Finanzgruppe

On the state of the Banking Union

Glossary on instruments and institutions

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Foreword

Helmut Schleweis

Dr. Karl-Peter Schackmann-Fallis

Dear reader,

The Banking Union is the European Union's response to the crisis of the financial market and the sovereign debt crisis in the euro area, which was now more than ten years ago. Since then, it has come to complement the Economic and Monetary Union (EMU) and the single market. The Banking Union brought about extensive changes to the regulatory framework and it has fundamentally changed the environment for the banking industry. The aim it pursues, to ensure financial stability and put firm common principles in place for banking supervision in the euro area, is the right one. Risk must be controlled and responsible management enhanced, to limit the extent to which financial market risks are borne by society as a whole.

The Savings Banks Finance Group believes that the Banking Union must constantly be measured against this initial motivation. Regulation and supervision must be proportionate to banks of different sizes and business models of financial institutions, because they conceal different risks. Stabilising features that are already in place must not needlessly be put in jeopardy.

The Savings Banks were not to blame for the financial crisis ten years ago. Nevertheless, aspects of the Banking Union are changing and endangering precisely such crisis-hardened and stabilising structures as the Savings Banks and the Savings Banks Association.

The core elements of the Banking Union have now been implemented and are working. However, additional instruments and procedures in relation to it are currently being discussed. These plans have interlocking effects, affect different actors at various levels and are technically highly complex. This makes forming an assessment of each individual plan extremely challenging.

The current glossary presented here is designed to support the opinion-forming process, put each initiative into context and describe their practical effects. Continued professional dialogue with everyone working on Banking Union in the political and public sphere is important to us.

Yours faithfully

Helmut Schleweis
President of the German Savings Banks Association (DSGV) and President of the European Savings Banks Group (ESBG)

Dr. Karl-Peter Schackmann-Fallis
Executive member of the board of German Savings Banks Association (DSGV)

Contacts at the DSGV

Department AV – EU Policy

Georg J. Huber
Head of the Representation to the EU
Tel: +32 2 74016-12
Email: georg.huber@dsgv.de

Max Wesseling
EU Policy Adviser
Tel: +32 2 74016-18
Email: max.wesseling@dsgv.de

Yafet Embaye
EU Policy Adviser
Tel : +32 2 74016-47
Email: yafet.embaye@dsgv.de

The Banking Union today

More than five years ago, the European Institutions created the Banking Union as a response to the financial crisis. It is meant to strengthen the stability and liability of financial institutions within the euro area. Therefore, a set of new institutions and regulation exists nowadays that did not prior to the financial crisis.

For credit institutions, the past years meant profound changes within the realm of supervision and resolution. While small- and medium sized banks – in particular Savings Banks and Cooperative Banks in Germany – have not caused the financial crisis, they are, nonetheless, strongly affected by banking regulation.

The Single Supervisory Mechanism (SSM) is a core element of the Banking Union. It has been in force since 2014. Under the SSM, all significant, systemically important banks are subject to direct operational supervision by the European Central Bank. Systemically important banks are those that are particularly large (generally with a balance of more than EUR 30 billion), have cross-border operations, are highly integrated with complex group structures, and whose financial and infrastructure services cannot be replaced without harming financial stability. The SSM also lays down basic principles for the supervisory activities of national banking regulators in the euro area.

The Single Resolution Mechanism (SRM) is the second key element of the Banking Union. It is intended to ensure that failed banks are dealt with efficiently at minimal cost to taxpayers and the real economy. Operational responsibility for the SRM lies with the Single Resolution Board (SRB), which has been in place since 2016. It is responsible for large cross-border banks.

Banking Union rules are intended to ensure that the costs of resolving a bank are borne in the first instance by the bank itself and its shareholders, with participation by the bank's creditors, if necessary.

If this proves to be insufficient, the Single Resolution Fund (SRF) can step in. The SRF is funded by the bank levy set up for this purpose, which in Germany, unlike in other EU countries, is not an allowable operating expense for tax purposes.

The Bank Recovery and Resolution Directive (BRRD) sets out procedures by which banks can be resolved. It follows the principle that the primary obligation lies with shareholders and creditors.

To stop banks from failing in the first place, new and higher minimum regulatory capital requirements were set by the capital requirements directive and the capital requirements regulation (CRD/CRR). These measures have already been revised several times and are to be revised once more in the context of the finalisation of Basel III.

