European Commission

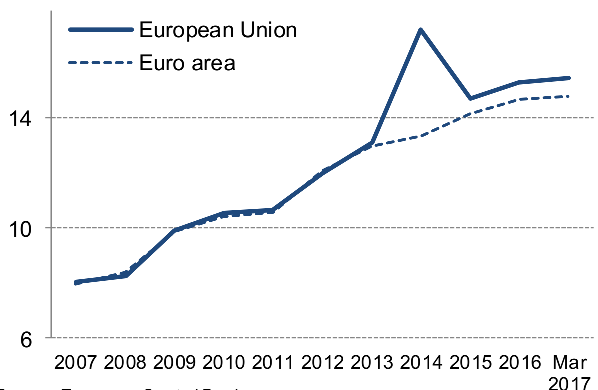
The future of the Banking Union

EUI online seminar, 10 November 2017

Banking and finance

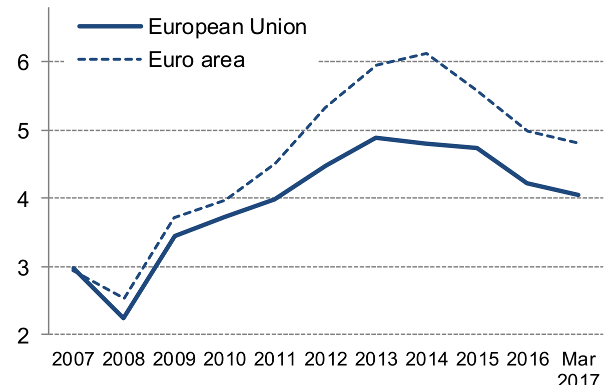
Since the financial crisis, European banks have more capital, higher asset quality, more stable funding structures

Banks' equity: Tier 1 ratio (%)



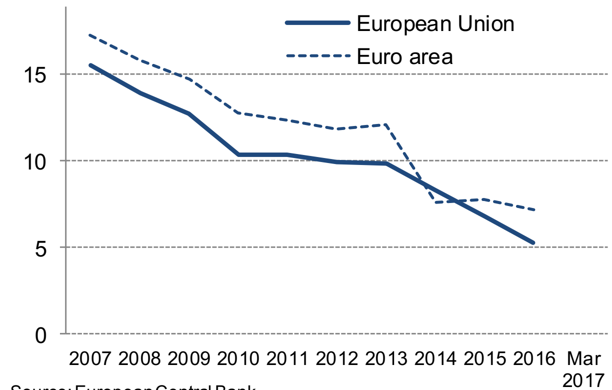
Source: European Central Bank

Gross non-performing debt instruments
(in % of total gross debt instruments, end-of-period values)



Source: European Central Bank

Banks' funding structure: Interbank market dependence (% of total assets)



Source: European Central Bank

Yet, problems remain in banks and Banking Union:

Institutions

- Banks' profitability: cyclical and structural challenges
- Still high amounts of non-performing loans in some Member States / institutions (→ ECOFIN Action Plan, July 2017)
- Home bias of assets: misallocation of risk
- ….

European framework

- Banking Union is not completed (in particular, a common deposit insurance (→ EDIS) and a backstop are still missing).

Completing the Banking Union

2017 State of the Union Address

Banking Union should be completed by the end of 2018, if it is to deliver its full potential as part of a strong Economic and Monetary Union (EMU)

State of play: Single rulebook, Single Supervisory Mechanism and Single Resolution Mechanism are in place

→ *Last October the Commission issued a* ***Communication on completing the Banking Union***

Aim of the Communication: set out an ambitious but realistic path in order to achieve political agreement and put in place the missing pieces

The content of the BU Communication

- ***Risk reduction measures proposed in 2016***
- ***EDIS***
- ***Backstop***
- ***Non-Performing Loans (NPLs)***
- ***Sovereign Bonds Back Securities (SBBSs)***

