BRIEFING

European Parliament

Banking Union: Defusing the “home/host” debate

While a banking group located in the Banking Union is supervised by a single supervisor and no longer by home and host supervisors of the Member States, subsidiaries are still subject to individual requirements with remaining national powers over legal entities of a group. Further integration of banking groups' risk management has been identified by the Chair of the Single Supervisory Mechanism (SSM) as one of the remaining steps to completing the Banking Union. For the Chair of the SSM, there are "still obstacles to the integrated management of bank capital and liquidity within cross-border groups operating in the banking union". As the SSM put it "the fences should be removed; they are out of place within a banking union where the concept of home and host supervisors has disappeared".

In order for banking groups to efficiently manage its financial resources within cross-border groups in a "steady stage Banking Union", the June 2019 report of Euro group's High Level Working Group (HLWG) on the European Deposit Insurance Scheme (EDIS) calls 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 briefing provides an overview of the home/host balance in banking legislation and further explains the extent to which the Banking Union has changed the situation. While the Banking Package (CRD5/CRR2) has not removed all restrictions to the free flow of capital and liquidity within a group, this briefing explains how banking groups may be further integrated under existing supervisory arrangements. The briefing further mentions how the completion of the Banking Union may help defuse the home/host debate.

The “home”/”host” balance in banking legislation

Group supervision as part of a collegial decision-making process

Supervision of cross-border banking groups is performed in the EU both on a consolidated basis (i.e. the supervisor of the parent entity is responsible for the supervision of a group as a whole) and on an individual basis (i.e. the supervisor of each of the subsidiaries is responsible for the supervision of the legal entities belonging to a group). Supervision on an individual basis extends to capital requirements, and importantly, Pillar 2 decisions (i.e. additional capital above the minimum levels laid down in Pillar 1), macro-prudential tools and liquidity requirements.

ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)
Authors: J. Deslandes, C. Dias, M. Magnus
Directorate-General for Internal Policies

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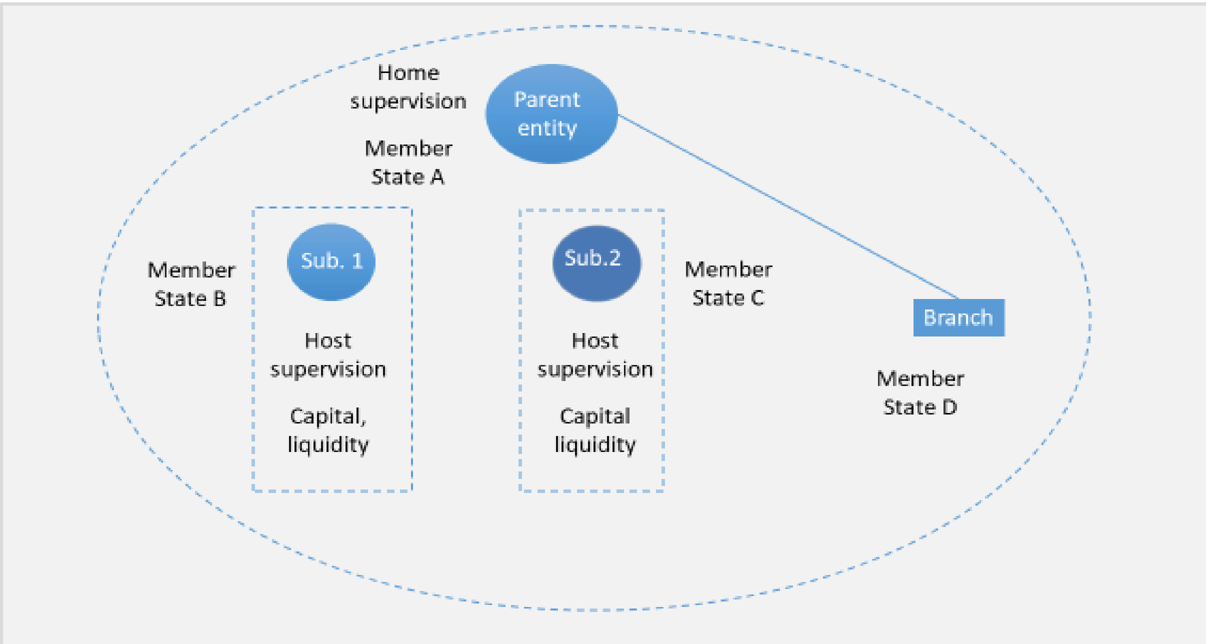
This "dual" supervision is facilitated through the establishment of "colleges of supervisors" that have existed since CRD2 in 2009. Chaired by the consolidating supervisor, "colleges of supervisors" provide a platform for exchanging information and agreeing on "joint decisions" (among the consolidating supervisor and all other supervisors of the EU subsidiaries of the banking group concerned) on key decisions affecting the group as a whole (e.g. Pillar 1 minimum capital requirements, Pillar 2 capital or liquidity add-on, intragroup treatment, resolution planning). Joint decisions between home and host supervisors are legally binding for all supervisors and are subject to a formal decision-making process whereby the concerned home and host supervisors share their risk assessment of the group as a whole. Where a joint decision on individual or consolidated requirements cannot be reached, the European Banking Authority (EBA) may be called upon by the home or the host supervisor to settle disagreement (binding or non-binding mediation, as foreseen in EBA and sectoral relevant legislation)[1].

