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The banking union is not centred round joint liability

The banking union encompasses a Single Supervisory Mechanism and a Single Resolution Board

The most important elements are in place for strengthening the common rulebook for banks and creating the Single Supervisory Mechanism and the Single Resolution Board. The health of the banking sector has improved in the banking union. Banks are better capitalised, and the number of non-performing loans has fallen.

Read more

Restrictive conditions for drawing on common funds for bank rescues

The Single Resolution Fund and the proposed joint deposit insurance scheme for the banking union are comparable with insurance against disaster. They are useful to have. But the likelihood of utilising them is very small. Owners and investors, in particular, will bear the losses of a distressed bank.

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No inclination for cross-border risk sharing

Minimisation of the risk of cross-subsidisation for bank rescues is inherent in the actual structure of the banking union. In the management of distressed banks so far in the banking union, no payouts have been made from the common funds contributed by all banks in the banking union.

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Neither the banking union nor the Economic and Monetary Union, EMU, is centred round joint liability. That is why concerns about "footing the bill" for bank rescues in other member states should not be the key issue in an assessment of the pros and cons of Danish participation.

The banking union with the Single Supervisory Mechanism, SSM, and the Single Resolution Board, SRB, for banks was launched in the 19 euro area member states four years ago. Other EU member states may join if they wish. Although some elements are still in the design and development phase, the largest and most essential elements are set, and the banking union has performed well.

The EU is currently discussing the further development of elements of the banking union under the heading of "risk reduction and risk sharing", cf. Chart 1.

The key issue in the debate about Danish participation in the banking union is the risk of funds being transferred from Denmark for bank rescues in other member states (cross-subsidisation). The rationale of the issues of risk reduction and risk sharing is to minimise this opportunity to transfer funds from banking sectors or taxpayers in one member state for bank rescues in another member state. The euro area member states have observed this principle in their management of the sovereign debt crisis in the euro area, maintaining that cross-subsidisation between member states was not to be an element of the solution.

Moreover, minimisation of the risk of cross-subsidisation for bank rescues is inherent in the structure of the banking union.

Improvement of the risk reduction framework by amendment of EU law

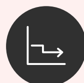
Risk reduction covers the joint effort to improve the health of the banking sector and thus reduce the risk of banks getting into difficulties and needing recovery or resolution.

The legislative part of this effort relates to all EU member states. In May 2018, the EU member states agreed on a comprehensive proposal for amendment of the two EU legal acts on requirements concerning capital adequacy, liquidity coverage, etc. The two legal acts are the Capital Requirements Regulation, CRR, and the Capital Requirements Directive, CRD.[1] The amendment proposal is now being negotiated with the European Parliament. Its key elements are:

- *Expansion of the CRR* to include a comprehensive framework for calculation of and own funds requirements for *market risk*. This will implement new Basel rules for market risk, with certain adjustments, into EU law.
- *Expansion of the CRR to include a new liquidity requirement,* the Net Stable Funding Ratio, NSFR. This is also a comprehensive framework which, with certain adjustments, implements a new Basel standard into EU law. The NSFR will supplement the Liquidity Coverage Ratio, LCR, which is already incorporated into the CRR and derived law.
- *A requirement for a leverage ratio of at least 3 per cent,* i.e. Tier 1 capital as a ratio of total non-risk-weighted exposures must be at least 3 per cent. The CRR already contained definitions, etc. of the leverage ratio, but now it is quantified and made into a binding capital requirement.

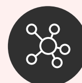
1 In November 2016, the European Commission issued a proposal and agreement was reached in the Ecofin Council on 25 May 2018, cf. press release (*link*). After final adoption, the amendments to the CRR will have direct effect in the EU member states. The amendments to the CRD must be implemented into national law to take legal effect.