→ To be completed by 2018

Risk reduction through the November 2016 Banking Package

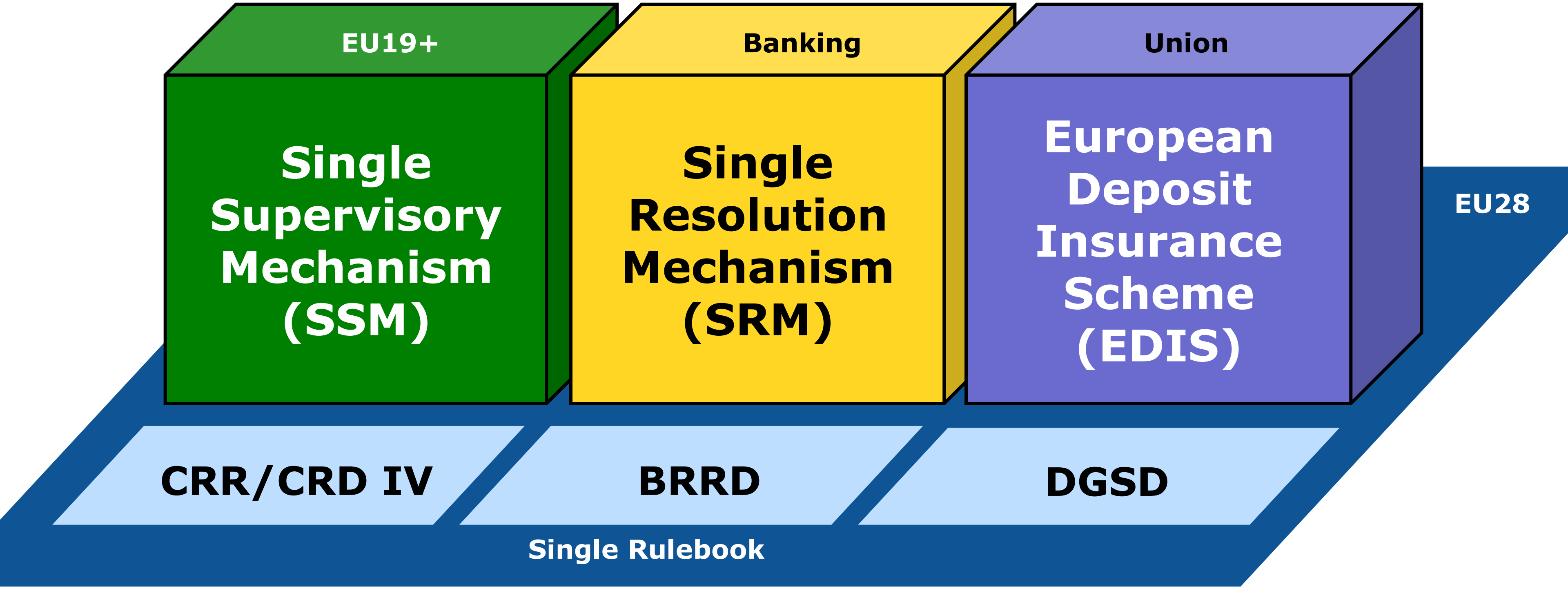
The November 2016 Banking Package fulfils most of the objectives set out in the 2016 Council Roadmap in terms of further risk reduction in the banking sector.

In particular with the implementation of *Total Loss-Absorbing Capacity (TLAC) /MREL, creditor hierarchy, moratorium powers and remaining Basel reforms (including NSFR and leverage ratio).*

What the BU Communication proposes:

→ *With a view to swift progress and reach adoption as rapidly as possible, EP and Council are encouraged to maintain the clearly defined scope of the package.*

A European Deposit Guarantee Scheme (EDIS)



EDIS – Why?

- Missing element to strengthen the BU for a stronger Eurozone
- EDIS will enhance financial stability because: break the link between banks and Member States; reduce vulnerability to large local shocks and reinforce depositor confidence.
- Robust deposit protection and depositor confidence are necessary for banks to restore lending – a precondition for growth and jobs.