Systemically important banks must also comply with the MREL ratio (Minimum requirement for own funds and eligible liabilities). This capital is then available in the event of a resolution.

Resolution mechanism

One key lesson from the 2008 financial crisis was that there must be a way to accomplish the orderly resolution of large banks with complex international entanglements. An orderly insolvency should above all ensure that costs are borne in the first instance by investors and shareholders (bail-in) and not by public funds (bail-out).

This applies particularly to banks that are "too big to fail", i.e. those that, because of their size and substantial interdependencies on other institutions, have to be rescued to prevent massive damage to other market participants. The mechanisms of orderly resolution thus apply to banks whose insolvency could otherwise trigger a destabilisation of the financial system. Formally, pursuant to Art. 32 of the Banking Resolution Directive (BRRD), resolution must be in the public interest.

In two early practical cases (Banca Popolare di Vicenza and Veneto Banca), the Single Resolution Board (SRB) found that no public interest case existed. As a result, the banks were not resolved and another form of market exit was carried out under Italian insolvency law, in compliance with European regulations. This sparked debate about conceptual deficiencies in the resolution mechanism. Another idea that is currently being discussed is to extend the resolution mechanism to cover all banks, not just the systemically important ones.

The resolution mechanism is essentially designed from an economic point of view. It is intended to recapitalise and stabilise the bank or to break it up in an orderly manner, in order to limit financial markets shocks. As a result, however, it disregards the regional diversity that characterises the European financial market and decisively contributes to its resilience in crises. For this very reason, it is important to ensure that the SRB's resolution work is focused on systemically important institutions, and to ensure that it is stringently carried out in those cases.

By contrast, decisions about small and medium-sized banks are best taken by national supervisory bodies applying national insolvency law, due to their knowledge of the national market. Such cases are not systemically important for the euro area as a whole.

GLOSSAR

How "bank resolution" works in the EU?

A resolution can only take place if certain conditions are met cumulatively: the institute is in danger of collapse, there is no prospect that alternative measures would prevent this, and resolution would be in the public interest (e.g. to preserve critical functions).

What measures are then taken will be decided in the specific case.

The resolution authority may arrange for assets and liabilities to be transferred to other institutions or order the holders of relevant capital instruments, i.e. creditors, to bear a share of the losses (a "bail-in").

→ If it is decided to carry out the sale of a business, the bank or its business units may be sold to one or more buyers without its consent (Art. 38 BRRD, § 107 et seq. German Recovery & Resolution Act).

→ If a bridge institution is established, the bank will be owned wholly or partly by one or more public bodies. Bridge institutions are overseen by the resolution authority (Art. 40 BRRD; § 128 et seq. German Recovery & Resolution Act).

→ In the case of an asset separation, the resolution authority transfers the assets, rights and liabilities of a bank or bridge institution in resolution to an asset management vehicle (Art. 42 BRRD, § 132 et seq. German Recovery & Resolution Act).

The most hotly debated resolution measure is the so-called bail-in (creditor participation). In a bail-in, creditors' claim are reduced or cancelled, or are converted into Tier 1 capital (equity). For the creditor, this means writing off eligible liabilities that are not part of the bank's own funds.

Numerous "forms of capital" that are vital to the stability of the financial system cannot be bailed in. These include covered deposits, covered bonds, fiduciary liabilities, liabilities to other banks or payment systems etc. with a remaining maturity of less than seven days, liabilities to employees, liabilities that are critical to ongoing daily operations, and obligations to contribute to deposit guarantee schemes.

Bank insolvency law

The Single Resolution Board (SRB) is the European body for bank resolution. It is essentially meant to deal with systemically important banks which, due to the complexity of their involvement in the market, could trigger a systemic financial market crisis if they were allowed to enter insolvency. However, it also covers banks for which standard insolvency procedures under national law would suffice.

In the Banking Union, a clear distinction is made between systemically important (significant) and non-systemically important (less significant) banks. Banks that are not systemically important rely, for example, on a strong deposit base. They do not need to have more own funds instruments than the minimum own funds requirement prescribes, and they are usually much smaller in size. For these banks, standard national insolvency procedures are the most suitable way to deal with a resolution.

Making the SRB responsible for all banks cannot be justified either economically or politically. It runs counter to the idea of a diverse Europe and undermines local self-reliance. Rather than this, the original proportional approach should be pursued and entrenched, as was also underlined by the judgment of the German Federal Constitutional Court of 30 July 2019.

