BRIEFING

Update on recent banking developments

Calendar week 40

This briefing gives an update on recent events and developments in the Banking Union, based on publicly available information.
The following topics are specifically addressed in the first section: banking statistics, non-performing loans, Wirecard, and the equivalence regime in financial services.,

The second section of this briefing gives a state-of-play on the Commission's work programme on some financial services: Green Finance Strategy, Fintech and digital currencies, the COVID-19 financial services package, Anti-money laundering framework, and the Capital Market Union.

1. Some recent developments

Banking statistics - in Q1 2020, COVID-19 impact still small

The spread of COVID-19, related generalised lockdowns and containment measures have had a massive impact throughout Europe, also in economic terms.

According to a preliminary estimate by Eurostat, seasonally adjusted **GDP decreased in the second quarter** of 2020 by 12.1% in the euro area and by 11.9% in the EU, if compared with the previous quarter. Those were by far the **sharpest declines** observed since time series started in 1995. In the first quarter of 2020, GDP had decreased by 3.6% in the euro area and by 3.2% in the EU.

The Eurostat release suggests that economic impacts of COVID-19. including on the banking sector, may become much more visible with some delay.

However, at present, the **most recent aggregate banking statistics** published by the ECB on 24 July for significant banks in the euro area, and by the EBA on 30 July for the largest banks in the EU, still refer to the **first quarter of 2020**. The ECB announced that it will release the next update for the second quarter 2020 on 6 October 2020.

Given the considerable overlap in the ECB and EBA samples, the observed developments usually show strong similarities. In any case, **EBA already noted a first impact of COVID-19** in the data for the first quarter 2020:

Average **capital ratios** (CET1) fell by 40 basis points (bps) to 14.6%, partially as result of an increase in risk-weighted assets, driven by a rise in credit risk and volatile markets (denominator effect), and partially as result of a decline in capital (numerator effect). Going forward, EBA expects further pressure on capital ratios, in view of the economic effects on some businesses of the COVID-19 spread and related containment measures.

EBA pointed out that the effects of COVID-19 on **asset quality** were so far hardly visible in the results of the first quarter 2020, and expects significant defaults only to materialise at a later stage. During the first quarter 2020, the **non-performing loan (NPL) ratio** remained broadly unchanged, at an average level of 3% (though there are notably large differences at country-level).

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In fact, even the sectors most affected by the pandemic - manufacturing, construction, accommodation and food service activities, transport, retail trade, as well as arts and entertainment - have **in the first quarter 2020 not yet seen a strong increase of NPL ratios**. Going forward, however, EBA expects those sectors - which even under normal circumstances typically have high NPL ratios - to experience further asset quality deterioration as result of the lockdowns.

Although the increase in NPL ratios is still to come, the banks' average **profitability has already seen a very significant decrease**, the return on equity (RoE) is down to a level of just 1.3% (the average level was 5.9% in the fourth quarter 2019, and in previous quarters ranged on average between 5% to 6%; though the differences are much larger at bank entity level).

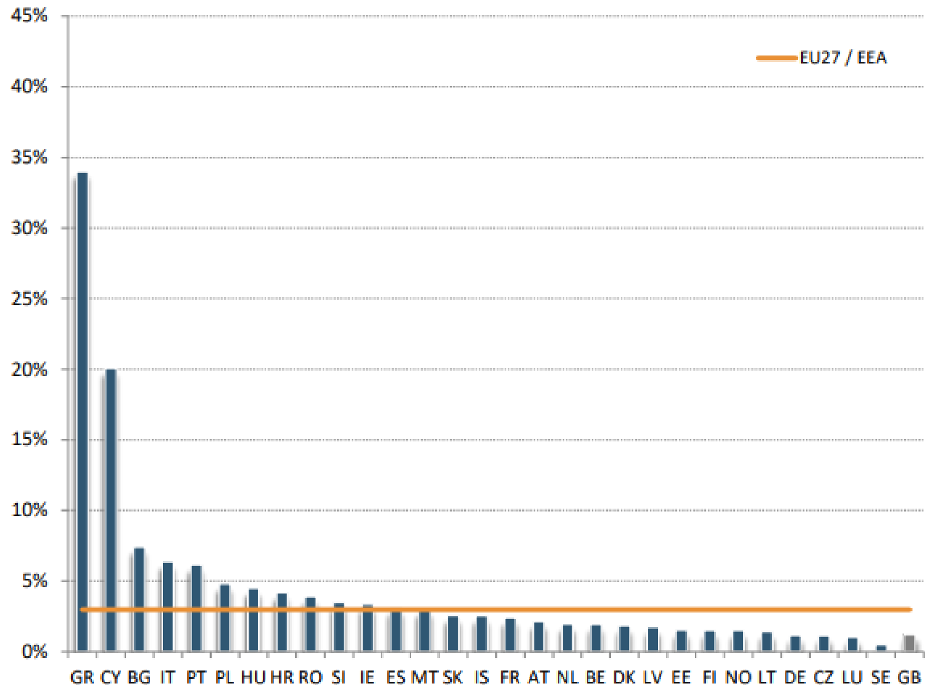
The strongest driver for that collapse in profits was the **significant fall in net trading income**, which fell by more than 300% due to market volatility. As not all banks engage in trading activities, that factor contributes to large differences in the profitability of EU banks.