Main features of the 2015 legislative proposal

- EDIS is introduced in 3 phases (reinsurance, coinsurance, full insurance).
- In all 3 phases both liquidity shortfalls and losses are covered but to a limited extent in the first two phases.
- The transition from one phase to another is automatic when reaching the date set (2020 starts co-insurance and 2024 starts full insurance).

The 2015 EDIS proposal

2017 - 2019

Phase 1: Re-Insurance

2020 - 2023

Phase 2: Co - Insurance

2024

Phase 3: Full Insurance

The 2015 EDIS proposal

EDIS phases (2015 proposal)	2017	2018	2019	2020	2021	2022	2023	2024
Re-insurance Liquidity shortfall coverage	20%	20%	20%					
Re-insurance Excess loss cover	20%	20%	20%					
Co-insurance Liquidity need coverage				20%	40%	60%	80%	
Co-insurance Loss cover				20%	40%	60%	80%	
Full insurance Liquidity and loss cover								100%

EDIS in the 2017 BU Communication

Negotiations on the Commission's proposal have stalled

What the BU Communication proposes:

→ *Sets out ideas to help facilitate a compromise on EDIS and allow political agreement in 2018*

→ Commission proposal of 2015 is still on the table, as well as the ambition to have at the end a fully-fledged EDIS.

→ details of such ideas to be specified and negotiated by the co-legislators.

Main suggestions for EDIS

Introduce EDIS in a more gradual manner, commensurate to progress on risk reduction and the tackling of legacy issues:

- *Two phases (re-insurance and co-insurance)*
- *Only liquidity coverage up to 100% by 2022*
- *Loss coverage subject to conditions starting at 30% in 2022*
- *Such conditions could include a targeted AQR to address NPLs and Level III assets issues.*

European Commission

HOW WOULD THE REVISED EDIS PROPOSAL WORK?

PHASE 1 Reinsurance	2019	2020	2021	**TRANSITION CONDITIONAL ON**	**PHASE 2** Coinsurance
EDIS covers liquidity shotfall after national Deposit Guarantee Systems (DGS) exhausted, repayable	30%	60%	90%	✓ targeted asset quality review on legacy risks, incl. NPLs ✓ banks address legacy risks with clearly defined targets ✓ actual reduction of NPLs ✓ monitoring by Single Supervisory Mechanism **TO BE CONFIRMED BY COMMISSION**	EDIS covers all liquidity needs from first euro and increasingly covers losses.
EDIS does not cover losses	0%	0%	0%		

2019 — 2020 — 2021 → indicatively **2021**

Banking and finance

European Commission

Completing a Backstop to the Banking Union

A common fiscal backstop would reinforce the overall credibility of the bank resolution framework within the Banking Union and instil confidence in the Single Resolution Mechanism

MS agreed in 2013 on the development of a common backstop

Criteria for the backstop identified in 2017 EMU Reflection Paper

What the BU Communication urges:

→ *to operationalize as rapidly as possible the credit line from the European Stability Mechanism (ESM) as a backstop. This will need to be articulated with the December proposal for transforming the ESM into an European Monetary Fund.*

