. Regulatory constraints involving higher capital and liquidity costs weaken the case for cross-border mergers and counteract an integrated and profitable banking system. The problem can be overcome with better European safety nets and assurances for host countries - whose banking sectors rely on subsidiaries of foreign banks - that they would be treated fairly in bank resolution. Ring-fencing of capital and liquidity would become less necessary and the operation of banking groups in the union could be strengthened. Giving up state capital and liquidity requirements was a key step in integrating the US banking market. In a union-wide banking market, sovereign financing is less reliant on national banks, bank portfolios are more diversified and banks are therefore safer and better placed to secure financing when single economies in the euro area face difficulties. Diversified sovereign bond holdings can enhance their stability in times of crisis.

A European safe asset can complement the completion of banking union.

A European safe asset can complement the completion of banking union. It would naturally lead to a diversified holding of sovereign risk in bank balance sheets and could help to secure government financing. It would strengthen monetary union because financing conditions across countries would be more equal. As we learned in the past crisis, this is an important condition for effective monetary policy transmission. It would also strengthen the international role of the euro.

Looking back: the banking sector since the financial crisis and the creation of banking union

Reaction to the crisis

The US real estate market collapse in 2007 exposed financial sector weaknesses and precipitated the euro area crisis. Liquidity became scarce, asset prices fell, and trust evaporated, making numerous financial institutions either illiquid or insolvent. Governments intervened to save a number of banks while leaving others to go bankrupt. The failure of a major financial intermediary such as Lehman Brothers caused panic in global markets. The repercussions in European markets were long-lasting due to pronounced structural weaknesses, and contributed to the development of a sovereign crisis in Europe.

Before the crisis, European regulation and supervision failed to keep pace with market developments. A combination of factors, including a lengthy benign environment and abundant liquidity, led banks to seek higher returns with less appreciation of emerging risks. Such risks arose both from traditional lending, where standards became more relaxed, and from more complex financial structures, such as derivatives and securitisations, which became important profit generators. These structures obscured the true risk in banks' balance sheets and increased the interconnectedness between market participants, intensifying market turmoil.

The immediate reaction to the crisis demonstrated a need for improved rules and regulations across the European Union (EU). National authorities provided capital and liquidity to lenders considered of national systemic importance, and only afterwards received approval for the state aid. The underestimation of capital needs was partly due to the urgency to provide support to keep institutions solvent, while the market continued to decline. However, this underlined the lack of a common and coherent methodology to assess capital and liquidity needs.

In June 2012, the EU leaders agreed to work towards a banking union for the euro area. The initial idea covered a single supervision mechanism, a single resolution mechanism, and a strengthened deposit insurance framework underpinned by a single rulebook. Many elements have been successfully implemented (see Boxes 1 and 2). However, improving conditions enabling banks to become sound and profitable requires further measures. In particular, the project of a common EDIS remains pending. An unequal level of deposit protection across the euro area undermines progress reached so far on building up a level playing field.

The financial turmoil in the euro area demonstrated the risks of the domestic sovereign-bank link. In some euro area countries, the financial crisis became a sovereign crisis, because the cost of supporting the banking sector caused a material deterioration in the sovereign financial capacity, for example in Ireland and Spain. In countries such as Greece and to a lesser extent Portugal, the weakness of the sovereign spread to the banks. The deterioration of Greece had a direct impact on Cyprus and, in all cases, banks required financial support that was significant relative to the size of the economy.

Risks were reduced by achieving greater convergence on common regulation and homogenous supervision. In the aftermath of the sovereign crisis, the focus of financial framework reforms has been to increase resilience to shocks through increased capital and to better control banks through more focused regulation, closer supervision and coordinated resolution (see Box 1).

In early 2009, the de Larosière report[1] outlined recommendations to improve financial sector functioning and oversight. It summed up EU contributions to the global debate and policy makers followed up on many of these recommendations.

Box 1 – New institutions were created in response to the crisis

Following the financial crisis, the Basel Committee on Banking Supervision developed the Basel III framework, an internationally agreed set of measures on prudential banking regulation. The initiatives aimed to strengthen the regulation, supervision, and risk management of banks.

Three European Supervisory Authorities were set up to take more prominent role in micro- and macroprudential oversight at the EU level:

- The European Banking Authority (EBA) is the regulatory agency of the EU which works to ensure effective and consistent prudential regulation and supervision across the European banking sector.

- The European Securities and Markets Authority (ESMA) is the agency responsible for the functioning of financial markets in the EU.

- The European Insurance and Occupational Pensions Authority (EIOPA) regulates the insurance and pensions sector.

The Single Supervisory Mechanism (SSM) was set up as the first pillar of banking union to ensure independent supervision of the euro area banking system and became operational in November 2014. Its creation was a major step in Europe transferring responsibility for supervision of significant banks from the national to the EU level, ensuring a consistent flow of supervisory information and supervisory enforcement practices across borders.

The Single Resolution Mechanism (SRM) came into force as the second pillar of the banking union to manage the orderly recovery and restructuring of euro area banks that are failing or likely to fail.

The Single Resolution Board (SRB) became operational as the resolution authority in the EU. The SRB determines the type of resolution and assesses whether it is in the public interest to use the Single Resolution Fund (SRF), which is funded by a levy on the banking sector equal to 1% of covered deposits collected over eight years, from 2016 to 2023. The SRB is also in charge of resolution planning and setting individual minimum requirements for own funds and eligible liabilities (MREL) targets for systemically important banks. In contrast to the US Federal Deposit Insurance Corporation (FDIC), it cannot use a liquidation instrument, as insolvency falls under the member states' competence and national authorities remain in charge.

[1] Report by the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, Brussels, 25 February 2009.

The European Systemic Risk Board (ESRB) was set up in 2010 as a central and independent body responsible for macro-prudential oversight of the EU financial system. Its aim is to identify risks to financial stability and, where necessary, issue risk warnings and recommendations for action to address such risks. In 2011, following the creation of the ESRB, Member States established national macro-prudential authorities and, in 2013, the ESRB recommended that Member States should identify clear intermediate macro-prudential objectives and assign concrete tools to achieve these objectives.

A key principle of new regulation was to cut the link between sovereigns and banks by requiring shareholders and creditors of banks to bear losses before recourse to any public funding. Regulations include requirements for banks to raise liabilities that can be bailed in to absorb losses in the event of resolution (See Box 2). These requirements, known as total loss absorbing capacity (TLAC) and MREL, are important as they provide a buffer of liabilities that can be bailed in to avoid a depositor bail-in. However, raising such liabilities is costly for all banks and for some smaller and mid-size banks could be prohibitively expensive or not achievable due to lack of demand[2]. As of today, banks have defined MREL targets but some banks have not fully funded these buffers[3].

The post-crisis regulatory framework has introduced additional costs for banks and requires a business model adjustment. The requirement to raise additional capital reduces returns, while MREL and TLAC increase funding costs. Fees paid to the SSM, SRM, and national deposit guarantee schemes (DGS) further burden the cost structure. Despite euro area banks' complaints about the impact of over-regulation, particularly in comparison with the US, the overall impact of new regulation has been positive, and banks need to further adjust to the new environment rather than expect regulatory oversight to diminish. At the same time, it may be possible to fine-tune some regulations to take into account market reality and to ensure efficiency, for example the timing of MREL implementation remains unclear and the methodology appears to create an excessive funding requirement.

Box 2 – Overview of key adopted EU banking legislation

The EU adopted regulatory change in several waves. The first was triggered by the financial crisis in 2009 and 2010. The original package was revised and extended several times. In November 2016, the European Commission (EC, Commission) published the last set of proposals, known as the risk reduction package. In a regulatory context, it is important to distinguish between regulation and directive. Whereas directives need to be transposed into national law and offer Member States some implementation leeway, regulations are directly applicable and the national framework needs to reflect the EU agreement.

The 2014 Bank Recovery and Resolution Directive (BRRD) applies to all EU Member States. It aims at reducing the impact of bank resolution and failure on financial stability. It granted new powers to the resolution authorities, including drafting resolution plans and solutions decreasing the impact on depositors and public money. It anchors the obligation to use a bail-in mechanism as of 1 January 2016. The BRRD also introduced the general MREL definition into the EU framework.

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

[3] The SRB published an update to its policy on MREL in light of the publication of the banking package in the Official Journal of the EU on 7 June 2019. For details see SRB (June 2019), *Minimum Requirement for Own Funds and Eligible Liabilities (MREL), Addendum to the SRB 2018 MREL policy on new CRR requirements*.

The Revised DGS Directive anchored unified deposit coverage in the EU with an emphasis on scope, eligibility, financing, and repayment time. It also covers cooperation modalities between the national guarantee schemes, including mutual lending. Moreover, it sets the minimum coverage level of deposits, currently at €100,000 per individual. The Commission can revise the coverage level every five years. The directive allowed numerous national options, discretions, and a gradual phase-in which makes several rules (seven days-delay for payouts, target level of national DGS) binding only from 2024.

The Capital Requirements Regulation (CRR) comprises rules concerning general prudential requirements regarding capital, liquidity, and credit risk for investment firms and credit institutions. The 2016 proposal included the possibility to extend cross-border liquidity and capital waivers to entities located in a different Member State than the parent. However, this possibility was not approved due to Member States' diverging views. Currently it is possible to grant capital waivers only for subsidiaries of banks within the same Member State consolidated under the same supervisor.

The Capital Requirements Directive (CRD) focuses on access to banking activities and their supervision. Its provisions set the rules on capital buffers, bankers' remuneration and bonuses, prudential supervision, and corporate governance. The most recent revision fine-tunes Pillar 2 capital requirements. It also clarifies the scope of Pillar 2 and exempts certain development banks and credit unions from the framework.

The Single Resolution Mechanism Regulation (SRMR) stipulates details of unified resolution within the banking union, including the establishment and modalities of the SRB.

The Single Supervisory Mechanism Regulation (SSMR), adopted in 2013, placed institutions classified as significant under the supervision of the SSM, and the national competent authorities. The ECB became responsible for the SSM's functioning and started regularly publishing a list of supervised institutions and the reasoning behind their classification as significant. Together with the SSM Framework Regulation adopted by the ECB, it outlines core principles governing collaboration within the SSM.

Post-crisis reality

In post-crisis times, banks face systemic regulatory changes and structural industry transformation. Successful transition to the new regulatory environment is accompanied by ongoing changes in the economic, financial, and technological environment. Banks must adopt strategies enabling their financial profitability vis-a-vis the new digital world. The regulators need to come up with laws that are appropriate to the post-crisis and technology-driven business environment. Therefore, this section looks into challenges confronted by both the industry and policymakers.

Improved regulations and institutional infrastructure have made European banks safer than before the crisis, with larger capital and liquidity buffers. However, the outlook is challenging, as the new regulations increase costs and, together with increasing competition, force banks to amend their business models to become more profitable. Banking sector consolidation is needed to eliminate marginal players and for banks to develop sufficient scale to compete internationally and with new market entrants. Legacy issues have been substantially reduced from their peak but still represent a material threat; the tools available to address them could be reinforced.

To safeguard financial stability, new regulations may be required to ensure that traditional banks have the ability to compete with new entrants. While banks are able to integrate and take advantage of some technological developments, the rapid development of bigtechs is a real threat to traditional banking. Further key steps are required; in particular, the completion of banking union is of crucial importance. Steps enabling the free movement of capital and liquidity could help banks address the profitability challenge and alleviate pressure arising from technological innovation and new competitors. Deepening integration in the banking sector creates new business opportunities. Increased competition minimises inefficiencies and naturally prevents moral hazard through enhanced market discipline. After the political agreement to make the ESM the SRF's backstop[4], agreement on the risk reduction package[5] was sealed in 2019[6]. There are, however, important missing pieces, such as the establishment of EDIS, the regulation of sovereign exposures, and further harmonisation of national legislation. This will require continued political and institutional commitment to avoid losing the momentum necessary to complete banking union, address remaining challenges, and avoid repeating the mistakes of the crisis.

The low interest rate environment and higher costs have depressed profitability, especially for smaller banks that rely mainly on lending margins to generate profits. Loan provisioning and litigation costs have weighed down many banks. Although these costs are now easing, the cost-to-income ratio is still high. There is a need for increased cost efficiency, which may be achieved by consolidation. Some consolidation has begun, for example in the traditional cooperative sector. This is both necessary and likely to continue as banks shift from traditional branch networks to online banking and implement other technological advances. Widespread consolidation seems less likely because restructuring business models is long-term work. In general, smaller banks face more constraints in generating economies of scale and scope. Therefore, they remain limited when adjusting to technological change. A simple merger between weak players will not provide a viable solution in the long term and structural rationalisation seems inevitable.

Low cost efficiency, over-banking, and weak revenue diversification stem from outdated business models. It is necessary for banks to adapt these models to the new regulatory and technology lanscape. The important regulatory changes implemented after the crisis have transformed the landscape in which European banks operate, given stricter qualitative and quantitative requirements. However, recent market developments have highlighted new phenomena related to technology changes and competition in services traditionally provided by banks from non-SSM regulated entities (fintech and bigtech companies). The speed of technological innovation is seen as a challenge to the financial system. Banks could turn this into an opportunity to jump into a more digitalised world and improve online services. Over-branching and overbanking in countries, such as Italy and Germany, remain a key challenge. Banks need to shift from the traditional costly branch networks to a new concept of banking, chacterised by significant technological advances. Operating costs need to decline to enable banks to contend with challenges coming from non-banks. Banks must take further steps to meet higher standards of governance and to promote enhanced risk management and risk culture to ensure that they remain sound. They should also be able to comply with new higher standards and demonstrate sustainable profitability under the newly established resolution framework.

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[4] President of the Eurogroup (December 2018), *Summing up Letter by the PEG to the December Eurosummit*.

[5] Official Journal of the European Union (2019), *Risk reduction package*. Official Journal of the European Union. L 150, Volume 62, 7 June 2019.