Even though the NPL ratios have so far remained rather stable, the average cost of risk grew significantly from 50 bps to 81bps, resulting from the **strong increase in allowances for future credit losses**. EBA moreover observed a widening dispersion of that indicator, which it partially explains with a different portfolio composition and geographical diversification, but also with different perceptions of the COVID-19 impact by individual banks.

Non-performing loans

As abovementioned, during the first quarter 2020 the NPL ratio remained broadly unchanged, at an average level of 3%, though there are notably large differences at country-level (see graph 1).

Graph 1: Country dispersion of the NPL ratio (as of March 2020)



Weighted averages by country; source: EBA Risk Dashboard for Q1 2020

The most recent Monitoring Report on Risk Reduction Indicators was jointly published by the Commission, ECB and SRB in June 2020; the data on NPLs in that report still refers to the fourth quarter 2019.

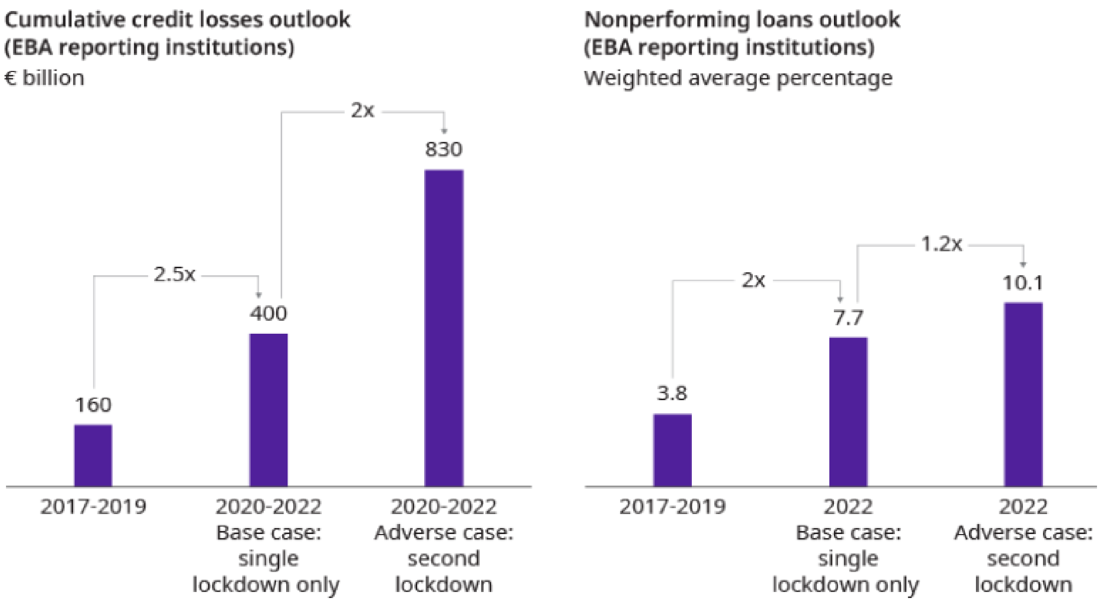
However, that report also lists two specific measures for NPLs that have been taken with regard to the COVID-19 situation, namely,

- the Commission's legislative proposal put forward on 28 April 2020 that introduced a more favourable treatment under the NPL backstop rule of loans that are subject to public guarantees granted in the context of COVID-19,
- and the ECB measures announced on 20 March 2020, allowing banks to fully benefit from guarantees and moratoria put in place by public authorities to tackle the current distress, and recommending that all banks avoid pro-cyclical assumptions in their models to determine provisions.

