CONSIDERATIONS ON THE FURTHER STRENGTHENING OF THE BANKING UNION, INCLUDING A COMMON DEPOSIT INSURANCE SYSTEM

Report of the HLWG Chair

1. Introduction

The Eurogroup in inclusive format decided in December 2018 to set up a High-Level Working Group (HLWG) on EDIS. In order to get a more comprehensive picture of a complete Banking Union, the HLWG broadened the discussions beyond EDIS.

This report outlines the personal considerations of the Chair of the HLWG. It builds on the discussions held at the HLWG and its Technical Group over the last 5 months. It is based on the fruitful discussions and constructive contributions from Member States, European Institutions as well as external experts, and could pave the way for progress towards strengthening the Banking Union, including the establishment of a common deposit insurance system. This report also outlines where further work could be done in the coming institutional cycle.

The set-up of the Banking Union was a key part of the policy response to the crisis. The progress that has been made since 2012 is substantial and unique.

Significant progress towards a single rulebook for banks across the entire European Union and the establishment of the Banking Union was made. A Single Supervisory Mechanism (SSM), and a Single Resolution Mechanism (SRM) including a Single Resolution Fund (SRF) were set up and are now operational. The common backstop to the SRF is being implemented. These measures have reinforced banking-sector resilience across the EU, thereby safeguarding financial stability and protecting taxpayers from the costs of any future crises. Moreover, risks in the banking sector are being further reduced, lately with the political agreement on the Banking Package in December 2018 and the implementation of the non-performing loans (NPL) Action Plan of July 2017, including the adoption of the Regulation on the prudential backstop.

Despite the significant progress made, the Banking Union is not complete yet and scope remains for further banking sector integration. The importance of further strengthening the Banking Union should not be underestimated. It is crucial for financial stability at the EU and Member State level and for ensuring a more efficient allocation of capital across participating Member States, enhancing the financing of investments across national borders and thereby fostering the growth potential of the European economy. Moreover, it would improve the adjustment capacity of Member States, by reducing the impact of asymmetric shocks, and thereby contribute to the smooth functioning of the Economic and Monetary Union (EMU).

While further work needs to be done to implement the building blocks of the Banking Union already in place, the so-called “third pillar”, a common deposit insurance system, is still absent. In line with the mandate from the June 2018 Euro Summit and adhering to all elements of the 2016 roadmap in the appropriate sequence, work has been ongoing on a roadmap for beginning political negotiations on a European deposit insurance scheme (EDIS). The progress on this has been slow, due to a stalemate between those Member States which would like to implement EDIS immediately and those countries that attach significant conditions to the introduction of EDIS.
The HLWG reflected on what the Banking Union in the steady state and the transition path towards the steady state should look like, i.e. what elements, in addition to EDIS, would be needed. This approach allowed the HLWG to make progress towards a common view on a steady state Banking Union. Some of these components may also be relevant for the internal market for banks, beyond the Banking Union. However, divergences on some issues - both regarding the definition of the steady state and the way forward - remain and this report also describes those.

These discussions were guided by the following principles for a steady state Banking Union:

- The banking system should be stable, profitable and resilient;
- Resource allocation should be efficient and integration should be enhanced;
- An effective and uniform protection for covered depositors should be achieved; and
- The consistency of the overall architecture of the Banking Union should be ensured.
2. Towards a steady state Banking Union: goals and policy measures

**Continued implementation of ongoing measures.** In the steady state of the Banking Union, the necessary conditions would be in place to ensure a stable, profitable and resilient banking system.

In the course of the coming years, a number of measures recently agreed should be phased in and implemented, which should yield increasing results and thus contribute to a resilient system. The twice yearly reporting by the institutions based on risk reduction indicators will allow Member States to monitor progress in implementation.

In terms of ongoing measures, the following should continue to be implemented:

- Implementation of the NPL Action Plan, including relevant supervisory measures;
- Implementation of the Banking Package, including the accumulation/build-up of MREL (minimum requirement for own funds and eligible liabilities); and
- Build-up of the national Deposit Guarantee Schemes (DGSs) to the target level of covered deposits;

**EDIS.** In the steady state, a uniform and effective level of protection of covered depositors across the entire Banking Union, regardless of their geographic location, is ensured. This significantly reduces the negative link between banks and their home sovereign. The implementation of EDIS should fully preserve the alignment of liability and control in the Banking Union (SSM, SRM and depositor protection). EDIS should be fully funded through risk-based contributions raised from the banking sector. In line with the Deposit Guarantee Schemes Directive (DGSD), national deposit guarantee schemes are fully built up to their target level.

The HLWG had technical discussions on the possible design of EDIS. As an initial stage, most members consider that EDIS should include repayable liquidity support. While some consider this to be the end-stage of EDIS, for many it is only a transitional phase to a fully fledged EDIS. Such an EDIS could provide for partial loss coverage or, in its most ambitious form, full loss sharing.

