# BANKING UNION AND OTHER CHALLENGES

Charter of Economists

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**This presentation was produced by the ECONOMIC AND FINANCIAL ADVISORY CENTRE AT THE APB, and particularly Catarina Cardoso and Vasco Gil.**

**During my presentation, I will be quoting many passages from the essay "EUROPE´S RADICAL BANKING UNION" by NICHOLAS VERON, Senior Fellow at BRUEGEL (Think Tank), (May 2015).**

**The main sources of this work were :**

- Website of Banco de Portugal - https://www.bportugal.pt/
- Website of the European Banking Authority - http://www.eba.europa.eu/
- Website of the European Commission - http://ec.europa.eu/
- Website of the European Central Bank - https://www.ecb.europa.eu/
- Website of the Single Supervision Mechanism (SSM) - https://www.bankingsupervision.europa.eu/
- Website of the Single Resolution Board (SRB) - http://srb.europa.eu/
- 2014 Annual ECB Report on supervision, March 2015
- Law 23-A/2015 of 27 March (transposing Directives 2014/59/EU - BRRD and 2014/49/EU - DGS)
- Decree-Law 157/2014 of 24 October (transposing Directive 2013/36/EU - CRD IV ) and Regulation (EU) 575/2013 of the European Parliament and of the Council (CRR)
- Regulation (EU) 1024/2013 of the European Parliament and of the Council conferring specific tasks on the ECB concerning prudential supervision of credit institutions
- Regulation (EU) 806/2014 of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms within the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund
- The Deposit Guarantee Scheme Directives (Directives 94/19/EC, 2009/14/EC and 2014/49/EU)
- EBA Guidelines on the Supervisory Review and Evaluation Process (SREP), December 2014
- Fifth Report of the Joint Committee of ESAs on the Risks and Vulnerabilities of the European Financial System, May 2015
- Survey de 2014 do Centre for the Study of Financial Innovation (CSFI) – Banking Banana Skins, April 2014

Fernando Faria de Oliveira

# Agenda

# Banking Union – Background (1/3)



Financial crisis in 2007

\+

Sovereign debt crisis in 2010

✓ Opacity of financial system

✓ Dispersal of supervisory structures

✓ Macroeconomic imbalances

**Needs**

- Standardise prudential rules
- Eliminate discrepancies in the Member States' supervision criteria
- Increase the solidity of the European banking sector
- Reduce interdependence between the banking sector and sovereigns

**European System of Financial Supervisors (ESFS*)**

- European Systemic Risk Board ESRB)
- European Banking Authority(EBA)
- European Insurance and Occupational Pensions Authority(EIOPA)
- European Securities Market Authority (ESMA)
- Joint Committee of European Supervisory Authorities (ESAs)
- National supervisory authorities

2011

## Banking Union

- 3 pillars:
  - ✓ Single Supervisory Mechanism
  - ✓ Single Resolution Mechanism
  - ✓ Deposit Guarantee Scheme
- More transparent systematic enforcement of the same rules for supervision, recovery and resolution of banks
- Deeper supranational integration in the financial sector under centralised supervision
- More concerted, timely, efficient action for banks experiencing difficulties with a view to protecting taxpayers' money

# Banking Union – Background (2/3)



## European System of Financial Supervisors (ESFS)

### Micro-prudential and behavioural supervision

**European Supervisory Authorities (ESAs)**

EBA ⇔ EIOPA ⇔ ESMA

Joint Committee of ESAs

**National supervisory authorities**

### Macro-prudential supervision

**European Systemic Risk Committee**

- ECB
- National central banks
- European Supervisory Authorities (ESAs)
- European Commission

**National supervisory authorities**

**President of the Economic and Financial Committee**

# Banking Union – Background (3/3)



## Banking Union

### Single Supervisory Mechanism (SSM)

✓

- Consisting of the ECB and national competent authorities (NCAs)
- Directly and indirectly supervises around 3,600 banks
- Classifies credit institutions as significant or insignificant. The former are under the direct supervision of the ECB, and the latter under the direct supervision of the NCAs
- Its bank supervision is effective and intrusive in order to guarantee stability, soundness and protection of the banking sector