As aforementioned before, NPL ratios have in Q1 2020 remained rather stable, but banks have already strongly increased the allowances for future credit losses.

According to an estimate published by the consulting firm Oliver Wyman in July 2020, European banks may face more than EUR 400 billion of credit losses in the next three years (see graph 2); Oliver Wyman expects the NPL ratio to go above 7% in the base case, and above 10% in the adverse case (assumption: second lockdown).

Graph 2: Oliver Wyman's European banking credit losses outlook published in July 2020



Source: Oliver Wyman European Banking Outlook 2020

According to an ECB vulnerability analysis published on 28 July 2020, however, the euro area banking sector is resilient to the stress caused by COVID-19, even though the depletion of bank capital would be material if the situation worsens.

During the pre-pandemic siutuation, the High-Level Working Group on EDIS (HLWG) set out in June 2019 the goals for the Banking Union in the steady state, including goals for non-performing loans. In the HLWG report of December 2019, the HLWG found that good progress had been made in reducing NPLs, and recommended that the reduction of NPLs and adequate provisioning should continue.

Wirecard

The recently uncovered Wirecard case is sparking concerns around a number of issues and its full impacts are still unknown. This case raises a number of questions related to the adequacy and application of the accounting and auditing frameworks and anti-money laundering legislation. Moreover, it raises concerns regarding the relationship between supervised entities and national competent authorities; the legal framework for payments institutions; the short selling regulation and its impacts on market stability and liquidity; rules of conduct and investor protection; and ringfencing. Lastly, the collapse of Wirecard highlights the challenges in how to classify, supervise and regulate fintech. For some further details, see a previous EGOV briefing.

The policy response has been at both the national and EU level. In Germany, the Bundestag will hold a full parliamentary enquiry into the collapse of Wirecard, following a series of special hearings before the Bundestag Finance Committee. Moreover, Finance Minister Scholz has called for an overhaul of the audit/accounting supervisory framework.

At the EU level, there are concerns that the scandal has highlighted deficiencies in the EU regulatory framework with MEPs asking *"...the Commission and the EU competent authorities* ***to assess to what extent this scandal can be attributed to deficiencies in the EU regulatory framework in the area of audit and supervision****, and whether national and EU supervisors are sufficiently equipped to effectively supervise big cross-border financial institutions with complex business models...reiterates in particular its call on the Commission to look into ways of improving the functioning of the accounting sector, including through joint audits"* (ECON Report on further development of the CMU).

On 4 September 2020, Commission Executive Vice-President Dombrovskis replied to a letter that the European Parliament sent on 23 July, drawing some prelimary conclusions about the case.

The European Commission invited ESMA to conduct a fact-finding analysis of the Wirecard case. Consequently, ESMA will complete an assessment of the supervisory response in the area of financial reporting area by BaFin and the Financial Reporting Enforcement Panel (FREP)[1] by 30 October 2020.

Moreover, the Commission's recently launched new action plan on CMU (see below) commits to *"...carefully assess the implications of the Wirecard case for the regulation and supervision of EU capital markets and act to address any shortcomings that are identified in the EU legal framework"*[2]. Commission Executive Vice-President Dombrovskis has also pointed to the Commission's upcoming second monitoring report on the statutory audit market of public interest entities and recently launched study assessing how current EU audit rules work as avenues through which issues of relevance in the Wirecard case be addressed.

ECON Coordinators have asked for external papers addressing the various angles of the Wirecard case and proposing possible policy recommendations. These are expected by end of October. A plenary debate on the European Supervisory Authorities' role in the scandal was initially scheduled for the September plenary session, but is now provisionally scheduled for 5 October 2020.

