IN-DEPTH ANALYSIS

European Parliament

Banking Union: What next?

Further to the conclusions of the December 2018 Euro Summit, the High Level Working Group (HLWG) on European Deposit Insurance Scheme (EDIS) mandated by the Eurogroup has not reached, in June 2019, concrete conclusions, but outlined "where further work could be done in the coming institutional cycle" for a steady state Banking Union. This includes the design of EDIS, Home/Host supervisory issues, insolvency law and resolution as well as the regulatory treatment of sovereign exposures. As the Chair of the HLWG put it, "progress will be needed in all areas and therefore a comprehensive approach building on a package of measures is needed". This echoes concerns expressed by the Chair of the SSM: "the banking union is far from complete and the banking sector remains largely segmented along national lines. We need help from [...] legislators at the European and national levels to improve this situation".

This briefing summarises the key areas of possible regulatory initiatives with a view to further completing the Banking Union: (1) EDIS, (2) Further harmonisation of banking law ("single rule book'), (3) Home/host issues, (4) Resolution financing, (5) Further harmonisation of insolvency law, (6) Safe assets and regulatory treatment of sovereign exposures and (7) AML supervision. These issues are further explained in additional thematic briefings.

The Eurogroup is expected to report back again on these issues in December 2019 to the Euro summit. It plans to define the sequence of the decision making process, including the "development of a roadmap towards beginning political negotiations on a European deposit insurance system (EDIS)".

A comprehensive approach

In December 2018, the Euro Summit called for the work on the Banking Union to advance, and in particular, to define a roadmap for starting political negotiations on the European Deposit Insurance Scheme (EDIS) as proposed by the Eurogroup report on EMU deepening. EDIS is still the third and missing pillar of the Banking Union. The June 2019 Eurogroup and the subsequent Euro Summit have not made tangible progress in this field. As noted by Commission in its June 2019 Communication on EMU, "*despite the significant risk reduction that has taken place in the EU financial sector, certain stakeholders remain firmly opposed to the pooling of resources and risk-sharing at this point*".

The Eurogroup set up a "High Level Working Group" (HLWG) in December 2018 at the level of Ministries of finance' deputies to further progress on EDIS. As EDIS "*interacts with many other policies and parts of the Banking Union*", the Eurogroup assigned a broad mandate to the high level working group. The HLWG was reported to mainly discuss three key issues:

ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)
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PE 634.374- July 2019

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- The "architecture" of the banking union, including the regulatory treatment of sovereign exposures and ring-fencing in the Banking Union;
- The sequencing, in particular whether the two-stage approach suggested by the October 2017 Commission's Communication on the Banking Union should be followed[1];
- Conditionality, i.e. which specific benchmark should be met for a Member State to access EDIS.

The 2016 Council roadmap on risk reduction

The Council roadmap to completing the Banking Union adopted on 17 June 2016 conditioned further progress on risk sharing (EDIS and backstop to the Single Resolution Fund) on achieving risk reduction measures. These steps are outlined in details in EGOV Briefing "Completing the Banking Union".

The Eurogroup reaffirmed in June 2019 the importance it attached to the 2016 Eurogroup roadmap. As the Chair of the Eurogroup put it in his June 2019 letter to the President of the European Council: "*We recognise that further technical work will be needed on defining a transitional path to the steady state Banking Union for relevant elements and their sequencing, adhering to all the elements of the 2016 roadmap*".

In terms of risk reduction, the HLWG on EDIS is monitoring the following in particular:

- Non-Performing Loans (NPL): implementation of the Council NPL Action Plan[2].
- Minimum Requirement for own funds and eligible liabilities (MREL): Implementation of the Banking Package (CRD5/CRR2), including the accumulation/build-up of MREL liabilities;
- Build-up of the national Deposit Guarantee Schemes (DGSs) to the target level of covered deposits;
- Implementation of the anti-money laundering (AML) Action Plan.

While the terms of reference for the backstop to the Single Resolution Fund (SRF) condition its early introduction by 2020 on sufficient progress in risk reduction, as measured by quantitative targets in terms of NPL[3], conditions for a European Deposit Insurance Scheme are still being discussed (see below next section on EDIS). Risk reduction is assessed against a broader set of criteria (NPL, MREL, liquidity, leverage, capital). In the June 2019 monitoring report on risk reduction indicators, the Commission Services, the Single Supervisor Mechanism (SSM) and the Single Resolution Board (SRB) pointed to substantial progress, in particular:

- The average NPL ratio has decreased by 4.1 pp since Q4 2014, reaching 3.8% in Q4 2018. The NPL ratio decreased for almost all Member States, with a stronger decrease for Member States with high NPL ratios;
- In terms of MREL, it is noted that "overall, banks have made progress in building up the MREL capacity in order to reach the steady-state requirement as set by the SRB. The total MREL still needed to reach the level of that requirement is [... 7,3% of the total requirements".

