Banking Union – 2015 annual report

Banking Union (BU) is an EU-level banking supervision and resolution system. It is one of the key components of the EU's attempt to create a 'genuine Economic and Monetary Union' (EMU) and to restore confidence in the banking sector in the aftermath of the financial and economic crisis. On 24 November 2015, the European Commission issued a proposal for a third element of the BU, a European Deposit Insurance Scheme (EDIS). In its first annual report, the European Parliament's Economic and Monetary Affairs (ECON) Committee assesses the state of play of the BU. In focus are effects of capital requirements, proportionality concerns and the third pillar.

Cornerstones of Banking Union – achievements so far

BU aims to ensure that the banking sector in the euro area and the wider EU is safe and reliable, and that non-viable banks are resolved without recourse to taxpayers and with minimal impact on the real economy. BU membership is compulsory for euro-area countries, and open to others which may join by establishing a close cooperation agreement. Thus far, BU has two pillars, a single supervisory mechanism (SSM) and single resolution mechanism (SRM), and an accompanying 'single rulebook' – a set of legislation applying to all EU Member States, and over 8 000 banks. These rules, among other things, lay down capital requirements for banks, regulate the prevention and management of bank failures and ensure better protection for depositors. On 4 November 2014, the ECB assumed supervisory tasks under the SSM, to directly oversee all 'significant' euro-area banks (in cooperation with national supervisory authorities). Banks subject to direct supervision are those with assets of more than €30 billion, or which account for at least 20% of their home country's GDP. At present there are 129 such banks in the euro area, representing almost 82% of its total banking assets. A first ECB comprehensive assessment ('stress test') in 2014 found capital shortfalls in 25 banks (of 130), and a second in 2015 in 5 (of 9). A European Parliament study (of 87 SSM banks, December 2013 to June 2015) finds improving capital ratios but warns that asset quality (such as non-performing loans) remains a challenge. On 24 February 2016, the European Banking Authority (EBA) launched a revised EU-wide stress test, analysing a sample of 51 EU banks, covering around 70% of EU banks' total assets.

The SRM is a system to unify the resolution of non-viable financial institutions, and consists of the central resolution authority (the Single Resolution Board) and a Single Resolution Fund (SRF). To be used in cases of bank failure, the SRF, financed by bank contributions, will be built up over eight years (2016-2023). As of 2024 it will reach at least 1% of covered deposits. In line with the Five Presidents' report on 'Completing Europe's Economic and Monetary Union' (stage 1) of 22 June 2015, the Commission presented concrete steps to strengthen EMU on 21 October, and on 24 November a proposal for a common European Deposit Insurance Scheme (EDIS) to become BU's 'third pillar'. Conceived as a risk-sharing instrument for the euro area and to be fully implemented by 2024, EDIS aims to reduce the potential spill-over risk of local bank failures on the financial stability of EMU as a whole. The Commission will soon present accompanying risk-reduction measures. In October 2014, the ECON Committee established a BU Working Group scrutinises BU implementation (ECB-EP agreement and SRB-EP agreement) through hearings and exchanges of views.

European Parliament's annual report on Banking Union

In its first own-initiative report on the state of affairs of Banking Union (2015/2221(INI)), (rapporteur Roberto Gualtieri, S&D, Italy), the ECON Committee welcomed BU as 'instrumental to ensuring stability and restoring confidence in euro area banks'. A total of 362 amendments were tabled to the draft report of 12 November 2015. Adopted on 15 February 2016 (40 in favour, 16 against, 0 abstentions), the report – which contains a minority opinion under Rule 56(3) of the Rules of Procedure – groups its findings following the three separate pillars of BU: SSM, SRM and a common deposit insurance scheme:

EPRS | European Parliamentary Research Service
Author: Andrej Stuchlik, **Members' Research Service**
PE 577.997

I. Single Supervisory Mechanism (SSM)

The report regards the **establishment of the SSM** as successful, 'both from an operational point of view and in terms of supervisory quality' (Pt 1). However, it also contains some criticism. With regard to the operational work of the ECB it finds that 'ECB contracting practices leave room for improvement' (Pt 3a). The report 'notes that a very significant share of work is routinely devoted to administrative procedures... which may not always be proportionate' (Pt 4). As to data collection, the ECB should 'avoid double reporting requirements' and an 'unnecessary administrative burden on credit institutions, in particular smaller banks' (Pt 8, 9). Finally, ECON Members note 'the limitations of the current stress test methodology' (Pt 11).