Development of the banking cooperation as per 2018 Chart 1



RISK REDUCTION

- Improved banking sector health
- Tighter capital adequacy and liquidity rules
- Measurement using indicators
  - Capital adequacy and leverage
  - Liquidity coverage
  - NPL ratio
  - Eligible liabilities



RISK SHARING

- Build-up of a Single Resolution Fund
- Establishment of SRF backstop (the European Stability Mechanism)
- A European Deposit Insurance Scheme

Note: Risk sharing and risk reduction have been discussed in the Eurogroup and at Euro Summits throughout 2018, and the topic is expected to be discussed again at the Euro Summit in December 2018. All EU member states, including Denmark, participate in these discussions.

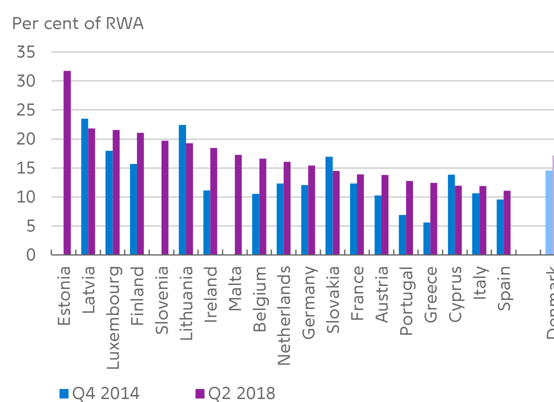
- *Adjustment of the macroprudential rules* in the CRD: The maximum SIFI buffer requirement is raised to 3 per cent (from 2 per cent) with an option to raise the requirement further, subject to authorisation from the European Commission.

In future, risk reduction progress is to be measured by selected key indicators

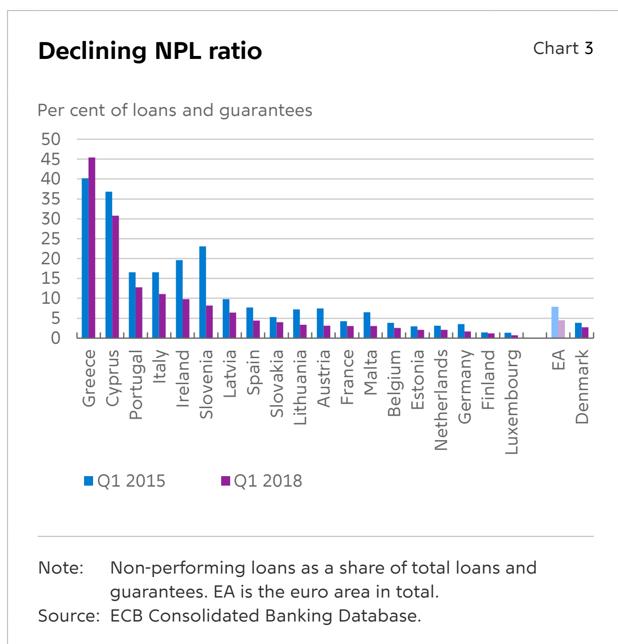
In recent years, the health of the banking sector has been improved considerably in the banking union. For example, the banks' capitalisation has improved, cf. Chart 2. Moreover, the share of non-performing loans of the loan portfolio, the NPL ratio, has fallen, cf. Chart 3. The volume of non-performing loans has been a major issue especially in several Southern European member states. Regarding this issue, further improvements are still required in some member states.

The euro area member states have agreed on future measurement of risk reduction progress in the bank-

Improved capitalisation Chart 2



Note: CET1 capital as a ratio of risk weighted assets, RWA, with fully phased-in EU capital definitions, etc. Observations are missing for 2014 for Estonia, Slovenia and Malta.
Source: EBA Risk Dashboard.



Note: Non-performing loans as a share of total loans and guarantees. EA is the euro area in total.
Source: ECB Consolidated Banking Database.

ing sectors of the member states by means of capital adequacy data and the NPL ratio as well as new leverage and liquidity indicators.[2] A further indicator concerns build-up of eligible liabilities which can be written down or converted into share capital if an institution becomes failing, cf. the recovery and resolution rules.