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1 In that Communication, it is envisaged to introduce EDIS more gradually. More specifically, moving to the co-insurance phase could be conditional on progress achieved in reducing the level of NPLs and other legacy assets through an asset quality review.

2 For further background information on how Banking Union banks perform in terms of NPL reduction, see EGOV Briefing: "NPL in the Banking Union: stock-taking and challenges";

3 "to be assessed with the aim of 5% of gross NPLs and 2,5% net NPL on all banks in the BU, and on adequate build-up of bail-inable liabilities". For further details about the backstop to the SRF, see EGOV Briefing 'Completing the banking Union (2015-2019).

Towards a new roadmap and a new package of measures?

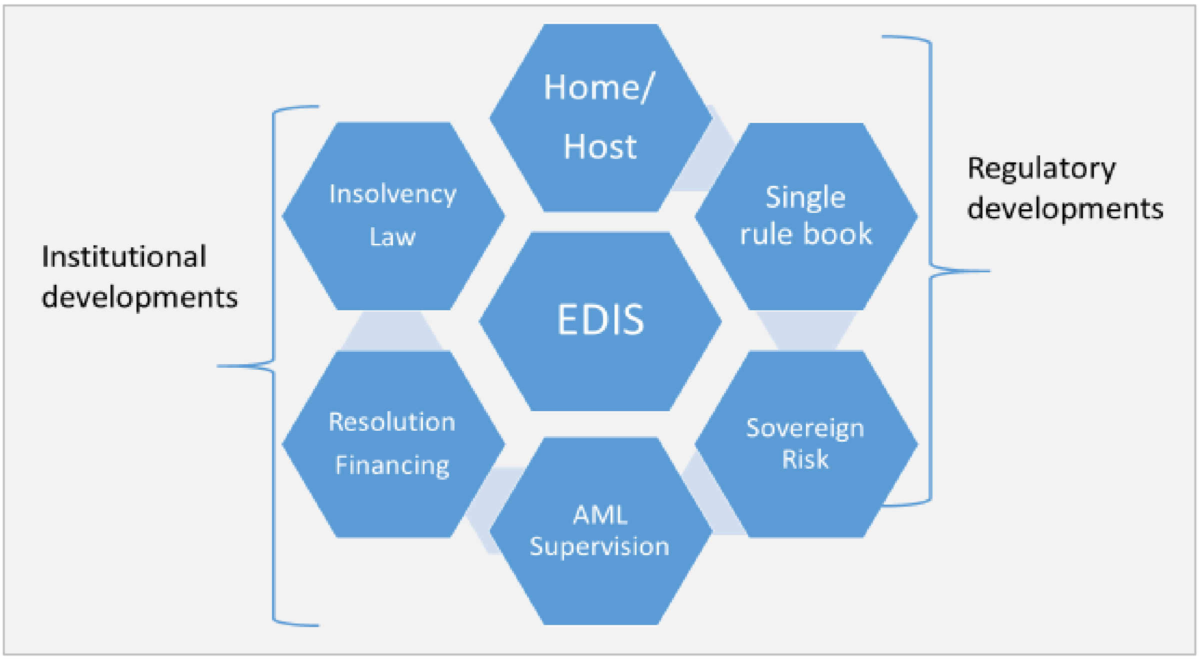
The report from the Chair of HLWG on EDIS outlined an "*illustrative transitional path to the steady state Banking Union*" consisting of four pillars (See Annex 2): (i) EDIS; (ii) framework for bank supervision, resolution and insolvency, including resolution financing arrangements and further harmonisation of insolvency law; (iii) sovereign exposures and financial stability implications and (iv) enhancing market integration by means of enhanced supervisory arrangements to defuse home/host issues.

These issues echo to a large extent the further "remaining steps towards completing the banking union" that A. Enria, Chair of the SSM outlined in its introductory remarks at the European Parliamentary Week in February 2019. He called for the following legislative actions in that respect: (i) integrated risk management for cross-border groups (i.e. Home/Host issue); (ii) higher degree of harmonisation ("the application of different rules and processes in each Member State unduly complicates the conduct of supervisory tasks and jeopardises the level playing field"); (iii) resolution financing (provision of liquidity to banks post resolution); (iv) framework for bank liquidation; and (v) a more European approach to AML.

