Analysis

Progress in work to complete Banking Union

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The EU's Banking Union is operational but not yet completed. The common European Deposit Insurance Scheme (EDIS) is the key missing component. To reinforce Banking Union and promote the EDIS it is important to decrease risks in the European banking system, the most important of which are the legacy non-performing loans and banks' large holdings of domestic sovereign bonds. The framework for resolution should also be further improved.



Operation of Banking Union is based on two pillars

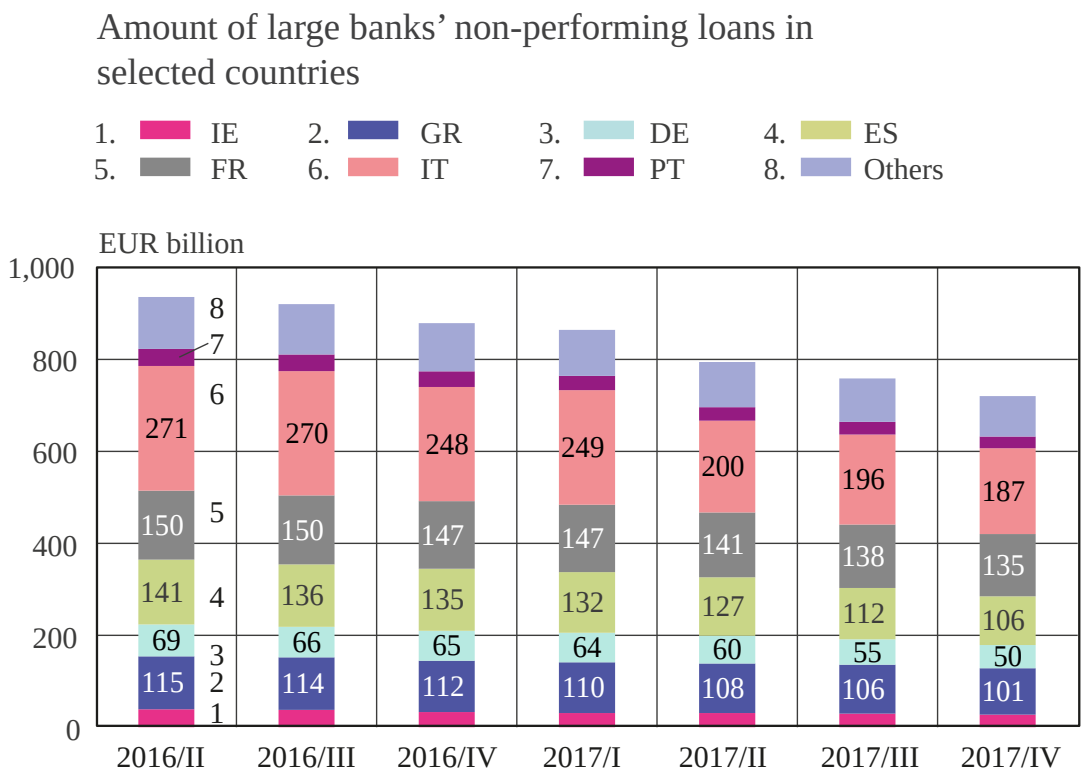
The objective of Banking Union, which became operational in 2014, is to ensure the stability and reliability of the banking system. Within Banking Union, banks are supervised based on common rules and principles. The resolution of distressed banks is managed without taxpayers' money and by minimising the adverse effects on the real economy. All euro area countries are participants in Banking Union. Other EU countries may join if they so wish.

Of the three key components, i.e. pillars of Banking Union, the first pillar – the Single Supervisory Mechanism, under the auspices of the ECB – has been operational for over three years and has harmonised and improved banking supervision. The Single Resolution Board, which is one of the institutions of the Banking Union's second pillar – the Single Resolution Mechanism – is operational and the Single Resolution Fund is being gradually built up. As a last resort and a backstop for the Single Resolution Fund, the European Commission has proposed the establishment of a European Monetary Fund, based on and succeeding the European Stability Mechanism.

Common deposit insurance scheme an important missing component

Banking Union is still lacking its third pillar, the common European Deposit Insurance Scheme (Chart 1). The European Deposit Insurance Scheme (EDIS) will guarantee deposits that are within the scope of the scheme in the event a bank operating in one or several countries becomes distressed. The objective of the EDIS is to increase confidence in the banking system during financial crises and to prevent deposit runs. The scheme will also mitigate the stability risks related to multinational banks and will be particularly important for countries with a large and concentrated banking sector.

Chart 1.



Source: SSM.