While subsidiaries are subject to fully-fledged capital and liquidity requirement, branches - as a credit institution's place of business - are not supervised by the host supervisor. In keeping with the country of origin principle, the prudential supervision of branches (not only capital and but also liquidity) is directly carried out by the home supervisor since CRD4, in 2013. Group supervision under the CRD/CRR framework is summarised below in Chart 1:

Chart 1: Group supervision



Source: EGOV

Over the past ten years, the Commission has repeatedly proposed major shifts of supervisory powers towards the consolidating supervisors (i.e. the "home supervisor" of the groups' parent entity) with a view to bring about a more integrated single market:

- As part of Solvency II, a "lead supervisor" model whereby capital in insurance undertaking groups would no longer be located at the level of subsidiaries;

[1] The 2009 EBA Regulation included a home/host balance that differentiated decision-making for legally binding mediation depending on the home or host powers: mediation for Pillar 1 decision (home supervisor competence) was taken by qualified majority while mediation on Pillar 2 (host supervisor competence) was taken by simple majority. That system was reviewed by the 2013 EBA Regulation which introduced a double majority voting to provide safeguards to non-participating Member States.

- In the CRD2 proposal in 2009, to entrust the consolidating supervisor with a last say in joint decision to determine the level of Pillar 2 within the group (i.e. capital add-on above the minimum Pillar 1 capital requirements);
- As part of the CRD5/CRR2 ("the Banking package"), introduction of waivers to capital requirements, coupled with collateralised guarantees from the parent.

As reflected in the Commission's CRD5/CRR2 explanatory memorandum, "*requiring subsidiaries to comply with own funds and liquidity requirements on an individual basis may prevent institutions from managing those resources efficiently at the level of the group*". That position is supported by the industry (see, as an example, AFME position paper, May 2017) advocating a "*free flow of capital and liquidity enabling integrated, open, competitive and efficient financial markets and services*". As emphasised by AFME, "*there are significant, recognised economic benefits to removing obstacles to the free flow of funds. In particular, the efficient internal capital allocation within banks allows resources to flow to where they are most in demand from businesses and households*".

Host supervisory concerns

The Commission's CRD5/CRR2 proposals from November 2016 were met with strong reservations from "host" supervisors (supervisors of the banking groups' subsidiaries). Host supervisors saw a need to be able to "*protect banks' domestic assets, so that they could be seized and liquidated under local law in case of failure of the foreign parent company or other group's affiliates*" (See Box 1, speech from A. Enria, then Chair of the EBA summarising host concerns).

Box 1 - What are the concerns of "host supervisors"?

"Host authorities took geographical ring-fencing decisions on affiliates of foreign banks operating in their territory, with the objective of protecting those banks' domestic assets, so that they could be seized and liquidated under local law in case of failure of the foreign parent company or other group's affiliates. Measures included but were not limited to increased capital and liquidity requirements on foreign-owned subsidiaries, legal restrictions on intragroup cross-border asset transfers and limitations on the distribution of profits by foreign-owned subsidiaries, in some cases despite relatively positive economic fundamentals. In the host Member State perspective, this was done to better safeguard the interests of local stakeholders – shareholders, creditors and depositors, as well as deposit insurers and taxpayers – mitigate spillovers and cross-border contagion and support credit supply at the national level.".