The gradual implementation of EDIS should be linked to the progress made on the other parts of the architecture of the Banking Union and to progress made in addressing legacy risks. A number of members are of the view that further risk reduction in the European banking sector based on certain benchmarks or targets and an Asset Quality Review (AQR) or comprehensive assessment, is needed before moving forward with (parts of) EDIS. For some members, specific quantitative targets should be met, while others would prefer qualitative assessments. Some members consider that the progress already made should allow the implementation of a first liquidity phase that does not entail loss coverage.
A lot of technical work has been done on EDIS. Based on the guidance from ministers, this technical work should continue in parallel to the preparation of the roadmap for beginning political negotiations on EDIS.

**Framework for bank supervision, resolution and insolvency.** The steady state Banking Union would have a further developed institutional architecture to effectively supervise the banking sector, to safeguard financial stability and to ensure a consistent and effective crisis prevention and crisis management mechanism for all banks, protecting tax payers and public funds. In the steady state, the Single Resolution Fund (SRF) has been built-up and mutualized to the target level, and the common backstop for the SRF has been operationalized. A coherent and credible solution has been agreed and implemented for liquidity in resolution.

On the road to the steady state, the Bank Recovery and Resolution Directive/Single Resolution Mechanism Regulation 2 (BRRD/SRMR2) would be implemented. Our discussions revealed that broad consensus exists on the need to address identified shortcomings, inconsistencies and potential loopholes to ensure operational credibility of the system. As part of this, the framework for resolution and liquidation, including the burden sharing rules, would be further enhanced in order to ensure consistency and improve its ability to deal with all cases. Broad agreement exists on the need for a harmonisation of necessary parts of bank insolvency law, including with regard to cross-border groups and the ranking of creditors, while the toolbox for resolution might need to be expanded.

In addition, a number of safeguards related to the resolution framework, which may come out of the home-host context, could be implemented (see also subsequent section).

As regards supervision, the scope of the supervisory framework, including regarding less significant institutions (LSIs) and how this relates to the rest of the Banking Union architecture and design could also be looked at – balancing proportionality, efficiency, effectiveness and consistency of bank supervision.

Work should continue to outline the next steps on bank supervision, resolution and insolvency.

**Home-host issues and ONDs.** In the steady state, the banking sector should be enabled to manage efficiently its financial resources within cross-border groups. This would contribute to addressing the home bias in banks’ balance sheets by increasing geographical diversification of banks’ exposures, including to sovereign debt. This would allow for the optimization of the functioning of the internal market and facilitate private risk sharing, whilst ensuring financial stability at both the national and Banking Union levels. In order to achieve this, the Banking Union should provide for a robust and coherent institutional and regulatory framework, which allows for the removal of unjustified barriers to cross-border banking that follow from national rules and from differences in capital (including MREL) and liquidity requirements, and the
introduction of other measures, such as those on depositor protection and resolution.

This framework should strike the right balance between the interests of home and host countries and effectively reduce the need to preserve ring-fencing measures.

The HLWG discussed a number of possible safeguards for the host Member States within such a framework for the steady state, whose introduction could facilitate the withdrawal of then no longer justified national options and discretions (ONDs) and home-host related provisions.

These safeguards could include, for example, the introduction of legally certain and enforceable intra-group parent support mechanisms as well as the harmonization of certain parts of bank insolvency law. One could also consider reviewing the governance of the Single Resolution Board (SRB) to assess whether appropriate safeguards are in place for host Member States.

Together with the continued implementation of the Banking Package and the build-up of MREL, a new balance in the home-host equilibrium can be found for the steady state.

Work should continue on defining the required measures and safeguards, as well as their timing.

**Sovereign exposures and financial stability.** In the steady state, the direct feedback loop between banks and their national sovereign, has been addressed and financial stability has been safeguarded. In our discussions, different views were expressed on the treatment of sovereign exposures and the introduction of a European safe asset.

The focus of discussion has been on how to strengthen market discipline, reduce moral hazard and safeguard financial stability, whilst preserving the essential role and attractiveness of European sovereign bond markets.

Several members consider that there should be a revision of the regulatory treatment of sovereign exposures (RTSE) to incentivize banks to diversify their holdings of sovereign debt, while other members are open to looking into the various options for RTSE, linked to sufficient progress on other measures. These members agree that further analytical work is needed before deciding and that measures should be appropriately timed, carefully designed and gradually implemented. Different options exist in this respect, ranging from risk-based contributions to EDIS, valuation measures, concentration based measures, risk based concentration charges, to credit risk based measures. Other members remain opposed to any changes to the RTSE, arguing that such changes could undermine the functioning of sovereign bond markets while not addressing the indirect feedback loop between banks and national sovereigns which derives from the relationship between banks and their wider national economic environment.

