Finance for Europe

The European banking system: tackling the challenges, realising the opportunities

Achievements and next steps in the reform programme

July 2019

Association for Financial Markets in Europe
www.afme.eu

/ About AFME

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues.

We represent the leading global and European banks and other significant capital market players.

We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society.

We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

Focus
on a wide range of market, business and prudential issues

Expertise
deep policy and technical skills

Strong relationships
with European and global policymakers

Breadth
broad global and European membership

Pan-European
organisation and perspective

Global reach
via the Global Financial Markets Association (GFMA)

Introduction

This paper aims to provide European decision-makers and other stakeholders with a concise overview of AFME's priority objectives for the European Union in the area of bank prudential and resolution regulation. A broader overview of AFME's priorities and key recommendations can be found in the accompanying publication "*Finance for Europe – Building competitive, resilient and integrated financial markets. A financial services strategy for sustainable growth and competitiveness in 2019–2024*".

Priority areas in banking prudential regulation for the new EU legislative cycle

Completing the Banking Union

The completion of the Banking Union remains a key priority to achieve a stronger monetary union. This includes considering the Banking Union as a single jurisdiction in terms of prudential requirements, achieving effective depositor protection and a solution for a European safe asset.

Removing the fragmentation in European banking markets

Cross-border banks need to be able to manage their capital and liquidity at a consolidated level and to achieve diversification and economies of scale. This will also help to address their lack of profitability and excess capacity. Together with Capital Markets Union this is a powerful way to share risks and to absorb economic shocks.

Achieving an ambitious Capital Markets Union

Capital Markets Union (CMU) can increase the diversity of funding sources, reduce the overreliance on banks, and provide the European economy with a 'spare tyre' during economic turmoil, when banks' ability to lend is constrained. Internationally diversified investment portfolios can also help to smooth consumption and investment in case of an economic shock in a specific region.

Ensuring openness to global capital markets

It is vital for users of financial services – corporates, investors, government bodies - to ensure that global capital markets, including the EU, remain open and closely connected.

Avoiding significant increases in capital requirements

The EU implementation of the Basel agreement should not result in significant additional capital requirements, in line with the commitment made by global and EU regulators.

Promoting global consistency

Given the global nature of wholesale banking activities, it is important that global consistency is promoted in respect of the outcomes resulting from the implementation of the prudential standards.

Summary: Achievements and Next Steps for the New EU Legislative Cycle

The long journey of Europe's banks: Over the last decade, the European banking system has been subject to profound changes. It is now a safer banking system, better able to contribute to sustainable growth. Through the efforts of EU and global policy makers, supervisors and the industry, banks are now considerably better capitalised, with higher levels of liquidity, stronger governance and less risky balance sheets – as evidenced by the significant reduction in holdings of non-performing loans. At the same time, interconnections between banks have been mitigated by centralising certain activities and increasing transparency requirements. These changes were complemented by stronger supervision of banks. In the Euro area this resulted in the creation of the Single Supervisory Mechanism (SSM) and the formation of three supervisory EU authorities for the banking, securities, insurance and pensions sectors. The EU has now implemented crucially important reforms aimed at ensuring that, in the event of bank failures, tools are available to mitigate their impact and to resolve the failing institution. These reforms include the establishment of the Single Resolution Mechanism (SRM), which consists of the Single Resolution Board (SRB), the central resolution authority within the Banking Union and the national resolution authorities). As well the requirement for banks to hold loss absorbing capacity (through significantly higher capital requirements and the introduction of new requirements for additional loss absorbing resources, so called: minimum requirements for own funds and eligible liabilities - MREL[1]). These measures enable banks to either recover from very significant losses or, if necessary, to be resolved by the authorities, without a negative impact on financial stability and without imposing costs on taxpayers.