Brexit and equivalence

Following the end of the transition period, the UK's provision of financial services will be subject to the relevant third-country rules from 1 January 2021, regardless of the outcome of any trade related negotiations on the future relationship between the EU and UK.

The EU may grant a limited number of equivalence decisions, where the regulatory framework is deemed aligned with that of the EU. This is of particular relevance to the areas of central securities depositories and central clearing counterparties (CCPs). The Commission, the ECB, the SRB and other stakeholders, have identified CCPs of derivatives as posing a possible financial stability risk to the EU. As such, the Commission adopted a decision on 21 September 2020 granting an 18 month time-limited equivalence decision for UK-based CCPs. In a press release, Executive Vice-President Dombrovskis stated that this decision *"...gives EU market participants the time they need to reduce their excessive exposures to UK-based CCPs, and EU CCPs the time to build up their clearing capability."* Subsequently, ESMA announced on 28 September that it will recognise three UK CCPs.

A Commission Communication published on 9 July 2020 indicated that the date agreed in the Political Declaration on the future relationship for finalising the equivalency assessments in the area of financial services, i.e. end of June 2020, was not met for most of the areas addressed. However, Executive Vice-President

[1] In Germany, enforcement of financial reporting of publicly listed companies is first done by FREP, a government-appointed privately organised institution, and is followed up by BaFin, which has sovereign authority.

[2] In the annex to the CMU action plan, the Commission considers that the Wirecard case raises questions around the effectiveness of Wirecard's corporate governance, external statutory audit and supervision of financial information.

Dombrovskis has since indicated that all questionnaires have since been answered, but that some equivalence decisions may be delayed due to the incomplete EU legal framework in some areas[3]. Lack of equivalence would require UK regulators to reach agreements with individual Member States for access to national markets. However, the ECB has warned that such arrangements "*...while useful for mitigating possible short-term risks, may give rise to level playing field or regulatory arbitrage issues and hinder the integrity of supervision in the medium term.*"

The Commission has published over 100 sector-specific preparedness notices, including in the field of banking and payment services (revised on 7 July 2020) and markets in financial instruments (revised on 13 July 2020). With COVID-19 shifting priorities, the ESMA, the ECB, the SRB and the EBA have recently urged financial institutions to finalise preparations ahead of the end of the transition period. Both the EBA and ECB have reiterated their expectation that authorised financial institutions should not operate as "empty shells", with the ECB stating that: *"all activities related to European products or European customers should, as a general principle, be managed and controlled from entities located in the EU."*

Box 1: Upcoming ECON hearing with Commissioner-designate McGuinness

On 8 September 2020, Commission President von der Leyen announced that Mairead McGuinness would replace Commissioner Phil Hogan, who resigned on 26 August 2020.

McGuiness, currently First Vice-President of the European Parliament, would take over the financial services, financial stability and capital markets union portfolio from Executive Vice-President Dombrovskis. According to her mission letter from Commission President von der Leyen, she would be responsible for completing the Banking Union; developing the green financing strategy; putting forward a fintech strategy and ensuring a common approach to cryptocurrencies; and developing a comprehensive approach to fighting AML. Other priority areas include completing work on the Capital Markets Union, with special focus on SMEs, and ensuring that the EU is more resilient to extraterritorial sanctions are other priority areas.

Under Article 246 TFEU, the replacement of an individual commissioner is not subject to a vote of consent by the European Parliament. Nevertheless, the procedure requires Parliament's consultation, which the Commission President should "seriously consider" before giving their accord to the Council decision. Commissioner-designate McGuiness will appear before the ECON Committee on 2 October 2020 where MEPs will evaluate if she is qualified to carry out the particular duties assigned to her. Once the hearing is closed and the Committee provides its evaluation, the Plenary will approve or reject the appointment in a vote scheduled for the 7 October. The Commissioner-designate was also required to respond to written questions submitted by ECON).

For more details on the appointment procedure, see EP homepage and EPRS briefing.

[3] See Footnote 21, Commission Communication on readiness at the end of the transition period between the European Union and the United Kingdom published on 9 July 2020 for a full list of where the Commission has stated that it will not adopt an equivalence decision in the short or medium term.