Source: Speech from A. Enria, Chair of the EBA, September 2018

Those concerns are grounded on the significant asymmetries between home and host authorities concerns. In a 2019 Working paper on the effects on small host countries in central, eastern and south eastern Europe, the World Bank, in particular, pointed to "*the differences in interests [that] are especially striking for small host countries, for whom the subsidiaries of multinational parent banks are often of systemic importance and thus the stability of the bank a high priority, while the host country operation of the bank is not material for the parent bank and thus of lower priority for the home country supervisor*".

The central problem in home/host supervision and relationship lies in the lack of incentives for home supervisors to consider the wider prudential implications of cross-border banking in host countries. For this purpose, CRD2 introduced a "European mandate" for supervisors to factor in the impact of their supervisory decisions on other Member States. Nevertheless, in the absence of an effective compliance mechanism there is a lack of incentives for home supervisors to internalise the externalities that domestic policies produce in other countries[2]. The establishment of the SSM has been intended to address that issue of supervisory failures.

[2] By way of example, the Icelandic banking crisis may illustrate that problem. Based on an EU passport, Icelandic banks had opened branches in other EU Member States for which no further approval from local authorities was needed.

Against that background, compromises on home/host concerns have been worked out by the co-legislators in an agreement reached in April 2019. The home/host balance arising from political compromises is as follows (Table 1). The home/host compromise of the CRD5/CRR2 Banking Package is explained in more details in the next section.

Table 1: Home/host balance in banking legislation (CRD/CRR)

Item	Commission proposal	Home/host compromise
Pillar 1 - Model validation (Market risk and IRB)	CRD1 - Last say for the consolidating supervisor	Last say for the consolidating supervisor - Non binding mediation of CEBS[3] (CRD2) - Legally binding mediation of EBA (CRD4)
Pillar 2	CRD2 - Last say for the consolidating supervisor	Last say for the host supervisor in the absence of a joint decision - Non binding mediation of CEBS (CRD2) - Legally binding mediation of EBA (CRD4)
Additional pillar 2 requirement for macro-prudential purposes	CRD4 - Case by case decision subject to joint decision (as above)	Additional powers for host supervisors responsible for macro-prudential policy (see Table 3)
Large exposures limits	CRD2 and CRD4 - Member states' option to apply large exposures limits to intra-group transaction	CRD2 and CRD4 - Member states' option to apply large exposures limits to intra-group transaction
Treatment of Intra-group transactions	CRD4 - Last say for the consolidating supervisor in the absence of an agreement (joint decision)	CRD4 - In the absence of a joint decision, each supervisor takes its own decision
Liquidity sub-groups (to waive liquidity requirements)	CRD4 - In the absence of a joint decision, each supervisor takes its own decision	As proposed

Source: EGOV

As part of "home/host" compromises, safeguards were introduced in banking legislation to provide comfort to host supervisors and secure some powers of host supervisors over subsidiaries of banking groups:

- Host supervisors have the last say in determining the level of Pillar 2 requirements of subsidiaries in the absence of a "joint decision" between the consolidating supervisor and the supervisors of subsidiaries (CRD2 home/host compromise);
- Host supervisors keep the power to limit intra-group transactions by subjecting the exposures of subsidiaries to the parent entity to large exposure rules (Member State option as part of the CRD4 home/host compromise);

Those banks, supervised only by the home supervisor in Iceland, offered savings accounts to customers mainly from the UK and the Netherlands, thereby considerable widening their deposit base. In the years preceding the crisis, the banks multiplied in size, and the financial system in Iceland grew to more than ten times the country's GDP. When the Icelandic banks failed in the wake of the 2008 financial crisis, the Icelandic deposit insurance scheme proved to be insufficient to repay all depositors. Neither the Icelandic Central Bank nor the sovereign had the means to step in. In 2013, an EFTA Court ruling [case E-16/11 [2013] EFTA Ct.] confirmed that Iceland was not obliged to repay Dutch and British depositors minimum deposit guarantees, leaving them with the consequences of failed home supervision.

3 The Committee of European Banking Supervisors (CEBS) was the "Level 3 Committee" in banking. EBA took over from CEBS in 2010.