The heavy costs of fragmentation: Despite the progress outlined above, important challenges remain. In order to enable banks to fund growth, the most important remaining challenge is the need to create a functioning single integrated European market. Even in the Banking Union, there continues to be a lack of trust between Member States resulting in them putting up national "fences" to protect local shareholders, creditors and taxpayers. This "ring-fencing" approach, which requires cross-border banks to hold minimum amounts of local capital and liquidity, imposes considerable costs on the economy and weakens financial stability, which are described in more detail below. Removing the national barriers and the negative effects of ring-fencing will be crucially important, particularly to deliver a strong and well-functioning Banking Union.

The completion of the Banking Union is essential: Completing the Banking Union is an essential step towards removing fragmentation and avoiding potential adverse feedback loops[2] between bank risk and sovereign risk. The debate around the completion of the Banking Union has often focussed on the sequencing and on the conditions to move from risk reduction measures to risk sharing policies. However, the debate, to date, has typically not taken into account the fact that risk sharing measures can – probably more than any other measures – result in very significant risk reduction, as explained below.

Private risk sharing and the importance of the Capital Markets Union: It cannot be emphasised enough that achieving deeper integration in credit/financial markets would be the most effective way to absorb economic shocks, and therefore prevent and reduce risks. This is where "private" risk sharing comes into play, through which risks can be shared (and through such sharing, reduced) without the need for the injection of public money. Studies[3] have indicated that in a geographic area with well-integrated financial and credit markets (e.g. the United States) economic shocks occurring in one part of it are absorbed mainly through the free flow of credit and investments from other unaffected regions.

1 The "minimum requirement for own funds and eligible liabilities" is a requirement for banks to hold a minimum amount of loss-absorbing equity or debt (i.e. instruments which can be converted to shares or be written off when the bank gets into difficulties) and facilitate the resolution plan, ensuring that losses are absorbed by shareholders and creditors of the bank and not taxpayers. This is in addition to minimum capital requirements and, where appropriate, ensures that banks have enough debt that can be bailed in to enable them to be recapitalised.

2 The feedback loop between governments' debt risk and bank risk, can be summarised as follows: governments are exposed to banks' risk if they need to bail-out failing banks, in the event that effective alternative ways to 'resolve' that bank are not available. At the same time, banks are exposed to sovereign risk: if the creditworthiness of sovereign debt is reduced, the market value of banks' holdings of domestic sovereign debt is also reduced, with possible impacts on the solvency of the bank; also if distressed banks cut back on lending, the negative impact on the economy could lead to a reduction in tax revenues, contributing further to the sovereign-bank loop.

3 For an overview please see "Risk sharing in the Euro area" by Cimadomo, Hauptmeier, Palazzo, Popov; ECB 2018.

Absorbing economic shocks without public money: the role of private risk sharing

Risk diversification
In fully integrated markets lenders/banks can diversify more, and offset losses made in regions hit by a recession with gains from regions in a more favourable cycle.

Efficiency & resilience
Banks can better allocate resources where they are most needed, improve profitability and strengthen their capital and liquidity position and overall resilience.

No credit crunch
Borrowers in the real economy (governments, households, enterprises) can avoid a credit crunch if they do not rely exclusively on local sources of funding.

Reduction of risks

Absorption of shocks

Reduced need to use public money

Investment diversification
Internationally diversified investment portfolios generate returns which are not related to a region. This would help to smooth consumption and investment during an economic shock in that region.

'Spare tyre'
Well developed market-based finance can act as a 'spare tyre' when bank lending shrinks during a crisis.

Credit / savings channel
This private risk sharing channel can only work if barriers for cross-border banks are removed

Capital markets channel
This private risk sharing channel would be activated by the completion of the Capital Markets Union

Therefore, private risk sharing is not only the most effective way to share risks and absorb shocks in a well-integrated area (particularly in a monetary union) by preventing or limiting the intensity of crises, it also significantly reduces the likelihood that public risk sharing tools will need to be used in the future. This is particularly important in the EU, where fiscal transfers which might be implied in the use of public risk sharing tools are politically sensitive and difficult. The removal of barriers to cross-border banking in the EU and the completion of CMU are necessary conditions for reaping these important benefits of private risk sharing. As we discuss below, progress towards a Capital Markets Union and Banking Union would have mutually reinforcing benefits in widening the financing options for European borrowers, diversifying risks and maintaining the availability of funding sources, independently of the economic cycle.