[6] EU Council (February 2019), *EU ambassadors endorse full package of risk reduction measures*

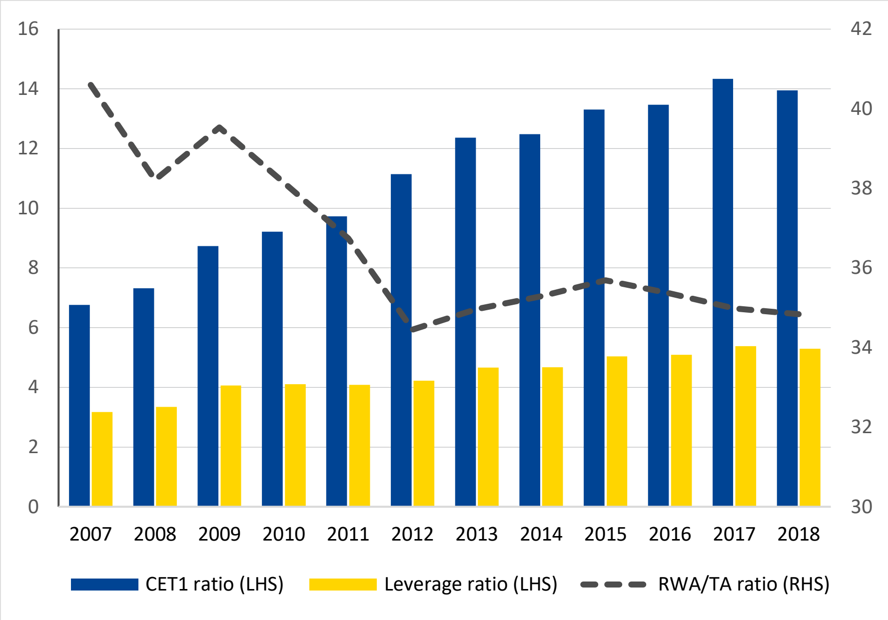
In 2017, the profitability of euro area banks was the best since 2007, both in terms of net profit and return on equity, which reached 6%; this improvement continued into 2018. While this represents significant improvement given that the equity base is much higher now than in 2007, it is still below the lower bound of the estimated cost of equity of 8%[7] and well below the 2007 level of 12.6%. A key driver of profit improvement is the reduction of impairment and litigation costs but further savings are unlikely, as these costs are approaching normalised levels. Interest income is declining due to low interest rates and anaemic loan growth, raising concerns over the sustainability of banks' business models. Euro area banks' cost-to-income ratio remains high at 64.3%, implying further room for cost reduction. However, banks face cost pressures arising from the need to invest to complete business model restructuring, in particular to improve IT systems. At the same time, banks are likely to face increased funding costs from raising liabilities eligible for bail-in.

Despite improved profit indicators, the euro area bank market is less integrated and profitable than banks in other jurisdictions. Key indicators of bank strength, resilience, and efficiency such as asset quality and profitability have been showing improvements but neither of these has returned to pre-crisis levels. According to IMF calculations on a sample of 431 publicly-traded banks, European banks appear to be more leveraged and have bigger problems with loan ratios than US banks[8]. Their US competitors have also profited more from low funding costs. While integration is slowly recovering, the European banking system is still far from a single market. The ECB's price-based indicator on banking market shows improvements in terms of lower cross-country price dispersion. However, price integration is still not back to pre-crisis levels.

Capital and liquidity indicators (Figures 1 and 2) demonstrate that euro area banks are safer than before the crisis. Banks have higher total capital, higher capital ratios, higher core equity, and better leverage ratios. Between 2007 and 2017, banks in our sample[9] reduced risk-weighted assets by 14.5% while increasing total capital by 41.9%. Over the same period, the proportion of highest-quality capital rose to 79.7% from 62.2%, leading to an increase in the core equity ratio to 14.4% from 6.8%. Regulators introduced the leverage ratio as a simpler measure of capital strength and it is also improving, having increased to 5.4% in 2017 from 3.2% in 2007.

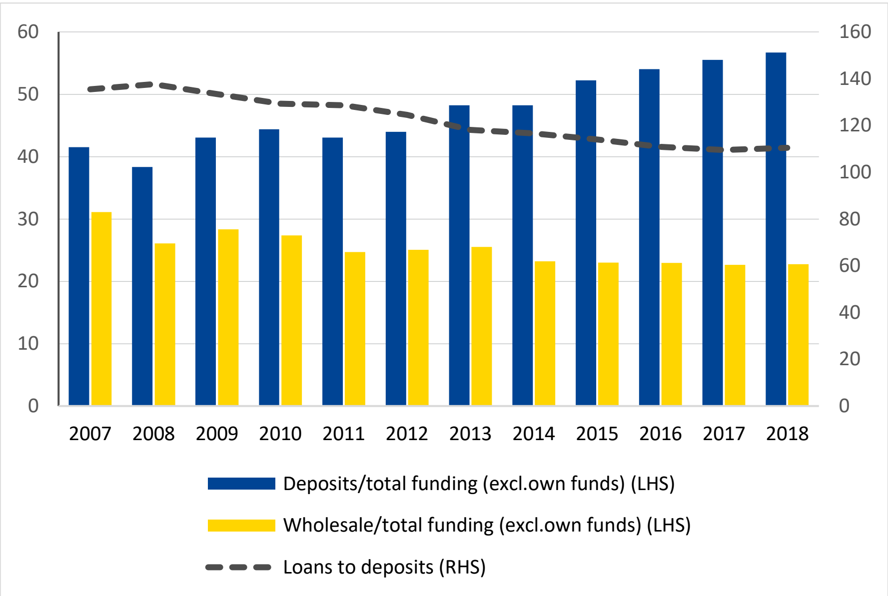
[7] Lower end of the range estimated by the EBA based on the December 2016 Risk Assessment Questionnaire
[8] Xu, T. T., Hu, K., Das, U. S. (2019), *Bank Profitability and Financial Stability*, IMF Working Paper WP /19/5, p. 23. The comparisons are made difficult by different accounting standards, but tentative comparisons with partial sterilisations of these differences show that euro area banks' leverage is much higher.
[9] Sample of around 100 European banks.

Figure 1
Improving capital
(in %)



Source: ESM calculations based on SNL Financial, LHS (left-hand side), RHS (right-hand side)

Figure 2
Improving funding conditions
(in %)

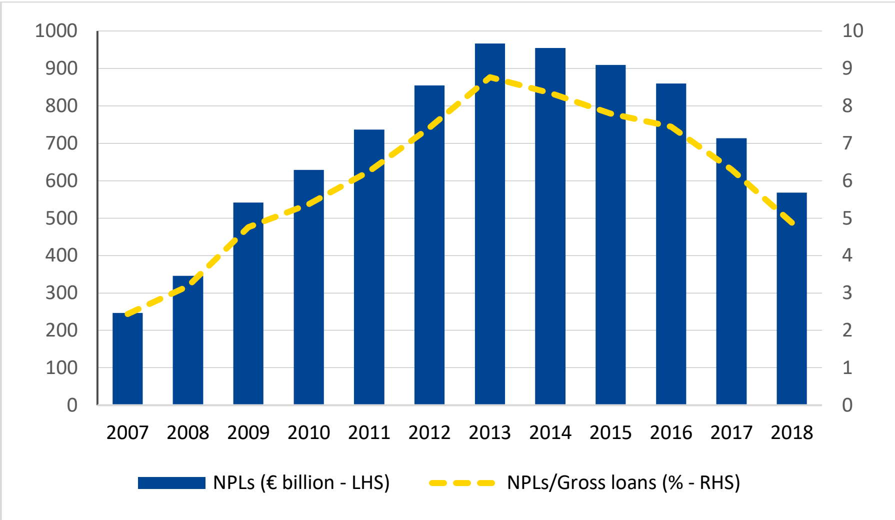


Source: ESM calculations, based on SNL Financial

Funding and liquidity show a similar improvement, albeit subject to greater volatility and sudden deterioration when confidence in banks decreases. Customer deposits have increased and represent traditionally a more stable source of funding, leading to improvement in the loan–to-deposit ratio to 1.1% in 2017 from 1.4% in 2007 and reducing reliance on wholesale funding to 22.2% from 31.1%. Regulators have introduced the liquidity-coverage ratio to ensure that banks maintain high quality liquid assets in the form of cash or liquid bonds to cover short-term obligations and the net stable funding ratio to reduce reliance on wholesale funding.

Other key indicators of bank strength, such as asset quality and profitability, confirm the already mentioned trends. Despite showing improvements (Figures 3 and 4), neither of these measures have returned to pre-crisis levels. In terms of asset quality, as measured by non-performing loans (NPLs)[10] to gross loans, there is a large disparity in results across the sample of banks and between countries. On average, banks have made significant progress in reducing NPLs, to 4.7% of gross loans from a peak of 8.7%, representing a reduction of nearly €320 billion. This remains high, however, compared to the pre-crisis NPL ratio of 2.4%. In all countries that received a financial assistance programme, the NPL ratios remain well above the euro area average and are unsustainably high in Greece and Cyprus. In other post-programme countries and in Italy, the problem persists despite progress.

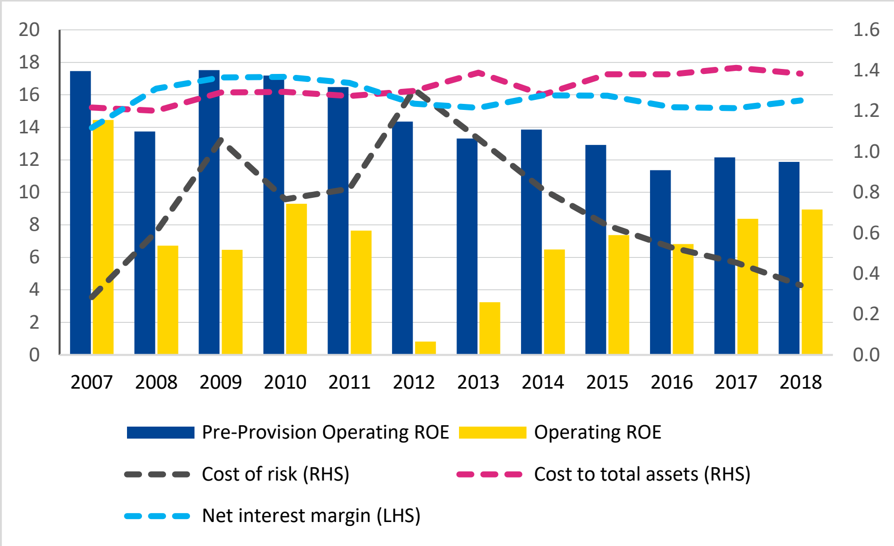
Figure 3
Improving non-performing loan ratios



Source: ESMcalculations based on SNL Financial

[10] The term NPLs is used in this paper as shorthand. In technical terms, we are referring to non-performing exposures (NPEs), following the EU definition (as defined in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278).

Figure 4
Improving profitability
(in %)



Source: ESM calculations based on SNL Financial

The persisting high level of NPLs and Level 3 assets represent an obstacle to mergers and acquisitions. Banks continue to face challenges related to residual NPL issues and low operational efficiency; even in countries where banks have reduced elevated NPL ratios to manageable levels, the clean-up process took far longer than in the US, where NPLs returned to pre-crisis levels much more quickly. The related uncertainty distorts the estimated value of banks' balance sheets and discourages banks from consolidating across borders. The NPLs not only limit bank lending but also lower demand for funding from the real sector. Banks could address the legacy issue more quickly if they could generate higher returns to attract more capital, but, with some exceptions, investing in European banks is still not attractive. Also, Level 3[11] (and Level 2[12]) assets remain high compared to international standards and supervisors have enhanced scrutiny in recent years. In comparison to NPLs, Level 3 assets are performing assets that are not of poor quality, but for which it is difficult or impossible to calculate an accurate fair market valuation. They are also typically illiquid and non-marketable. The lack of proper valuation prices or models may give rise to uncertainties about the related risks and may hide material losses.

[11] Level 3 assets are financial assets and liabilities treated as the most illiquid and hardest to value. A fair value for these assets is determined by using estimates or risk-adjusted value ranges, methods open to interpretation.

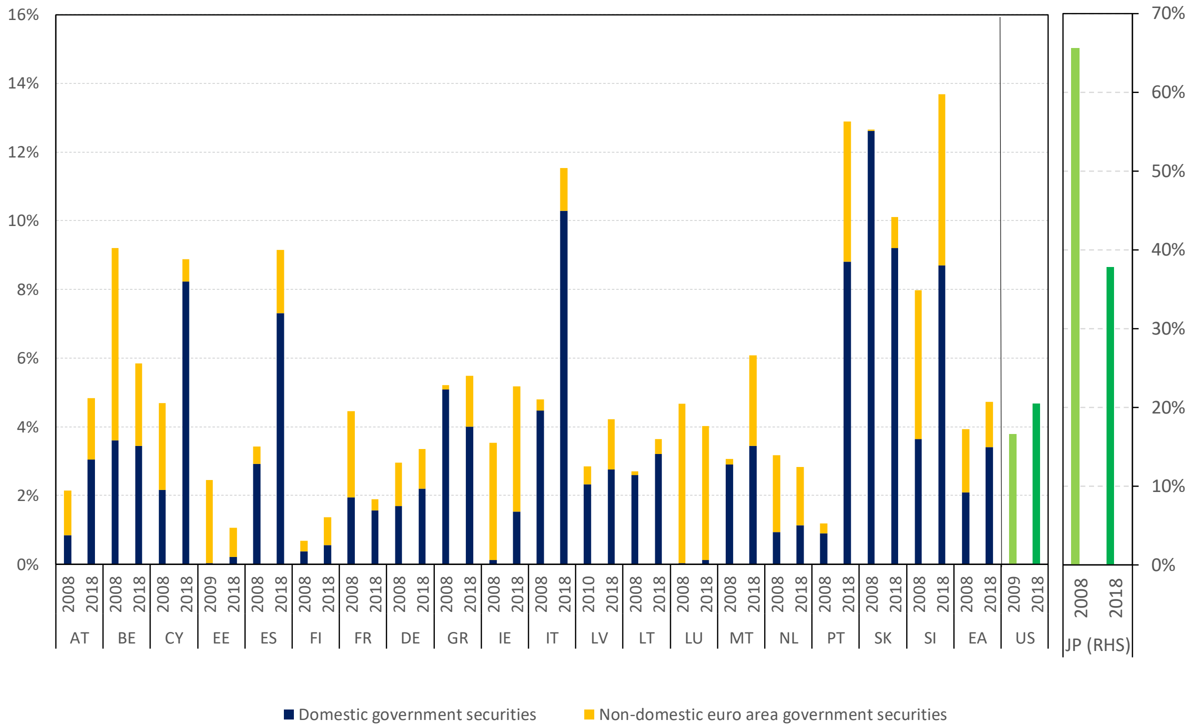
[12] Level 2 assets are financial assets and liabilities that do not require regular market pricing, although a fair value can be determined for them based on other data values or market prices. Level 2 asset values can be closely approximated by using simple models and extrapolation methods using known, observable prices as parameters.

Finally, on the asset side, banks continue to show a strong bias for buying sovereign bonds of their home country, which reinforces the link between sovereigns and banks and makes banks in many euro area countries vulnerable to local shocks. The close link between banks and their domestic sovereign represents a persistent threat to euro area financial stability. While in some euro area countries, bank securities portfolios are sufficiently diversified, the share invested in sovereign bonds remain relatively high; in more vulnerable countries, banks continue to be excessively exposed to sovereign shocks and the link with their sovereign has strengthened compared to pre-crisis levels (Figure 5). In these latter countries, sovereigns depend heavily on banks where their debt securities are held by the banking sector in a large percentage. Potential sell-offs under distressed conditions may jeopardise sovereign refinancing (Figure 6).