- Host supervisors maintain the possibility, as part of their macro-prudential powers, to require additional capital for subsidiaries of Global SIFIs or other systemically important institutions, subject to a cap (Article 131(8) of CRD4 modified by CRD5) as well as systemic buffer (CRD4).

Commenting on how national supervisors ringed fenced asset during the financial crisis, A. Enria (then-Chair of the EBA) highlighted that "*At that time, it was deemed reasonable to fence off national banking sectors. But such a territorial approach comes at a cost, and not only for banks. It harms efficiency across the entire system, and an inefficient financial system puts a burden on the economy. So, the fences should be removed; they are out of place within a banking union where the concept of home and host supervisors has disappeared and where the supervisors of the 19 euro area countries take supervisory decisions together in a single European supervisory board*". On the other hand, as emphasised by A. Enria, now Chair of the SSM in a recent speech "Mutually assured cooperation - the issue of cross-border bank", "*another step we could take is to acknowledge that the concerns of host authorities might be justified*". This calls for additional safeguards to be thought through to provide greater confidence (see last section on defusing the home/host debate).

Home/host balance in the Banking Union (supervision under CRD/CRR)

In the Banking Union, the SSM supervises both the banking group, including the parent entity, as a consolidating supervisor, and subsidiaries and branches of the banking group established in the Banking Union[4]. As previously discussed, it thus renders home/host dimensions less relevant insofar as the home and host supervisor is, *de iure*, the same (the SSM). The SSM Regulation particularly aims at addressing supervisory cooperation in a cross-border context[5].

While home and host supervisors benefitted from specific safeguards under CRD/CRR (i.e. last say in the absence of a disagreement), the very nature of the SSM no longer features those safeguards. Decisions are taken by the Supervisory Board of the SSM which is mainly composed of national competent authorities. In that respect, the World Bank noted that "*a potential future concern for Eurozone small hosts is that they may feel powerless to oppose the granting of cross-border liquidity and, when legally possible, capital waivers for their subsidiaries, since these authorization powers are, or may in future be with the SSM*". That shift in the home/host balance can be summarised as follows.

Under the CRR, capital requirements at the level of a subsidiary may be lifted provided that the parent and the subsidiary are located in the same Member State. By proposing to extend a capital waiver to subsidiaries in other Member States, the CRR2 proposal meant to "substantially reinforce group supervision" to keep pace with the establishment of the Banking Union, as explained in the CRR2 explanatory memorandum. That waiver proposed by Commission was subject to additional requirements that the subsidiary's own funds must be guaranteed by the parent. The cross-border waiver proposal was at the discretion of the competent authority (the SSM in the Banking Union).

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4 See Recital 38 of the SSM Regulation: "Where the ECB carries out the tasks conferred on it by this Regulation with regard to a group of credit institutions that is not less significant on a consolidated basis, it should carry out those tasks on a consolidated basis with regard to the group of credit institutions and on an individual basis with regard to the banking subsidiaries and branches of that group established in participating Member States".

5 According to Article 6(4) of the SSM Regulation, the ECB may, on its own initiative, consider an institution to be of significant relevance and place it under direct supervision where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities.

Table 2: Impact of the Banking Union on the home/host balance

Item	Home/host compromise pre-SSM	post-SSM
Intra-group treatment	Host supervisor may take its own decision in the absence of a disagreement	Decision to be taken by the SSM
Large exposure - Intra-group treatment	Member State option	Member State option (the SSM cannot override a Member State option)
Liquidity sub-group	Host supervisor may take its own decision in the absence of an agreement	Decision to be taken by the SSM
Pillar 2	Host supervisor may take its own decision in the absence of an agreement with EBA binding mediation	Decision to be taken by the SSM
Pillar 1	Home supervisor to take the final decision in the absence of a joint decision, subject to EBA binding mediation	Decision to be taken by the SSM
Macro-prudential powers	National responsibility, but cap to buffer	Idem, as SSM has limited macro-prudential powers

Source: EGOV

The macro-prudential framework

In accordance with the SSM Regulation, the SSM has limited macro-prudential powers. It may only "top-up" macro-prudential requirements imposed by national macro-prudential authorities when they are deemed insufficient on financial stability grounds. The responsibility for macro-prudential supervision lies with Member States' national authorities, including in relation to subsidiaries of a banking group. As part of the SSM negotiations, that national responsibility for macro-prudential supervision was predicated on the need for Member States to keep full responsibility for financial stability, particularly in the absence at that time of an EU resolution regime and a deposit guarantee insurance scheme.