It is certainly a sensible idea to provide opportunities for taking an overall view and for cross-border coordination in bank resolution. The deepening of the Banking Union, however, should not lead to responsibility for all institutions, regardless of their risk orientation, being centralised at the SRB. What is needed is an efficient system that operates according to the principle of proportionality and subsidiarity and promotes regional responsibility, rather than creating incentives for moral hazard.

At the same time, national rules on bank insolvency should be coordinated so that bank insolvencies pursue the same objectives throughout the EU, creditor bail-ins are possible and resolution takes a form that does not distort competition. This will require a harmonisation of national banking insolvency laws. However, this cannot be achieved by amending the Banking Recovery and Resolution Directive (BRRD) or the Deposit Guarantee Schemes Directive (DGSD), each of which only covers some aspects of the issue.

European Deposit Insurance Scheme (EDIS)

The centralisation of European deposit insurance was outlined by the European Commission in 2015 and is now in the European legislative process. Since then, the initiative has been a total failure. Despite this, the Commission has shown no desire to give up its plans and present, for example, a new proposal that would exclude institutional protection schemes from centralisation on subsidiarity grounds.

In technical terms, the Commission's idea is that full competence for deposit insurance should be vested centrally in the Single Resolution Board (SRB) and that all guarantee funds should therefore be pooled in a central fund.

Advocates argue that an EU-wide system would essentially create more investor confidence, as well as serving towards the integration of the single financial market. Under a common system, however, bailing out depositors in one country would affect confidence in other, unaffected markets. Since 2015, the standards for depositor protection have largely been harmonised in any case by the Deposit Guarantee Scheme Directive. Identical standards already apply to every euro deposited in the euro area. There is no divergence.

Above all, however, the fundamental goal of a centralised system – intergovernmental risk sharing and the perverse incentives it creates – deserves to be called into question. National economic policies would no longer have an incentive to take impacts on the stability of the banking market into account. This would encourage governments to shift potential burdens to the European level. How this "moral hazard" problem and its economic consequences will be dealt with has not been made clear. It is also unclear in what form a backstop to the centralised scheme could be set up.

It would cause national guarantee schemes to lose their risk-reducing function of local self-reliance, which is also a stabilising factor in crises. In some cases they would be reduced to mere payment counters and would entirely lose their ability to lobby for low-risk business policies. Existing institutional protection schemes that are on an equal footing with guarantee schemes, such as those of the savings banks and their joint institutions or the Cooperative Financial Network, would also be hollowed out and effectively abolished, depriving them of their stabilising effect on banks. The vital anchors of stability that these institutions proved to be in previous crises would be hauled up. As a result, every time a bank failed, nothing would stop it causing the greatest possible harm to the community as a whole.

Institutional Protection Scheme (IPS)

Institutional protection schemes (IPS) are independent bodies set up by alliances of credit institutions to prevent insolvencies and liquidations. They do this in a spirit of self-reliance – the institutions provide each other with mutual support. IPSs enable troubled banks to remain in business and avoid becoming total "write-offs", rather than falling into insolvency and forcing depositors to claim compensation. This secures both customer deposits and loan facilities. The EU rightly recognises these schemes as deposit guarantee schemes.

In the well-functioning IPS of the Savings Banks Finance Group, depositor compensation exists merely as a formal last resort. In practice, the group-wide mutual protection of all member banks makes insolvencies virtually impossible. Depositors, therefore, have all their money protected by the institutional scheme. Another valuable feature is that the institutional scheme allows loan facilities and payment services for business and personal customers to remain operational if an individual bank gets into trouble. EDIS, by contrast, is merely a paybox for compensating depositors in the event that a bank goes insolvent.

It follows that EDIS would effectively sweep aside the proven approach of the savings banks and their joint institutions towards financial market stability and sustainable corporate lending. If the IPS were retained, the structural effect of EDIS would be to place an unsupportable double burden on the members of the Savings Banks Finance Group and their municipal sponsors.

EDIS thus puts the functioning of the characteristically German guarantee schemes of the regional banking alliances (Savings Banks Finance Group; Cooperative Financial Network) at risk.

Given the cross-border activities of many credit institutions, further enhancement of the EU's common strategy for banks and banking supervision is, of course, an understandable idea. Yet, even if every Member State had a healthy banking sector and its government bonds enjoyed a solid risk weighting on bank balance sheets, centralising deposit protection would essentially downgrade IPSs into pure depositor compensation schemes. The special framework of the savings banks, the cooperative banks and their IPSs should be taken into account politically. If the European Commission were to present a new proposal on deposit insurance, it would be appropriate to exclude functioning institutional protection schemes from its scope.

