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Final steps towards EDIS: how the Banking Union can be completed

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Abstract

The completion of the banking union is currently one of the key issues in which the economic debate within the European Union is concentrated. The implementation of the third pillar of the banking union, called EDIS, remains one of the critical aspects that needs to be addressed in order to achieve the level of financial harmonization that has not yet been achieved with the two previous pillars. This working paper analyses the main proposals to minimize the financial, economic and legal differences that hinder the creation of EDIS. Among these proposals are the creation of new financial instruments called Sovereign Bond Backed Securities (SBBS), based on a "securitization" of government bonds issued by European countries, and the introduction of new policies for banks to measure government bonds held, with the aim of reducing the links between these banks and the sovereign risk. In addition to the legislative and financial analysis, the working paper aims to observe these proposals also from a critical aspect trying to highlight the merits and defects, since on the one hand these proposals can prove to be a great opportunity, on the other hand they risk leading to an inevitable failure the whole process of banking union.

Keywords: Banking union, EDIS, Sovereign Bond Backed Securities, Sovereign risks, Banks.

Introduction

Following the 2008 financial crisis, the European Union has undergone a complete change in financial regulation. Before the financial crisis, banking supervision rules, bank resolution rules and bank deposit insurance against the bankruptcy of a financial institution were subject to the rules of each state. The high fragmentation within the borders of the European Union had important distorting effects on the perception of banking risk among the various institutions in the EU. With the outbreak of the sovereign debt crisis, many Countries and banks were penalized by this fragmentation, risking not only to further deteriorate the already precarious financial situation, but also to be the victims of speculative attacks by the market. To face this fragmentation and the relative problems the European Union starts its project of a banking union in 2012. The banking union process was decided to harmonize these rules between the various member countries of the union. This process is based on three pillars: one single mechanism of banking supervision, one single resolution mechanism for banking crises and one single insurance deposit to protect bank deposits in case of a bank's failure. While the first two pillars have been realized between 2014 (when the Single Supervisory Mechanism started), and 2016 (when the Single Resolution Mechanism was applied in its entirely), the implementation of the third pillar is still missing, even if the European Commission proposed its creation in 2015. So, why the third pillar is still missing? Which steps have been taken to complete the banking union and what proposals have been made to resolve different views within the European Union and to establish EDIS?

The paper describes briefly what is EDIS and why it should be implemented and how it should guarantee European bank deposits alongside the GDSs (Guarantee Deposit Schemes). Then, the links between European Banks and their home country will be analysed, looking at the proposals of the EU to weaken these links, and looking at how these proposals could bring some EU Members into trouble.

EDIS Regulation and Functioning

The idea of having one common schemes of deposit insurance between EU Member states is present in the original deposit guarantee schemes directive of 1994. This directive states that "Each Member State shall ensure that within its territory one or more deposit-guarantee schemes are introduced and officially recognized"[1]. This directive established the creation of the Deposit Guarantee Scheme. A Deposit Guarantee scheme (DGS) can be defined as a fund whose scope is to reimburse bank deposit holder in case of a bank failure. The most important principle of the directive 94/19/EC is that these funds must be financed by private institution (banks in particular) and any taxpayer funds must not be used. Each country must have at least one deposit Guarantee Scheme (DGS) composed by all the banks of the Member States, and the Directive 94/19/EC provides the minimum level of harmonization between EU Members States. During the 2007-2009 crisis the directive proved to be disruptive for financial stability, and so it was implemented by the Directive 2014/49/EU, which increased the deposit's level of protection (from 50,000€ to 100,000€) and increased the level of harmonisation inside the European Union. This directive also strengthens the collateral of a DGS by imposing that each DGS covers the possible losses of a bank that come from its branches that operate in a foreign country.