The costs of ring-fencing

Fragility and lower resilience

Ring-fencing makes a crisis more likely if (even within a single banking group) capital and liquidity cannot flow where they are most needed. The system (and individual banks within it it) becomes more fragile as entities of a cross-border banking group are unable to support each other in difficult times. The ability to only count on local resources, rather than those of the broader group, means that ring-fencing might also result in lower, and not higher, protection for local stakeholders.

Drag on consolidation and profitability

A requirement to hold excess amounts of local capital and liquidity leads to inefficiencies and a heavy drag on banks' ability to achieve adequate profitability as the cost for such resources will be higher. As a result, necessary (given the persisting excess capacity in the European banking sector) cross-border consolidation becomes impossible. An excessive number of locally-focussed banks will also be unable to mobilise the resources needed to innovate and be competitive and profitable in the context of increasing digitalisation of the business.

Amplification of crises

Ring-fencing amplifies the negative effects and the costs of any crisis by limiting banks' ability to diversify risk across several jurisdictions thereby magnifying the impacts of a local downturn (asymmetric shock). These effects are compounded if - when local banks are experiencing a crisis - cross-border credit flows cannot step in and compensate for the reduced access to credit at local level.

Higher costs for the economy

The inability to count on a large integrated domestic market, the resulting lack of economies of scale, as well as the higher cost of capital and liquidity caused by fragmentation results in many cases in higher costs for financial services users.

The challenge of profitability - The cost of fragmentation is one of the key factors in pushing down EU banks' profitability. Given the EU economy's heavy reliance on banks (around 75% of corporate financing and around 90% of household financing is provided by banks; those proportions are 25% and 45% in the US) the lack of adequate profitability results in banks' inability to support greater growth and innovation. Moreover, profitability and stability are two sides of the same coin: if banks can achieve sound returns on equity at least equal to their cost of capital and sustainably profitable business models, they can retain more capital, further reducing their risk of failure and making the entire system more stable as a result.

The evolving regulatory framework and upcoming reforms - The final part of Basel III was agreed in December 2017 and its implementation in the EU will be discussed in the coming months and years. This is a major set of reforms and one of the most prominent legislative proposals expected from the next European Commission, which will have a significant impact on EU banks and will require careful consideration by EU legislators. At the same time, resolution regulation will also remain important. While the recently reformed resolution framework will be implemented, further progress is still needed to minimise fragmentation, further develop cross-border cooperation and provide a more effective framework for providing liquidity to a bank in resolution.

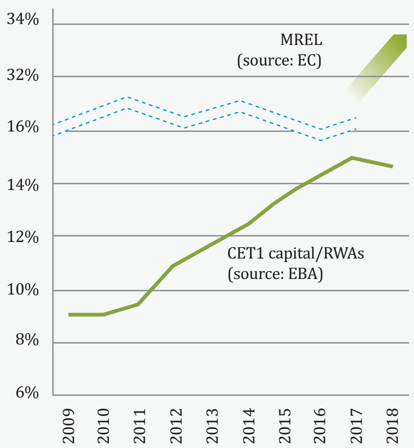
The journey towards stronger, safer, resolvable banks in Europe

The health of EU banks has improved markedly during the last decade as a result of post-crisis reform efforts. If we consider key indicators, banks have become much more robust and the probability of their failure has decreased significantly. According to an ECB study[4] "the average probability of default of banks decreased from 3.5% in 2007 to 1.1% in 2017, less than a third of its pre-crisis value".

The aggregate core **equity capital ratio** ("Common Equity Tier 1", or CET1 in regulatory jargon - the highest quality capital) of EU banks stood above 14% of the risk weighted assets[5] (RWAs) at the end of 2018, after a period of steady growth since 2009. Broader additional loss absorbing resources (minimum requirements for own funds and eligible liabilities – MREL; see footnote 1) have been growing steadily and at the end of 2017, they reached 33.8% of RWAs[6] average for firms under the remit of the Single Resolution Board. MREL levels have continued to grow significantly in 2018, with issuance levels at EUR 97 bn[7].