- HQ in Frankfurt

### Single Resolution Mechanism (SRM)

✓

- Handles the centralised, organised, coordinated management of the resolution of credit institutions and mitigates the risks to the stability of the financial systems of the Banking Union Members States
- Reduces interdependence between the banking sector and sovereigns
- Creates a supranational mechanism for funding resolution

- HQ in Brussels

### Deposit Guarantee Scheme (DGS)

✗

- Protects depositors from the effects of the insolvency of a credit institution
- The publication of the DGS Directive in 1994 and the revisions that followed as were designed to harmonise national frameworks for deposit guarantee schemes
- In the 2014 revision, the Directive enshrined the role of assisting the DGS to the funding of resolution of credit institutions
- The plan to create a common European deposit guarantee scheme has no implementation date as yet

**Single Rulebook**

**SSM Supervisory Manual**

# SSM Structure and organisation (1/2)



## Organisational structure: 4 general directorates and 1 back office

### Direct supervision

**Microprudential Supervision I**

- ≈ 30 banking groups
- Staff allocated ≈ 200

**Microprudential Supervision II**

- ≈ 90 banking groups
- Staff allocated ≈ 200

**Joint supervisory teams (JST*)**

### Indirect supervision

**Microprudential Supervision III**

- Institutional and sectoral supervision
- Control of supervision and NCA relations
- Analytical and methodological support
- Staff allocated≈ 80

### Horizontal supervision

**Microprudential Supervision IV**

- Analysis of risk in the SSM
- Guaranteed quality of supervision
- Supervision policies
- Execution and sanctions
- Crisis management
- Internal models
- Staff allocated≈ 250