This scheme is not totally safe as highlighted by the proposal of regulation COM(2015) 586 final: the European Commission reported as the DGS are still "vulnerable to large locals shocks"[2]. So, by amending the Regulation 806/2014 the European Commission aims to create a single deposit to insure the bank deposit in all the Member States. The European Deposit Insurance Scheme (EDIS) would apply to deposits below €100,000 of all banks in the banking union (regardless of the location of the bank), and will reduce the influence of macroeconomic shocks, in addition to increase the "resilience"

[1] Art. 3 Directive 94/19/EC
[2] COM(2015) 586 final

in facing new crisis. One critic that has been moved against the DGS is that they are too much influenced by the macroeconomic background of the country in which they operate. Even if the DGS system works in the same way in all the countries in which the directive has been received, there are still differences in favour of some countries and there are disadvantages for other members.

As stated in Article 2.2 of the proposal, EDIS will be developed in three stages. In its first stage, which will last for three years from its application, EDIS will provide liquidity in case of a liquidity shortfall and will absorb losses of a DGS (art. 41a) up to 20%. In the second stage the DGS will be co-insured with EDIS: during this phase will be possible for a DGS to ask for a funding and a loss cover. The percentage of the loss borne by a DSG covered by EDIS will increase by 20 percentage points for each year of the co-insurance phase (since this phase will last four years, at the end EDIS will absorb 80% of the loss). In the last phase, a deposit guarantee scheme will be fully insured by EDIS, meaning that it may ask for 100% of liquidity need and may request to cover all the losses borne. This framework highlights how much the DGS will keep playing a key role in insuring bank deposits, and how they will be integral part of EDIS. The main function of a DGS will be to cover up the losses in the re-insurance period. In the co-insurance period, coverage of deposits would be shared between the Deposit Insurance Fund and the national DGS. A European Deposit Insurance Fund will be established to insure national deposit guarantee schemes. The European deposit insurance fund will be finance by banks through ex-ante contribution, keeping into account its risk profile. According to the commission proposal, the EDIS will be managed by the Single Resolution Board that will also have supervision tasks (over decisional duties) on banks. The commission identified this third and independent authority as the best one to make EDIS works correctly, since bank deposit insurance occurs within a broader scope of the resolution of a banking crisis, for which the Single Resolution Mechanism has been established.

The DGS will keep playing a crucial role in insuring bank deposit: these funds will be the one which will trigger the process of reimbursement of the amount of a bank deposit holder, in case this bank deposit had less than 100,000€. The insurance process is made of different phase which are explained in articles 41l and following of the same Commission proposal. When a DGS has been informed or has become aware of the possibility that a credit institution is likely to result in a pay-out events, the article

41k states that "it shall inform the Board about such circumstances without delay if it intends to request coverage by EDIS. In this case the participating DGS shall also provide the Board with an estimate of the expected liquidity shortfall or liquidity need"[3]. If the DGS incur in a pay-out events it shall immediately advise the Board providing all the information pointed in article 41l second paragraph: "(a) the amount of covered deposits of the credit institution concerned; (b) its available financial means at the time of the pay-out event or use in resolution; (c) in case of a pay-out event, an estimate of the extraordinary contributions it can raise within three days from that event; (d) any circumstances which would prevent it from meeting its obligations under national law transposing Directive 2014/49/EU and possible remedies"[4]. This information is necessary "to allow the Board to assess whether the conditions for the provision of funding and loss cover in accordance with Article 41a, 41d and 41h of this Regulation are met". The article 41m says that the board has 24 hours to verify that all the conditions to obtain the EDIS insurance are met and will determine the amount that EDIS will provide to the DGS. Article 41n explain two provisions for the funding: "(a) the funding shall be provided in the form of a cash contribution to the participating DGS; (b) the funds shall be due immediately after the determination of the Board in Article 41m"[5]. After having provided the DGS with the funds necessary, the Board will monitor closely the use of the funds as states in article 41p paragraph 1, and it will ensure that the DGS will pay EDIS back on a pro-rata basis (article 42p paragraph 2).

The commission proposal to establish EDIS doesn't seek to just protect European citizens by banking failures. As state in the proposals, one goal of this proposal is also to increase the European monetary union, and especially to weaken the links that banks have with their home country. Many proposals have been done to reduce these links, but many of them have been blocked for political and technical reasons.