The home/host CRD5/CCR2 compromise features an increased flexibility in the macro-prudential toolbox to compensate for the removal of the macro-prudential dimension of Pillar 2. Under CRD5/CRR2, host supervisors may no longer impose additional capital requirements to account for systemic risks, i.e. supervisors' powers to impose Pillar 2 capital requirements are confined to institution-specific cases. As part of a compromise, CRD5/CRR2 allows for a use of the systemic risk buffer for certain sectors and increases the cap on the buffer rate that can be applied to other systemically important institutions (O-SIIs), including subsidiaries.

That flexibility provided by the macro-prudential toolbox provides additional instruments to host supervisors. In that respect, the Commission emphasised that "*there is some evidence that a number of Member States may have used institution-specific tools in order to ring-fence capital inside their jurisdictions, at the level of local subsidiaries of cross-border banking groups they supervise*" (2016 Review of the EU macro-prudential policy framework).

Table 3: Powers of national authorities in the Banking Union

Item	Banking Union framework	National powers
Pillar 1 Capital	SSM to decide for the entire group, including subsidiaries	Macro-prudential tool: Supervisors to possibly impose higher capital, subject to EU Council's approval (Article 458 of CRR)
Pillar 2 Capital	SSM to decide for the entire group, including subsidiaries	No national power, but possibility for host supervisors to impose higher capital requirements for macro-prudential purposes (see below)
Global or other systemically important institution buffer (G-SII and O-SII buffer)	National competence - Doesn't fall within Banking Union (i.e. SSM) competence.	Macro-prudential tool: Possibility to impose a systemic risk buffer on subsidiaries of GSII or O-SII subject to a cap that has been increased by CRD5 Article 131(8)
Systemic risk buffer	National competence - Doesn't fall within Banking Union (i.e. SSM) competence	Possibility for national supervisors, subject to limits and processes laid down in CRD Article 131, to impose higher capital requirements to all exposures or sectoral exposures located in a Member State
Liquidity	SSM to decide for the entire group, including subsidiaries and where appropriate, to establish liquidity sub-group	Macro-prudential tool: Supervisors to possibly impose higher liquidity requirements, subject to EU Council's approval (Article 458 of CRR)
Large exposure	SSM to possibly waive intra-group requirements	Member state option to require intra-group large exposure Macro-prudential tool: Supervisors to possibly impose higher large exposure limits, subject to EU Council's approval

Source: EGOV

Home/host balance in the Banking Union (Resolution under BRRD and SRMR)

Debates between home and host authorities on the "CRD5/CRR3 Banking Package" have also focussed around the allocation of MREL (minimum requirement of eligible liabilities) within a group. MREL held at subsidiary level gives assurance to the host supervisor that sufficient and easily bail-inable debt would be located in a host country so that national Deposit Guarantee Schemes would not be called upon to absorb losses. In line with FSB standards, BRRD2 has introduced the concept of 'Internal' MREL. 'Internal MREL' are eligible (debt) instruments that are issued to the resolution entity (i.e. typically the parent company) from other legal entities in a group (i.e. subsidiaries supervised by host supervisors)[6]. Internal MREL for material subsidiaries was calibrated by the FSB with a scale range of 75% to 90% of the full amount of external MREL that would apply if the subsidiary were itself a resolution entity.

[6] As explained in Commission's explanatory memorandum, "Where a resolution group entity which itself is not a resolution entity reaches the point of non-viability, such instruments are written down or converted into equity and losses of that entity are then up-streamed to the resolution entity. The main advantage of the internal MREL is that it allows recapitalising a resolution group entity (with critical functions) without placing it into formal resolution, which could potentially have disruptive effects on the market."