The HLWG has not provided indications as to the sequencing of these measures. It must be noted that these buildings blocks are closely inter-connected, which may call for a comprehensive approach combining both institutional and regulatory developments (see figure 1). In particular:

- For some, EDIS would be instrumental in defusing home/host issues while for others facilitating an integrated risk management of banking groups should be a prerequisite for further headways in the completion of the Banking Union;
- Further harmonising insolvency law may be seen as a way to facilitate EDIS as this would harmonise the conditions for banks to be liquidated (and thus to use EDIS as a pay box, where appropriate). In contrast, others may consider that the harmonisation of insolvency law would further delay the implementation of a European Deposit Guarantee Scheme;
- Some condition EDIS on a regulatory treatment of sovereign exposures, while others consider that such a policy would constitute a major supervisory shift that needs to be coupled with the development of an EU safe asset.

Figure 1: Banking Union's building blocks



Source: EGOV

These building blocks are further analysed below. Annex 1 provides a summary of possible legislative actions that might prove necessary to further underpin a "completed" Banking Union.

The Commission has already mentioned areas where further regulatory actions would be appropriate, which is likely to feed into the next Commission's legislative agenda:

- **Sovereign risk treatment**: "Changing the regulatory treatment of banks' sovereign exposures and introducing a common safe asset are two measures that raise a number of economic, legal, political and institutional questions that will need to be tackled in parallel, in close cooperation with the Member States" (Commission's June 2019 Communication on EMU);
- **Home/host issue**: "*more should be done to remove unnecessary obstacles to the cross-border integration of the banking system*" (Commission's June 2019 Communication on EMU);
- **Insolvency law**: in its April 2019 report on the review of the BRRD, Commission has announced its intention to set up a working group involving representatives of the EP and Member States to further discuss a possible harmonisation of national insolvency laws "*taking into account the interaction with policy developments in relation to deposit insurance*";
- **EDIS and DGS**: Commission has launched a survey on a further harmonisation of deposit guarantee schemes (see below).

In her political guidelines for the next European Commission 2019-2014, the President-elect of the European Commission, Ursula von der Leyen, committed to "focus on completing the Banking Union", adding "we need a European Deposit Insurance Scheme. […] I will also put forward measures for a robust bank resolution and insolvency framework".

European Deposit Insurance Scheme

Stalled negotiations

The European Commission proposal articulated the introduction of EDIS in three stages: the re-insurance phase (2017), the co-insurance phase (2020), and the full insurance phase (2024). Discussion at the Eurogroup has come up against contrasted views among Member States both in terms of design and objective and in terms of conditions.

- In terms of design and objectives, as summarised by the June 2019 report of the Chair of the HLWG on 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*".
- In terms of conditions, the report of the Chair of the HLWG on EDIS notes that "*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*".

The European Parliament has not come to an agreement on the Commission proposal. The EP's rapporteur draft report (MEP E. De Lange, EPP) has not been voted through. The 2018 EP Banking Union report underlines that the process for establishing EDIS should continue for the completion of the Banking Union; recognises the benefits of risk sharing and further risk reduction".

For **further background information** on EDIS, see EGOV Briefing "Completing the Banking Union" (Update July 2019).

Further possible policy developments

In its April 2019 report on the BRRD review, the Commission announced that it will particularly engage in a comprehensive discussion of a further possible harmonisation of insolvency law, "tak[ing] into account the interaction with policy developments in relation to deposit insurance, including the work of the High Level Group established by the Eurogroup, and the review of the Deposit Guarantee Scheme Directive".

In September 2018, the Commission launched a survey on national options and discretions of the Deposit Guarantee Scheme (DGS) Directive in the context of EDIS. It must be noted that the DGS Directive feature significant national options. While some Member States only consider DGS as a "pay-box" (i.e. DGS only uses its funding to pay out depositors), other Member States involve DGS for early intervention purposes or use DGS to finance resolution (i.e. transfer of the deposit book from the failing institution to an acquiring bank) under national law in accordance with Article 10(6) of the DGS Directive. Those discussions are expected to take place in a working group involving Member States, representative of the European Parliament and other relevant stakeholders. In addition, a recent decision by the General Court that annulled a Commission decision considering illegal the aid granted to Banca Tercas, an Italian bank, will also be of interested to the developments in this area.

For further background information on how harmonisation of insolvency law (i.e. liquidation regime for banks) and deposit insurance interact, please see EGOV Briefing ("Liquidation of Banks: Towards a FDIC for the banking Union). This briefing compares the Banking Union arrangement with the crisis management framework in the US, combining deposit insurance and liquidation in a single institution (i.e. the FDIC). This issue is further discussed below (see Section on insolvency law).