Figure 5

Monetary and Financial Institutions' government debt securities

(in % of total assets)



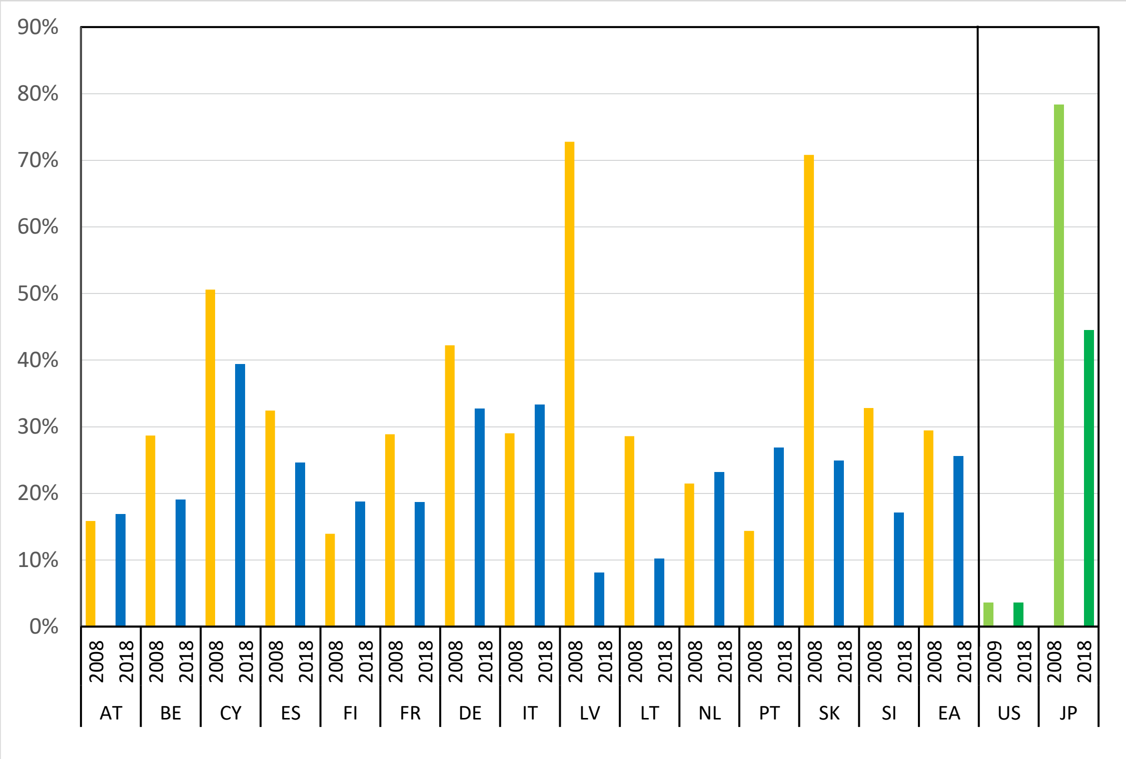
Source: ESM calculations based on ECB Statistical Datawarehouse: Monetary and Financial Institutions (excl. ESCB), Federal Reserve: All Commercial Banks, Bank of Japan: Domestic Banks.

Note - Euro area: The numerator and the denominator take data from the aggregated balance sheet of the MFI sector at accounting values, which is the sum of the harmonised balance sheets of all the MFIs. Assets and liabilities are presented at aggregated level for the euro area as a whole and euro area Member States. US: the numerator includes US Treasury securities held by all commercial banks in the US. The denominator is the total assets of all commercial banks. Japan: the numerator represents the domestic debt issued by the general government and held by financial institutions (excl. central bank). The denominator is the total assets of domestic banks.

Figure 6

Domestic government debt securities held by deposit-taking corporations (excl. central bank)

(% of total outstanding government debt securities)

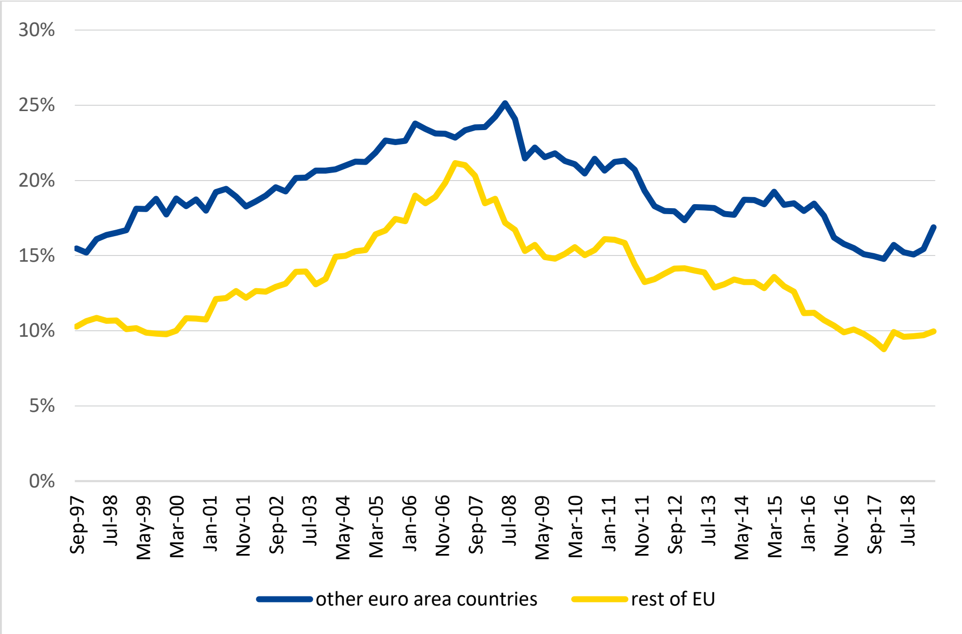


Source: ESM calculations based on ECB Statistical Datawarehouse: Government Finance Statistics, Eurostat, Federal Reserve: All Commercial Banks. US Treasury: Securities outstanding. Bank of Japan: Domestic Banks, Domestic Bonds.

Note - Euro Area: The numerator refers to government debt securities at face value held by the domestic deposit taking institutions (excl. central bank). The denominator contains outstanding government debt securities. They are defined in terms of the ESA 2010 classifications. Government debt securities are measured at "nominal value" - further defined in the Regulation as "face value". This means, in particular, that government debt is not affected by changes in market interest rates, and excludes unpaid accrued interest. US: the numerator includes US Treasury securities held by all commercial banks in the US. The denominator is the total outstanding US Treasury securities. Japan: the numerator represents domestic debt issued by the general government and held by financial institutions (excl. central bank). The denominator is the national government debt in domestic bonds.

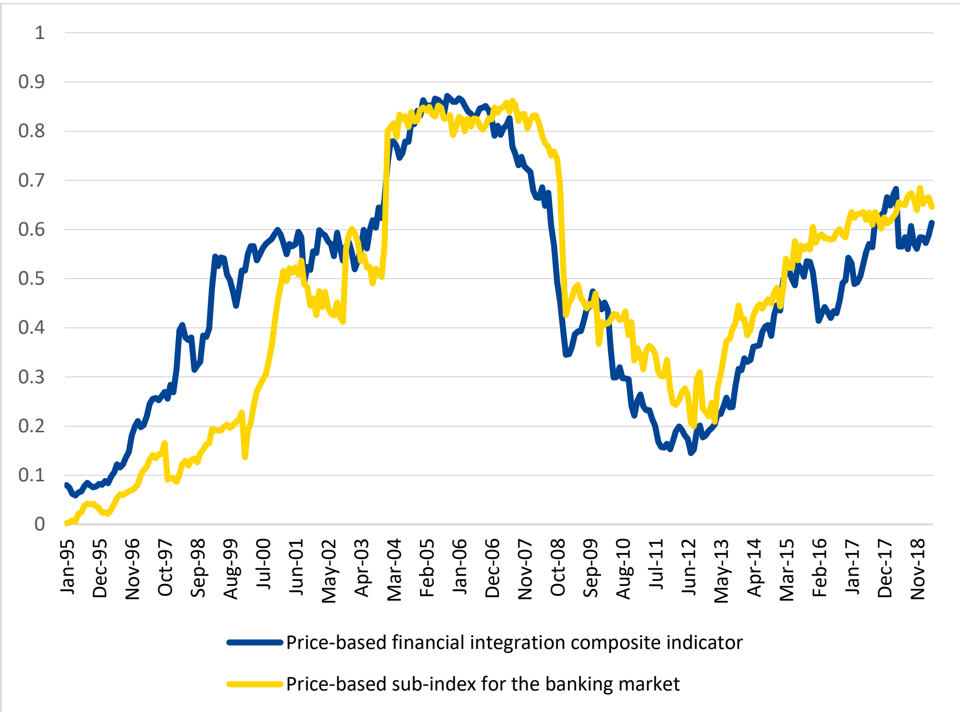
In adapting to the new market environment and stricter requirements, banks reoriented their business to more traditional retail banking activities, which resulted not only in reducing speculative investments and relying on more stable funding sources such as deposits, but also in declining financial integration. Banks retrenched to core markets, closing subsidiaries and branches in other countries. The impact of this retrenchment can be seen in the decline in financial integration (Figures 7 and 8). In part, this was triggered by state aid rules, which forced banks that received financial assistance to dispose of non-core assets, but it also represents a decline in risk appetite. Since the crisis there have been no large-scale cross-border mergers within the euro area. In the near future, the consolidation of smaller banks within countries appears more probable than cross-border expansion. At the same time, banks are large buyers of domestic sovereign bonds, which increases the domestic focus and the link between sovereigns and banks.

Figure 7
Euro area banks' cross-border loans to monetary and financial institutions
(in %)



Source: ESM calculations based on ECB, Statistical Warehouse, Financial Integration Database

Figure 8
Euro area price-based composite indicators of financial integration



Source: ESM calculations based on ECB, Statistical Warehouse, Financial Integration Database

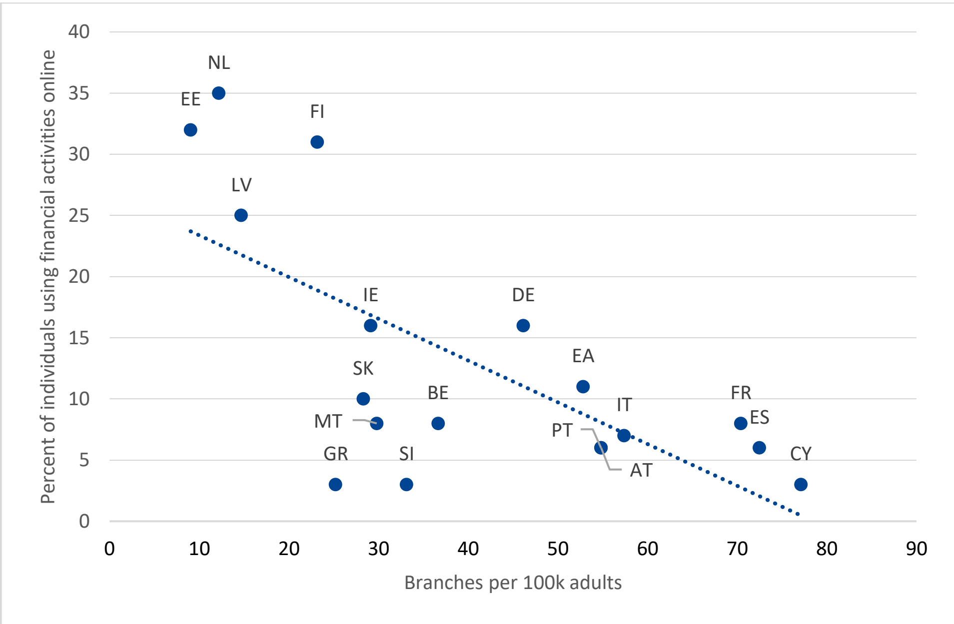
Banks face increasing competition from new technology driven companies and from 'shadow banking', meaning non-bank financial service providers. The relative importance of non-banks in the financial sector has steadily increased, and now represents 40% of the entire EU financial system. The revised Payment Services Directive (PSD2) opens up competition for services traditionally carried out by banks to non-banks, which use new technology to provide more efficient services. This is positive for consumers but is likely to depress a traditional source of banking income.

New market entrants tend to be more effective users of technology, which represents both an opportunity and a threat to traditional banking models. Banks can take the opportunity to jump into a more digitalised world and improve online services, enabling them to cut the fixed costs of branches (Figure 9 and 10). At this juncture, not all banks can seize this opportunity as they may not have the necessary resources to make the investments required.

A potentially bigger threat to traditional banking comes from large technology companies entering the financial services market, such as Google, Apple, Facebook, Amazon (GAFA or 'big tech'), particularly for payment services. Companies such as PayPal cut out traditional banks from some fee-generating activities. Big tech companies have access to more granular personal data than banks, enabling them to target specific customers for other services, such as loans.

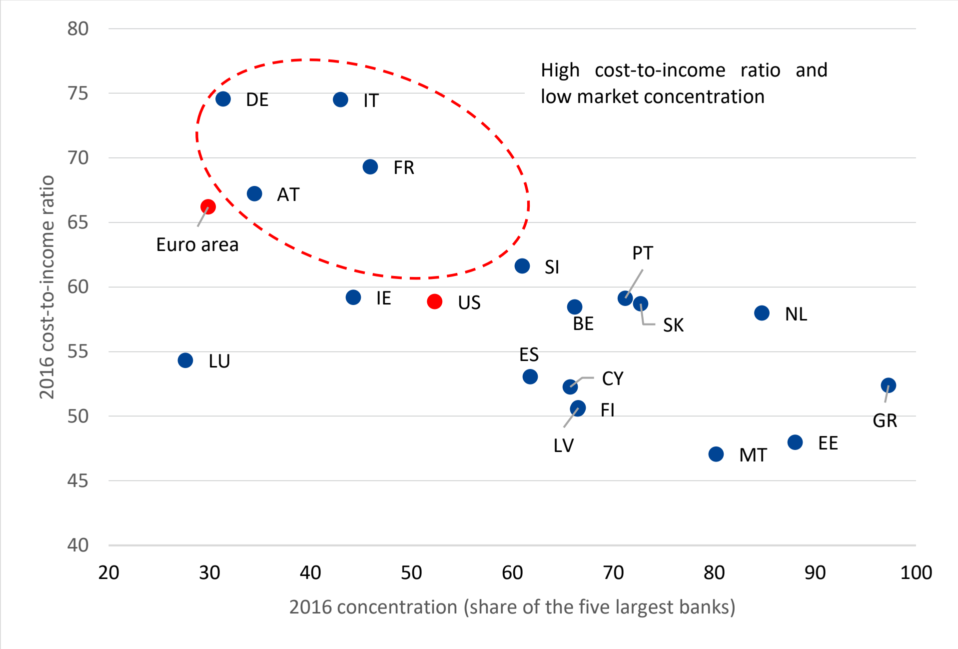
Figure 9

Online banking and concentration expressed as percentage of individuals using financial activities online and number of branches per 100,000 adults.