### Secretariat

**Secretariat of the Supervisory Board**

- Decision-making policy
- Decision-making process
- Staff allocated ≈ 30

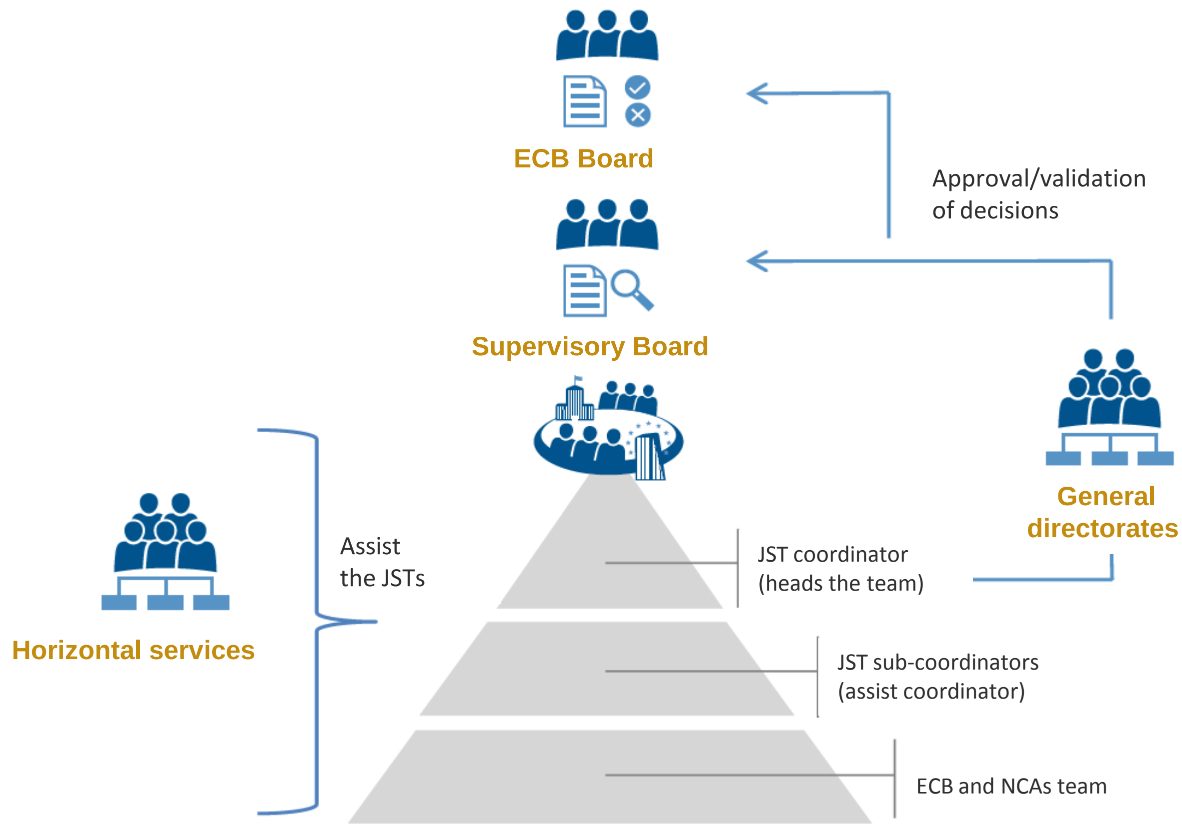
Source: ECB

# SSM – SSM Structure and organisation (2/2)



## Direct supervision : joint supervisory teams

- A JST is set up for each significant banking group
  - ✓ Each JST includes members of the ECB and NCAs (not only from the group's country but also from other Member States)
  - ✓ It is headed by an ECB coordinator
  - ✓ The size of each JST depends on the nature, complexity, scale, risk profile and business model of the institution in question
- They exercise permanent supervision of significant banking groups
- They implement decisions of the Supervisory Board and the ECB Board related to their remit
- They develop and implement a supervision plan for each significant credit institution

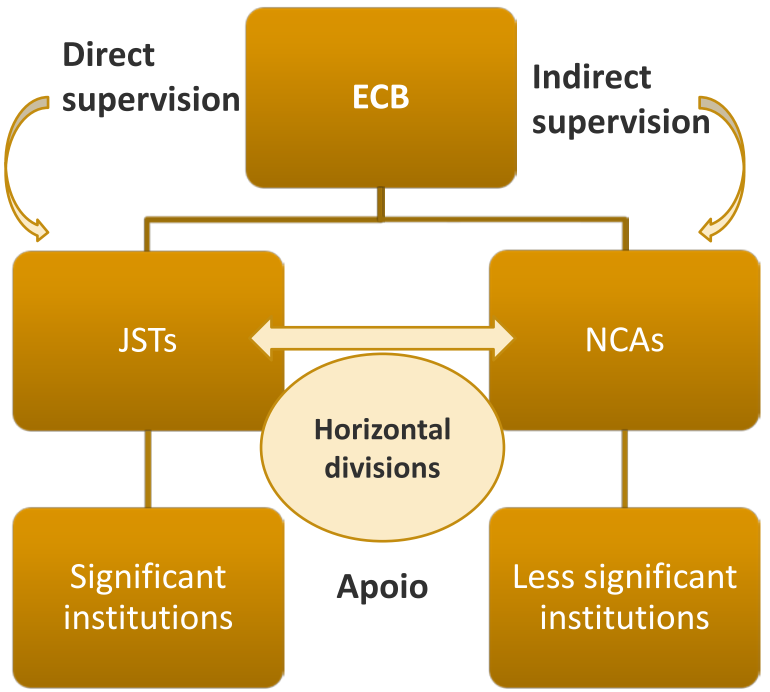



Source: ECB

# SSM – direct and indirect supervision



## I. Sharing competences in the SSM




Source: ECB

## II. Criteria for determining significant status

| | |
|---|---|
| **Size** | Total assets worth more than €30 billion |
| **Economic importance** | Total assets worth more than €5 billion and more than 20% of national GDP |
| **Relative national importance** | One of the 3 largest credit institutions in Member State |
| **State aid** | Requested or received financial assistance from the European Stability Mechanism or European Financial Stability Fund |
| **Cross-border business** | Total assets worth more than €5 billion and of cross-border over total asset/liability ratio higher than 20% |
| **Others** | The SSM can classify an institution as significant if it considers this necessary to guarantee coherent application of high standards of supervision |

# SSM – Supervision (1/4)

2015 | 3 June

**2013**

- Preparation of the Comprehensive Assessment
- Creation of SSM Regulation and SSM Framework Regulation
- Initial draft of the Supervision Manual
- Formation of committees and working groups made up of NCAs members
- Design of organisational structure, supervisory model and information reporting model

**2014**

- Classification of significant (120) and less significant institutions
- Appointment of President, Vice-president and Directors-General; recruitment of experts for SSM
- Formation of JSTs and their first meetings with banking groups and NCAs
- Preparation of capital and liquidity decisions in SREP (Supervisory Review and Evaluation Process)
- Comprehensive Assessment; Development of additional regulations, methods and processes