No inclination for risk sharing – neither in the EMU nor in the banking union

The conditions for joint liability in the banking union, i.e. the conditions for drawing on common funds that are not just from one member state, are called "risk sharing" in the current discussions in Brussels. The key issue of the discussion is when banks or government finances in one member state may become liable for problems in another member state's banking sector.

Consequently, risk sharing attracts considerable political attention. On the one hand, the common insurance elements are beneficial, as they prevent a banking crisis in one member state from spreading to other member states, and they reduce the interdependence between the banking sector and the central government in the individual member states. On the other hand, it may seem unfair if taxpayers and banks in one member state are to "foot the bill" for a banking crisis in another member state.

Given the functioning of the EMU in practice and the structure of the banking union, there is clear aversion to risk sharing, cf. Chart 4.

A case in point is the management of the sovereign debt crisis in the euro area and the borrowing programmes for crisis-ridden member states, with Greece as the most well-known example in recent years. Like the other programme countries, Greece received support on very lenient interest rate conditions and long maturities for sovereign loans. This saves Greece several per cent of GDP annually on interest payments, compared with a situation where Greece would have had to raise the loans on market terms. No transfer of taxpayer funds was involved in the assistance to Greece. Risk sharing actually in recent years consisted in capital injections from the euro area member states to the European Stability Mechanism, ESM, which issued AAA-rated bonds and granted the loans to Greece. In other words, other member states lent their creditworthiness to support Greece.

Another example of the low inclination for cross-border risk sharing is the crisis management so far of individual banks in the banking union.[3] In some cases, government funds have been used – as precautionary recapitalisation of one bank and to cover losses in connection with liquidation of two other banks. But the member state where these banks were domiciled, Italy, used only its own government funds. No common funds were used. Consequently, banks and taxpayers in the other member states of the banking union did not contribute to these solutions.

2 Cf. letter (*link*) from the President of the Eurogroup of 25 June 2018 to the President of the Euro Summit.

3 The three bank rescue occurrences in the banking union so far comprise precautionary recapitalisation of Banca Monte dei Paschi di Siena in Italy, resolution of Banco Popular in Spain and liquidation of Banca Popolare di Vicenza and Veneto Banca in Italy.

Addressing risk sharing

Chart 4

Neither the banking union nor the EMU is centred round joint liability

Practice so far in the banking union	**Potential risk sharing under current rules**	**Potential risk sharing under future rules**
No common funds have been used in crisis management of banks in e.g. Italy so far.	The Single Resolution Fund, SRF, does not become liable until after bail-in of 8 per cent of non-risk-weighted assets. *Utilised only in the event of extremely high losses.*	Proposal for a European Deposit Insurance Scheme, EDIS; no liability until loss of all capital, eligible liabilities, senior debt and uncovered deposits.

Borrowing programmes for euro area member states, such as Greece, are liquidity support.
No examples of fiscal transfers.

The access to funds from the banking union's Single Resolution Fund, SRF, is severely restricted. The SRF is financed by the banks and is in the process of being built up. A condition for accessing SRF funds in a crisis management situation is prior bail-in[4] equivalent to 8 per cent of the liabilities of the distressed bank. During the financial crisis from 2008, only one systemically important European bank had losses exceeding this threshold.[5] As regards the Danish banks overall, 8 per cent of their liabilities corresponds to around 28 per cent of risk-weighted assets, i.e. far more than the own funds requirement, which is 13-18 per cent of risk-weighted assets for the large banks. Furthermore, contributions from the SRF may not exceed 5 per cent of the bank's liabilities, and it constitutes a receivable, not an income transfer.

Negotiations have been underway in Brussels in 2018 about what to do in the extreme situation of the SRF running out of funds. It has been agreed that in such case it would be possible to borrow funds from the ESM, which is common to all euro area member states. The ESM will thus act as a backstop to the SRF. The more detailed conditions have not yet been finalised.