Defusing home/host concerns and further integrating banking groups' risk management

As part of the broad discussions leading to the design of such steady state Banking Union, the June 2019 report of the Chair of the HLWG on EDIS highlights that "*the banking sector should be enabled to manage efficiently its financial resources within cross-border groups. (…) In order to achieve this, 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*". These concerns also feature in the June 2019 Commission Communication on EMU that recognises that *"while significant progress has been achieved in harmonising the Single Rulebook, more should be done to remove unnecessary obstacles to the cross-border integration of the banking system*".

Banking legislation features a delicate balancing act between the interests of host supervisors (i.e. keeping control over subsidiaries of a banking group on financial stability grounds) and home supervisors (i.e. allowing a more integrated risk management). As part of the latest banking package (CRD5/CCR2) agreed in March 2019, the proposal of Commission to allow the SSM to waive capital requirements at the level of supervisors met with stiff resistance of host authorities. In addition, while the SSM may decide to waive liquidity requirements at the level of a subsidiary under CRR, the Capital Requirement Regulation allows host Member States to apply intragroup large exposures limits that make liquidity waivers non-operational by limiting liquidity flows across legal entities of banking group.

It has been considered that "*fences [...] are out of place within a banking union where the concept of home and host supervisors has disappeared" (Andrea Enria, Chair* of EBA). On the other hand, host supervisors in the SSM share the view that additional safeguards would need to be further worked out to secure financial stability in host Member States (i.e. where subsidiaries of a banking group is located). Those safeguards include the establishment of EDIS, an enhanced governance of the SRB, a more robust institutional and legal framework to provide financial support from one entity to another, and, where appropriate further harmonisation of insolvency law.

The report of the Chair of the HLWG recognises the legitimate interests of host supervisors that would need to be factored in "*in a new balance in the home-host equilibrium" to "facilitate the withdrawal of then no longer justified national options and discretions*".

For **further background information**, see EGOV Briefing "Banking Union: defusing the home/host debate" (July 2019).

A higher degree of harmonisation: completing the Single Rule Book

Further harmonisation of banking law has been singled out as one of the remaining measures to complete the Banking Union. As explained by the Chair of the SSM, "*the smooth operation of the SSM requires a higher degree of harmonisation, as the application of different rules and processes in each Member State unduly complicates the conduct of supervisory tasks and jeopardises the level playing field*".

By turning the Capital Requirements Directive into a Directive (CRD) and a Regulation (CRR), the CRD4/CRR banking package in 2013 has gone a long way in further harmonising banking law. It removed many national options and discretions and provided directly applicable legislation to facilitate direct supervision of banks by the SSM. Nevertheless the Single Rule Book is still incomplete. According to the ECB, 175 options and discretions (O&Ds) are still available under EU law, 130 of which are available to national supervisors and are now applied in a uniform way across the Baking Union. As the President of the ECB put it "*the remaining O&Ds exercised by national legislation still stand in the way of a level playing field for banks, and so further legislative action is still needed*". In addition, in areas that have not been included in the Capital Requirements Regulation but still fall within the scope of the Directive (governance, Pillar 2, supervisory powers, authorisation), failing a single rule book, the SSM has to apply 19 different national rules.

The Council roadmap to complete the Banking Union of 17 June 2016 called on the Commission to table a legislative proposal on national options and discretions by end 2016. Likewise, the 2017 EP Banking Union report recommended that options and discretions be harmonised as much as possible. The 'banking package' proposed in 2016 and agreed upon in spring 2019 did not however cover these issues.

The completion of the Single Rule Book in banking would mean further harmonisation of banking law, in particular in the following areas:

- Extending the scope of CRR. In terms of priorities, the SSM identified "Fit and proper rules" that "are not harmonised at all". Other areas of further harmonisation could include governance and internal control rules that are not directly applicable but currently dealt with in CRD.
- Making national options a supervisory competence. CRR still includes a Member State option whereby intragroup large exposures rules may be imposed by national legislator to limit, where appropriate, the exposure of a subsidiary to its parent. That national discretion is closely linked to the home/host debate (see above).
- Enacting supervisory powers in Regulation. In its October 2017 report on the SSM, the Commission proposed extending the scope of directly applicable supervisory powers to facilitate supervision by SSM.

For **further background information**, see EGOV Briefing: "Banking Union: completing the Single Rule Book (July 2019).