EU-Federal Deposit Insurance Corporation (EU-FDIC)

The idea of an "EU FDIC" – an EU equivalent to the US Federal Deposit Insurance Corporation – is occasionally floated in political debate. The US FDIC is the US deposit guarantee scheme. In the United States, it combines the functions of depositor protection and bank resolution.

The US FDIC can decide at its discretion whether to wind up an institution, compensate investors, seek a full or partial sale or undertake restructuring. It decides in accordance with the least-cost principle, i.e. it picks the cheapest of the options available. It is not bound by structural policy, antitrust or consumer protection considerations.

By focusing exclusively on minimising cost, it disregards the potential adverse repercussions on customers, SMEs and regions. It is precisely to protect consumers and depositors that the European framework separates deposit insurance from resolution and limits the Single Resolution Board's (SRB's) resolution functions to systemically important institutions. It is therefore questionable whether a European FDIC would be suited to the social and political culture of European countries.

There are also constitutional obstacles, because there is currently no European legal basis that would support an American-style FDIC. In its judgment of 30 July 2019, the German Federal Constitutional Court has already found that beefing up the SRB with sole competence for resolution and deposit insurance would foreseeably be incompatible with the German constitutional law (Grundgesetz). For such a body to function effectively, Member States would also need to share the same administrative law, which they do not. In addition, the US FDIC has a borrowing line from the US Treasury and thus has the contingent fiscal backing of the United States government.

The fact that the latter backstop dimension does not form part of the current European architecture has already been pointed out in connection with the centralisation of depositor protection. It is foreseeable that in the event of a crisis, the European Central Bank will have to intervene. However, using monetary policy mechanisms to provide a final backstop to a deposit insurance authority with resolution powers would ultimately leave it overstretched and jeopardise the pursuit of the price stability objective.

Sovereign exposures

From a prudential viewpoint, exposures to sovereign states and to regional and local authorities currently have to be classed as zero risk. Such exposures are favourably treated in own funds calculations (Art. 114/4 CRR) and are excluded from the large exposure limits (Art. 400 CRR).

In the light of the European sovereign debt crisis in 2012, there was a debate as to whether it was still appropriate to assume that sovereign debt was always risk-free. Proponents of a change also argued that a zero weighting could give rise to cluster risks. In practice, many euro area banks have very substantial sovereign exposures, making banking stability and state financial stability mutually interdependent. The problem is exacerbated when these exposures are to the banks' home countries – what is referred to in political debate as the "state/bank nexus".

Nevertheless, there are several reasons why the zero-risk weighting of sovereign exposures should not be prematurely abandoned in all cases. Government actions alone did not cause the sovereign debt crisis, which was also triggered by the preceding financial markets crisis and accelerated by targeted speculation against individual euro area countries.

Moreover, credit institutions and insurers need to hedge their portfolios with investments in "safe assets". If certain exposures were not designated as safe havens, it would be almost impossible for banks to meet the stringent liquidity and capital ratios required by prudential supervision. If sovereign exposures ceased to be ranked as safe and highly liquid, banks would then be forced to scale back their long-term lending. Sovereign exposures have long ceased to be completely exempt from capital adequacy requirements. The whole of a bank's portfolio is included in its unweighted leverage ratio and must be backed by capital.

In addition, banking regulators are now empowered to take action where lending activities have led to overly close links between the banking sector and the state; this is the case especially where specific action is needed to wind down a large portfolio of problem loans.

Even in Germany, revising the regulations would have clear consequences. A revaluation of municipal loans would affect volumes in the twelve-digit range. Given the low margins on public sector business, the result would make the financing of state and public projects unnecessarily difficult. This would have an adverse impact on the scope of action of German municipalities and would exacerbate regional disparities.

"Ring-fencing" and the "home-host" debate

"Ring-fencing" means putting a barrier in place in order to limit cross-border liquidity or capital allocation in banking groups. To date, the purpose of such barriers has been to protect the subsidiaries of foreign banks from having to transfer excessive amounts of liquidity and capital to their foreign parent. Efforts to have prudential requirements applied at group rather than individual company level are referred to as the "home-host" debate.