Source: ESM own calculations based on ECB SDW, Eurostat and SNL Financial

Figure 10
Cost efficiency and concentration



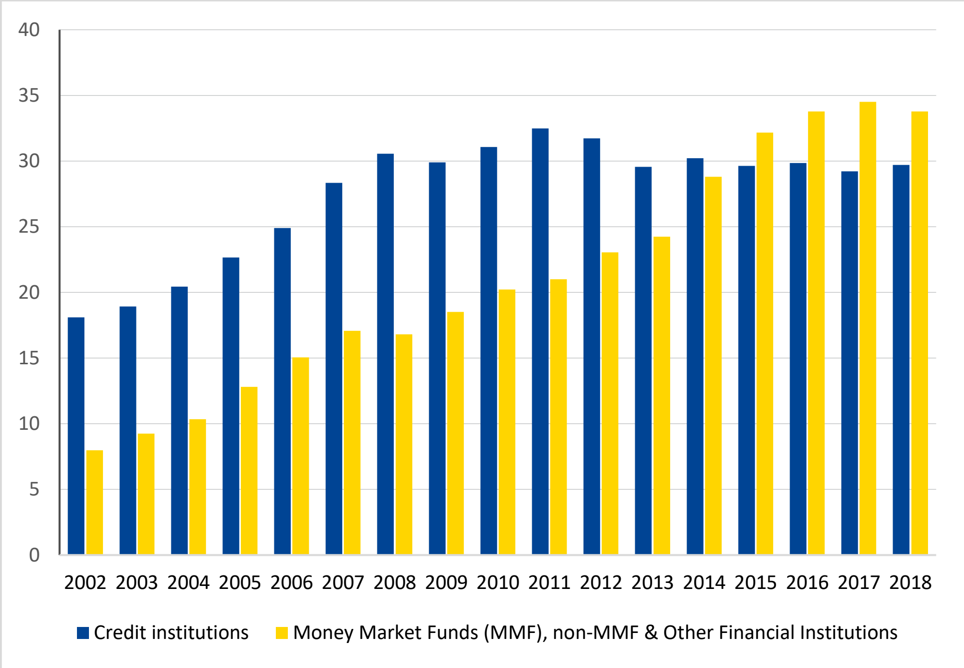
Source: ESM own calculations based on ECB SDW, FDIC and SNL Financial

The use of technology clearly improves the speed of financial operations, but it also increases the risk of contagion. A major threat comes from potential cyber attacks that may either access customer data or destabilise financial infrastructure. Overall, technology should be beneficial to the financial system as more transactions are carried out, but the risks must be properly identified and mitigated.

The growing size of shadow banking represents a potential risk to financial stability. It is not subject to the same regulation as the banking sector and thus creates a risk of contagion. Shadow banking entities are not sufficiently restricted from assuming higher leverage and liquidity risk, nor from assuming the higher risks emanating from derivatives and securities financing transactions. Banks finance these entities, effectively assuming the same risk. Shadow banking entities are also direct market counterparties, such as money market funds (MMF), repo counterparts, or securitisation vehicles. Many hedge funds, private equity firms, and investment funds are also investors in banks, further increasing interconnectedness. Following the last Financial Stability Board report (February 2019[13]), funding and credit interconnectedness between banks and Other Financial Institutions (OFIs), as measured by balance sheet items, increased marginally in 2017; the overall size of the sector has substantially increased since the crisis (see Figure 11). Banks' exposures to, and use of, funding from OFIs varied significantly across jurisdictions; banks' exposures to OFIs were below 5% of bank assets in the majority of jurisdictions, but made up over 10% of bank assets in Belgium and Ireland[14]. Vulnerabilities in shadow banking could spill over to banks, as in 2008.

[13] Financial Stability Board (2019), *Global Monitoring Report on Non-Bank Financial Intermediation 2018*. 100p. 4 February 2018.
[14] Ibid

Figure 11
Total assets of euro area financial corporations
(in € trillion)



Source: ESM calculations based on Haver and ECB, ECB Risk Assessment Indicators, Quarterly data unless otherwise noted, Not Seasonally Adjusted

Apart from restructuring business models to compete with new entrants, banks also need to enhance governance practices to instil a true risk awareness culture. The lack of such a culture and of sufficient controls contributed to the financial crisis. Despite efforts to simplify, larger banks remain overly complex with many subsidiaries, internal models that may understate risk, and significant exposure to derivatives markets. Recent high-profile money laundering cases imply that the risk culture is not properly embedded in banks' operating models and that controls remain inadequate. The rapid growth of the leveraged loan market, together with lighter covenants and controls over borrowers, is a potential sign that risk awareness may still need enhancement[15].

The SSM has assessed that banks have made progress but that most large banks need to improve their governance and risk frameworks to be in line with international best practices and guidelines. Supervisory expectations on the governance set-up were made public in 2018 and revealed that euro area banks should improve five critical areas: fit and proper assessments, oversight function of the board, independence of the supervisory board, risk appetite frameworks and risk data aggregation. In addition to that, the Targeted Review on Internal Models (TRIM), which will be concluded by early 2020, has already highlighted several shortcomings,[16] ranging from model governance to detailed technical aspects, including compliance issues. Next to the capital adequacy effect of model repairs needed, the thematic review further stressed the need to enhance the risk management and risk culture of several significant banks in the euro area.

[15] Lautenschläger, S. (2018), *Ten years after the crisis – risks, rules and supervision.* Speech by Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the 13th ASBA-BCBS-FSI High-Level Meeting on Global and Regional Supervisory Priorities in Nassau, Bahamas, 30 October 2018.
[16] ECB (2019), *Interim update on the Targeted Review of Internal Models*, Second update on TRIM outcomes (as of March 2019), 3 April 2019.

The completion of banking union: issues and challenges ahead

Since the launch of banking union, bank supervision and resolution have, as envisaged, been shifted to the European level, and banks have become safer. But at this stage neither the infrastructure of banking union is complete, nor have the original objectives been achieved in full, as the previous section has shown. More than 10 years after the Lehman Brothers' collapse, the fresh EU institutional cycle marked by the newly elected European Parliament and a new Commission offers a good opportunity to examine the remaining issues and challenges ahead. From an economic perspective, only a safe, profitable, and integrated banking sector can efficiently serve the needs of the European economy and support a strong international role of the euro. We take these objectives – profitability, safety, and sector integration – as yardsticks to analyse challenges ahead and prioritise possible interventions.

After the great financial crisis, the need for safety and financial stability is self-evident. Safety is predominantly the responsibility of banks themselves and the supervisory authorities putting in place the appropriate financial and governance requirements. Safety in a broad sense also includes consumer protection, particularly of retail bank clients – be it as savers, investors, or borrowers – who could be exposed to unwarranted risks. Safety does not mean that a bank cannot fail. Precluding the possibility of bank failure would restrict the adaptability of the banking sector in a rapidly changing financial and technological environment and eventually protract banking inefficiencies at the expense of the sector's role for the economy.

Bank failure has to be manageable so as to minimise financial stability risks. An effective and efficient structure to manage banking failure in a banking union provides incentives conducive to reduced use of public funds and a fairer allocation of costs for failure. This means in the first place that the costs of bank failure are borne by the owner and investors, and not socialised to make taxpayers liable. The creation of banking union has shifted responsibilities to the European from the national level. Therefore, the chain of bank supervision and resolution would have to be fully consistent to avoid residual regulatory patterns where 'banks are European in good times, and national in death'.

Profitability is the basis for the long-term commercial viability of the banking sector. Profitability based on a sustainable business model adds to the health of the banking sector. Profitable banks can invest and provide effective services to the economy. The strength of internal capital generation and their attractiveness also makes them safer, and less dependent on external support. There can be trade-offs between profitability and safety. The excesses prior to the past crisis have shown the dangers of failing to tame the aberrations of short-term profit seeking. Precluding these excesses was the reason for the regulatory changes instituted since the start of the financial crisis. At the same time, the profitability requirement underpins the need for efficient regulation, avoiding unwarranted costs on financial institutions. It serves as a 'health check' for sound regulation.

An integrated banking sector with cross-border services makes economies less vulnerable to crises and banks themselves less exposed to their business in a specific country or region. A more integrated and competitive market will foster a more efficient allocation of resources, contribute to better risk diversification, and economies of scale and will as well benefit the economy at large. Low competition and risk segregation may reduce idiosyncratic risks but also reduce the ability of the system to absorb shocks, hence heightening systemic risk. Integration could imply more consolidation, but this should not be considered a general panacea. Cross-border market integration will not necessarily fit all banks, many of which would continue to serve a domestically focused market. But the banking sector overall should provide these cross-border services with a set of banks.

Fostering an integrated banking sector requires a true single market with the same rules and standards across borders and the possibility for banks to operate freely. The regulatory conditions should enable fair competition, prevent regulatory arbitrage, and create growthfriendly conditions for banks, making them attractive for foreign investment and competitive with their peer comparison. Banking groups should be considered single entities in terms of supervision, resolution, and regulatory requirements and should be able to move their capital and liquidity freely within the group.

Looking at the current state of banking union, we have identified a number of issues that would advance the safety, profitability, and integration of the banking sector. Various proposals have been put forward in this policy debate. The following section analyses some key aspects of these issues and the policy measures designed to tackle them.

A European Deposit Insurance Scheme (EDIS)

Reliance on national deposit guarantee schemes leaves Member States more vulnerable to local shocks and the euro area more fragmented. The 2014 DGS Directive did not provide a fully unified framework for the structure and functioning of deposit insurance schemes and left Member States considerable discretion[17]. In general, the national deposit insurance funds are funded and managed differently. Among other differences, in several countries the legal number of days for payout from the national deposit guarantee fund still exceeds seven days, although this is still in line with the transition period envisaged under the DGS Directive.[18] Most importantly, however, the concern for national deposit insurance schemes is that they may be seen as vulnerable to the weaknesses of their national banking systems and sovereigns in a crisis, and eventually perceived as providing an insufficient level of insurance. Depositors who view their savings at risk could withdraw deposits and, in extreme cases, trigger bank runs, as it occurred in the last crisis. If a system is at risk of failing, political pressure will build for the sovereign itself to step in and provide assurances that would intensify a sovereign-bank doom loop.

A common European deposit insurance renders more financial stability in an economically efficient way when moral hazard issues are addressed. EDIS has the benefits of a large insurance system – it can better and more efficiently ensure sufficient resources than individual backstops even in extreme scenarios. Bank failures will not occur everywhere at the same time and resources can be shifted accordingly. Therefore, fewer resources need to be invested for protection than in a system where everyone insures individually. Moreover, EDIS matches European responsibilities for supervision and resolution with financial liabilities. This is why the original discussion on banking union envisaged EDIS as a solution for systemically important banks[19]. The common regulatory supervision and resolution regime aims to prevent exploitation of the insurance in a one-sided manner. Under the current system, small banks are supervised by national authorities, but the SSM has the task of ensuring common supervisory practices based on the common rulebook. In addition, the SRB is responsible for the resolution of failing banks, where a public interest can be confirmed. When this is not the case, banks are wound down under national liquidation regimes. We consider in more detail remaining issues on insolvency regimes and how to deal with small banks later in this section. In addition, localised risks – especially legacy assets from the past crisis and concentrated exposure to vulnerable domestic sovereigns – will have to be addressed to minimise the risk of unidirectional payouts from the common scheme to the benefit of some more vulnerable countries, which would jeopardise the functioning of the insurance system.

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[17] The overview study commissioned in September 2018 by the European Commission for a review of the DGSD will provide further clarity on possible loopholes in the current framework. For details see Deslandes, J., Dias, C., Magnus, M. (2019), *Completing the Banking Union*, European Parliament, 2019.

[18] European Forum of Deposit Insurers (June 2017), *Results from the EFDI Survey on Payout Approach, Issues and Challenges - EFDI Workshop - Payout under the new Regime of the Deposit Guarantee Scheme* (Berlin, 14 June 2017), 12p.

[19] European Council (June 2012), *Towards a Genuine Economic and Monetary Union*. Report by President of the European Council Herman Van Rompuy. p. 4.

A number of different operating models have been proposed for EDIS without risk-sharing. These proposals vary in their degree of centralisation, coverage of protection, and mutualisation of funds. Proposals for the design of EDIS range from simple reinsurance forms, covering only liquidity needs, to a fully-fledged and mutualised EDIS. In the status quo, current national deposit guarantee funds would continue to build up their funds to at least 0.8% of covered deposits by 2024. The current national funds could be coupled, at a minimum, with a mandatory lending model where national DGSs back each other up by extending loans if another national fund runs out of money.[20] Loans from national DGSs would provide a liquidity backstop in emergencies. Funds would be locally managed and there would be no sharing of losses as the banking sector that causes the drawdown must repay all amounts. As an alternative, a hybrid model[21] offers an in-between option, where funds are split between the centrally managed EU deposit insurance fund and those funds remaining with the national DGS. Still, this model would not involve more than a coverage of liquidity needs emerging from payments in the first place. There would be no mutualisation of losses at the European level. For both models, further differences in the precise arrangements would depend on the way contributions are set (whether they are computed based on national or euro area peers as benchmark) and the target level of the ex-ante funds (fixed or adjustable on the basis of the relative riskiness of the national compartment). In the proposals discussed so far, the share of bank contributions to the deposit insurance scheme in the mandatory lending and in the national compartment of the hybrid model would remain national and would be calculated relative to the national peers. This could create inequalities among banks and undermine EDIS performance and trust.

Under the fully-fledged EDIS proposed by the European Commission in 2015, EDIS would eventually fully insure deposits and mutualise risk. It would cover all liquidity needs and losses in the event of pay-out or in a resolution procedure across banking union.[22] But the system would pass through two stages of loss mutualisation, allowing experts to gain experience with its operation and develop safeguards in the banking system. The European Commission suggested a first re-insurance stage for EDIS. At this stage, under the 2017 revised proposal, the scheme would provide liquidity support to a national DGS, after a national DGS exhausted its own financial means, but with no loss coverage[23]. In the second stage, EDIS includes some co-insurance with progressively increasing loss coverage. Losses through payments to depositors would be shared on a proportional basis between the national DGS and EDIS. The share of EDIS contributions in this scheme should increase over time until it reaches 100% in the final stage of a fully-fledged EDIS operation. The European Commission suggested a 30% contribution from EDIS for the initial stage of co-insurance.

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[20] EU Council (2018), *Austrian Presidency Progress report on Banking Union*, p. 3, 23 November 2018, 14452/18 LIMIT, EF 297, ECOFIN 1079, CODEC 2069, DRS 54, CCG 40, p. 19.

[21] Ibid, p. 4.

[22] This proposal was later revised to make progress less automatic. European Commission (2017), *Communication of 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*. Brussels, 11 October 2017, COM(2017) 592 final, p. 20.

[23] In line with the 2017 EC proposal, national DGSs would have to deplete their funds before a possible intervention by the European Deposit Insurance Scheme. EDIS would only provide liquidity to the national Deposit Guarantee Schemes (in the form of a loan to be fully recovered from the national banking sector afterwards) and would cover up to 30% of liquidity shortfall in the first year (2019), 60% in the second year (2020), and 90% in the third year (2021).