**2015**

- Publication of the EBA Guidelines for the SREP and consequent implementation of the Short-Term-Exercise for the 120 banks directly supervised in 2015 and 2016
- Formation of a working group to review national options and discretions
- Design and start of indirect supervision

Detail next 3 pages

# SSM – Supervision (2/4)



## Supervisory Review and Evaluation Process (SREP)

### I. Methodology

- **Feasibility and sustainability of the business model**
- **Suitability of internal control and governance system**
- **Suitability of capital requirements**
- **Suitability of liquidity/ funding requirements**

**Overall assessment of institution**
***Score from 1 (low risk) to 4 (high risk)***

**Supervisory measures**

- **Additional capital needs**
- **Additional liquidity needs**
- **Over supervisory needs (qualitative)**

### II. Implementation

- 2015/2016: around 120 directly supervised banking groups
- Information gathering (DG IV)
  - ✓ Reports from ICAAP and ILAAP (annual)*
  - ✓ Short-Term-Exercise: quarterly templates of quantitative data (credit, operating, market risks, interest rate, sovereign, liquidity and concentration risks and profitability projection chart)
- Calculation of score for each block (DG IV)
- Capital and liquidity assessment (JSTs):
  - ✓ Regulatory capital and liquidity (CRR/ CRDIV)
  - ✓ Challenge of banks' internal capital and liquidity estimates (ICAAP, ILAAP, peer groups)
  - ✓ Forward looking / stress testing analysis
- Final decision on supervisory measures

(*) ICAAP - Internal Capital Adequacy Assessment Process;
ILAAP - Internal Liquidity Adequacy Assessment Process

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# SSM – Supervision (3/4)

2015 | 3 June

## National options and discretion

### I. Framework

**Over 100 options…**

**Capital requirements Regulation (CRR)**

**Capital Requirements Directive IV *(CRD IV)***

**… that can be exercised by:**

**Competent authorities (BdP)**

**Member States**

**… to meet the specificities of each country.**

**Options cover a variety of issues of two main types**

- Capital requirements
- Liquidity /Leverage requirements
- Limit on major risks
- Credit risk
- Capital buffers

**Phase-in**

**or**

**Permanent**

### II. ECB action

**Assessment of importance of options = €125 bn of additional capital needs**

- Inconsistent application of options can:
  - ✓ Result in discrepancies in quality of capital
  - ✓ Jeopardise the level playing field between European banks
  - ✓ Put the correct operation of the Banking Union at risk
- When the SSM goes into operation, the ECB will revise different national options in two phases in 2015:

**1. Classification of options on the basis of their criticality and possibility of change**

**2. Final decision on options to be dropped, maintained or altered**

# SSM - Supervision (4/4)



## Implementation of indirect supervision

**SSM**

**Microprudential Supervision III**

**Supervision Control and NCA Relations**

- Point of contact with NCAs
- Cooperation with NCAs
- Supervision of NCAs' approaches to guarantee their quality and consistency, based on the principle of proportionality (under DG IV)

**Institutional and Sectoral Supervision**

- Monitoring banking subsectors and institutions in particular
- Assessment of possibility of ECB taking over direct supervision
- On-site inspections in articulation with DGV IV

**Analysis and Methodological Support**

- Development and updates of methodology for classifying institutions and :
  - SREP
  - Risk assessment system (RAS)

**Microprudential Supervision IV**

- Articulation with DG III divisions in guaranteeing quality of supervision, proportionality and local inspections

- Monitoring of status of less significant institutions (LSIs)
- Exchange of information and personnel between NCAs and between them and the ECB

- Regular reports on LSIs
- Draft decisions with a material impact on the LSIs and dismissal of members of the board of directors
- Periodic ex-post information on measures taken

**NCAs**

Planning of supervision under superintendence of DGIII

**Direct supervision**

**Less significant institutions**

**Next step**: review of classification of High Priority LSIs in each country

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# SRM – Overview

2015 | 3 June

## Goals of Single Resolution Mechanism

- ✓ To harmonise resolution processes for credit institution within the Banking Union
- ✓ To create a mechanism for funding supranational resolution
- ✓ To guarantee that supervision and resolution are exercised at the same level
- ✓ To align interests and ensure the sharing of losses in the resolution de banking groups that do cross-border business
- ✓ To foster impartiality in decision processes and limit the risks of possible indulgence by local supervisors
- ✓ To give preference to cross-border solutions rather than strictly national ones
- ✓ To reduce interdependence between the banking sector and sovereigns