Developing an EU Bank Liquidation regime

Further harmonisation of bank insolvency law in the EU has been advocated by the ECB, the SRB, the IMF and other international organisations. These organisations advocated the setting-up of new institutional arrangements in the Banking Union combining depositor insurance protection and liquidation:

- As part of its July 2018 assessment of the Euro-Area, the IMF recommended to entrust the SRB with administrative liquidation powers, along the lines of the US Federal Deposit Insurance Corporation (FDIC);
- The Chair of the SRB, Elke König put it, "the ultimate goal [...] must be to have in place an EU liquidation regime alongside an EU resolution regime". In a hearing at the ECON committee, she portrayed the FDIC model as a way to wind up small and medium-size institutions while protecting insured depositors;
- The Chair of the Financial Stability Institute (FSI) noted in a speech that "*There is a strong case to consider the creation in Europe of a common insolvency regime for financial institutions that are not subject to resolution. That regime should include common rules, perfectly compatible with the spirit of the resolution framework that would be applied by a single administrative authority. Following the example of other jurisdictions, that administrative authority could well be the SRB in order to ensure consistency of action in managing the crisis of different types of financial institution*" (F. Restoy, October 2018);
- In his introductory remarks at the European Parliamentary Week in February 2019, the Chair of the SSM A. Enria advocated for "a common framework for bank liquidation, enabling a smooth managed exit of defaulted banks from the market, as is the case in the United States, for instance".

The Eurogroup is also considering ways to improve the resolution framework. As reported by the Chair of the HLWG on EDIS, "*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 the same vein, the Commission announced in its April 2019 report on the BRRD review that it will particularly engage in a comprehensive discussion of a further possible harmonisation of insolvency law, "*tak[ing] into account the interaction with policy developments in relation to deposit insurance, including the work of the High Level Group established by the Eurogroup, and the review of the Deposit Guarantee Scheme Directive*". The Commission plans to establish a working group involving Member States, relevant stakeholders and representative of the European Parliament to further discuss its study on the differences between bank insolvency laws and on their potential harmonisation (to be published in autumn)[4].

In a paper commissioned by the ECON Committee ("An effective regime for non-viable banks: US experience and considerations for EU reform", July 2019), A. Gelpern and N. Véron argue that "*the examination of the US regime supports the proposition that completing the banking union and making the EU regime for non-viable banks effective may be viewed as two facets of the same policy effort. The shortcomings of the EU status quo are most compellingly addressed through centralization and*

[4] This study is being conducted in the context of a European Parliament Pilot Project on the Banking Union (Creating a true Banking Union - Research on differences in bank related laws and regulations in Eurozone countries and the need to harmonise them in a Banking Union).

empowerment of the SRB as the decision-making hub for a unitary regime that encompasses what is currently covered in EU law by resolution, bank insolvency proceedings, and deposit insurance".

Further harmonisation of bank insolvency law might be proposed incrementally with the view to develop over time a more integrated crisis management framework. That approach has been suggested by the Chair of the SRB: "*Proposals for harmonisation across the board will inevitably be fraught with political perils and resistance. An incremental approach – such as the one exemplified by the recent harmonisation of the ranking of unsecured debt instruments in insolvency – may be a more palatable solution. The ultimate goal, however, must be to have in place an EU liquidation regime alongside an EU resolution regime*".

For **further background information**, see EGOV Briefing "Further harmonising insolvency law from a Bank resolution perspective" (July 2018) and EGOV Briefing "Liquidation of Banks: towards a FDIC for the Banking Union?" (February 2019).

Towards new resolution financing arrangements?

The Eurogroup report endorsed by the December 2018 Euro Summit noted the "broad support for the assessment of the institutions that there are limitations in the current framework [for liquidity provision in resolution] which may hamper its effectiveness". The 4 December 2018 Eurogroup mandated further work on solutions, with input of relevant institutions, to be done during the first half of 2019 and reporting expected by June 2019. The June Eurogroup has achieved limited progress in this area.

At the ECON hearing in April 2018, Vitor Constâncio explained that the ECB needs a way to finance failing banks while they are being resolved, quoting the British and U.S. models as possible examples: "*The UK and U.S. have [...] a solid, whole process of resolution that includes those liquidity problems during that period of time, and I hope that Europe will get to some solution to this problem*". In the US and in the UK, liquidity financing in resolution is provided either directly by the Treasury or the central bank (Bank of England backed by the UK Treasury). These arrangements are meant to provide liquidity "in the necessary scale" and "for a sufficient period of time" to allow banks to make the transition to market-based funding. In contrast, the Banking Union framework has been qualified by Elke König as "*being geared towards addressing solvency issues more than liquidity*" (See April 2018 conference). The following example was taken: should a bank that is short of sufficient collateral be resolved on a Friday, bail-in would not provide on Monday additional collateral that would allow the bank to have access to central bank money.