[3] Art. 41k, COM(2015) 586 final
[4] Art. 41l, COM(2015) 586 final
[5] Art. 41n, COM(2015) 586 final

The "Doom-Loop"

European banks are affected by sovereign credit risk due to their high exposure on sovereign bonds. Total exposure of the EBA-covered large banking groups in the euro area to sovereign debt amounts to 25-40% of home country GDP in most countries[6]. The main reason for which banks hold such a huge amount of sovereign bonds in its asset can be tracked in the many advantages that these assets guarantee to a bank: sovereign bonds were considered "zero-risk" assets before the crisis and due to this classification, they carried a zero-risk weight in the calculation of capital requirements and could be used as collateral for accessing to the ECB's refinancing operation. Many banks bought sovereign bonds before the crisis and kept doing the same even when the crisis of euro shown how these assets were not zero-risk. Many banks suffered and were saved by governments because of the deterioration that hit sovereign bonds of countries like Italy, Greece, Spain, Ireland and Portugal showing how these banks were linked to the macroeconomic background of some European countries. The so called "doom-loop" (i.e. the link between banks and countries) is considered a high risk within the European Union, since negative events affecting a State's balance sheet or economy can be directly reflected in the banks' assets[7].

The different strengths of these links between different banks on different countries make the project of banking union impossible to complete, because EDIS can't be implemented in such a fragmented background. One key aspect of the new common

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- [6] Fontana, Alessandro and Langedijk, Sven, *The Bank-Sovereign Loop and Financial Stability in the Euro Area,* JRC Working Papers in Economics and Finance 2019/10. Publications Office of the European Union, Luxembourg, 2019, ISBN 978-92-76-02955-7, doi:10.2760/81563, JRC115569, p 1, [online] available at https://publications.jrc.ec.europa.eu/repository/bitstream/JRC115569/jrc115569_sovereign_bank_feedback_fontana_langedijk_final.pdf

- [7] M. Lamers, T. Present, R.V. Vennet, *Sovereign exposures of European banks: it is not all doom.*, pp 1-3 [online] available at file:///C:/Users/Utente/Downloads/SSRN-id3519136%20(1).pdf, 2019.

deposit insurance is that the risks of banks failure is shared between each member states: since every DGS can ask for a financing to EDIS (which is financed commonly by all the banks in Europe), every European banks is bearing the risk that any bank in Europe could fail and its deposit holder will be repaid with its money. Looking at this possibility, some banks of some countries are unwilling to complete the banking union as there will be banks which have very high risks. The proof of this lies among the Italian public debt: the main banks in Europe hold about 425 billion euros of public and private Italian debt, while just the Italian banks hold about 400 billion of Italian sovereigns in its balance sheet[8]. Italian banks have a very strong links with the macroeconomic background of its home country because of the huge amount of bonds in its portfolio, and since the Italian bonds are characterized by uncertainty (due to political instability and "weak" macroeconomic indicators) these banks borne higher risks than the other European banks.

The European commission proposed different measure alongside EDIS to break this type of links in order to build a more homogenous and secure banking system. Between all these measures there are two that have captured the most the attention of government and economists: a) the introduction of ratios that reflect the exposure of a bank to sovereigns and b) the introduction of a new financial assets called sovereign bond-backed securities (SBBS).

New Capital Requirements: Weighing Sovereign Bonds

Many proposal advanced by economists and also within the European Union aim to reduce the banks' exposure to sovereign by introducing new capital requirements to banks, or by adding new ratios and measure that could reflect how much that bank is exposed to sovereign risk and intervene if it exceeds that limits. The German Council of Economic Experts (GCEE) has developed a proposal for removing privileges for

[8] G. Salzano, D. Pogkas, B. Sills, *Why Italy's debts are Europe's big problem*, «Bloomberg », 4 February 2019, [on-line], available at https://www.bloomberg.com/graphics/2019-italian-banks/

sovereign exposures that rests on two key elements: risk-adjusted large exposure limits and risk-adequate regulatory capital requirements[9].