## Purpose of resolution measures

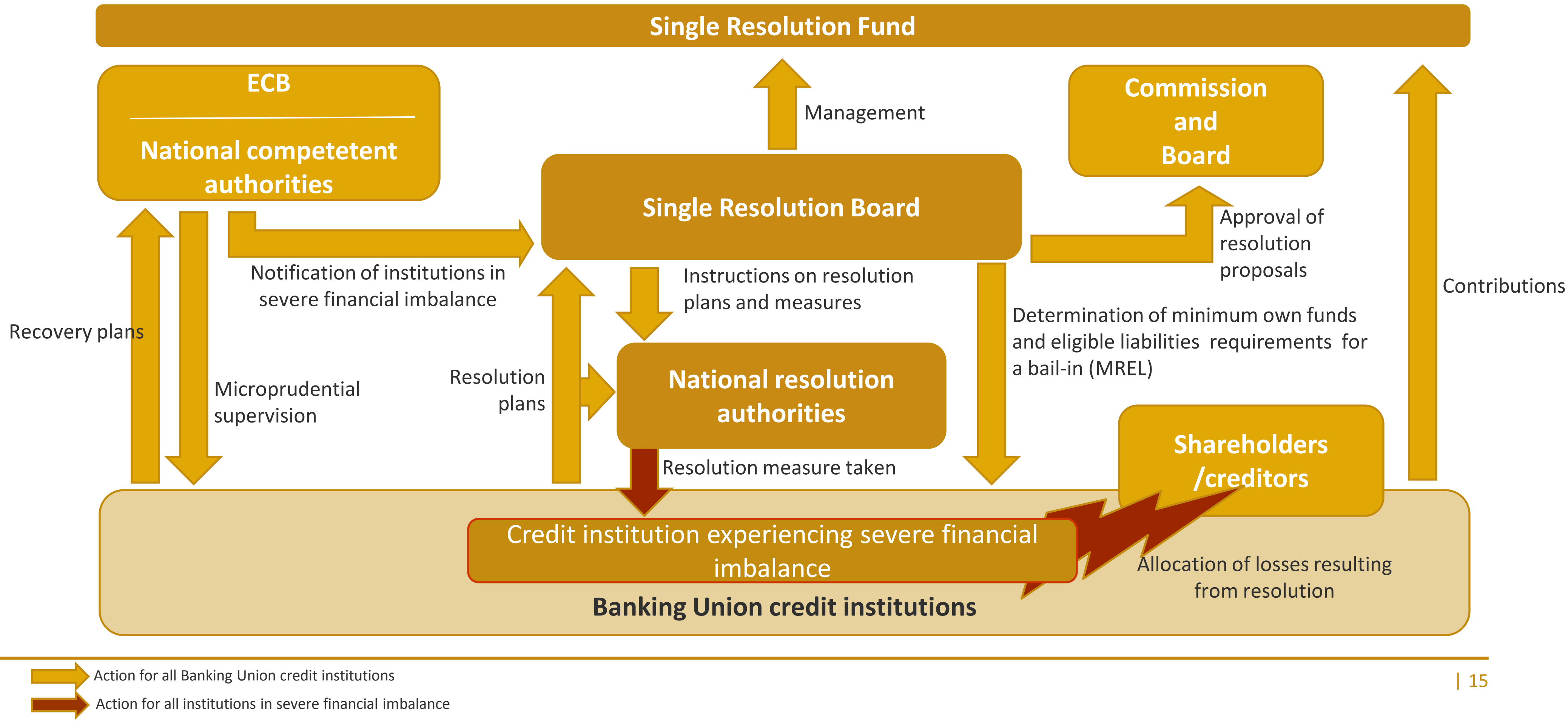
- ✓ Ro ensure the continuity  of financial services essential to the economy
- ✓ To prevent serious effects on financial stability
- ✓ To safeguard the interests of taxpayers and the exchequer and minimise  use of extraordinary public financial support
- ✓ To protect depositors whose deposits are guaranteed by deposit guarantee systems
- ✓ To protect funds and assets held by credit institutions on behalf of their customers