A higher level of financial centralisation with a stronger governance structure that can evolve over time in a co-insurance setting would provide positive market signals and more confidence from the start. From a governance perspective, both the European Commission and the hybrid models would hold funds at a centralised level. These funds would be readily available in case of a liquidity shortfall. Therefore this solution seems more robust in case of a payout event, compared to the mandatory lending mechanism. The implementation and operational costs might initially be somewhat higher with a central fund than in the decentralised mandatory lending model. But the reinsurance and the hybrid models would allow for a smoother evolution of EDIS at a later stage. Moreover, the reassurance that the system can provide depends on the degree of loss mutualisation and the terms of lending. In a fully compartmentalised setting and a pure re-insurance stage with no loss sharing, the liquidity needs of the deposit insurance can be covered. Then the burden of repayment falls entirely on the banking sector in the country under stress, which may undermine its ability to serve the economy. EDIS, like any insurance, can internalise banks' risk through risk-based bank contributions. Calibrating contributions to a bank's risk profile has been part of the European Commission's EDIS proposal from the start. A riskier bank would have to contribute more to cover its deposits. A risk-based computation of bank contributions creates, therefore, an incentive-compatible mechanism to increase the overall financial stability feature of the common deposit insurance. It is also possible to design the contributions to dynamically reflect the need for risk reduction. For example, the significance of legacies from the crisis, in terms of NPLs, would naturally diminish over time in line with supervisory action targeting NPL reduction. In addition, EDIS contributions could also take into account bank exposures toward domestic sovereigns in line with future policy preferences to address this issue in banking union. This feature will be explored in more detail in the last section of the paper when the different stages of EDIS are described.

Box 3 – Can EDIS work if savings and cooperative banks are excluded?

Many savings and cooperative banks operate locally and are comparatively small. They are not directly supervised by the SSM but by national authorities, which makes it more complex to secure equal supervisory standards across all Member States and build trust among all market participants. The German savings bank sector in particular has voiced strong objections against the idea of a common deposit insurance scheme. The association argues that the current DGS based on the 2014 EU directive works well in Germany. In its view, a European DGS would jeopardise their existing institutional guarantee mechanisms, as under certain conditions the institutional schemes could be used to cover the losses of other less-well funded national schemes. The question arises whether one could consider an exemption for savings banks and cooperatives in joining the scheme or a design of EDIS that would mitigate such concerns.

Under the 2015 Commission proposal on EDIS, in principle all credit institutions and deposits already affiliated with participating DGS should be covered by the European scheme. The treatment of non-CRR entities and third-country branches under EDIS, however, is still under discussion. In this respect, the DGS Directive makes it possible to include deposit takings that are currently excluded from the SSM (non-CRR entities, like credit unions); it also allows a Member State to require a third country branch to join a national DGS if the third-country protection is not considered equivalent.

Could the coverage of the European system be limited to SSM-supervised systemic banks while national systems continue to cover smaller banks? Although significant banks under SSM supervision would be obliged to participate in EDIS, less significant banks, credit unions, and third-country branches not directly supervised by the SSM could remain covered by their current national scheme. Such an entity could join EDIS only if it simultaneously goes under SSM supervision and the SSM confirms the strength of its balance sheet and the lack of any excessive NPL problem.

This solution would account for the national supervisory responsibility and local operation of small banks, but it may create financial stability risks. This system would provide the right incentives at corresponding levels. The supervision at the national level would be matched with national responsibility for rescuing small depositors, and the same holds for the European level. However, this 'mid-way solution' would perpetuate the fragmented structure and create its own financial stability risks. First, such a dual structure is not fully in line with the idea of a banking union, because it distorts the level playing field. Second, the vicious circle between sovereigns and banks would remain. Politically, the implicit sovereign guarantee for small banks not under EDIS is likely to persist, which could again contribute to market distortions. Thirdly, depositors could react in a crisis situation by migrating deposits based on the confidence they have in different schemes. This could lead to a deposit flight and 'bleeding out' of parts of the banking sector. Therefore, the dual structure could lead to the acceleration of a systemic banking crisis.

On balance, a system running a European deposit insurance scheme for SSM-supervised banks and separate national schemes for others does not seem recommendable as a long-term solution, as it entails different levels of protection. On a transitional basis, some differentiations could be justified with a view to the consistency between supervisory authority and financial responsibility.

Heterogeneity of insolvency frameworks and liquidation procedures

The crisis-driven adoption of EU legislative rules for bank crisis management did not yield a single set of rules for bank insolvency. In response to a concerted international effort, the EU introduced a common resolution framework for institutions considered as significant while less significant institutions remain under national jurisdiction when they fail. The liquidation procedures remain a national competence.

Member States have different approaches to the liquidation of credit institutions. Some countries introduced a specific regime for credit institutions, while others subsume them under commercial law; additionally, liquidation features differ as per priority of claims, creditors' and other stakeholders' rights in the process, role of the court and administrative bodies, involvement of various authorities, and availability of external support. Even the definition of insolvency may differ as key concepts such as the insolvency test lack unified rules and procedures. As a result, bank resolution and liquidation are incompatible with each other as there is no common banking union liquidation regime for financial institutions. This has repercussions for the consistency and coherence of the European and national systems when a bank runs into trouble, the legal certainty and predictability of the resolution regime and inherent litigation risks, the equal treatment of creditors and depositors, and the coordination among relevant authorities.

Zooming into the resolution process highlights several technical issues requiring further reflection.[24] These aspects are explained more specifically below:

- The assessment of public interest remains a key factor when a decision on resolution or liquidation is taken, but may lead to different outcomes, given the lack of harmonised national insolvency regimes. The existence of public interest is a precondition for undertaking bank resolution under the BRRD. It is determined by assessing the impact on the BRRD resolution objectives for a bank that is failing or likely to fail, namely ensuring the continuity of critical functions for the real economy, avoiding adverse effects on the financial stability of one or more Member States or the Union as a whole, protecting taxpayers, public funds, depositors, and clients. In the well-known 2017 Italian cases, the SRB and national authorities diverged in their interpretation of the public interest test encompassing financial stability and the need to preserve critical functions. The varying outcomes of such proceedings undermine the assumption of equal treatment across banking union. This may also lead to a situation where a bank is failing or likely to fail based on banking union standards, but is not insolvent from the national viewpoint.

- The lack of a unified framework leads to litigation risks for the SRB and can affect its efficiency in bank resolution. Under the current resolution framework, the SRB is obliged to apply the 'no creditor worse off' (NCWO) principle, under which it needs to assess whether the creditors and shareholders would be better treated under insolvency or resolution and compare the ranking of claims under both regimes. According to the 2001 Directive on the reorganisation and winding up of credit institutions, the assessment is performed based on the law of the home Member State. The SRB has repeatedly called for the harmonisation of the claims as these legal disparities expose the SRB to litigation under the NCWO principle by bailed-in creditors or may effectively constrain the action it can take in different national jurisdictions.

- Differing creditor rankings in insolvency legislation counteract the equal treatment of creditors. The BRRD established a priority ranking between certain classes of creditors. However, the primary objectives of national insolvency laws remain dispersed. Some focus primarily on protecting depositors whereas others give priority to maximising returns for all creditors[25]. The position of other depositors such as large corporates also varies across the Member States and can have repercussions for the protection of different asset classes[26]. The Directive 2017/2399 as regards the ranking of unsecured debt instruments created a more level playing field[27]. But the directive only provides for partial harmonisation. Additional reforms would be needed to reduce divergences between national rules concerning the allocation of losses and recapitalisation capacity of banks.

[24] See e.g. Baudino, P., Gagliano, A., Rulli, E., and Walters, R. (2018) How to manage failures of non-systemic banks? A review of country practices. FSI Insights on policy implementation No. 10, Financial Stability Institute, Basel; or Restoy, F. (2019) *How to improve the crisis management in the banking union: a European FDIC. Speech delivered at the Annual International Conference 2019 on "Financial supervision and financial stability 10 years after the crisis: achievements and next steps",* Lisbon, July 2019.
[25] Baudino, P., Gagliano, A., Rulli, E., and Walters, R. (2018), *How to manage failures of non-systemic banks? A review of country practices.* FSI Insights on policy implementation No. 10, Financial Stability Institute, pp 10-15.
[26] Ibid; pp. 10-15.
[27] Official Journal of the EU (2017), *Directive (EU) 2017/2399 of the EP and Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy*, OJ L 345, 27.12.2017, pp. 96–101.

- Similarly, different requirements for dealing with losses lead to misalignments of burden sharing by creditors in the application of state aid regulations. The resolution anchored in the BRRD/SRMR and exercised by the SRB often has stricter loss absorption requirements than liquidation conducted in compliance with national insolvency law. In fact, the burden sharing required under EU state aid rules is a more flexible tool than the 8% bail-in requirement for the SRF-provided support to handle a crisis. This again harbours the potential for creditors to be treated differently across countries.[28] A higher degree of harmonisation of insolvency laws for banks could be achieved through diverse instruments implying a different degree of integration. The 2001 Directive on the reorganisation and winding up of credit institutions, complemented later by the BRRD and SRMR regulations and their revisions, has not brought unified rules for bank insolvencies within a country or cross-border group liquidation. The framework could be harmonised further based on different EU legal formats. We outline below some general considerations on the suitability of these instruments, but this prejudges neither their political nor their legal viability, which are beyond the scope of this paper.

- Introduction of common administrative liquidation procedure into the SRMR. Such a procedure could ensure a high degree of harmonisation from the start. The use of a regulation would also allow the transfer of the liquidation authority to the European level, and its conferral on the SRB. This would create a European counterpart to the US FDIC,[29] and would represent the most far-reaching departure from the current insolvency regime. Such a transfer of authority to the European level would raise a number of governance issues. The consistency of governance and an incentive-compatible regime would also require both the transfer of all prudential supervision to the European level and the furnishing of all the necessary resources to cover possible liquidation costs to the institution in charge of insolvencies. This approach would therefore also weaken the link between the banks and their sovereign. A less radical solution could be the replication of the supervisory system. The SSM has indirect oversight of less significant institutions by its role in ensuring harmonised supervision criteria and high-level standards also among national supervisors. Moreover, the SSM can decide to assume direct supervision over an institution. The approach would leave resources at the national level but aim to ensure common practices.

- Launching a new EU directive or regulation on specific liquidation areas. This approach would be less intrusive as it necessarily leaves the liquidation of banks under national authority. An EU directive on the liquidation of banks would define key policy elements and create a common framework but leave a higher degree of leeway to national authorities in transposing the directive, and therefore would allow for more national features and specific circumstances. On the one hand, this may be an important or even indispensable advantage given the differences in the existing structure of insolvency law. It would also require less adjustment to the supervisory structure and allocation of liquidation costs. On the other hand, a more flexible approach militates against the objective of harmonisation of insolvency regimes. A higher degree of harmonisation could be achieved by including specific areas, such as creditor rankings in case of liquidation, in existing or new EU regulation, which supersedes national law. This would ensure legal harmonisation, which would hopefully also entail common practices in the medium term.

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[28] IMF (July 2018), *Euro Area Policies: Financial Stability Assessment*, IMF Country Report No. 18/226. 86p.

[29] See Restoy, F. (2019), who advocates this solution as the end stage after some transitional arrangements.

- A European Commission communication on insolvency and liquidation procedures is the least binding EU instrument. It could help to generate a common understanding, for example on the definition of solvency, financial stability, and public interest. However, it would still leave all legally binding discretion in national hands and would therefore by definition not result in harmonisation.

An additional point to be addressed is the interaction between deposit insurance and the crisis resolution toolkit. The IMF suggested a flexible use of deposit insurance in bank resolution in line with the Key Attributes issued by the Financial Stability Board[30]. However, one needs to consider carefully its implementation in the European context where different objectives are assigned to resolution and insolvency. The guiding objective of resolution is the continuity of critical functions and financial stability, while insolvency procedures mainly aim at maximising creditor value and protecting depositors. The use of the national funds in resolution may, therefore, raise questions about possible conflicting implications of a 'least cost'/'highest value' test applicable to the deposit insurance scheme, which would require strict rules in the allocation of losses, and a 'public interest test' of bank resolution which could call for some discretion. In addition, most Member States have not availed themselves of the option of using the DGS for purposes other than pay-out in resolution or insolvency[31] [32]. Alternative measures to prevent the failure of a credit institution or alternative tools envisaged under the national insolvency schemes to preserve the sound part of a business and depositors' access to their savings (like FDIC 'Purchase and Assumption') can be more effective in minimising the cost of a crisis, maximising the recovery rate from the insolvency, and at the same time preserve essential functions. These measures, however, are not yet harmonised and can also create conflicts with the no-state aid rule (see Banca Tercas case[33]). Looking ahead, in the context of EDIS implementation, these measures would be better harmonised and administered under the same regime. Failing that, national deposit insurance schemes will likely maintain their own reserves for these interventions and the sovereign-bank nexus, which a pan-European insurance should help to unwind , would re-emerge.

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[30] FSB (October 2011), *Key Attributes of Effective Resolution Regimes for Financial Institutions*. FSB, 2011, 45p.

[31] Official Journal of the EU (2014), Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes. OJ L 173, 12.6.2014, pp. 149–178. Article 11(6)

[32] Deslandes, J., Dias, C., Magnus, M., (February 2019), *Liquidation of Banks: Towards an 'FDIC' for the Banking Union?,* European Parliament, Directorate-General for Internal Policies PE 634.385, February 2019, 23p.

[33] General Court of the EU (March 2019), The General Court annuls the Commission's decision that support measures adopted by a consortium governed by private law for the benefit of one of its members constituted 'aid granted by a State'. Press Release No 34/19, Luxembourg, 19 March 2019.

European Commission (2015), S*tate aid: Commission finds Italy provided incompatible state aid to Banca Tercas and welcomes plans of private funds to step in.* Press release. Brussels, 23 December 2015.

Addressing the sovereign-bank nexus: the regulatory treatment of sovereign exposures (RTSE)

Bank regulation counteracts only to a limited extent the vicious circle between sovereigns and banks through the exposure of banks to their sovereign. Regulatory changes have mainly aimed at making the banking sector safer and reducing the need for bank bail-outs with public money. However, regulation accounts only to a limited extent for the exposure of banks to sovereign risk. The Basel III regulation as implemented in the EU does not embed specific incentives to reduce banks' exposure to sovereign risk[34]. The EU implementation of the international framework in the Capital Requirements Regulation (CRR) allows EU banks to permanently apply the standardised approach (STA) instead of the internal ratings based (IRB) approach. Under the standardised approach, banks can apply a zero percent risk weight to sovereign exposures denominated and funded in the domestic currency of that central government. In addition, sovereign exposures are exempted from the large exposure framework. Within the Supervisory Review and Evaluation Process (SREP) assessment, sovereign risk is part of the credit risk and market risk assessment but without strict quantitative criteria. Where there is high sovereign risk, supervisors can take bank-specific action, including additional Pillar 2 requirements. Also, supervisory stress tests incorporate risks from sovereign holdings. Finally, the leverage ratio provides a backstop to the maximum share of risk-free assets that can be invested in.

The 2016 Council Conclusions on Banking Union aimed to tackle this issue based on an international approach defined by the Basel Committee on Banking Supervision, but the debate at international level has stalled and the EU Member States need to decide if they want to find a common European approach. The proposals to reverse excessive concentration of sovereign bonds in bank balance sheets range from minor accounting framework changes to extensive shifts in bank regulation. Various proposals exist on how to address the issue of sovereign exposures. Overall, they can be grouped into three approaches: first, the adjustment of existing accounting standards; second, the inclusion of sovereign exposures in the design of contributions to EDIS; and third, changes of Pillar 1 regulation to account for sovereign risk, either via concentration charges or risk weights.