Introducing new capital requirement to banks that held government bonds could damage banks that currently present a large amount of them in their balance sheet, and this is the case of the Italian banks that, as stated before, hold about 400billion of national bonds on their assets. This high exposure increases the risks of the banks, and it undermine the solvency of the whole European banking system. During the 2011 crises, the assets of the Italian banks were undervalued due to the depreciation of the Italian government bonds. If the proposal advanced by the German council of economic experts would be accepted, Italian banks are likely to be forced to get rid of the bonds they hold on the market to meet the new requirements. A massive sale of these securities in a short time would devalue these bonds, creating the opposite effect that the proposal would want to achieve. Banks would lower the price to ensure a higher return for the buyer, so that they can be able to sell their government bonds. By acting in this way, they feed the link between the bank and sovereign risk through two channels: the first is that if the bank devalues government bonds to sell them, it implicitly devalues an important portion of its balance sheet assets, going against an increased risk of insolvency. The second channel concerns the higher return resulting from this devaluation implemented by the banks. Higher returns from a collapse in sovereign prices can lead the market to perceive the country's risk more than it is. The market may therefore require an even higher return on government bonds, leading to an even greater devaluation and a deterioration in public finances.

The European Union studied a new policy regime aims at reducing the links between banks and countries by a proposal that should not be implemented alone but should be implemented alongside with the proposal on EDIS. The European Union is in fact conscious of the risk and the disorder that may appear in the market, due to a severe regulation on sovereign exposure. The new proposal consists on introducing new

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- [9] J. Andritzky, N. Gadatsch, T. Körner, A. Schäfer and I. Schnabel, *Removing Privileges for Banks' Sovereign Exposures – A Proposal*, [online] available at https://european-economy.eu/2016-1/removing-privileges-for-banks-sovereign-exposures-a-proposal/, 2016.

regime to banks by introducing the Sovereign Concentration Charges (SCCR). The SCCR modifies the risk-based capital ratio and is designed to incentivise greater diversification: if the sovereign exposure ratio (given by the amount held in sovereign debts divided by tier-1 capital) is below the threshold of 33%, the banks will not pay any charge. If the ratio is above the threshold, the banks will pay a charge that it would increase geometrically fast as the sovereign exposure ratio increases. This proposal, in addition to moving in the direction of inserting ratios that may indicate a bank's exposure to sovereign risk, criticizes the approach aimed at reducing sovereign exposure through a weighted risk of government bonds. The proposal states that weighing the sovereign bonds for the risks may increase the effect of a strong depreciation of these assets, also because there would not be a free asset in Europe anymore. The proposal highlights also that if the risk-weighing is carried on differently between European countries, there may be advantages for some banks based in some countries, compared to banks based on other countries[10].

Another problem would be related to the magnitude of the risk weight to be imposed on every sovereign issue. This would hold regardless of the methodology adopted for the determination of the risk weight. The credit risk assessment is indeed not a straightforward procedure. Moreover, correctly estimating the creditworthiness of a sovereign is much more difficult with respect to another subject. The solution to adopt a standardized approach solution would leave the assessment decision to rating agencies or other public entities. Giving so much power to these subjects would involve controversies related to their governance and independence. Alternatively, another solution could be to derive the proper risk weight from market signals, but this would entail the potential for market manipulation. Through SCCR, conversely, the choice of the concentration charge to be implemented would be established a priori, in a clear and objective way. The concentration charge imposed on sovereign holdings would not depend on the sovereign's creditworthiness, the problem of the correct assessment of the risk weight would thus not be in place. Adopting a positive risk

- [10] N. Veròn, *Sovereign Concentration Charges: a new regime for banks' sovereign exposures,* provided at the request of the Economic and Monetary affairs committee, November 2017, p 23, [online], available at https://www.bruegel.org/wp-content/uploads/2017/11/IPOL_STU2017602111_EN.pdf weight on sovereign exposure could also bring two negative effects to banks and to member states: the first one consists on the polyciclical effect that may arise, the second one cope with the competition between European banks and other financial institution. The introduction of positive risk weight on sovereign exposure would increase the links between a bank and a country because if sovereign debt can be under pressure, an increment in the risk weight of the related securities would happened, and it may trigger a strong sale reaction, leading to a major threat for that sovereign's creditworthiness. The second negative effect consist that without an international harmonization between banks worldwide the Euro Area banks would be subject to higher capital requirements with respect to the other banks and so the competitiveness of the EU banking industry would be endangered. Under the framework hypothesized by SCCR if a European bank hold a high number of sovereigns under the threshold there would not be any kind of penalisation, and so its competitiveness would not be affected[10].