Views on sequencing with other measures also still differ. For many members, the opening of the
discussion on RTSE is linked to progress on other files of the Banking Union or to international developments. For some members the implementation of RTSE should go hand in hand with the introduction of a new European safe asset in order to cater for any unintended financial stability consequences. Some highlight that is too early to make this connection, especially as there is no agreement on what could constitute a European safe asset for this purpose. Others argue that a distinction should be made between a safe asset which leads to a mutualisation of public debt and one that does not, including both public and private initiatives. They consider the first option to be closely related to the discussion on a Fiscal Union and underline that safe assets are not part of the 2016 Council Roadmap.

Work should continue, including through an impact assessment of the introduction of possible new measures and an analysis of market changes and implications thereof for financial stability at national/EU level, building on existing work.

3. Conclusion

The discussions in the HLWG these past months have allowed for progress in shaping a common view of what the Banking Union could look like in the steady state, and on what would be needed to get there. Although some divergences remain, we reached a broad agreement on the principles that should guide the further strengthening of the Banking Union and the main areas concerned. Progress will be needed in all areas and therefore a comprehensive approach building on a package of measures is needed.

More technical work will be needed in each of these areas to further define the possible ways forward, which would open up the way to a roadmap for political discussions on EDIS. Work could notably start in the next 6 to 9 months, on the following short and medium-term actions:

- **EDIS**: work on the different models for EDIS, that ensures an effective and uniform protection for covered depositors within the BU;
- **Bank supervision, resolution and insolvency**: this should include work on:
  - The crisis management framework, including bank insolvency law;
  - The scope of the supervisory framework;
  - Consistency of the overall framework;
- **RTSE**: Analytical work and impact assessments of the different options for addressing the sovereign-bank nexus and its financial stability implications at the EU/national level, building on existing work; and
- **Financial integration**: Assessment of the current state of play of the integration of the European Banking sector, obstacles to further integration and use of existing tools and existing ONDs.

In the Annex to this report an illustrative example is set out of what the different stages for each
of the above four policy areas could look like going forward, without committing on the timeline for each policy area, its elements, nor the relation in terms of timing or political agreement between the different policy areas.

This report and the outcome of any future work could then feed into the next Commission’s work in putting forward possible legislative proposals (such as a legislative proposal for a harmonised bank insolvency law and review of relevant elements of the second pillar of the Banking Union, including BRRD and SRMR).
**Annex - Illustrative transitional path to the steady state Banking Union**

The table below shows for the four policy areas what the transition paths could look like. This table is purely illustrative and does not take any position on the possible timing of measures either within policy areas, or in terms of the synchronisation between the different policy areas (i.e. measures on the same line do not necessarily occur at the same time).

<table>
<thead>
<tr>
<th>EDIS</th>
<th>Framework for bank supervision, resolution and insolvency</th>
<th>Sovereign exposures and financial stability implications</th>
<th>Enhancing market integration</th>
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<tbody>
<tr>
<td>Continued risk reduction monitoring and implementation and application of already agreed actions (Implementation of the NPL Action Plan / package; Implementation of the Banking Package; Accumulation of MREL)</td>
<td>Continued monitoring of the application and further analysis of the bank recovery and resolution framework</td>
<td>Study and impact assessment of the different options for effectively addressing the sovereign-bank nexus, building on existing work.</td>
<td>Assessment of the current state of play of the integration of the European Banking sector, obstacles to further integration and use of existing tools and existing ONDs.</td>
</tr>
<tr>
<td>Gradual implementation of EDIS, with different stages depending on: - Conditionality related to addressing legacy risks including benchmarks - Possibly an AQR/comprehensive assessment - Build up of the national DGS to the target level. - Progress made on other parts of the architecture of BU</td>
<td>Review of the BRRD/SRMR, including: - a harmonised toolbox; and harmonisation of the necessary parts of bank insolvency law, also regarding cross border groups and ranking of creditors</td>
<td>Gradual phasing in of agreed measures on sovereign exposures.</td>
<td>Deepening integration of the EU banking sector, including withdrawing regulatory barriers to cross-border banking and the phasing out of then no longer justified ONDs, with appropriate safeguards for host Member States, including: • Formalisation of the parent support; • Review of the governance of the resolution pillar</td>
</tr>
<tr>
<td>Fully fledged EDIS</td>
<td>Revision of the scope of supervision, including on LSIs, and its relation to the Banking Union architecture</td>
<td>Full implementation of agreed regulatory treatment of sovereign exposures / whilst safeguarding financial stability, possibly by introducing a new category of safe assets</td>
<td></td>
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Continued build-up of the SRF to the target level and implementation/operationalisation of the common backstop for the SRF