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In October 2017, the European Commission adopted a proposal for the implementation of a European Deposit Insurance Scheme.[1] The most noteworthy amendment in this two-step proposal, compared with the Commission's previous proposal, is the conditionality of the full implementation of the system.

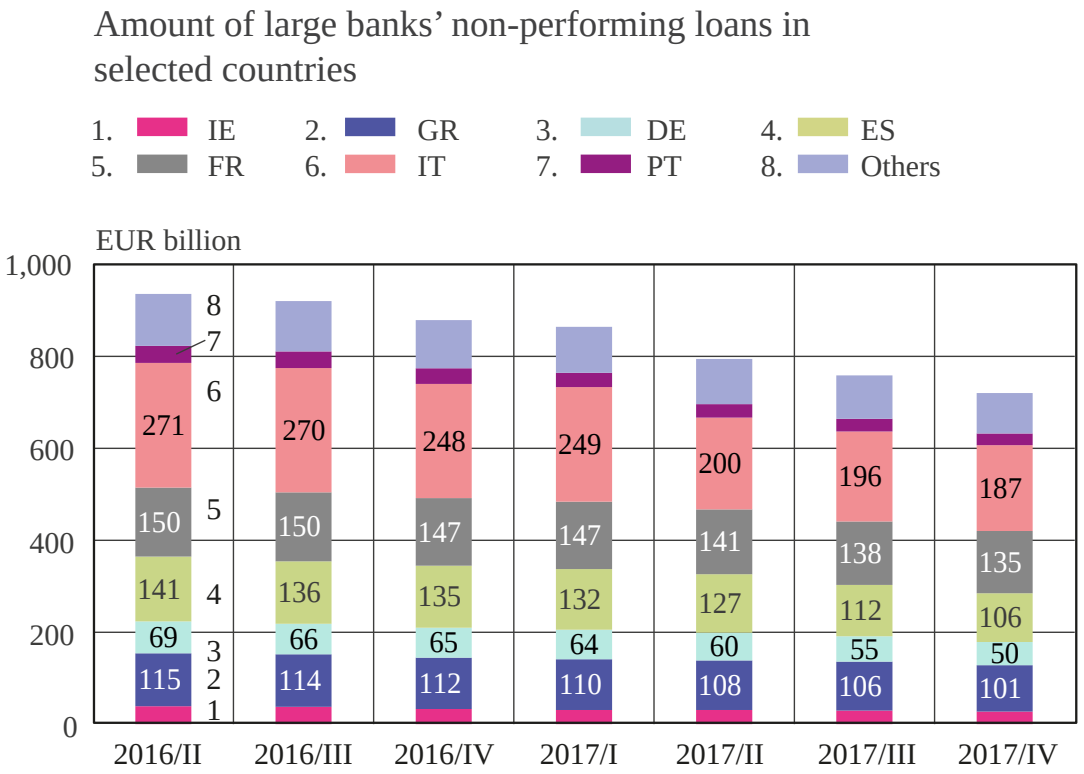
The Deposit Insurance Scheme would be based on contributions from banks to the common Deposit Insurance Fund. A study published by the European Central Bank shows that deposit insurance contributions calibrated based on individual banks' risk profiles could take into account the specificities of banking systems.[2] The common European Deposit Insurance Scheme, as a rule, would not involve a situation in which the banks in some countries would contribute to the Deposit Insurance Fund more than they would benefit from it. In addition, a fully fledged common European deposit insurance scheme would be sufficient to cover deposits even in a very severe non-systemic crisis.

Realisation of the European Deposit Insurance Scheme can be promoted and Banking Union reinforced by reducing risks in the banking system and improving the loss-absorbing capacity of banks.

Stock of non-performing loans must be decreased further

The stock of non-performing loans on banks' balance sheets, as a legacy of the financial crisis and the European sovereign debt crisis, has decreased. According to the Single Supervisory Mechanism , the euro area banking sector's non-performing loans at the end of 2017 totalled EUR 721 billion, which is some 18% less than a year earlier (Chart 2).

Chart 2.



Source: SSM.

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To mitigate risks in the banking system, it is important to further reduce the amount of legacy non-performing loans. To ensure the most effective reduction of non-performing loans, legacy problems should be tackled with national funds and in line with the guidelines issued by the

European Commission. An adequate amount of time should be given for resolving the problem, by issuing transitional provisions. Transitional provisions facilitate the write-down of non-performing exposures to a level that enables market-based solutions (e.g. the selling of non-performing loans to investors). The long-term objective is to abolish the transitional provisions.