## Main guidelines in resolution

- ✓ The shareholders of the credit institution being resolved bear the main losses of the institution
- ✓ Its creditors then bear  the institution 's losses on an equal footing on the basis of a scale of their credits
- ✓ No shareholder or creditor can bear a loss o more then s/he would bear if the institution went into liquidation (non-creditor worse-off)
- ✓ Depositors bear no losses on deposits guaranteed by deposit guarantee systems

## How the Single Resolution Mechanism works

***"The Single Resolution Board has been created to respond to the Eurozone crisis and establishes the second pillar of the Banking Union. By avoiding bail-outs and worst-case scenarios, the SRB will put the banking sector on a sounder footing - only then, can we achieve economic growth and stability"*** *- Elke König, Chair of the Single Resolution Board*



## *Timeline for implementing the main measures in the Single Resolution Mechanism*

**19 Aug 2014**
Regulation of Single Resolution Mechanism (Regulation (EU) 806/2014 of 15 July came into effect

**Centralised resolution power can go to the Single Resolution Board**

**1 Jan 2015**
Start of application of the Bank Recovery and Resolution Directive (Directive 2014/59/EU of 15 May)

**Appointment of national reslution authorities**

**1 Jan 2015 – 1 Jan 2016**
Resolution plans drafted

(in accordance with Articles 8 and 9 of the do Single Resolution Mechanism Regulation)

**Information gathering and cooperation with national resolution authorities in planning resolution**

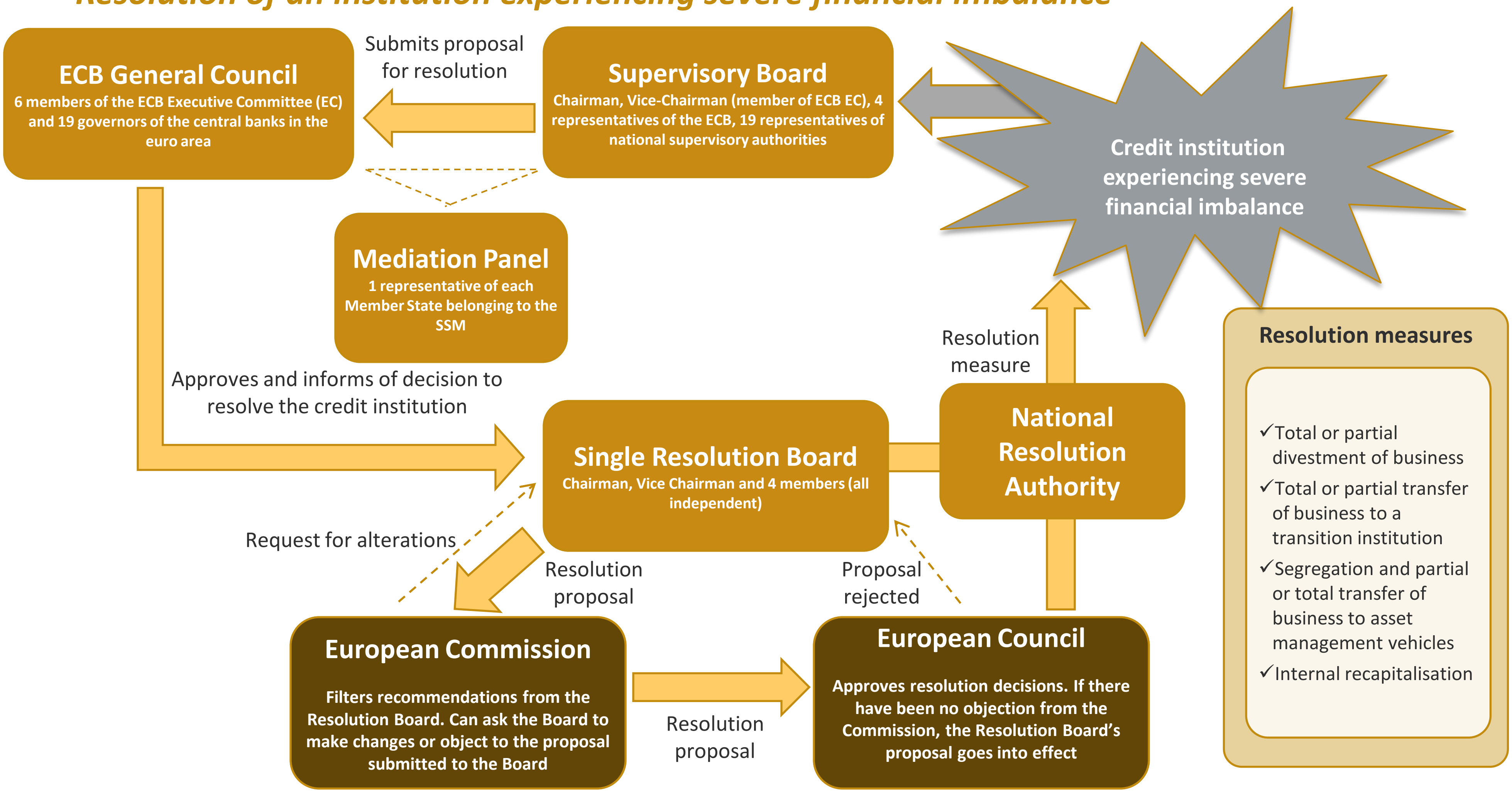
**As of 1 Jan 2016**
The Single Supervisory Board will go into full operation with powers and responsibilities for resolution