At the same time, **the leverage ratio** (that is the ratio between Tier 1 capital and on and off-balance sheet assets) has become much more conservative, doubling over the same period. This means that each € of lending is backed by more capital than was the case historically.

Figure 1: **Steep increase in capital and broader capacity to absorb losses**



While the growth in the capital and leverage ratios indicates EU banks' improved ability to remain solvent, banks also need to be able to deal with unexpected demand for cash. The liquidity and funding requirements introduced after the crisis aim to ensure that banks have an appropriate amount of high-quality liquid assets (that is cash or assets that can be readily converted into cash, e.g. top-rated government securities).

4 "Is taxpayers' money better protected now? An assessment of banking regulatory reforms ten years after the global financial crisis", ECB – 2019.

5 Risk-weighted assets (RWAs) are computed by adjusting each asset or asset class for risk to determine a bank's real exposure to potential losses. Regulators then use the risk weighted total to calculate how much loss-absorbing capital a bank needs. The risk weighting varies accord to each asset's inherent potential for default and what the likely losses would be in case of default – for instance, a loan secured by property is given a lower risk weight.

6 Source: EC-ECB-SRB joint risk reduction monitoring, November 2018

7 AFME estimates with Bloomberg data.

The **Liquidity Coverage Ratio (LCR)** requires banks to hold enough high-quality liquid resources to withstand estimated cash outflows over a 30-day stress period, therefore aiming to promote short-term resiliency. The LCR is calculated as the ratio between stock of High-Quality Liquid Assets (HQLA) and net cash outflows over a 30-day stress scenario. Such a ratio needs to be greater than 100%.

The **Net Stable Funding Ratio (NSFR)** limits over-reliance on short-term wholesale funding, encourages better assessment of funding risk across all on and off-balance sheet items, and promotes funding stability. It is therefore a more long-term, structural requirement which not only focuses on a subset of liquid assets, but on the entire interaction between assets and liabilities in the balance sheet. The NSFR is a ratio between stable funding available from a bank's liabilities and capital, and stable funding that is required for a bank's assets. This ratio is required to be above 100%.

As shown to the right, EU banks have consistently improved such ratios after the crisis, and in aggregate are well in excess of stipulated requirements.

Additionally, regulation on market infrastructure and resolution has also contributed to making EU banks more robust[8]. During the last decade, against a background of unfavourable economic conditions and a difficult environment for their clients, banks had to undertake important efforts to repair their balance sheets, in particular by reducing the amount of non-performing loans (NPLs). Such loans reduce banks' profitability, tie up capital and may restrict their ability to lend. Strong progress has been made in reducing the proportion of banks' loan books which are non- performing and in increasing provisions set aside for such loans, as shown in the graphs above.

As highlighted recently by an ECB study, banks' loss-absorbing capacity has increased 12-fold in the ten years since the financial crisis (under conservative assumptions), owing to the introduction of larger capital buffers and the new resolution framework (which enhances banks' loss-absorbing capacity via the bail-in[9] tool). This means that banks are now able to absorb very significant losses, well in excess of those incurred during the last crisis, while minimising the likelihood of taxpayers having to bear the cost in the event of failure.

8 For instance: EMIR has introduced mandatory clearing and margining requirements which mitigate systemic and counterparty risks; MIFID2/MIFIR has increased market transparency; BRRD2 has introduced requirements to ensure that banks have adequate loss absorbing and recapitalisation capacity.

9 Bail-in is a resolution tool which provides the authorities with the power to apply a mandatory write down or conversion of debt to equity, enabling the bank to be recapitalised and stabilised quickly and be restructured in an orderly manner.