Sovereign Bond-Backed Securities (SBBS)

The so-called sovereign bond backed (SBBS) have been proposed by the European Commission in 2018. According to the proposal-COM (2018)339 the "SBBSs would be created by the private sector. A private sector entity would assemble an underlying portfolio of sovereign bonds from the market and would subsequently transfer them to a legally separate, self-standing entity, specifically set up for the sole purpose of issuing to investors a series of securities representing claims on the proceeds from this underlying portfolio"[11]. In practice, a private institution will buy sovereigns issued by European countries which adopted euro and, after having bundle them into different portfolio with different levels of risk, these portfolios will be passed to other private institution. The regulation, indeed, adds two main requisites about the composition of these portfolio. The first requisite is that each portfolio must be composed by bonds issued by every country which adopted the euro. The proportion of the bonds issued by a country must reflect the contribution into the capital of the European Central Bank given by that country (art 4.2). The second requisite is that the highest risk security will

[11] COM(2018)339 final, Context of the proposal

be first in line to bear every loss it may emerge (art. 6). While articles 4, 5 and 6 explain how a SBBS must be composed, the article 10 explains which steps follow the creation of the financial instrument and identify the ESMA as the authority appointed to rule and monitor the right use of this new financial instrument. As reported in article 10 the special purpose entity (i.e. the private institution that issues the SBBS) shall notify ESMA at least one week before the issuing of the SBBS. ESMA will monitor if the new issuing respect the articles 4, 5 and 6 of the proposal. ESMA is also obliged to inform the market of all the SBBS that have been issued by keeping an update list of the all SBBS issued in the website. ESMA is also supposed to develop draft regulatory technical standards on these new instruments. Article 13 of the regulation said that also each Member States (referring to all the countries which adopted the Euro and whose bonds could be part of a SBBS) shall designated an authority to monitor and supervise the private institutions allowed to issue SBBS. The Members State shall notify the Commission and the ESMA about this competent authority and how its duties and tasks are developed and divided accordingly to article 13.1. Art 13.2 states that the national competent authority shall have the power to supervise, investigate and sanction the special purpose entity by stating that the national competent authority "shall have the power to:

(a) request access to any documents in any form to the extent that they relate to SBBSs, and to receive or take a copy thereof;

(b) require the special competent authority to provide information without delay;

(c) require information from any person related to the activities of the special competent entity;

(d) carry out on-site inspections with or without prior announcement;

(e) take appropriate measures to ensure that a special competent entity continues to comply with this Regulation;

(f) issue an order to ensure that a special competent entity complies with this Regulation and desists from a repetition of any conduct that breaches this Regulation."[12]

[12] Art 13.2, COM(2018)339 final

In order to have a close and an efficient cooperation, art 14 of the regulation recalls the regulation 1095/2010 to define the action of the ESMA with the national competent authority. Article 14.2 and 14.3 of the same proposal states that if a competent authority finds that a special competent entity is breaching the regulation while issuing SBBS, it shall notify properly the special competent authority to the national competent authority of the Members in which the issuing entity is established. If the national competent authority of the country of the special competent entity has not make the issuing entity respect the regulation, it can act directly after having properly informed ESMA and the National competent authority of the country in which that entity is established. In the following articles are indicated the transparency and the information requirements that the special competent entity must comply with. If the special competent entity does not comply with these requirements, it will incur the penalties set out in Articles 16 17 and 18 of the same proposal.