A European Deposit Insurance Scheme is still in the negotiation phase

Given the SSM and the SRB, it is evident that some kind of common deposit insurance scheme is also needed. The European Commission issued a proposal to this effect in 2015, but the negotiations have progressed slowly. The issue is politically sensitive as it seems to have a clear risk sharing element in prin-

4 This means covering losses and possible recapitalisation by writing down shareholders and writing down/converting creditors.

5 Cf. report from the UK Independent Commission on Banking, "Vickers Report", September 2011.

ciple. Some member states are concerned about the risk of their banks having to cover losses for depositors in other member states.[6]

A considerable effort has been made to address these concerns. For example, the Bank Recovery and Resolution Directive gives priority ranking to covered deposits in the creditor hierarchy.[7] This priority ranking considerably reduces the risk of any need to draw on the European Deposit Insurance Fund.

In April 2018, the European Central Bank, ECB, published an analysis, cf. Box 1, which shows that the need to draw on a future European Deposit Insurance Fund will only arise in extreme crisis scenarios with very high losses for the banks – higher than during the most recent financial crisis. And the Deposit Insurance Fund will not run dry even in such extreme situations.

The ECB analysis is based on a future completed EDIS with a European Deposit Insurance Fund, cf. the third and final development phase according to the Commission proposal of 2015. In 2017, the Commission declared itself open to adjustment of its proposal to provide for a slower transition from national deposit guarantee schemes to a gradually more joint scheme, where the transition is to be dependent on progress in the risk reduction area (cf. the above section).[8]

The ECB analysis of potential payouts from a Deposit Insurance Fund in the banking union Box 1

The ECB analysis[1] is based on balance sheet data for 1,675 banks in the euro area. The European Deposit Insurance Scheme, EDIS, cf. the Commission proposal from 2015, is assumed to be completed. The ECB simulates various scenarios in which the most risky banks are assumed to become distressed and resolved. The ECB then calculates the size of the payouts from the Deposit Insurance Fund as a result of the scenarios.

The result is that the banks' losses should be very large indeed to even prompt payouts from the Deposit Insurance Fund. For example, the analysis shows that even if the 10 per cent most risky banks lose 15 per cent of their assets, this will not prompt payouts from the Deposit Insurance Fund.

One reason is the requirement that losses are to be primarily covered by impairment of own funds and eligible liabilities. Moreover, the special priority ranking of covered deposits in the creditor hierarchy means that other senior debt and uncovered deposits are utilised before impairment of covered deposits in a resolution situation.

1 European Central Bank, Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?, *Occasional Paper Series*, No. 208, April 2018.

Limited significance of the insurance element in practice

All in all, it seems that the SRF and a future deposit insurance fund in the banking union will be used for bank recovery and resolution only in extreme – and not very likely – situations. In other words, risk sharing across member states is not likely to occur to any notable extent. Just as it has not occurred in connection with the borrowing programmes in the euro area.

This does not mean that these insurance elements do not matter. They need to be available and are useful as confidence-building measures. The SRF

6 Proposal … in order to establish a European Deposit Insurance Scheme, COM(2015) 586, 24 November 2015. Also called EDIS.

7 Article 108 of the Bank Recovery and Resolution Directive (2014/59/EU).

8 Communication of 11 October 2017 on completing the Banking Union, COM(2017) 592.

and a future EDIS should be regarded as a kind of insurance against disaster. They are important to have, but the likelihood of having to use them is very small.

Consequently, the insurance element and its counterpart – the fear that banks and taxpayers in one member state will have to foot the bill for bank rescues in other member states – should not be the key arguments when assessing the pros and cons of Danish participation in the banking union.[9]

9 For an overall assessment of the pros and cons of Danish participation in the banking union, see Danmarks Nationalbank, Danish participation in the banking union, *Danmarks Nationalbank Monetary Review,* 4th Quarter 2014.

ABOUT ANALYSIS

As a consequence of Danmarks Nationalbank's role in society we conduct analyses of economic and financial conditions.

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