2. The European Commission work programme on financial services: where do we stand?

The von den Leyen Commission presented its annual work programme on January 2020. It evolves around a twin strategy - Green and Digital - as sources of sustainable growth. In the meantime, the COVID-19 crisis forced the Commission to amend its annual work programme in May. The amended work plan does not fundamentally change the financial services agenda, with the digital package remaining a priority (3Q2020), Capital Markets Union, Anti-money laundering and scheduled review of a number of financial services directives and regulations (MiFID and MiFIR, benchmarks, capital requirements framework). The COVID-19 crisis forced the Commission to put forward a number of targeted amendments to various financial services pieces (see below) as a complement to actions by EU and national supervisors (please see specific EGOV briefing for more detailed information). This chapter presents a summarised state of play of various pending and ongoing initiatives in the area of financial services.

Green Finance Strategy

Following upon the work by the previous Commission, President Von den Leyen implemented a "Green Deal" as the new growth strategy for the EU. Work at EU level has been evolving around the priorities recommended by a High Level Expert Group (HLWG) set up by the Commission in December 2016 whose recommendations were reflected in the Commission March 2018 Action Plan on Financing Sustainable Growth[4]. More recently, the Commission launched a consultation on a renewed sustainable finance strategy aiming at collecting views on a roadmap to increase private investment in sustainable projects and activities to support actions set out in the European Green Deal and to manage and integrate climate and environmental risks in financial system, together with providing additional enabling frameworks for the European Green Deal Investment Plan[5] (EGDIP).

The green agenda also comprises legislative work and two texts have been adopted at the end of the European Parliament's eighth term. The first amended the Benchmark Regulation by introducing EU Climate Transition and Paris-Aligned Benchmarks. The second introduced new disclosure requirements in the field of financial services and was adopted as Regulation 2020/852 and published in the Official Journal on 22 June 2020. In its Annual Sustainable Growth Strategy, the Commission points to the Taxonomy Regulation being used as a guide to assess reforms and investiments eligible under the Recovery and Resilience Facility.

Based on the taxonomy regulation and the work of a Technical Expert Group set up in June 2018, the Commission is currently working on a delegated act defining technical screening criteria for climate change mitigation and climate change adaptation. The Commission expects such act to be established by the end of 2020, in order to ensure its full application by end of 2021. For the four other environmental objectives, the taxonomy should be established by the end of 2021 and will apply by the end of 2022.

In parallel to the EGDIP, the Commission also put forward a proposal for a Just Transition Mechanism (with a Just Transition Fund to be agreed in co-decision between Parliament and Council) to mobilise investments to support workers and citizens of the regions most impacted by the transition.

[4] The Plan aims at (a) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth; (b) managing financial risks stemming from climate change, environmental degradation and social issues; and (c) fostering transparency and long-termism in financial and economic activity. It foresees 27 actions around 10 clusters linked to the three priories above. Actions include, for instance, establishing a common language for sustainable finance ("taxonomy"), creating EU labels for green financial products, clarifying the duty of asset managers and institutional investors to take sustainability into account in the investment processes and enhancing disclosure requirements, requiring insurance and investment firms to advise clients on the basis of their preferences on sustainability, incorporating sustainability in prudential requirements (including the so-called green supporting factor) and enhancing transparency in corporate reporting.

[5] The European Green Deal Investment Plan sets out the financing leg of the European Green Deal comprising, namely, an "*enabling framework for private investors and the public sector to facilitate sustainable investments*" and "*support to public administrations and project promoters in identifying, structuring and executing sustainable projects*". Both areas could relate to financial markets, as well as the proposals to be addressed through the InvestEU.