Two years before the proposal, the European Systemic Risk Board published a report about the feasibility and the legal issues of the SBBS. While the report says that exists good chances that these new instruments will reach its goal of improve the banking union, it also highlights some legal obstacles that SBBS may find. Under current regulations, SBBS would receive a worst treatment than government bond. Since SBBS would be a bundle of different bonds, they would be treated as securitized products since they include bonds subjected to credit risk. From this classification, two main problems would emerge to banks which are willing to invest in SBBS. These problems deal with capital requirement and liquidity requirement. Holing securitised products means banks set aside more capital for the higher credit risk that this category of securities entails (as they are subject to multiple different credit risks). So, as stated in the ERSB reports, the SBBS would require higher capital standards as the sovereign bonds. The second main problem that emerges is that, since the SBBS would be treated as securitized product, they would not be part of the computation on liquidity ratio. This treatment would be unfavourable to SBBS respect to government bond which can be classified as liquidity asset. The European Commission is moving to remove these obstacles pointed out by the ERSB: the "final agreement on the comprehensive set of reforms proposed by the Commission" contained some reforms already proposed in the 2018 proposal on SBBS, supported by wider reforms aimed to improve the homogeneity between European banks.

This new financial instrument can be the solution against the high exposures of the European banks to sovereign bonds, and so to the financial background in which they operate. As stated in the ERSB report, there is no reason to doubt the success of the SBBS, provided that the European Union can change the laws that prevent them from being implemented. But the risk that these instruments could create a bubble effect in the market is not negligible. It should not be forgotten that these instruments are still public debt, and because their supply is expected to be driven by the demand they receive, the risk that a country will over-borrow, driven by the fact that it will surely find a buyer in the market, damaging its finances, should not be overlooked.

Conclusion

As is possible to see from this analysis, EDIS is not just about insuring the banking deposits of the banks' clients, but this new financial tool copes with equally important financial problem. The difficulties faced by governments on the policies to be followed to reduce the doom-loop have meant that a great deal of precious time was wasted, without affecting the same critical issues that put monetary and economic union at risk. Without the implementation of the third pillar of the banking union, the risk that the taxpayers' money is used to protect the clients of banks is still strongly present. Thanks to the second pillar, the bail-out has been forbidden, but public funds exists to reimburse clients of banks that lose money due to banking resolutions (as in Italy for example was established a "savers compensation fund" with public money). If EDIS won't be implemented, then all the efforts done until now to reach a banking union will be useless. That's why few months ago the third pillar of the banking union was put in agenda again and became one important topic in the Euro meetings. But this meetings highlighted the different opinions if the governors: while some countries, like Germany, prefer to intervene by modifying the asset purchasing policy, others like Italy, ask for a stronger union by issuing bonds which risk is equally shared between the European countries (as the SBBS). It's interesting to note as the new developments in the economic and in the financial background due to the coronavirus have accelerated the steps towards a new financial tool where the risks is shared by the

European countries (Covid-Bond), and it’s not random that the best promoter of this new bond is the Italian government.

It's also evident how both the strategies explained present important pitfalls, not just for banks (that can see its asset undervalued), but also for the governments of countries which benefit from a good financial situation. These countries could be perceived as riskier than they are perceived now, since they would be involved in paying more its debt because they would guarantee also for countries with a worse financial background. On November 2019, the German finance minister Olaf Scholz opened the hypothesis of completing the banking union by implementing the EDIS only if banks set aside resources against purchased government bonds, just as it does for loans to individuals. This is in line with the proposal analysed previously, and this proposal would damage the banks of other countries, for the same reason previously expressed.

It’s necessary for the European Union to reach an agreement as soon as possible, especially when the economic background is seriously threatened by a new global recession, that can harm firstly the firms all around the world, and secondly the banks which have lent money to those firms. It’s necessary to increase the integration inside the Europe that is still too divided politically and financially: the implementation of new policies that may put in danger banks all around the Union risk to increase this fragmentation. It’s necessary to be more united, and since the final goal is to reach a common insurance of the deposits around Europe, is necessary that all the Member States bear the risk for the debts issued inside the European Union, as permitted by the Sovereign Bond Backed Securities.