**The actual date will depend on the date of ratification by all the Member States participating in the Intergovernmental Agreement on transfers and pooling of contributions to the Single Resolution Fund**

**31 Dec 2024**
Minimum level of resources of Single Resolution Fund = 1% of total deposits guaranteed at all credit institutions in participating Member States

**The amount of the Single Resolution Fund is expected to reach 55 billion euros**

## *Resolution of an institution experiencing severe financial imbalance*



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# DGS - Overview

2015 | 3 June

## Directive 94/19/EC

- Ensures protection of depositors throughout the European Union and obliges the Member States to introduce at least one deposit guarantee system
- Sets the minimum level of protection at 20,000 euros per depositor and per institution
- Establishes obligations of information by credit institutions to customers on deposit protection rules

## Directive 2009/14/EC

- Amends the previous Directive
- Increases minimum protection to 50,000 euros and then to 100,000 as of 31 December
- Reduces deposit repayment time to a maximum of 20 business days
- Steps up obligation to inform and credit institutions must now inform customers if a financial instrument is not covered by the guarantee fund

## Directive 2014/49/UE

- Amends Directive 94/19/EC
- Establishes a harmonised level of coverage of 100,000 euros, regardless of the Member State's currency
- Reduces the repayment time to 7 business days
- Harmonises DGS funding methods
- Fixes a minimum target of DGS financial resources at 0.8% of guaranteed deposits, which must be reached by 31 December 2024
- DGS now play a role of providing assistance in funding the resolution of banks

## Funding of deposit guarantee systems

**_Ex-ante_ contributions (initial and periodic*)**

**If these prove insufficient…**

+

**Special contributions**

+

**Loans from gurantee systems of other EU Member States** (maximum 5 years)

+

**Loan from country's central bank and government** (in latter case can be guarantees)

* By decision of the national guarantee system, payment of up to 30% of annual contributions can be replaced by irrevocable commitments to pay (collateralised by blue chip securities)

# Risks to the European financial system (1/2)

**According to a survey by the Centre for the Study of Financial Innovation (CSFI) in 2014, the largest risk to the banking sector was regulation…**

**Greatest risks to banking sector**

1. *Regulation*
2. *Political interference*
3. *Macroeconomic context*
4. *Technological risk*
5. *Profitability*
6. *Fair price*
7. *Credit risk*
8. *Internal governance*

Source: *Banking Banana Skins 2014*, CSFI

***Main regulatory changes***

**It is not a question of a lack of regulation but rather the way it is designed and implemented**

**I. CRR/ CRD IV**

- Increase in regulatory capital
- Stricter internal governance rules
- Stricter requirements for management of internal risk
- New short and long-term liquidity requirements (LCR and NSFR)
- Definition of leverage ratio

**II. BRRD**

- Recovery plans
- Resolution plans
- Minimum own funds and eligible liabilities requirements (MREL)

**III. Additional reports**

- COREP (new requirements and templates)
- FINREP
- Measures for non performing loans (NPL)

**The way in which the regulation process has been defined is behind some of Europe's challenges**

# Risks to the European financial system (2/2)



## Financial integration – risks and vulnerabilities for the European financial system

### Monetary Union is still fragmented

**Each Member State is subject to its own monetary conditions** (liquidity, interest rates, lending conditions)

**The Eurosystem's institutional framework does not ensure macroeconomic or financial stability**

### Introduction of quantitative easing by ECB

- The ECB introduced QE as part of its monetary policy to achieve a target of 2% inflation
- It used QE to buy securities from banks, thereby increasing the money supply.
- This increase in liquidity encouraged the banks to grant more loans and boost economic growth.
- The ECB's aim is to expand its balance sheet from 1 billion to 3 bullion euros by the end of 2016.