In the absence of a Euro area treasury, alternative solutions are being thought through. As explained by the ESM at an online seminar on liquidity and resolution held in February 2019, the objective is to provide sufficient assurance to the ECB and national central banks on the quality of collateral. The following solutions have been discussed:

- A guarantee provided by Member States. Guarantee provided by Member States have been suggested in a paper commissioned by the ECON Committee as a temporary solution pending the completion of the Banking Union[5]. This solution has been discarded by the Chair of the SRB, as going against the very principle of the Banking Union. It would also further reinforce the sovereigns-banks loop;
- A guarantee provided by the Single Resolution Fund. That solution has been put forward in a paper commissioned by the ECON Committee[6];

[5] See Maria Demertzis, Inês Gonçalves Raposo, Pia Hüttl, Guntram Wolff (Bruegel).

[6] See Willem Pieter de Groen (CEPS). The paper proposes an European Central Bank liquidity facility with a Single Resolution Fund-guarantee as an alternative solution for providing liquidity to banks in resolution.

- A guarantee provided by the ESM. That solution would, according to the ESM, require a change to the ESM treaty. The draft ESM Treaty as agreed by the June 2019 Eurogroup does not feature such mechanism;
- Using SRF bonds as collateral for repos. Under this proposal, the SRB would, according to Politico, issue and hold long term bonds, instead of selling them to investors. The SRB could then lend bonds to a troubled bank in need of collateral. The banking industry - throughout contributions to the SRF - would face higher levies as the SRF would need to pay interest on the bonds issued by the SRB. The banking industry (i.e. the SRF) would ultimately bear the risk of a default;
- As an alternative, the ECB would buy bonds issued by the SRF. That solution would require changes to the ECB collateral policy together with the definition of appropriate haircuts, where appropriate.

According to the ESM, an alternative "private solution" has been tested. Under that proposal, the ECB would be able to use as collateral a "collateral pool" consisting of a proportion of High Quality Liquid Asset (within the meaning of the Liquidity Coverage Ratio) of banks of the Banking Union. Those unencumbered assets would remain ("earmarked") in banks' balance sheet. It has been suggested that those assets be 0% risk-weighted to make up for their use as collateral. The size of that collateral pool has been reported to amount to €284 billion (or 1% of banks' assets).

The Eurogroup has not reached an agreement yet and is expected to continue its discussion in the second half of 2019. According to the Letter of the President of the Eurogroup to the President of the European Council ahead of the June 2019 Euro-Summit, discussion would focus on "*the most consensual options for the refinement of current practices and on the proposals on SRB guarantees to the Eurosystem as well as the capacity of the SRB to provide collateral to banks in resolution*".

The question as to whether SRB guarantees - based on ex ante and ex post contributions to be levied from banks - would provide sufficient collateral to finance banks post resolution remains. However, the very existence of liquidity arrangements would provide comfort to interbank markets that would be more likely to provide liquidity post resolution.

For **further background information**, see EGOV Briefing "Towards new arrangements for the provision of liquidity in resolution? (July 2018 updated in July 2019).

A more European approach to AML

Cooperation on AML matters has been reinforced in the EU, following a number of high profile cases. The Commission presented in September of 2018 a Communication setting out a number of initiatives to reinforce money laundering. It mostly addresses three areas: (i) better incorporation of AML into supervisory actions (ii) better cooperation of AML authorities and prudential supervisors, and (iii) institutional changes. The 5th anti-money laundering Directive published on 30 May 2018 and being transposed by Member States (at the latest by 2020) also reinforces cooperation among relevant authorities namely by requiring the conclusion of an agreement on the practical modalities of information exchange between AML authorities and prudential supervisors. This MoU between the ECB and all relevant AML authorities was concluded in January 2019. Other initiatives taken by authorities include the ECB "AML office"[7] announced by the ECB last November in a hearing in ECON. More recently, the review of the European Supervisory Authorities framework adopted in Parliament

[7] "*This "AML office" is intended to fulfil three roles. First, it will act as a single point of entry with respect to the direct exchange of AML information between the ECB and AML authorities. Second, the AML Office will set-up and chair "an AML Network" among Joint Supervisory Teams in charge of the banks whose business model leads to a high level of money laundering risks. Third, it will act as a centre of expertise on the SSM related AML/CTF issues. On this basis, the AML Office will contribute to the development of ECB positions on AML topics.*" A. Enria, reporting to ECON at his hearing on 21 March 2019 signalled that the ECB was in the process of hiring staff for the AML office.

in April 2019 mandated the EBA with additional functions and powers on preventing money laundering.