Existing regulation can be implemented more stringently to account for the sovereign-bank nexus, taking into account market valuation of sovereign securities. Rules requesting mark-to-market valuation for sovereign bonds in accounting books could motivate banks to actively manage their sovereign portfolio.[35] Sovereign bonds are meant to be one of the liquid assets a bank can sell as needed. The sovereign debt held to comply with the liquidity coverage ratio from this perspective should be part of the trading or the Available for Sale (AfS) accounting portfolio using market values. Regulators enforcing this standard would avoid current practice of including such securities in the held-to-maturity or loan and receivables books, where the changes in market prices have no impact on the banks' accounts. As market prices vary with the risk profile of the sovereign, banks would have to act more cautiously with this part of their portfolio and ensure the availability of sufficient capital to cover this exposure. However, this benefit carries some risks. Banks' balance sheets would become more volatile while market volatility in sovereign securities prices might be highly unpredictable. Therefore, enforcing market valuation of banks' balance sheets could even become a crisis-accelerator as banks could try to dispose of riskier bonds. In conclusion, this approach sets an incentive for active credit risk management as reflected in market prices but can be less effective for diversification.

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[34] Official Journal of the EU (2013), Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. OJ L 176, 27 June 2013, pp. 1–337, Article 114 (STA Approach), Article 150 and Article 160 (IRB Approach)

[35] Enria, A., Farkas, A., Overby, J. L. (2016), *Sovereign Risk: Black Swans and White Elephants*, European Economy, 2016/1, p. 69.

Alternatively, sovereign risk could be reflected in contributions to EDIS. The most straightforward solution could be the introduction of charges based on the level of sovereign risk or exposure concentration, taking the form of higher contributions to EDIS on a bank-by-bank basis. Banks would have an incentive to diversify and would be more resilient in the face of disturbances in sovereign markets. The strength of the incentive would depend on the parameters of additional contributions and the likelihood of payments to be made. Linking EDIS contributions to sovereign risks has some advantages. It is rather uncomplicated to administer and creates a direct link between the mutualisation of risk through EDIS and contribution payments. It does not put an extra burden on the banking system if banks preserve overall stability, i.e. if the insurance fund is filled and no or limited contributions have to be paid. This approach also has some weaknesses. Incentives may vary over time depending on the amount of resources available to the fund. Moreover, payments of EDIS to depositors may or may not depend on the bank's sovereign exposure. In the last crisis, the banking crisis emerged predominantly from a housing boom and misguided bank lending behaviour, and not necessarily from sovereign exposure. Linking contributions to sovereign exposures may therefore entail a re-distributional element.

More far-reaching proposals address excessive exposures to the domestic sovereign through new regulation on raising capital costs. In this context, expert proposals focus on measures to cater for credit risk and the concentration of sovereign exposures.[36] For credit risk, generally capital risk weights that differ from the current zero weight are considered. For concentration risk, proposals look at exposure limits and concentration charges. They enforce sovereign portfolio diversification. Both policy options could lead to improved bank risk management and render banks more resilient. They would enable them to better absorb losses, improve risk transparency, and correct distorted incentives for investing in sovereign bonds. At the systemic level, leverage would decrease and losses in the event of default would be more spread out. On the downside, both regulatory proposals could lower bank profitability. A longer-run negative effect on profitability is more likely for positive credit risk weights. Concentration-focused measures, therefore, seem preferable as they would avoid undermining the competitiveness of European banks in an international environment where other countries do not follow the same route.

[36] Overview of impact related to selected proposals see e.g. Lenarčič, A., Mevis, D., Siklós, D. (2016), *Tackling sovereign risk in European banks*, ESM, Discussion Paper Series, 1/2016; or Véron, N. (2017), *Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures*. Study provided at the request of the ECON Committee of the European Parliament. November 2017.

The benefits of increased resilience in the banking sector could come at a cost for some sovereigns and drive a financing wedge between countries. Looking at these regulatory proposals from the perspective of the sovereign, these measures could raise funding costs for some sovereigns with higher debt or a riskier profile and reduce liquidity in some sovereign debt markets. These effects could be particularly pronounced at the start when banks first need to readjust their existing portfolios and therefore may not be in a position to absorb the supply of new debt issuance. Moreover, positive risk weights could even have a pro-cyclical effect enforcing market tensions at times of crisis. Countries that have earned a 'safe haven' status or relatively low debt on balance would benefit from higher demand and those accumulating more debt during a crisis less so. These regulatory changes could thereby cause disparate sovereign funding costs across countries. This inherently leads to redistribution among euro area countries and economic divergence rather than convergence. The potential divergence of sovereign funding costs in turn also entails a financial stability risk for the euro area as a whole. This trade-off between a safer banking sector and its benefits and the potential negative repercussions on sovereign funding and market access point to the need to move ahead cautiously in the design of any new regulatory rules. Significant transition periods may be required to avoid market disruption when such regulatory changes are introduced. Moreover, a more integrated European banking market would be better able to dilute reliance on the domestic banking system for sovereign financing and to create a stable demand. The issues related to the regulatory treatment of sovereign exposures have also led to the proposal of a European safe asset as an alternative, which would achieve a higher diversification of bank portfolios while avoiding negative repercussions and re-distributional effects on sovereign funding. This topic is discussed in Box 4.

Box 4 – Euro area safe asset

Issuing a European safe asset in a sufficiently large quantity could bring several benefits.[37] First, a European safe asset can address financial stability concerns, as it is a natural diversification instrument for banks. By holding this instrument, banks would be exposed to the euro area countries overall instead of a single sovereign or a subset of governments. Government financing drawing on this instrument would be more stable, particularly for those countries that are not considered traditional safe havens. More euro area financial stability in turn benefits all countries, irrespective of their credit rating. Second, a European safe asset promotes financial integration, supports a common monetary policy, and strengthens the international role of the euro. A large, liquid market in euro area debt that does not reflect the sovereign risk of a specific member state would provide a single asset that can serve capital markets' demand for safe assets, improve the transmission of monetary policy, and increase the attractiveness of the euro as a reserve currency.

A number of different approaches have been proposed to create a European safe asset. According to Leandro and Zettlemeyer (2019), three main approaches can be distinguished. The first works through collective public guarantees or capital. Euro area sovereigns could jointly issue 'Eurobonds,' backed by joint guarantees or equity. Alternatively, a euro area institution, such as the ESM, could guarantee portions of the outstanding debt of individual members. Like current ESM bonds, Eurobonds would derive their high creditworthiness from a common capital base which member states provide. ESM bonds, and similarly European Investment Bank bonds, demonstrate that a European safe asset can be successfully introduced to capital markets. The bonds currently issued by these European institutions are meant, however, to fund their specific needs, rather than provide general financing for European governments. They are also limited in scale compared to the size of European fixed income markets. The second approach involves a euro area fiscal authority empowered to issue debt, within predefined limits, backed by a pre-allocated revenue stream. The third would create a (senior) financial entity, or a legal framework for private intermediaries[38] that would issue debt securities backed by a diversified portfolio of euro area sovereign bonds. This last approach is known under the label of sovereign bond-backed securities (SBBS); the ESRB has studied the SBBS in depth[39]. The European Commission has also based its proposals for a safe asset on this concept[40]. So far, however, these approaches have all met with mixed reviews, especially from academia and private actors including rating agencies. Currently, the banks have no incentive to invest in asset-backed securities as they are treated less favourably than sovereign bond holdings[41].

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[37] Leandro, A., Zettelmeyer, J. (2019), *Creating a Euro Area Safe Asset without Mutualizing Risk (Much).* Washington, DC: PIIE, PIIE Working Paper 19-14, August 2019. 33p.
[38] Brunnermeier, M. K., Garicano, L., Lane, P., Pagano, M., Reis, R., Santos, T., Van Nieuwerburgh, S., and Vayanos, D. (2011), *ESBies: A Realistic Reform of Europe's Financial Architecture*. VoxEU, 25 October 2011.
[39] ESRB, (2018), *Report of the High Level Task Force on Safe Assets: Volume I: main findings, Volume II: technical analysis.* January 2018.
[40] European Commission (2018), Proposal for a Regulation of the European Parliament and the Council on sovereign bond-backed securities. Brussels, 24 May 2018.
[41] For critical assessment of SBBS idea, see e.g. Clayes, G. (2018), *Are SBBS really the safe asset the euro area is looking for?* Bruegel, Blogpost, 28 May 2018; or Moody's Investors Service (2019), *Sovereign bond-backed securities to have little impact on assessment of European credit risk*. Research Announcement, London, April 17, 2019.; For market participants' views see ESRB High-Level Task Force on Safe Assets (2018), *Sovereign bond-backed securities: a feasibility study, Volume II: Technical Analysis,* January 2018. pp. 84-158.

More recently, an alternative proposal has been made. It combines different approaches. Under this plan, 'E-bonds'[42] would be issued by a publicly owned intermediary, similar to the ESM's structure. Importantly, the E-bonds would have a preferred creditor status and serve to finance loans to member states. A safe asset can be created without further public guarantees and capital if the preferred creditor status is firmly anchored legally and issuance volumes are moderate compared to overall European sovereign debt issuance. As this brief overview shows, proposals related to safe assets also imply several risks. First, all proposals entail at least a limited degree of budgetary pooling or risk mutualisation. This raises issues of moral hazard and coordination failure as for any pooling and mutualising scheme. Moving towards a common safe asset seems, therefore, only possible with the necessary underlying governance structure, that is a fiscal policy coordination framework enforcing the commonly agreed budgetary stance. Moreover, some have argued that national governments would even have less incentive to conduct sustainable fiscal policies due to reduced market discipline and an implicit euro area guarantee. But this argument is more ambiguous, because another issue is the segmentation and subordination of sovereign debt markets. All of the above proposals imply greater fragmentation of national debt markets, in the sense that part of the national debt is funded jointly and some through national liabilities. Some proposals imply even the explicit subordination of national debt to the common safe asset. Any investor doubt about the credit quality would therefore be reflected even more in the pricing of national liabilities. Therefore, the extent to which national debt is replaced by a common safe asset is crucial.

Movement of liquidity and capital in banking groups

The full integration of the banking market requires the removal of barriers to liquidity and capital movement in banking groups across countries. Subsidiaries could then conduct cross-border activities more profitably. Therefore, the removal of these barriers could incentivise the extension of cross-border activities and banking mergers. This is an important feature in an era marked by the need for further consolidation in some countries' banking sectors. It would also help to improve banking services across the union and to stabilise banking services during crises as bank portfolios and their performance would be more diversified. Currently, however, the common euro area rules for resolution and liquidation of banking groups have led national supervisory authorities to adopt a cautious approach to granting waivers on liquidity and capital needs of bank subsidiaries. This caution also stems from the fact that national deposit guarantee schemes are liable for savers' claims in case of bank liquidation. The economy's exposure to foreign-owned banks should not leave a country vulnerable to additional financial stability risks or undermine the credibility of the hosting sovereign.

[42] Leandro, A., Zettelmeyer, J., (2019), *Creating a Euro Area Safe Asset without Mutualizing Risk (Much).* Washington, DC: PIIE, PIIE Working Paper 19-14, August 2019. 33p.

Lifting barriers to capital and liquidity mobility in banking groups can have a positive impact if implemented gradually and together with complementary measures. While reducing regulatory restrictions is beneficial overall, it needs to be designed as a gradual process where the removal is counterbalanced by converging regulatory standards related to euro area supervision, resolution, and liquidation of banking groups. A parent company guarantee could need to be included in the recovery and resolution plans and steps should be taken to prevent abusive liquidity transfers. De Groen[43] proposed to follow the US practice of publishing resolution plan summaries submitted to the FDIC. Not only do public resolution plans provide an overview of the group structure, but also high-level insight into group resolution strategy. A similar approach could be adopted at euro area level to provide reassurance to stakeholders. In addition, the waiver could be restricted to banking union members, where the SSM has the right to access all the necessary information. This ensures consistent prudential supervision within a banking group. The discussion and implementation of more lenient conditions for waiving liquidity and capital requirements could also be made in parallel with the completion of EDIS, which could mitigate concerns related to unbalanced obligations of national DGS.

[43] de Groen, W. P. (2016), *The different legal and operational structure of banking groups in the euro area, and their impact on banks' resolvability.* European Parliament, November 2016, In-depth Analysis provided at the request of ECON Committee, pp. 16 and 20.

Liquidity in resolution

The completion of banking union also requires addressing the remaining risk of a liquidity gap during and after resolution. The resolution of Banco Popular in June 2017 exposed a gap in the European resolution framework. It remains geared towards tackling solvency problems rather than liquidity shortfalls. While solvency issues are covered by bail-inable instruments, liquidity needs under resolution have limited specific safeguards. If a resolved bank falls short of collateral to access central bank support when it reopens on a Monday after the resolution weekend, the problem of liquidity will not be solved by the bail-in tool or injecting additional capital[44]. This may not only be caused by inappropriate bank or resolution action; market reactions may cause strong and unpredictable liquidity outflows. A bank that has been recapitalised in resolution by the SRB may still be unable to secure liquidity funding from the market, as it could have yet to restore market confidence, and may also not have assets of sufficient quality to obtain funding either from the ECB through normal monetary policy operations or from the national central banks through emergency liquidity assistance.

Different proposals to address the possible liquidity shortfalls in resolution have been discussed. They differ in their reliance on supervisory action, backstopping by the central bank, or by another public entity. Regulatory and supervisory measures could address the need to improve current practices and amplify the available liquidity, or buy time to restore market confidence. This could be done, for instance, by increasing bank obligations in terms of holding of unencumbered asset levels, accelerating the failing or likely to fail (FOLTF) determination, extending the moratoria periods to suspend payment obligations coming due. Non-compliance with potential regulatory collateral requirements could also result in an early FOLTF assessment. Improvements can be made without adding rigidity to the resolution framework in order, ultimately, to minimise the impact of a bank's failure on the economy.

Proposals for more far-reaching solutions include public liquidity support provided by the SRB or another entity, such as the ESM. Under this plan, institutions would provide short-term collateral to a bank emerging from resolution, or provide guarantees to enhance the credit quality of the bank's existing collateral. In principle, this arrangement can be made without the ECB's involvement – although the bank may then pledge the collateral to the ECB in order to receive liquidity as part of their standard liquidity operations. The bank may, however, also obtain liquidity in the market if the source of the shortfall was simply the lack of collateral. This may be difficult to do, though, as simulations have shown that the liquidity needs of a systemically significant bank can be substantial. The SRB's ability to generate sufficient collateral of high credit quality has yet to be fully assessed. As to ESM guarantees, it is clear that this option is not foreseen under the current ESM Treaty and that providing such guarantees could significantly dent its capacity to operate as a sovereign rescue mechanism.

[44] Deslandes, J., Magnus, M. (2019), *Banking Union: Towards new arrangements to finance banks under resolution?* p. 9, European Parliament, Directorate-General for Internal Policies PE 624.402 - July 2019, 12p.