The home-host debate as well as ring-fencing are important issues for those that aim at establishing large European banks that operate cross-border. In the view of the Savings Banks Finance Group, such a change would ignore the lessons learned regarding the "too big to fail" problem. It is also noticeable that group structures are designed and maintained in order to generate tax arbitrage and other tax advantages.

If the home-host debate was settled in favour of "home", compliance with prudential requirements would focus on the level of the banking group rather than individual banks (i.e. subsidiaries). This would eliminate national ring-fencing and so take away the ability of national supervisory authorities to prevent liquidity from being syphoned off from a subsidiary in order to prop up the group. Proponents argue that the free allocation of liquidity and capital within the group creates a greater incentive for cross-border mergers, which in turn should lead to a consolidation process in the European internal market.

This overlooks the risks of an increase in the "too big to fail" problem and a deterioration in the supply of financial services, especially for SMEs, due to a loss of proximity to customers and an increase in asymmetric information.

Countries whose banking market is dominated by subsidiaries of foreign banks (so-called "host" countries) are demanding a fully communitised European Deposit Insurance Scheme (EDIS) to protect depositors at national level if they lose the ability to prevent parent companies from extracting liquidity. However, the problem could easily be solved in favour of the host countries by making the deposit guarantee scheme in the home country assume the deposit protection function for the whole group. In addition, cross-border supervision by the ECB acts to prevent crisis-induced liquidity and capital movements.

Risk reduction in the banking sector (non-performing loans/TARGET balances)

Targeted risk minimisation in the Banking Union is sensible and necessary. For it to work, however, risks must be properly and comprehensively identified. The level of risk in a financial system is reflected by the share of non-performing assets in the overall portfolio (NPL ratio) and the differences in the Eurosystem's TARGET balances.

Centralisation of the safeguard mechanisms creates the risk of perverse incentives towards negligence or overly risky behaviour. This reinforces the regulatory principle that risk minimisation must be ensured on a lasting basis before risk can be pooled at the EU level. To prevent problem cases in the banking sector from becoming a community-wide liability, a comparable level of risk must be achieved in the economies of the various EU Member States.

In addition to the Tier 1 capital ratio, the ratio of non-performing loans on a bank's balance sheet is used as a measure of the risk level in the financial system. A major macroeconomic advantage of bank-based financing, in comparison with anonymous, standardised capital market-based financing, is precisely the ability of lender and borrower to rearrange terms or defer repayments.

On the one hand, this prevents insolvencies from occurring in the real economy and on the other, it ensures that receivables on bank balance sheets are not written off prematurely, which is in the interests of savers and depositors.

It would therefore be wrong to try to reduce risk by creating economic policy incentives for the sale of receivables to financial investors or imposing prudential requirements that demand the rapid writing-down of receivables. Borrowers, especially in downturns, depend on deferral offers and on reaching cooperative solutions jointly with their banks and this should not be prevented by prudential obstacles, as we have also learned from the ongoing experience of the Covid-19 pandemic.

The differences in the Eurosystem's TARGET balances also point to a lack of equilibrium. Imbalances in the TARGET system are a clear indication of risk asymmetries in the euro area that are deeply rooted in the structural aspects of national banking markets and national economic policies, which cannot be resolved simply by harmonising NPL ratios.

All the risk indicators considered will have to converge over a long period of time before we are able to talk about structural risk alignment.

NPL reduction

Many banks choose a rapid sell-off of receivables at risk of default as their preferred means of risk reduction. The stringent prudential supervision applied to NPLs often creates incentives for this. However, the points below show that it is economically questionable to create prudential incentives for sales of receivables or to force banks to write down loans at an early stage.

- → Selling receivables does not really reduce risk – it simply moves it from the seller's balance sheet to the buyer's.
- → By selling their loans off, banks give up the opportunity to prevent borrower insolvency through rearrangements and deferrals. Sales of receivables thus increase the risk of insolvency in the real economy.
- → The current risk situation is never more than a snapshot. It may be sufficient to justify the sharing of risk now, only for a significant deterioration to occur after the risk has been shared.

This shows that the forced reduction of NPL ratios alone is far from being a sufficient basis for risk sharing in the euro area.

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Publisher
Deutscher Sparkassen- und Giroverband
Charlottenstraße 47
10117 Berlin
Phone +49 30 20225-0
Fax +49 30 20225-250
www.dsgv.de

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Responsible
Communications and Media

Contact
Communications and Media
Phone +49 30 20225-5115

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