Speaking to the Financial Times in March 2019, A. Enria noted, in relation to a number of banking problems connected to money laundering and fraud, that "*We are prudential supervisors, we are not primarily responsible for conduct. There are limits to what we can do. (...) But via our focus on governance and internal controls we can and should contribute to address these issues. (...) You ultimately need stronger European arrangements, though. We can help, but we cannot fully substitute for a lack of such arrangements*."

Proposals to further deepen the fight against money laundering could address two specific areas: (a) a more harmonised legal regime, namely, incorporating money laundering legislation into a regulation and (b) the setting up of a European authority in charge of money laundering.

Several authorities have been calling for both approaches to be implemented but the setting up of a new authority has been put off until Commission's report on AML due by January 2022 in accordance with the 5th AMLD. Further to the publication of Commission's communication and legislative proposal on EBA, the President of the ECB, at the EP ECON Committee September 2018 monetary dialogue reiterated the need for the EU to establish an EU Authority for AML supervision. In what concerns further harmonising anti money laundering legislation, one should note that in its December 2018 AML conclusions, the Council invited "*the Commission to propose, as necessary and in respect for the interinstitutional agreement on better law-making, longer-term actions to bring about further improvements in the prudential and AML frameworks identified on the basis of a thorough assessment, including inter alia a rigorous post-mortem exercise, in due consultation with Member States*", by Q3 2019.

The Eurogroup High Level Working Group on EDIS report of June 2019 refers to AML but with no significant actions foreseen, besides continued implementation of the Commission Action Plan.

For **further information on AML matters**, please see separate EGOV briefing "*Money laundering - Recent cases from an EU banking supervisory perspective*".

Equipping the Banking Union with a safe assets and the regulatory treatment of sovereign exposures

The financial crisis highlighted the need to address the so-called 'sovereign-bank' nexus, the interdependence of the financial health of banks and sovereigns, as ailing banks can degrade the financial standing of their home country and a weak financial position of a country can impact the solvency of banks. In particular banks that hold sovereign bonds or that have given loans to the central government are exposed to various forms of sovereign risk, including credit, interest rate, market and refinancing risk.

Nevertheless, the fact that sovereign bonds and other sovereign exposures are backed by central governments makes them comparatively safe. For that reason the regulatory treatment of sovereign exposures is usually more favourably than that of other asset classes. Most notably, the legal framework[8] includes a national discretion for jurisdictions to apply a preferential risk weight (a "zero-risk weight") for sovereign exposures denominated and funded in domestic currency, and sovereign exposures are exempted from the restrictions targeting concentration risk ("large exposures").

The debate around whether the preferential treatment in its current form is justified already goes on for quite some time. The European Systemic Risk Board (ESRB), for example, pointed in its study of March 2015 on the regulatory treatment of sovereign exposures to residual risk that puts the

[8] In the standardised approach, "*exposures to Member States' central governments and central banks denominated and funded in the domestic currency of that central government and central bank shall be assigned a risk weight of 0%*", according to Article 114(4) of the CRR. The internal ratings-based (IRB) approach allows for a similar treatment.

undifferentiated zero-risk weighting into question: "*Sovereign risk arises from the fact that a sovereign may, for a significant time, have higher expenditures than tax revenues and go so much into debt that, eventually, it finds it impossible or undesirable to pay its debts as they fall due or, more generally, may not comply with its contractual debt obligations*".

In January 2015, the Basel Committee on Banking Supervision (BCBS) set up a high-level task force to review the regulatory treatment of sovereign exposures and recommend potential policy options, which completed its review in December 2017 without making any changes to the current rules. That task force, however, published a discussion paper that suggests some potential ideas regarding the definition of sovereigns, revisions to the risk-weighted framework, the mitigation of concentration risk, revisions to the credit risk mitigation framework, additional Pillar 2 guidance and additional Pillar 3 disclosures.

The recent Communication from the Commission of June 2019 doesn't give much insight as regards which of those ideas might actually result in concrete proposals to change current rules; the Communication merely states that "*Changing the regulatory treatment of banks' sovereign exposures and introducing a common safe asset are two measures that raise a number of economic, legal, political and institutional questions that will need to be tackled in parallel, in close cooperation with the Member States*."