Other proposals build on a stronger role for the ECB, or the European System of Central Banks, as a provider of a special liquidity facility. Central banks' standard tasks include acting as the lender of last resort for liquidity to solvent banks. Banks emerging from the resolution process should be adequately recapitalised and viable, therefore in principle financially sound and eligible for ECB operations. But the ECB statute also requires adequate collateral. Enhancing the provision of central bank liquidity in resolution would therefore entail an adjustment of the statutory rules. Such changes would need to either mitigate collateral requirements or support collateral enhancement, as in the proposals mentioned earlier. The proposals suggest that this collateral enhancement could come from the SRB, the ESM, or other institutions, such as national treasuries. It has also been argued that the ESM could serve as a back-up to the SRB in this scheme, equivalent to the backstop arrangement agreed for bank resolution more generally. Overall, this arrangement is financially similar to the one under which the SRB would provide the credit enhancement or collateral to the bank, but it allows for tailored arrangements between the guarantor and the ECB or the national central bank. Such an arrangement could prove more efficient than an outright provision of collateral or guarantees to the bank if the backing provided in this scheme only serves as credit enhancement. In other words, it serves to improve the quality of less creditworthy assets or has to provide only partial coverage for possible losses. However, it would have to be confirmed whether and to what extent this approach is compatible with ECB statutes.

As a second-best option, if no sufficiently sizeable solution involving the public sector can be found, the issue could be addressed through privately-led solutions, such as collateral pools. Pooling collateral from peer banks could help to bridge a transitory collateral gap of the resolved entity and mitigate a sudden liquidity pressure in the early days of its re-opening that are not foreseen in resolution planning. A new regulation could be introduced to require banking union banks to earmark a portion of otherwise unencumbered Eurosystem eligible assets so that they are readily available to cover such a gap. Then, should a resolved bank lack the necessary collateral, peer banks could lend these assets directly to the resolved bank or pledge the residual collateral amounts on its behalf. This would allow the resolved bank to maintain its market funding or request recourse from the Eurosystem. To counter the impact on peer banks and compensate them for the service, donor banks could receive a fee from the resolved bank in exchange for providing collateral on its behalf; additionally, given the ultimate positive impact on the overall stability of the financial system, a more favourable regulatory treatment of these assets or other compensatory measures on loss absorbing capacity requirements could be envisaged. This scheme could of course also complement any solution based on the proposals mentioned earlier involving the SRB or other forms of guarantees by European institutions. In deploying such a scheme, one has to be conscious of the costs the banking sector would bear and banks' liquidity needs in crises. Under the assumption that all costs would ultimately be borne by the banking sector, the choice between private sector-led solutions or public guarantees with recourse to the banking sector in the event of default, appears more as an industrial policy choice. If the resolved bank proves to be viable, the liquidity support will be very short-lived and fully recovered. Creating a solidarity system via a collateral pool could also be a vehicle for enhancing market discipline and reducing moral hazard.

Additional issues

Options and national discretions contribute to the fragmentation of the banking union's regulatory framework. During the crisis, a centralised model replaced purely national supervision. However, different economic starting points of participating countries led to diverging national regulatory preferences that resulted in the embedding of options and national discretions (ONDs) in European legislation and the ensuing fragmentation of the single rulebook. Despite SSM efforts resulting in guidance on a unified application of 130 ONDS[45] for both significant and less significant institutions, many exceptions are applicable through national legislation implementing CRR and CRD IV. The latest revisions do not address ONDs for a significant set of regulatory elements related, among other matters, to market risk, large exposures, liquidity, own fund requirements, and credit risk[46]. These ONDs undermine the level playing field which should exist in a common market for banking services. They also leave open the possibility that banks do not have the same safety buffers across countries, which would affect pay-outs under a common insurance scheme.

In the aftermath of the crisis, resolving the NPL issue has become a priority. The ECB, European Commission, and EBA started to tackle NPLs through various initiatives. In July 2017, the Council adopted an NPL Action Plan[47] to accelerate NPL reduction, both to reduce new flows and to decrease the outstanding stock of NPLs. In reaction to the Council Action Plan, the Commission proposed a package of legislation further addressing NPLs.

In April 2019, the prudential backstop for NPEs was finalised and extended provisioning targets to the entire EU banking sector. However, the prudential backstop only covers loans that turned into NPEs after April 2019. When it comes to NPE stocks, the ECB can on a case-by-case basis develop individual supervisory strategies for significant institutions under the Pillar 2 framework. A solution for less systemic institutions is still to be defined.

Since 2018, the European Commission has monitored developments in tackling NPLs with regularly published progress reports. The political decision on the early introduction of the ESM backstop to the SRF is also conditioned by the assessment of the trend in NPL reduction.This assessment will be made against the aim of 5% gross NPLs, and 2.5% net NPLs or adequate provisioning, for all SRB banks. In the case of EDIS, no such conditions were stipulated. Nonetheless, NPL reduction is often mentioned as a necessary precondition for EDIS implementation.

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[45] Draghi, M. (2018), *The benefits of European supervision*, Speech at the Autorité de contrôle prudentiel et de resolution (ACPR) Conference on Financial Supervision, Paris, 18 September 2018.
[46] See EBA (2019), *EBA summary of national options and discretions*.
[47] Council of the EU (2017), *Banking: Council sets out action plan for non-performing loans*, Press release, 11 July 2017.

From a banking union perspective, a more effective and harmonised approach to commercial insolvency could simplify successful recovery of bank balance sheets and credit risk assessment of cross-border transactions. Differences in bank insolvency laws have direct effects on bank resolution. Bank liquidation laws are part of the general insolvency laws in some countries. However, the ability of banks to manage non-performing assets and recover value hinges more generally upon the effectiveness of the commercial insolvency law and court practices. There have been remarkable differences in this respect across European countries. For example, the time to finish insolvency procedures varies between four years in Slovakia and five months in Ireland.[48] Recovery rates range from 33.2 cents on a dollar in Greece to 89.8 in the Netherlands.[49] Reforms of insolvency laws outside the financial sector covering the non-financial corporate and household sector would support faster and more effective procedures. This can be achieved, among other measures, through enhancing out-of-court work-out procedures and more resources for the judiciary. Harmonisation of commercial insolvency laws would bring an additional improvement in two respects. First, it could help to create a common secondary market for impaired assets. It is difficult to pool non-performing bank assets across countries and create a common market if resolution in each country has its own requirements and characteristics. This weakens investor demand. Second, more harmonisation would help in dealing with cross-border cases of business insolvency and improve the single market.

European initiatives to harmonise insolvency laws have made some progress, but they still do not address core elements of insolvency procedures. As early as 2009, the European Commission highlighted that insolvency law is closely related to national property, contracts, and commercial law which, together with biases in defending creditors of local entities, hampered progress in the harmonisation in commercial insolvency law. The 2000 insolvency regulation was first recast in 2015 and provided cross-border rules for identification of proper jurisdiction and applicable law. The latest 2019 directive on business insolvency, restructuring and second chance mainly targets a pre-emptive restructuring framework, allowing companies in difficulties to negotiate a restructuring plan with creditors, while maintaining their activity and preserving jobs. The directive envisages a second chance for honest insolvent or over-indebted entrepreneurs, through full debt discharge after a maximum period of three years, with safeguards against abuse, targeted measures for Member States to increase the efficiency of insolvency, restructuring, discharge procedures, and minimum standards for stay powers. However, this proposal fails to tackle the complexities of the insolvency laws and avoids the harmonisation of core aspects, such as: (a) the conditions for opening insolvency proceedings; (b) a common definition of insolvency; (c) the ranking of insolvency claims; and (d) avoidance actions[50]. Financial institutions are explicitly excluded from its scope.

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[48] World Bank Doing Business database (2019), *DoingBusiness Measuring Business Regulations: Resolving Insolvency*.

[49] Ibid

[50] ECB (2017*), Opinion on the ECB of 7 June 2017 on a proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, (CON/2017/22).*

In 2018, the anti-money laundering (AML) initiatives gained prominence after several breaches of rules revealing gaps in the division of responsibilities and information sharing related to AML in the EU supervisory framework. That year, a series of high-level money laundering cases occurred, which led, for example, to the closure of a bank in Latvia and its subsidiary in Luxembourg. An inter-institutional working group noted a number of structural deficiencies in the supervisory setting that undermine the effectiveness of AML surveillance.[51] The working group identified gaps and weaknesses regarding the provisions in prudential rules to tackle money laundering and terrorist financing, the provisions for cooperation between prudential and AML supervisors, difficulties of interaction between European and national AML supervisors due to differences in national laws, and insufficient human resources available. Already in 2015, the Commission proposed legislative changes strengthening EU rules on anti-money laundering and terrorism financing, implementing the 2012 Recommendations of the Financial Action Task Force. The activity gained renewed traction in 2018, when the Council adopted an Action Plan for AML at the December ECOFIN Council. Actions proposed reflect previous Commission ideas and its proposal to provide the EBA with specific powers related to the AML within the on-going review of European supervisory authorities. The Conclusions adopted by the ECOFIN proposed several short-term non-legislative actions. The enhanced supervisory convergence will cover the inclusion of Anti-Money Laundering/Combating the Financing of Terrorism-related aspects into the prudential supervisory process. It also touches upon intensified cooperation and exchange of information among supervisors and sharing of best practices. In the meantime, however, more far-reaching proposals have also been made requesting the creation of a centralised AML authority at the European level.[52]

Efficient supervisory coordination and the timely response to new industry developments could further mitigate risks in the European banking sector. One lesson from the crisis was that national supervision of banks was insufficient to monitor risks to global financial stability. With the newly established European framework, supervision has grown in complexity, requiring intensive cooperation and coordination among all stakeholders. The SSM coordinates with national authorities; the SRB coordinates its activities not only with national resolution authorities, but also with the ECB and the European Commission's Competition authority. After the operationalisation of the common backstop to the SRF, the SRB will also interact with the ESM. Smart financial regulation necessitates timely reflection on new industry trends such as shadow banking and new technology challenges, as well as more intensive cooperation across European regulatory and supervisory bodies. Legislation adapted to this new environment could facilitate strategic shifts and mitigate newly emerging financial stability risks.

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[51] See e.g. *Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Unio*n. 31 August 2018.

[52] This was, among other matters, requested by Mario Draghi in the press conference in Vilnius on 6 June. See ECB (2019), *Press release, Mario Draghi, President of the ECB, Luis de Guindos, Vice-President of the ECB, Vilnius, 6 June 2019*.

The roadmap to complete banking union: outlining a step-wise approach

In 2016, the Council adopted Conclusions on the Roadmap to Complete the Banking Union with EDIS as the main pending element of the original plan. As the most immediate steps the Council foresaw work on a number of risk-reducing measures, the introduction of the common backstop to the SRF, and technical discussions on EDIS. The Euro Summit in December 2018 assigned the backstop function to the ESM. Work is now ongoing for its operationalisation. In spring 2019, banking union reached another important milestone when consensus was found on the November 2016 banking package. The latest achievements mean implementation of the new measures could begin and set the stage for the discussion on EDIS, which remains the main pending issue of the banking union agenda as originally proposed. Following up on the mandate of the European Council given at the December 2018 meeting, the Eurogroup established a High-Level Working Group on EDIS with a mandate to work on next steps ahead from a broad perspective, taking a view on the long-term 'steady state' to be achieved for the European banking sector. The High-Level Group reported back in June and will continue its work until December 2019.

Given gaps in the banking union structure and the objective of creating a safe, profitable, and integrated banking sector, we consider three key elements of the roadmap: a) EDIS – design and contribution framework; b) bank insolvency regimes and the completion of the resolution framework – this includes the harmonisation of insolvency laws, trust-building measures for host countries, as well as the start of the common backstop; and c) risk-reduction incentives and the removal of barriers to an integrated banking market in supervisory regulation and practice – this includes measures related to the sovereign-bank nexus, the removal of restrictions to capital and liquidity in banking groups, and the reduction of ONDs. Additional elements that could accompany the main workstreams are the AML regulation, the regulation of shadow banking, and commercial insolvency regimes.

This section outlines our suggestions on a roadmap towards the completion of banking union. The ordering of steps balances several guiding principles: first, moving towards the full implementation of EDIS as the major missing element of banking union provides a structure for finding a reasonable sequence of measures. Other agenda elements will be implemented hand-in-hand with progress made on EDIS. We give priority to issues – such as the fixing of remaining gaps in the resolution or liquidation framework – that directly affect payouts of the common deposit insurance scheme and the SRF. Second, the proposed sequencing allows for 'trust building'. This translates into institutional safeguards ensuring the desired effect and the possibility of stock-taking before the next step is taken. This links particularly to more far-reaching steps, like those proposed to address the bank exposures of the domestic sovereign. The timeline envisaged approximates the time necessary for the decisions to be taken and implemented. It also takes into account the adaptation time necessary for the industry. The rationale behind sequencing considers links between single initiatives, potential synergies, and negative spillover effects.

For the sake of clarity, we classify identified measures with regard to their impact on banking union safety, integration, and banks' profitability. In summarising the completion process in Figure 12, we distinguish three key apects: a) increased safety of the banking sector implying reduced risks, prevention of excessive risk taking, and moral hazard, b) deepening integration mainly through greater harmonisation of bank regulatory standards and national insolvency regimes, c) measures potentially increasing bank profitability via greater investment opportunities, specialisation, economy of scale and scope.

Step 0 : 'Setting the stage' (until 2020)

A preparatory phase should allow policymakers to discuss and agree upon the design of EDIS and, in parallel, implement the recently approved risk-reducing measures.

- On EDIS, the latest European Commission proposal could provide a basis for discussion, but Member States need to discuss and confirm important design elements, particularly the design of stages with different degrees of mutualisation, the confirmation of the final stage with a fully mutualised common deposit insurance scheme, and the structuring of contributions to EDIS. When defining EDIS, an agreement needs to be reached on a method to calculate bank contributions to EDIS taking into account the degree of mutualisation at the different stages. The contribution scheme should be risk-based, similar to the FDIC approach, which includes a scoring system for banks and selected financial indicators called CAMEL (capital adequacy, asset quality, management, earnings, and liquidity). Moreover, risk parameters can already be structured during the preparatory phase so as to reflect risk reduction achieved at each stage and thus embed adequate incentives toward enhanced risk discipline (see arguments below, under the subsequent steps). Finally, as mentioned in the original European Commission 2015 proposal of EDIS, Member States where the national DGS has not yet reached the targeted level of accumulated funds would need to accelerate the building-up of resources to be eligible for re-insurance in stage 1 of EDIS. To ensure legal certainty, an agreement on the contribution methodology in all three stages could be specified at the very start before making the first step, together with any necessary details of the related regulation to move from one stage to another. This would also provide enough time for banks to adapt.

- On the supervisory side, the preparation phase could be used to implement the agreed banking package as well as the AML action plan and to push ahead further with NPL reduction. In addition, at this stage, one could look at the scope of supervision, including regarding shadow banking in the context of a more complete banking union and risk-sharing arrangements. During this stage, supervisory practices based on the existing regulation could already be adjusted so as to more effectively address the sovereign-bank nexus. Against that background, further empirical work would be useful and could be conducted in parallel to detect and assess the determinants of sovereign exposures in bank balance sheets and the regulatory impact. Based on the empirical work benchmarks and a path of measures could be agreed taking into account the different options available from regulatory practices and necessary transition periods. Supervisory practices could also be staged up to cater for the availability of liquidity in resolution.