Fintech and digital currencies

As early as 2016, the European Parliament, based on earlier reports by the Commission and international organisations, suggested in its initiative report on virtual currencies, that "*addressing these risks [derived from using virtual currencies and distributed ledger technologies] will require enhanced regulatory capacity (...) and the development of a sound legal framework that keeps up with innovation, ensuring a timely and proportionate response if and when the use of some DLT applications becomes systemically relevant*". Such report also pointed out, however, that "*if a regulation is adopted at a very early stage, it may not be adapted to a state of affairs which is still in flux and may convey a wrong message to the public about the advantages or security of virtual currencies*". The Parliament also noted that existing legislation at EU level could be already adjusted for activities underlying virtual currencies but noted nevertheless that "*more tailor-made legislation might be needed*". The Parliament then recommended to the Commission to draw up a comprehensive assessment of virtual currencies and consider, if appropriate, to revise the legislative framework, and to draft guidelines to reinforce transparency on virtual currencies and relevant actors.

The March 2018 Commission Fintech Action Plan included references to crypto assets but considered that fintech did not warrant, at the time, a legislative initiate[6]. The Commission proposed, nevertheless, to assess the "*suitability of the current EU regulatory framework with regard to Initial Coin Offerings and crypto-assets more generally* (...)", mandated the ESAs to "*map current authorising and licensing approaches for innovative FinTech business models (...)* and to [where appropriate] "*issue guidelines on approaches and procedures or present recommendations to the Commission on the need to adapt EU financial services legislation*". The Commission also undertook to continue monitoring developments and work with international partners to assess whether regulatory action is warranted. Following up on the Action Plan and its Work Programme, the Commission launched in late December 2019[7] and in April 2020 public consultations seeking views on the way forward on crypto assets and on digital finance, and committed to come forward with a revised strategy by the third quarter of 2020.

On 24 September, the Commission put forward a Digital Finance Package comprising two communications, one setting out a digital finance strategy for the EU[8] and a second on digital finance and retail payments, and legislative proposals on crypto-assets, on a pilot regime for market infrastructures based on distributed ledger technology, and digital resilience[9].

The ECON report on "Digital Finance: emerging risks in crypto-assets - regulatory and supervisory challenges in the area of financial services, institutions and markets", scheduled for a vote in plenary on 5 October, contain a number of recommendations for the Commission, namely calling for legislative proposals in the area of crypto assets and cyber resilience.

Supervisors have also been working on fintech and crypto assets for some time now, both at European and international level[10].

6 "*... the Commission considers that the case for broad legislative or regulatory action or reform at EU level at this stage is limited*".

7 The Commission launched also late December 2019 an inception impact assessment where it recognised that digital assets and digital currencies in particular might evade existing EU legislation (at least when not covered by the definition of financial instruments) and pointed to possible needed amendments in a number of financial markets sectoral legislation.

8 The digital strategy aims at addressing four priorities: tackle fragmentation in the Digital Single Market for financial services; ensure that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency; create a European financial data space to promote data-driven innovation, building on the European data strategy, including enhanced access to data and data sharing within the financial sector; address new challenges and risks associated with the digital transformation.

9 Accompanied by proposals to amend a number of connected legal texts.

10 To name just a few, please see the January 2019 ESMA advice on Initial Coin Offerings and Crypto-Assets; the 2019 EBA advice on crypto-assets or the ECB Occasional paper on Crypto-Assets: Implications for financial stability, monetary policy, and payments and market infrastructures. The FSB led efforts by the Basel Committee on Banking Supervisors (BCBS), the Committee for Payments and Market Infrastructures (CPMI) of the Bank for International Settlements (BIS), the International Organisation of Securities Regulators (IOSCO), the Financial Action Task Force (FATF) and the Organisation for Economic Cooperation and Development (OECD) to assess and monitor developments on crypto assets within their respective mandates. The US Library of Congress provides an overview of bespoke national regimes.

Anti-money laundering (AML) framework

Under the umbrella of completing the Banking Union, the Commission adopted in May 2020 an action plan for a comprehensive EU policy on preventing money laundering and terrorist financing. This follows the December 2019 Council conclusions on strategic priorities regarding AML, inviting the Commission to explore further actions that could enhance the current framework. A September 2019 European Parliament resolution also called for more impetus to initiatives in this policy area. In particular, the resolution highlights the shortcomings in the current regulatory and supervisory architecture, and need for enhanced cooperation between the various AML authorities.