Market-based solutions are the primary alternatives for decreasing non-performing loans. It is, however, unlikely that only one solution would be sufficient to resolve the issue. Banking sector structures and the economy, as well as legislation, differ across countries. History has also shown that the best solutions are a combination of several alternatives. Therefore, in addition to measures targeted directly at non-performing loans themselves, progress is also needed in areas that support resolving the problem of these loans, for example the opening of loan-specific data to investors and the establishment of a secondary market for non-performing loans. The European Commission published in March 2018 a proposal for measures to accelerate the reduction of non-performing loans.[3]

The resolving of legacy problems should be separated from the management of future non-performing loans. The Single Supervisory Mechanism (SSM) has already published a proposal on provisioning methodologies for new non-performing loans, which increase banks' loan loss provisions and resilience. In addition, the accounting standard IFRS 9, which entered into force on 1 January 2018, introduced changes in the recognition of non-performing loans, as a result of which projected loan loss provisions are recognised already at the time of granting credit.

Measures sought to break the bank-sovereign loop

Breaking the undesirable links between national banking sectors and their sovereigns is one of the fundamental reasons for creating Banking Union. Many euro area banks have a relatively large portfolio of their home country's sovereign bonds. One incentive for holding sovereign bonds is the fact that they are treated as risk-free in banks' capital adequacy calculations: euro area banks are not required to allocate capital for risks related to holdings of euro area sovereign bonds.

Sovereign bonds are, however, not risk-free. A deterioration in central government finances is reflected as a weakening of the balance sheet quality of the bank that has in its portfolio the sovereign bonds in question. As a result, the bank's funding costs will probably increase and its ability to act as a financial intermediary to non-financial corporations and households will weaken, which may further dampen the economy of its national sovereign. Particularly during the financial and debt crises, these links caused a negative loop between banks and their sovereigns.

To break this vicious circle, banks' domestic sovereign exposures should be decreased and the quality of capital to cover these risks should be improved. As part of completing Banking Union, it

has been proposed that banks be required to increase their capital position if they want to hold large amounts of individual sovereign debt.[4] This additional capital requirement that would be based on concentration risk would encourage banks to diversify their sovereign bond portfolios and support the distribution of risk on the euro area bond market. The negative market effect of the concentration charge would probably be quite small.

In the future, too, there will still be a demand for low-risk investment objects, such as sovereign bonds, on the financial markets. European sovereign bond-backed securities (SBBS) have been proposed as an alternative for banks' large holdings of national sovereign bonds. In the best case, the issuance of sovereign bond-backed securities would facilitate the diversification of banks' sovereign bond portfolios and provide a low-risk investment object.

Securing the conditions for resolution decreases the need to resort to the deposit insurance scheme

The reduction of banking sector risks can be considered to also include ensuring banks' loss-absorbing capacity. Individual banks must be prepared for facing problems that are so severe that the bank has to be placed under resolution. In resolution, the activities of a distressed bank are restructured so that the bank can continue with the provision of critical services, or alternatively, the bank is wound up in an orderly way. The bank's losses are absorbed, and in resolution the bank is recapitalised.

To ensure successful absorption of losses and recapitalisation, banks must hold a sufficient amount of debt that can be converted to equity or written down, if necessary. Therefore, resolution authorities require that banks hold on their balance sheet a minimum amount of liabilities eligible for such purposes. The minimum requirement for own funds and eligible liabilities (MREL) ensures the implementation of bail-in, as investors in the bank's debt securities have to bear their share of the costs of resolution.

Banks' resolution plans and the MREL to be imposed as part of the resolution plans are still being finalised. The Commission has also proposed some amendments to legislation on resolution and MREL. The finalisation, calibration and harmonised implementation of MREL will decrease banking sector risks, facilitate the achievement of a uniform level of risk and improve the conditions for resolution. Effective and credible resolution, in turn, will safeguard the position of depositors, prevent the lack of confidence from spreading more widely in the banking sector and decrease the likelihood of the funds of the deposit insurance scheme being used.

Notes

1. See Financial Stability Assessment Finland's banking sector expands – Banking Union mitigates risks, Bank of Finland Bulletin, 13 December 2017. ↑
2. See Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation? ECB Occasional Paper Series, and Construction of a risk-based European Deposit Insurance Scheme, Bank of Finland Bulletin, 27 March 2018. ↑
3. For more information, see the European Commission website at: http://europa.eu/rapid/press-release_IP-18-1802_en.htm. ↑
4. See Nicolas Véron: Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures. ↑

Keywords

banking union, crisis resolution, deposit insurance, non-performing loans