Table 4: Home/host balance (BRRD/SRMR)

<table>
<tr><th>Item</th><th>(A) Commission proposal</th><th>(B) Home/host compromise BRRD/SRMR</th><th>(C) Home/host compromise (BRRD2/SRMR2)</th></tr>
<tr><td>Governance of the SRM</td><td>Voting rights split between the members of the Board (one vote), the home (one vote) and the host resolution authorities sharing one vote</td><td>Resolution decisions taken by a Supervisory Board composed of independent board members</td><td>Idem to (B)</td></tr>
<tr><td rowspan="4">Allocation of MREL within a group</td><td rowspan="4">BRRD2 proposal: 90% pre-positioning with possibility to use collateralised guarantees</td><td rowspan="2">Joint decision expected in resolution colleges</td><td>- No cross-border waivers -
100% internal MREL propositioning rule
- Mandatory exclusion of Intra-group liabilities from bail-in of parent, unless subordinated
- Deletion of collateralised guarantees in cross border situations</td></tr>
<tr><td>Joint decision expected in resolution colleges</td></tr>
<tr><td>"top-down' approach: level of consolidated requirement decided first</td><td>'Bottom-up' approach: level for subsidiaries decided first</td></tr>
<tr><td>Safe harbour clause in the absence of joint decision: host authorities may request a higher internal MREL, part of which would not be subject to EBA mediation (1% of Total liabilities and own funds)</td><td>Safe harbour clause in the absence of joint decision: 2% RWA (risk-weighted assets) above consolidated level</td></tr>
<tr><td>Intra-group financial support</td><td>The supervisor of the transferor has the power to prohibit or restrict financial support</td><td>Idem to (A)</td><td>Idem to (A)</td></tr>
</table>

Source: EGOV

The allocation of MREL within a group is a delicate balancing act that EBA, in its 2016 final report on MREL, summarised as follows: "*The requirement to issue capital and debt instruments at subsidiary level, also known as prepositioning, is a reliable mechanism to support the implementation of the resolution strategy by absorbing losses and recapitalising an entity upon failure. On the other hand, prepositioning constrains banks in centrally managing liquidity and financial resources at the group level, including in dealing with asymmetric shocks. The issuance at local level may also raise liquidity beyond the needs of the local operations from a business perspective, which could (in turn) lead to a search for more risky investment opportunities if no other way to reshuffle the liquidity within the group* *can be found. A way to address this possible concern is to allow parental guarantees as an internal loss absorbing instrument*".

In that respect, the Commission's original proposal on the banking package featured a supervisory arrangement whereby the internal MREL could be replaced with collateralised guarantees between the resolution entity and other resolution group entities that could be triggered under the equivalent timing conditions that the instruments eligible for the internal MREL. That proposal was rejected by the Council, who favoured a 100% prepositioning rule (Commission suggested 90%) and objected to the waiver and collateralised guarantees proposed by Commission (See Table 4). The home/host balance agreed at Council has been adopted by the co-legislators as part of the CRD5/CRR3 Banking Package. In contrast, in keeping with the FSB TLAC Term Sheet, the EP position supported the 75-90% scale range that provides flexibility to take account the credibility of resolution plans.

Concerns of host authorities that opposed collateralised guarantees in lieu of internal MRL have been broadly acknowledged by the IMF FSAP on the Euro area that stressed that "*a yet incomplete banking union causes home-host tensions, which need to be carefully balanced in the interim [...]. While the FSAP supports the single market, it is also mindful of national financial stability concerns while completing banking union*". In that respect, and consistent with FSB, the IMF supported internal MREL targets to enable recapitalisation of material subsidiaries

Further integrating banking groups under the existing supervisory arrangements

The home/host balance under existing banking legislation still leaves room for further integration, if implemented by the SSM supervisory board where both home and host authorities and ECB representatives are represented. The SSM has started developing an action plan to reduce legal fragmentation in supervision.

Liquidity sub-groups

CRD4 allows competent authorities to waive liquidity requirements (Liquidity Coverage Ratio) and constitute "liquidity sub-groups" (Article 8 of the CRR). Liquidity sub-groups come down to applying liquidity requirements (the Liquidity Coverage Ratio) to a sub-group composed of different legal entities of the same banking group as opposed to applying the Liquidity Coverage Ratio to all entities within that banking group. The March 2016 ECB guide on options and national discretions available in Union law sets out SSM supervisory expectations to be met for banking groups to constitute liquidity sub-groups.