The 2020 action plan builds on the Commission's findings of the anti-money laundering package of 2019, and recognises the need for a framework that can evolve to take account of new innovations. It is structured around six pillars: i) effective implementation of existing rules; ii) a single EU rulebook; iii) EU-level supervision; iv) support and cooperation mechanism for financial intelligence units; v) better use of information to enforce criminal law; and vi) a stronger EU in the world.

Deliverables include presenting legislative proposals bringing about EU level supervision (organised either at the EBA or at a new entity) and establishing a support and coordination mechanism for FIUs. Moreover, the Commission recognises that *"EU AML/CFT legislation needs to become more granular, more precise and less subject to diverging implementations"*. It thus intends to reinforce and develop the **EU ALM single rule book** by identifying areas to be turned in a Regulation alongside an amended Directive, setting out new areas to be regulated at EU level, and identifying amendments necessary in respect of other existing legislation. The Commission intends to deliver on these actions by early 2021.

In addition to a public consultation on the action plan, the Commission issued a call for advice to the EBA on how to strengthen the EU legal framework on AML. The EBA's response was published on 10 September.

The Commission also recently published an assessment looking at whether Member States have duly identified and made subject to the obligations of Directive (EU) 2015/849 all trusts and similar legal arrangements governed under their laws.

For further details, see also EGOV briefing and Pol Dep A Study on Improving Anti-money Laundering policy.

Capital Market Union (CMU)

Despite significant progress since 2015, when the CMU initiative was launched, regulatory and other barriers still hamper smooth movement of capital, investments and related services. The initial 2015 action plan set out a programme of 33 actions (30 of these actions had political agreements by spring 2019, with only few legislative files still open from the original action plan). After the mid-term review of the CMU action plan in 2017, the Commission recalibrated the action plan after a public consultation. However, measures taken so far fall short of what is necessary for a complete and truly operational CMU. Remaining issues include the divergent insolvency regimes across the EU, burdensome cross-border taxation procedures, further strengthening of effectiveness and consistency in supervision, etc.

To further advance CMU, the Commission launched a high-level forum on CMU to identify long-term trends and determine areas where further action are needed. The forum started its work on 26 November 2019 and published its interim report on 20 February 2020. Its final report was published on 10 June 2020, and set out 17 recommendations for removing barriers in the EU's capital market. These recommendations fall under four categories: creating a competitive business environment; stronger and more efficient market infrastructure; fostering retail investments; and fostering a level playing field in the Single Market. The report underlined the importance of CMU in Europe's post-pandemic recovery. The forum's final report will feed into a new Commission CMU Action Plan, expected by end 2020.

Ministers discussed priorities to bring CMU forward in the 10 July ECOFIN meeting. Minister Scholz reiterated that strengthening CMU will be one of the priorities of the German Presidency.

ECON Committee has prepared an own initiative report on "*Further development of the Capital Markets Union (CMU): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation*", which is currently submitted to the 5 October 2020 Plenary Session.

On 24 September, the Commission has published an action plan in order to boost CMU. The Action Plan is comprised of 16 actions (e.g. simplification of public listing rules, revision of regulatory framework for securitisation, minimum harmonisation of non-bank insolvency law, etc.) that are aiming at three key objectives: *"(i) Ensuring that the EU's economic recovery is green, digital, inclusive and resilient by making financing more accessible for European companies, in particular SMEs; (ii) Making the EU an even safer place for individuals to save and invest long-term; and (iii) Integrating national capital markets into a genuine EU-wide single market for capital."*

Commission package COVID-19 financial services

On 24 July, the Commission put forward a package of legislative proposals under the umbrella of the Capital Markets Union fine-tuning a number of existing legal texts to address the COVID-19 crisis. It complements a banking package adopted on 28 April. The CMU recovery package contains targeted adjustments to the Prospectus Regulation, MiFID II and securitisation rules and aim at encouraging greater investments in the economy, allow for the rapid re-capitalisation of companies and increase banks' capacity to finance the recovery.

The Commission has also proposed amendments to the EU rules on financial benchmarks. The aim of the proposal is to ensure that when a widely used benchmark is phased out – as is now the case with LIBOR - it does not cause disruptions to the economy and harm financial stability in the EU, and fills in a gap in existing legislation.

All proposals are currently being discussed in Council and Parliament. Developments can be followed through the EU Legislative Observatory.

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