**In spite of more regulation and supervision, there are still challenges arising from the...**

### Risks and vulnerabilities of the EU financial system

#### Macroeconomic risks

- Geopolitical uncertainty and the Greek crisis affecting the funding of the economy
- Volatile exchange rates causing an adverse reaction in capital movements
- Falls in energy prices reducing the quality of assets in the sector and having a negative impact on instruments indexed to oil
- Risks of using internal models to calculate capital requirements
- High impairments (+ €134 bn in the AQR)
- Low interest rates raising the risk of overvaluing assets
- Lower yields resulting in reallocation of investment to the capital market and funds: lower-risk, less liquid assets with longer maturities and more leverage

#### Operational risks

- reputational risk events arising from inappropriate commercial practices (less demand for services and greater political pressure on the sector)
- Inefficient internal control due to the lack of a harmonised approach to supervision of the conduct risk
- More complex IT resulting in greater, more frequent cyber attacks unavailable systems
- Pressure on net interest income preventing the reformulation of IT, which is generically associated with unsuccessful projects fairly long payback periods

Source: *Fifth report of ESAs on the risks and vulnerabilities of the financial system in the European Union*

# Challenges to the European financial system (1/2)

2015 | 3 June

## I. Business model

**Low economic growth**
(with impact on demand for financial services)

+

**Minimal interest rates**
*(potential for overvaluation of assets)*

+

**More demanding regulation**

**Pressure on profitability**

**Difficulty in generating capital**

**Redesign of business model**
(runoff of segments, fewer assets and risks)

## II. Level playing field and competititon

**Revision of national options by ECB with a view to harmonisation of regulation in European banks**

**… if not articulated with nacional legislation …**

**Maintenance of national accounting legislation (recognition of impairment) and tax legislation**

***--- No tax union---***

**Prudencial approach**
**one size fits all**
**with no regard for specificities of each jurisdiction**
(e.g. treatment of DTA)

**Potential adverse impact in some countries with effects on competition in Europe**

## III. Consolidation processes

**Pressure on profitability plus stricter regulations**

+

**Unattractiveness and non-feasibility of some business models**

**Consolidation processes**
*(e.g. among cross-border groups)*

**Greater systemic risk, higher pressure on resolution processes under the BRRD, especially for countries with low concentrations of IFs**

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# Challenges to the European financial system (2/2)

2015 | 3 June

## IV. Relations between the SSM and SRM

Minimum own funds and eligible liabilities requirements for bail-in (MREL)

Core Tier 1
+
Capital buffers
+
SREP buffers

Resolution authority reassesses decision of supervisory authority

Recovery plans + resolution plans

(Critical activities and strategic business lines)

Recapitalisation plans + Funding and Capital Plan

(business model)

Two authorities looking at the same reality in different contexts

## V. Cooperation between entitites

Potential impossibility of ECB reversing national legislation during revision of national options

**Decision made by SREP to achieve the same effect** (impact at prudential level and reversion of bank's expectations)

No effective compliance with the total separation of supervision (ECB) and regulation (ESAs) activities

+

Multiple reporting of the same reality (EBA, BCBS, ECB)

**Greater effort at reporting instead of effective analysis of risks** (challenge to risk management)

## VI. Formation of Capital Markets Union

Promotion of alternative sources of funding from other financial entities subject to less demanding supervision but with a close connection to the banking sector (some of them Shadow Banking Entities - SBEs)

SBEs characterised by Maturity/Liquidity Transformation activities and credit risk transfer

**Higher risk of contagion for banks and the economy as a whole**
(fire sales)

**Need to step up supervision of these entities to ensure mitigation of risk and a level playing field between these entities and the banks**

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