According to the ECB, the requirement to comply with the liquidity coverage ratio at individual level "locks up liquidity in cross-border subsidiaries of G-SIBs of up to €130bn". The effects of removing large exposure limits on intragroup lending could even be more significant, given the importance of intra group lending in the euro area, which in 2017 accounted for 70% of cross-border lending. In relation to intragroup lending, it must be noted that SSM powers are limited. The large exposure waivers on intragroup lending is not a supervisory responsibility, but falls with national legislator, where appropriate, under CRR Article 493(3)(c).

Intra-group financial support for resolution planning purposes

Articles 19 to 26 of the BRRD feature intragroup financial support arrangements that have been worked out to secure asset transfers in stress situations, based on pre-agreed terms both by supervisors and shareholders. Financial support may take the form of a loan, the provision of guarantees, or the provision of assets for use as collateral in transaction to other entities within the group that experience financial difficulties. Those arrangements are intended to be included in banks' recovery plan as they may facilitate to up-stream, down-stream or side-stream losses, depending on which group's entity is under stress.

The agreements are voluntary. This means that each banking group has to assess whether such arrangements fit in with its structure (a group might be more or less integrated and pursue more or less strongly a common strategy). As a safeguard, the supervisor of the transferor has the power to prohibit or restrict financial support pursuant to the agreement when that transfer threatens the liquidity or solvency of the transferor or financial stability. In the Banking Union, the safeguard provided in BRRD does not necessarily provide sufficient comfort to both home or host authorities as the SSM is the single supervisor. In addition, it must be noted that problems may only materialise when the "questionable financial support" has already been done. In that respect, A. Enria, as chair of EBA suggested further developing BRRD intra-group financial support arrangements to garner support from host supervisors: "*The approval process of such agreements could be further streamlined, to provide sufficient comfort to all supervisors and shareholders involved that, in case the conditions for early intervention materialise, the transfer of resources is contractually regulated and predictable*". That proposal is echoed in the Report of the Chair of the HLWG on EDIS (See next section and Box 2) which calls for the "*introduction of legally certain and enforceable intra-group parent support mechanisms*".

For the Chair of the SSM, intragroup financial support in the Banking Union *"would help to map out how group entities could support each other in a crisis while taking into account local needs and restrictions. The challenge would be to better integrate the assessment of capital and liquidity needs for all the group entities with the safeguards provided for in recovery plans*" (speech from April 2019 on "Mutually assured cooperation" - the issue of cross-border banks).

'Branchisation' of subsidiaries

Turning subsidiaries into branches would provide unfettered flows of capital and liquidity as branches are not subject to capital and liquidity requirements on their own (See Chart 1). That supervisory model has been implemented by Nordea that started to operate in Finland, Norway, and Denmark with branches instead of subsidiaries in 2017, before moving its head office from Sweden to Finland. Nordea is now supervised by the SSM on a consolidated basis (as its seat has been located in Finland) with branches in other Member States of the Nordic region. That restructuring would result, according to Nordea, in material cost savings with a net present value between 0,9-1,2 bn EUR[7].

While possible under Union law, 'branchisation' is a highly sensitive issue for many host supervisors that would lose powers - in particular macro-prudential powers - should subsidiaries be turned into branches. That debate is echoed in recital 44 of the SSM Regulation which states that "*Nothing in this Regulation should alter in any way the current framework regulating the change of legal form of subsidiaries or branches and the application of such framework, or be understood or applied as providing incentives in favour of such change. In this respect, the responsibility of competent authorities of non-participating Member States should be fully respected, so that those authorities continue to enjoy sufficient supervisory tools and powers over credit institutions operating in their territory in order to have the capacity to fulfil this responsibility and effectively safeguard financial stability and public interest. Moreover, in order to assist those competent authorities in fulfilling their responsibilities, timely information on a change of legal form of subsidiaries or branches should be provided to depositors and to the competent authorities*".

[7] Source World Bank, 2019.

Defusing the home/host debate?

Home/host supervisory concerns are recognised as part of additional steps needed to complete the Banking Union. As part of the broad discussions leading to the design of such steady stage Banking Union, the Chair of the HLWG on EDIS outlined a number of additional safeguards that might be worked out to allow banking groups to manage efficiently its financial resources (See box 2).