The second element mentioned in the quote above, "common safe assets", are conceptually also already on the agenda for quite some time. They have previously also been called Sovereign Bond-Backed Securities (SBBS), or before that European safe bonds (ESBies), but while the name has changed, the content remained quite the same. Those common safe assets are securitised financial papers that are offered to investors and are composed of at least two tranches, backed by a pool of sovereign bonds of all Euro area Member States. The senior tranche is meant to be safe for investors, while the riskier junior tranche shall absorb losses.

Common safe assets are presented by the Commission as a "*pragmatic solution to reduce the bank-sovereign loop*", as they are expected to help banks diversify their holdings of sovereign bonds. Diversified banks' balance sheets would loosen the feedback-loop between banks and their national sovereigns. Some critical points, however, put into question whether the proposal for common safe assets is really the best way forward to address the underlying problem; those critical points include the fact that the diversification of holdings of sovereign bonds in the banks' balance sheets can be directly achieved without common safe assets, that the cover pool of common safe assets may itself be insufficiently diversified, that the costs and risks related to the issuance of those assets represent an additional burden, that the perception in time of crisis may be different from that in a bullish market environment, and in particular that there might be a lack of suitable buyers for the most risky junior tranche, which might then end up in public hands.

For a **more detailed assessment** of the pros and cons of common safe assets, see the EGOV briefing "Are Sovereign Bond-Backed Securities ('SBBS') a 'self-standing' proposal to address the sovereign bank nexus?" of September 2018.

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Annex 1 - Remaining steps to complete the Banking Union

Remaining steps	Where do we stand?	Possible legislative or institutional developments
EDIS	> Negotiations are stalled: (i) no report voted at the EP and no conclusions reached at the June 2019 Eurogroup	> Eurogroup to report back again to the European Council in December 2019 > Commission to prepare a review of the DGS Directive to further harmonise national law, where appropriate
A more integrated risk management for cross-border groups	> Intragroup exposures are subject to large exposures limits that are a Member State option under CRR (i.e. not implemented by ECB) > No agreement on possible liquidity and solvency waivers for subsidiaries as part of the Banking package	> Absent legislative changes, some provisions of the existing framework, if implemented, do support further integration of risk management (e.g. intragroup financial support under BBRD) > Additional safeguards for host authorities as a *qui pro quo* to remove obstacles to the allocation of liquidity/capital within a group
Higher degree of harmonisation of EU banking rules	> While prudential rules laid down in the CRR (Capital Requirements Regulation) are directly applicable, the ECB has to apply national law transposing the CRD > The CRD includes critical supervisory issues, e.g. corporate governance, fit and proper, supervisory powers and pillar 2, which may vary from one Member States to another.	> Replacing Directive-based requirements by a regulation (to be decided, where appropriate, by new Commission) > EBA has particularly supported a regulation to conduct the fit and proper assessment.
Resolution financing	> No conclusion reached at Eurogroup in June 2019 as to how liquidity should be provided post resolution (as planned in the Eurogroup conclusions)	> To be discussed in S2 2019 by Eurogroup
"Framework for bank liquidation (as is the case in the US)"	> Commission has launched a study on a possible harmonisation of insolvency law, as part of an EP pilot project (to be released in Spring)	> To be decided by the new Commission, where appropriate
"A more European Approach" to AML	> ESA review includes an enhanced role for EBA in AML	> Commission's report due by January 2022 as to whether an EU body is needed
Safe assets and regulatory treatment of sovereign exposures	> EP has voted its report on Commission's proposal on SBBS (Sovereign-Bond Backed Securities) > Discussion has not started at the Council	> Possible new legislative proposal coupled, where appropriate, with other measures to bring about a European safe asset

Source: EGOV

Annex 2 - Illustrative transitional path to the steady state Banking Union

EDIS	Framework for bank supervision, resolution and insolvency	Sovereign exposures and financial stability implications	Enhancing market integration
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)	Continued monitoring of the application and further analysis of the bank recovery and resolution framework	Study and impact assessment of the different options for effectively addressing the sovereign-bank nexus, building on existing work.	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.
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	Measures on liquidity in resolution 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 Revision of the Banking Communication Revision of the scope of supervision, including on LSIs, and its relation to the Banking Union architecture	Gradual phasing in of agreed measures on sovereign exposures. Study of an RTSE for the steady state, including its implications for financial stability at the national and EU level, and of a new category of safe asset.	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
Fully fledged EDIS	Continued build-up of the SRF to the target level and implementation/operationalisation of the common backstop for the SRF	Full implementation of agreed regulatory treatment of sovereign exposures /whilst safeguarding financial stability, possibly by introducing a new category of safe assets	

Source: Report of the Chair of the HLWG on EDIS