- As regards the resolution regime, banks would have to continue to build up MREL and complete their resolution plans. Moreover, a set of important elements could be addressed in this step. First, work on the implementation of the common SRF backstop could continue. It has already been agreed that the progress in risk reduction will be assessed against an agreed set of elements[53] by the end of 2020 to decide on whether to introduce the common backstop early. Second, progress on the design of more harmonised bank insolvency regimes would be an important agenda element. A review of the resolution framework and practices would build host-country trust if a systemically relevant subsidiary needed resolution. Third, a solution of the issue of liquidity in resolution could be discussed to clarify the future strategy to close this gap. The timing of next steps would also crucially depend on the solution chosen as it could rely on a number of different instruments ranging from issuing capacity of the SRF to the ability of banks to provide collectively collateral.

Step 1 : 'Initiating the European backstop and insurance schemes': the remaining preparatory technical work necessary for the design of a common backstop to the Single Resolution Fund and EDIS would be completed. (2021–2023)

Step 1 would implement first initiatives towards a more robust financial structure of banking union and a more harmonised regulatory structure providing trust in the functioning of resolution and insolvency regimes.

- With sufficient risk reduction, a case can be made to enter the first stage of EDIS. At this re-insurance stage, EDIS implies no mutualisation of losses but only a liquidity backstop. To enter this stage, Member States must fund their respective national DGS whose funds would then be made available to EDIS. Originally, it was foreseen that each DGS achieves the target level by 2024 at the latest, which may imply an accelerated payment in some countries. If this is not possible, one would have to find an intermediate target size for EDIS until all countries have reached the target level. For stage 1 of EDIS (re-insurance), the newly defined calculation methodology of the contributions could take into account MREL build-up, level 3 assets, and NPL reduction. Defining the calculation method to give higher weight to NPLs would be a way to embed the incentive for NPL reduction in the EDIS design.[54] A clear risk-based approach in defining the conditions for participation in the European insurance scheme should provide reassurance that legacies of the crisis are being effectively addressed, resilience of the banking sector has further increased, and residual mutualised risk will be fairly priced.

- On the supervisory side, steps could be initiated to reduce ONDs. This would help to strengthen trust among Member States about a supervisory level playing field for banks and at the same time support the integration of the banking sector.

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[53] The 4 December 2018 Eurogroup agreed on terms of reference detailing the main elements of the SRF backstop. The terms of reference conditions early introduction of the backstop on sufficient progress in risk reduction by 2020 "to be assessed with the aim of 5% of gross NPLs and 2.5% net NPL on all banks in the BU, and on adequate build-up of bail-inable liabilities.

[54] In defining the calibration method, factors impacting crisis legacies and benchmarks need to be carefully weighed up. We suggest referring to a sustainable risk indicator rather than historical averages in the current market and economic context. In fact, the historical cost of risk might actually no longer be sustainable looking forward and it may also be necessary to consider bank business models and specificities of national banking sectors. Also, additional indicators, like level 3 assets and the actual level of MREL need to be taken into account in the risk-based calculation. As proposed by the Commission, in the first phase banks' riskiness will be compared to national peers.

- During step 1, various initiatives could be taken to effectively progress the completion of banking union in the area of resolution: First, the the common backstop could be implemented as early as possible based on the assessment at the end of 2020. It is agreed that the common backstop should effectively start operating by the end of 2023 at the latest. Second, new rules for burden sharing and creditor hierarchy in bank liquidation and resolution could be agreed and implemented to ensure legal certainty and harmonisation in the area of liquidation affecting possible future pay-outs of EDIS in a crisis situation. This step mitigates concerns about higher degrees of risk-sharing in subsequent stages of EDIS. Third, step 1 should be used to implement trust-building measures to advance further integration. Host countries need to be reassured that subsidiaries are well protected by intra group arrangements, living wills, and enhanced transparency. As proposed by de Groen[55], resolution and recovery planning exercises could be further fine-tuned. Host countries could be adequately involved in the approval and scrutiny of recovery and resolution plans and selected non-confidential information could be made public including the group structure. Anchoring the guarantees for the resolution of subsidiaries and branches into recovery and resolution plans could help mitigate fears of national supervisory authorities.

Step 2 : 'Deepen the European Deposit Insurance Scheme': Before moving to full mutualisation, the treatment of sovereign exposures in bank balance sheets would be addressed. (2024-2027)

The second step would mainly be marked by the gradual implementation of a stage where common EDIS funds start to cover losses related to the use of deposit insurance in case of payout or resolution. Work would also continue on addressing the sovereign-bank loop and improving conditions for the full integration of banking union in the final stage.

- EDIS could enter the co-insurance stage as a key element to advance in banking union. As suggested by the European Commission, the co-financing of losses through EDIS could gradually increase over time. This could start at low rate, or at 30% as suggested by the European Commission, and eventually increase to full coverage. Higher-level burden sharing through EDIS could be offset by the fact that at this stage, bank contributions to EDIS would apply a methodology for calculation of the contributions based on the full set of prudential risk elements, like in the FDIC CAMEL approach, and also taking into account excessive sovereign exposures. The increased weight given to sovereign exposure could reflect concentration parameters, but without credit risk charges. To provide adequate time for banks to adjust, the measures could gradually phase in to reach full implementation towards the end of the second step in 2027. The risk-based assessment of banks coupled with the SSM risk assessment system could replace the Asset Quality Review (AQR) as a precondition for entry into the co-insurance stage. Common standards and common supervision should provide sufficient safeguards for that.

[55] de Groen, W., P. (2016), *The different legal and operational structure of banking groups in the euro area, and their impact on banks' resolvability.* European Parliament, November 2016, In-depth Analysis provided at the request of ECON Committee, p. 16 and 20.

- For the resolution framework, this step would offer the opportunity to start implementing the final arrangements addressing the issue of liquidity in resolution. The process of building up the SRF resources will have ended and the common backstop will have been made operational. For any publicly backed scheme, the available infrastructure and funding should be in place to progress. In case the collateral pool provided by private banks were chosen as the way forward, an appropriate path for phasing in this regime could be designed in view of the banking sector.

- Step 2 could be used to complete initiatives started in step 1 that could not be fully implemented. This could entail further steps to remove ONDs, reinforce and strengthen the AML framework, and improve regulation on shadow banking where needed.

Step 3 : 'Move to a complete banking union': The Member States could approve the implementation of stage 3 of EDIS, which foresees full mutualisation, implementation of a scheme to diversify sovereign exposures, and more lenient conditions for capital and liquidity waivers. (after 2027)

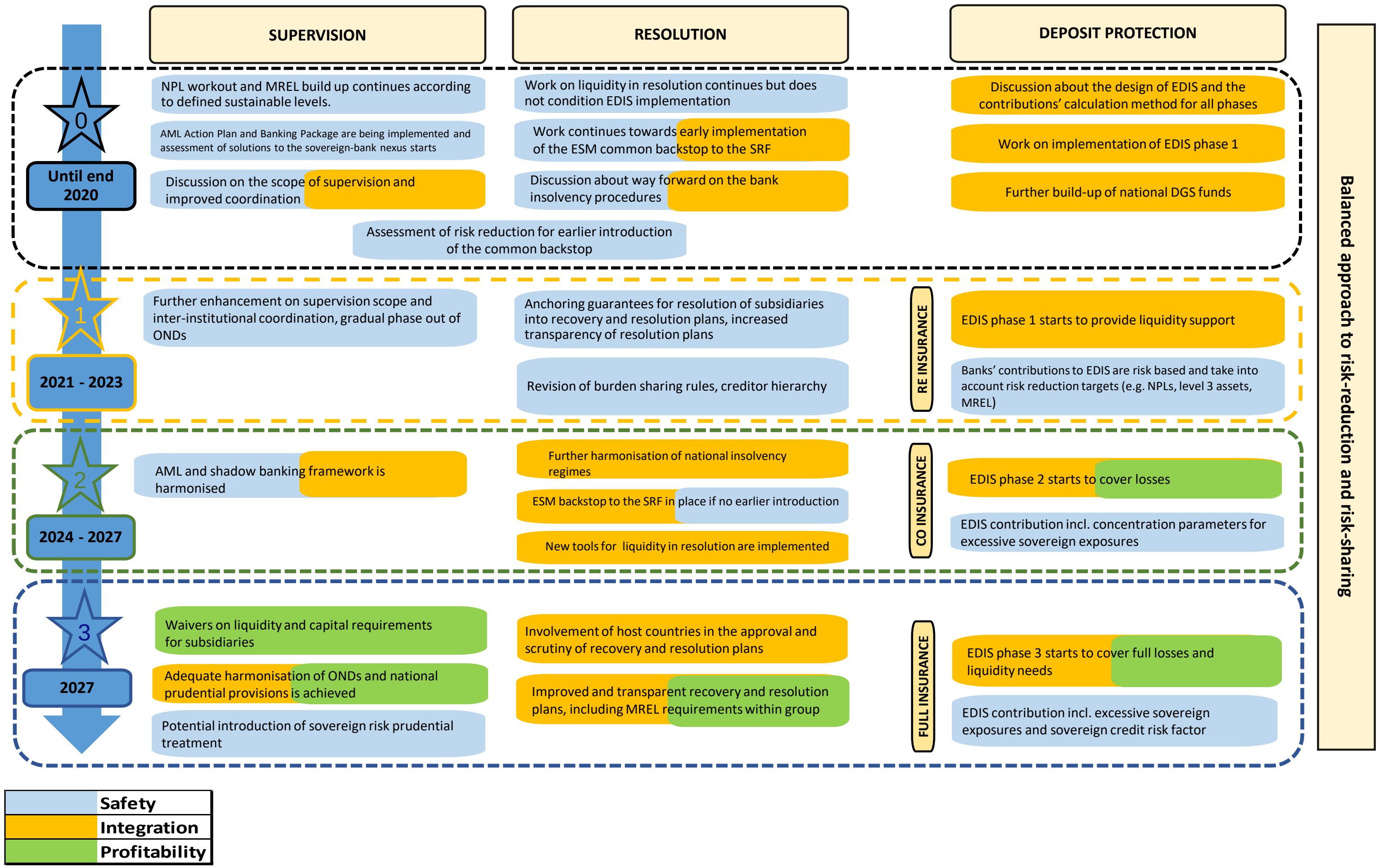
Step 3 of the completion of banking union would be the final set of measures to achieve full integration.

- This step would be marked by stage 3 of EDIS, which entails the full mutualisation of deposit insurance. In other words, the co-insurance stage between national DGS and EDIS comes to an end as EDIS covers all liquidity needs and losses. A fully mutualised insurance scheme would reinforce the banking union framework and complement the fully mutualised SRF when confidence in the banking sector is restored. The last stage of EDIS would be introduced if all the required quantitative and qualitative risk reduction measures are adopted and implemented, and adequate harmonisation has been achieved among national insolvency regimes. The calculation of contributions to EDIS could move one step further and also incorporate a sovereign risk factor for excessive domestic sovereign bond holdings in addition to the risk-free concentration factors introduced before. The calibration will again reflect the actual needs at the time as the incentives set earlier should have already affected sovereign debt bank holdings.

- Once the euro area moves to a common deposit insurance scheme and all accompanying measures have been implemented, a revision of the home-host issue will be possible. At this stage, an agreement on the right balance between free movement of capital and liquidity on the one hand, and national control of subsidiaries and intra-group transfers on the other hand, can more easily be settled to allow efficient operations for banking groups across the banking union. This requires that capital and liquidity regulations apply to the banking group as a whole, rather than being ring-fenced at national level. An amendment to the CRR addressing the home-host balance issue could be introduced following the entry into stage 3 of EDIS. The host countries could retain their powers to make proposals for macroprudential buffers, potentially applicable at solo level in a selective way, to cater for specific concerns on the financial stability of a Member State. Finally, the MREL and capital requirements need to be set consistently within the group structure and according to the resolution strategy. The MREL requirements could be flexibly applied to reflect the size and risk of each bank.

- The development in sovereign exposures could be re-assessed based on the initial impact study in parallel to the introduction of credit risk weights into the framework of EDIS contribution. Further measures on the regulatory treatment of sovereign exposures could be taken in line with the initial commitment for this step. The precise calibration of the regulatory incentives can a) take into account the achievements in reducing exposures to the domestic sovereign at the time, and b) specify the necessary transition phase to avoid market disturbances. Similar to the EDIS contributions, concentration charges could be introduced and a risk-based component reflecting a country's risk profile could be considered.

Figure 12
Proposed scheme and sequencing



Note: Colours link actions to identified reform objectives, aiming to strengthen the resilience of the banking sector in the euro area.
Source: ESM

Conclusion

The crisis experience has stimulated an unprecedented cooperative response to develop solutions to stabilise banks and mitigate systemic risks in the euro area. The intensive activity of EU institutions and Member States helped to fend off negative repercussions of financial market shocks and create structures underpinning euro area stability in the medium term. New supervisory and resolution regulation together with reinforced deposit protection provides a solid basis in further reducing banks' vulnerabilities.

Key banking indicators, highlighted in the first chapter, confirm persisting challenges. Bank strength and resilience, as represented by asset quality and profitability variables, have improved but have failed to return to pre-crisis levels. On the asset side, banks continue buying the sovereign bonds of their home countries, which reinforces the sovereign-bank link. Despite significantly improved prudential indicators, the euro area bank market remains less integrated than before the crisis and compared to other jurisdictions. As a result, banks are less efficient and more vulnerable to idiosyncratic shocks.

We connect residual challenges in the euro area banking sector with additional measures to complete and consolidate banking union. We take the view that a common EDIS provides an opportunity to further improve banking union. As the banking industry plays a key role as a financing provider and guardian of households' savings in the euro area, the still missing common EDIS remains at the centre of the debate. Defining adequate safety nets, capable of sustaining the needs of the economy even under severe distress, can further underpin the single currency and cement its international role. The implementation of EDIS also provides an opportunity to fine-tune the overall regulatory framework. Improved safety nets could go hand in hand with incentives reducing the sovereign-bank feedback loop and legislation allowing more cross-border integration.

Our roadmap unfolds in three stages. Gradual transition leverages on synergies of different initiatives. The banking union's three pillars need to evolve together and strengthen each other to foster confidence and promote stability. An improved and transparent recovery and resolution framework, coupled with a fully mutualised deposit insurance scheme, should provide sufficient reassurance that bank subsidiaries in host countries are well protected. This would enable banks to benefit from economies of scale within a large economic union, reaping the benefits of a truly integrated single market.

The completion of banking union will support euro area economic growth. In the absence of fully developed capital markets, banks perform tasks crucial for the euro area's economic growth. The reconciliation of diverging views could create conditions promoting further market integration. A safely growing banking sector – supported by credible insurance and regulation promoting a sustainable business model – would underpin economic growth.

In the long term, banking union can only be robust and able to support a safe, profitable, and integrated banking industry if its rules and institutions evolve in response to changing market conditions. Euro area banking regulation will require continued upgrades while adapting to new challenges arising from global competition, technology, and pressures from alternative service providers.

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