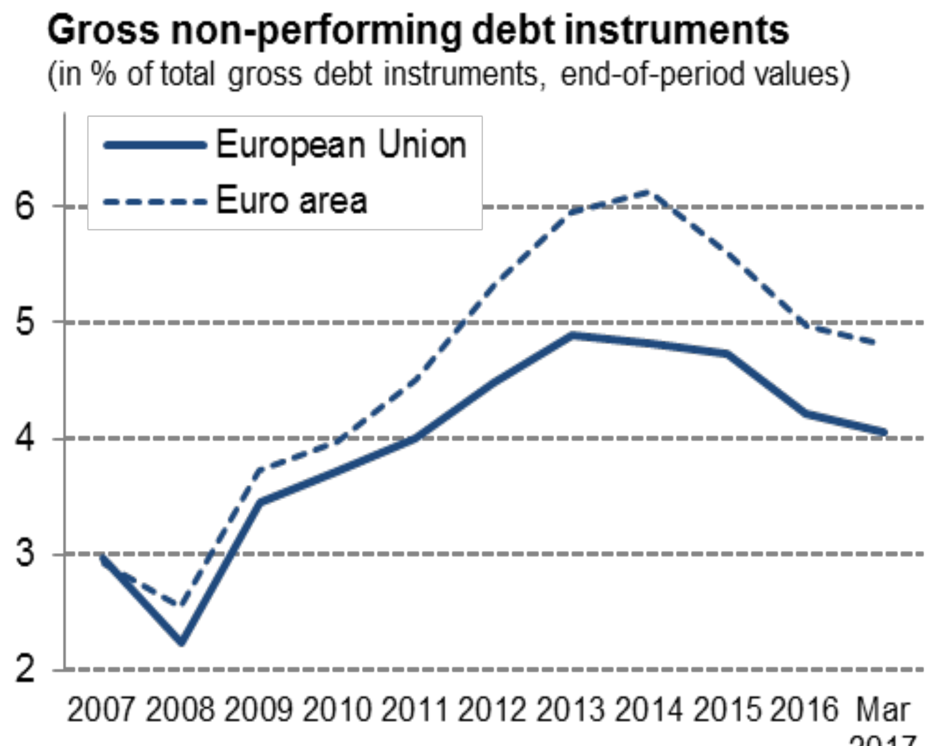
European Commission

Actions announced to address NPLs

The EU NPL ratio has recently decreased. But progress is slow where it is needed the most.

EU Finance ministers therefore announced an Action Plan to tackle NPLs in July.

The aim is to reduce NPLs that hinder banks from providing new credit to the real economy, and limit economic growth.



Source: European Central Bank

Banking and finance

Actions announced to address NPLs

Policy action is needed to address

- *the current stock, and*
- *to avoid future build-up of NPLs.*

In order to effectively tackle NPLs measures addressing four key areas are needed:

- *supervisory policies*
- *structural reforms (enforcement and insolvency),*
- *the development of secondary markets for NPLs*
- *aiding the restructuring of banking systems.*

Package of NPL measures in spring 2018

1) Blueprint for Asset Management Company (AMC)

2) Measures to develop secondary markets for NPLs

3) Measures to enhance the protection of secured creditors

4) A Report, accompanied if appropriate with the necessary proposals to amend the CRR, to possibly introduce minimum levels of bank provisions for future NPLs arising from new loans

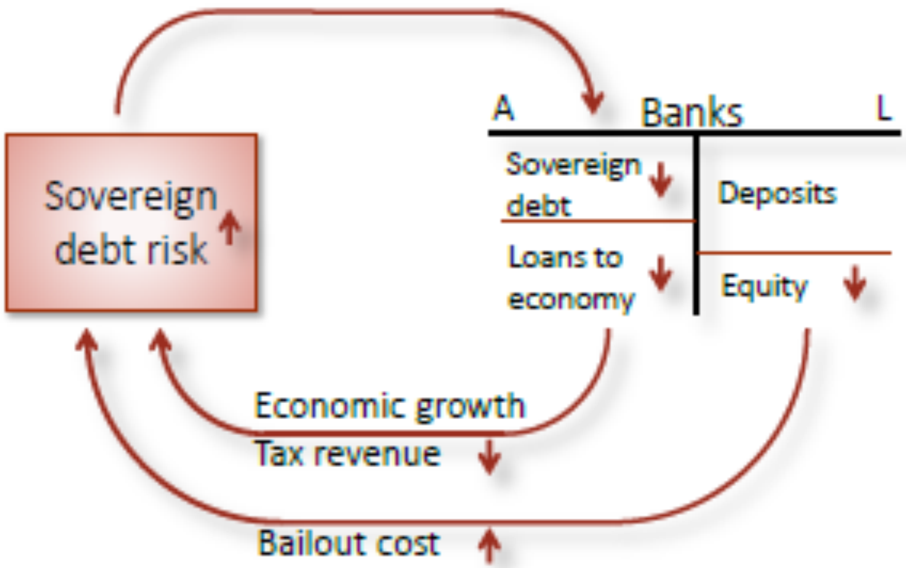
The Commission is also undertaking a benchmarking exercise of loan enforcement regimes