Regarding the **financing environment**, the report stresses the fragility of the euro area's economic recovery: 'Credit dynamics are still subdued in many jurisdictions and a large stock of non-performing loans weighs on many European banks' balance sheets, limiting their capacity to finance the economy' (Pt 14). As to non-performing loans (NPL), the report 'recalls that the ability to write off or sell on non-performing loans is vital, as it frees up capital to fund new loans, in particular to SMEs'. The issue of NPL needs to be addressed at European level, 'notably by facilitating the setting-up of asset management companies in those countries where this is deemed to be necessary, as was the case in Spain and Ireland' (Pt 15).

The report stresses the importance of **supervisory convergence** and macro-prudential regulation. The latter 'must place greater emphasis on preventing large fluctuations in the financial cycle' (Pt 16, 20, 27). It also 'considers transparency vis-à-vis market players and the public... to be essential for a level playing field between supervised entities' and 'calls for more transparency with regard to pillar 2 decisions (Pt 37, 25)'. The report 'urges a swift legislative agreement' on the Banking Structural Reform dossier, as this was 'conceived to reduce systemic risk and address the issue of "too big to fail" institutions' (Pt 18).

On **capital requirements (CR)**, the report notes that CR 'beyond a certain threshold may in the short term create unintended consequences, limiting banks' lending capacity' (Pt 21). For financing of SMEs, the European supervisory authorities should 'conduct a comprehensive assessment of CR embedded in current and future legislation' as well as take into account 'the balance between short-term and long-term impact of CR' (Pt 22). Since the EU's prudential requirements framework (CRD-IV/CRR) already existed, the report 'encourages' the Commission to align it with the BU framework. It calls for flexibility on the Maximum Distributable Amount (MDA), to avoid being 'too rigid' and 'negatively affect[ing] the Additional Tier 1 bond market and the level playing field' (Pt 26). The report pushes for regulations rather than directives (Pt 29).

On the issue of **sovereign exposures of banks** (ranging in the euro area from 0.8% in Finland to 10.1% in Italy), the report recalls that possible changes to the current regulatory framework in the medium term should take care not to reduce available funding for Member States, or 'create unintended market or competition distortions'. It 'underlines that if there is to be a comprehensive risk reduction, parallel measures should be taken among others to reduce level 2 and level 3 assets exposure and to ensure the full convergence of internal ratings-based (IRB) systems for the measurement of credit risk (Pt 33).

II. Single Resolution Mechanism (SRM)

The report 'welcomes the efficient setting-up of the SRB and the establishment of national resolution authorities (NRAs)' (Pt 43). It calls for 'timely progress to be made in drawing up **resolution plans** and setting a minimum requirement for own funds and eligible liabilities (MREL)', and to prioritise systemically important institutions (Pt 50, 52). It welcomes the ratification of the agreement on the transfer and mutualisation of contributions to the SRF, yet 'regrets' that this decision was not taken through Union law and 'stresses the need to rapidly put in place an adequate bridge financing mechanism'. MEPs 'recall' the Ecofin Council's commitment to develop a **common backstop** to facilitate borrowings by the SRF, yet stress that it 'will be used only as a last resort' and should be 'fiscally neutral in the medium term' (Pt 61-63).

III. Third pillar – European Deposit Guarantee Scheme (EDIS)

The report recalls that 'the capacity to afford a uniform and high level of protection of deposits, irrespective of their location', should be ensured in an effective BU. Such a capacity would contribute 'to genuinely break the sovereign-bank loop' but any system of protection of deposits 'must always avoid the introduction of any moral hazard, while ensuring that risk takers remain liable for their risk taking'. In this vein, the report 'welcomes' the Commission's 24 November 2015 '**package on risk sharing and risk reduction**'. The creation of EDIS requires, apart from implementation of existing BU legislation (including BRRD, see Pt 54, and DGSD) by all the participating Member States, 'further measures to achieve a substantial reduction of risks in the European banking system'. It regards the bail-in tool as a systemic mechanism of risk avoidance (Pt 64-66).