A better inclusion of 'local risk' into the group's requirements

In keeping with collegial supervision which is at the very heart of EU banking supervision, the Chair of the SSM suggested in April 2019 to better take host authorities' concerns into account when setting prudential requirements for the entire banking group: "*If a local risk does not diversify away or net out in consolidation, it needs to be captured in group requirements. This might help to limit the risk at the national level and reduce the need to ring-fence*". This echoes the EBA findings that further efforts are needed, in particular to ensure that the group risk/liquidity risk assessment reports form a real joint assessment of the group-wide risks.

Box 2 - Home/host issues as discussed at Eurogroup

"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".

Source: Report of the Chair of the HLWG on EDIS

At the core of host authorities concerns is the risk that parent entities would deleverage or stop financing their local subsidiaries as experienced during the global financial crisis that led to the Vienna Initiative sponsored by the European Bank for Reconstruction and Development (EBRD), World Bank, International Monetary Fund (IMF) and European Investment Bank in 2008. The Vienna initiative provided support to host countries by ensuring that parent bank groups maintain their exposures and recapitalise their subsidiaries. Against that background, consideration might be given to additional safeguards before waiving, where appropriate, liquidity requirements within a group or capital requirements should the legal framework be changed at a next juncture. Those safeguards may include e.g. whether the structure of host Member States' banking system is sufficiently diversified or additional comfort that financing flows in the host Member State would not be impaired in crisis situation.

Reviewing the governance of the SRB

As part of the additional safeguards to provide reassurance to host supervisors, the Eurogroup (See Box 2) identified “a new governance of the SRM”. The existing governance of the SRM is already the outcome of a compromise between home and host concerns. In Commission’s original proposal, voting rights are split between the members of the Board (one vote), the home (one vote) and the host resolution authorities sharing one vote. These voting modalities have been replaced by a collegial decision making process whereby Board members took decisions in lieu of home and host authorities. Further safeguards may include a more direct involvement of both host and home authorities in decision making or a broadening of the SRB Board.

EDIS

Absent a third pillar of the Banking Union, host supervisors remain responsible for paying out depositors should a subsidiary be liquidated. As EBA Chair A. Enria put it, “*notwithstanding all the efforts to set up an integrated institutional setting for supervision and resolution, host authorities still fear that capital or liquid assets might no longer be available to cover for local losses or outflows as they fall due, especially during a crisis. They often argue that their concerns will not be allayed until the European risk sharing architecture has been completed, and only once a waterproof cross-border resolution framework is in place*”.

Pending the completion of EDIS, host supervisors’ concerns might also be averted should subsidiaries had the option to be covered by the DGS of the home Member State. That option does not exist under the DGS Directive. This would come down to treating subsidiaries as branches under DGS arrangements. This supervisory arrangement would offer an alternative to the ‘branchisation’ of subsidiaries while providing support to host Member States to allow for waivers to individual requirements. That arrangement - as opposed to ‘branchisation’ - would also keep macro-prudential powers of host Member States intact.

Insolvency law

The SRB coordinates the resolution of a group, but does not resolve a group as a whole. As E. Köning, Chair of the SRB put it in April 2019 in her Eurofi statement, “*in the current framework insolvency is clearly entity-specific as is NCWO” [Non Creditor Worse Off Principle]*. In that respect, the SRB called for further harmonisation of insolvency law to facilitate resolution planning for cross-border banking groups within the Banking Union. Absent such framework, the SRB warned against the risk that “*the focus during the resolution of banking groups will have to remain at entity leve*l”. This statement echoes the concerns voiced by Commission in its 2009 Communication on crisis management: “*the* fundamental *obstacle to cooperative resolution of a cross-border group is, inter alia, rooted in the territorial nature of insolvency law. If insolvency law is national, domestic authorities have a legitimate – as well as a strong political – interest to ring-fence the national assets of an ailing bank in order to protect national deposits and maximise the assets available to the creditors of the national entity*”. The Eurogroup report on EDIS also recognises the importance of further harmonisation of insolvency law to provide additional safeguards to host countries (See Box 2).

For further background information on the harmonisation of insolvency, see EGOV Briefing “*Further harmonising EU bank insolvency law from a prudential perspective”* and EGOV Briefing “*Liquidation of Banks: Towards a FDIC for the Banking Union* ?”

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