Sovereign Bond-Backed Securities

- First idea: Brunnermeier, Garicano, Lane, Pagano, Reis, Santos, Thesmar, Van Nieuwerburgh & Vayanos (2011) on "European Safe Bonds" (ESBies) and "European Junior Bonds" (EJBies).

- Main goals:
  - Help weaken bank-sovereign "doom loop"
  - Expand supply of "safe assets"

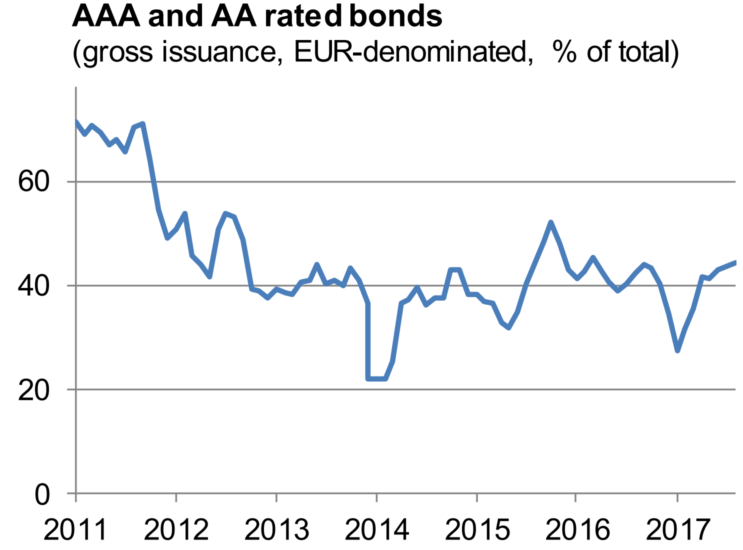
The bank-sovereign loop



Source: Brunnermeier et al (2011)

Declining supply vs raising demand of safe assets

- Issuance of bonds with high rating has been falling since the sovereign crisis.



- Meanwhile, banks' demand for safe and liquid assets keeps going up, including for regulatory reasons

→ Safety premium only on some Member States' bonds

SBBS: basic concept

- **Pooling (→ diversification)**
- **Tranching (→ seniority)**

"Safe" asset

- **No mutualisation!**

Could be arranged by any qualified institution: private or public!

Pooling ⇒ diversification

Portfolio of
(central euro area)
government bonds
(e.g. ECB capital key weights)

Senior
(calibrated for low-risk)

*(**Mezzanine**)*

Junior

Tranching ⇒ seniority

SBBS: potential advantages, challenges, open questions

+ More geographical diversification of banks' holdings of government bonds

  → banks' asset risks better spread (reduced impact of home country)

  → better cross-border risk sharing via private sector

+ Additional supply of safe assets

- Is there sufficient demand for all tranches?
- Would they be profitable for the arrangers/issuers?
- Would they impact liquidity of national bond markets?
- ….

What Role for European institutions?

→HLTF of ESRB (established in mid-2016)

→President Juncker's LOI (September 2017)
to launch and/or complete by end 2018:

"an enabling framework for the development of sovereign bond-backed securities …"

→BU Communication (October 2017)

"In light of the upcoming report of the European Systemic Risk Board (ESRB), the Commission would consider putting forward legislative proposal for an enabling framework for the development of SBBS (2018)"

European Commission

Questions?

Comments?