Figure 2: **Constant improvement in liquidity positions and leverage ratio; Strong reduction of NPLs**

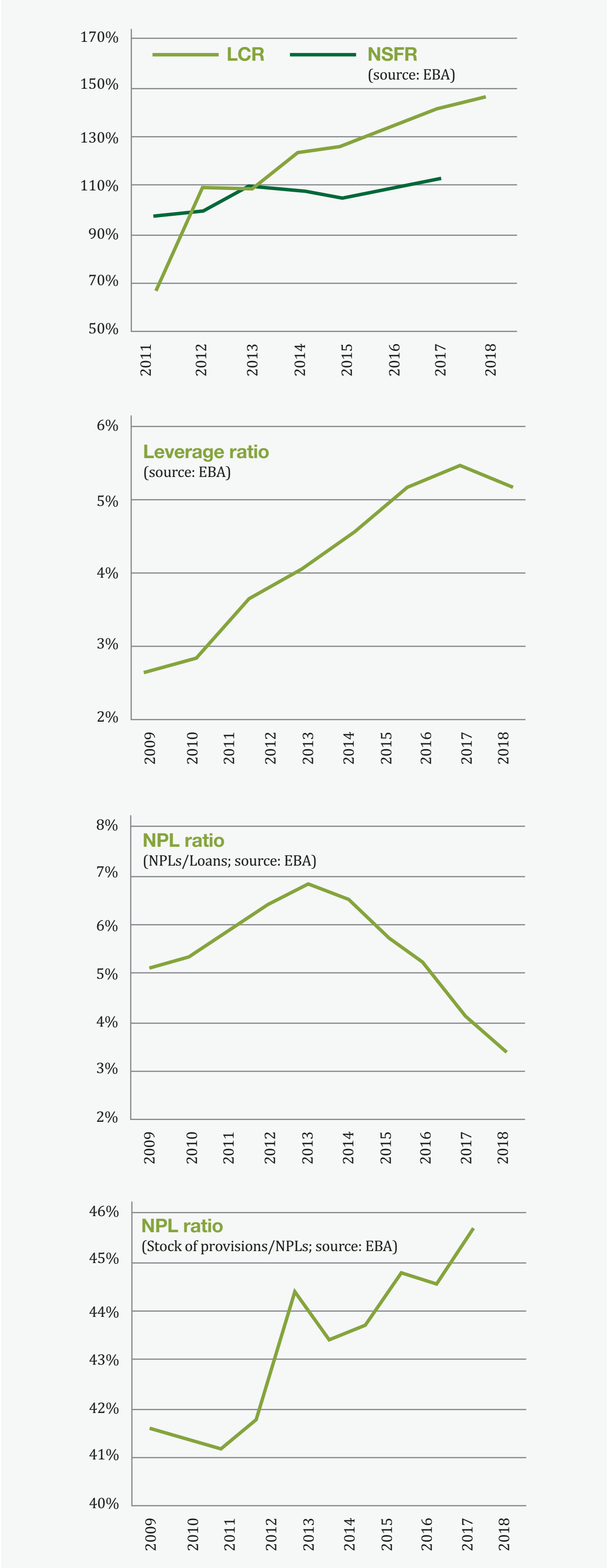


Figure 3: **System's loss absorbency in the € area: 12-fold increase**

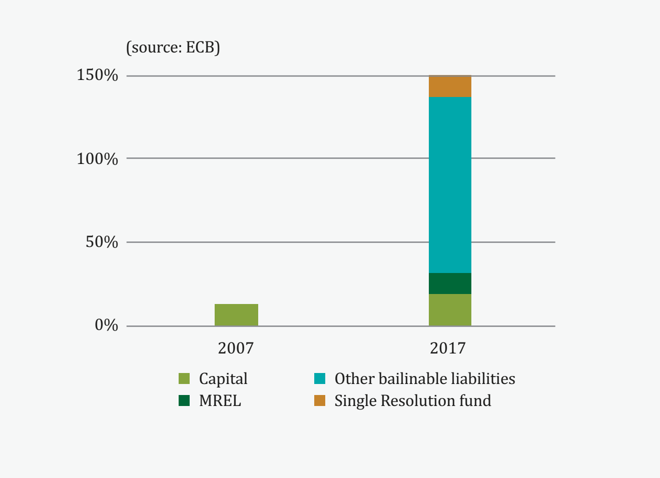
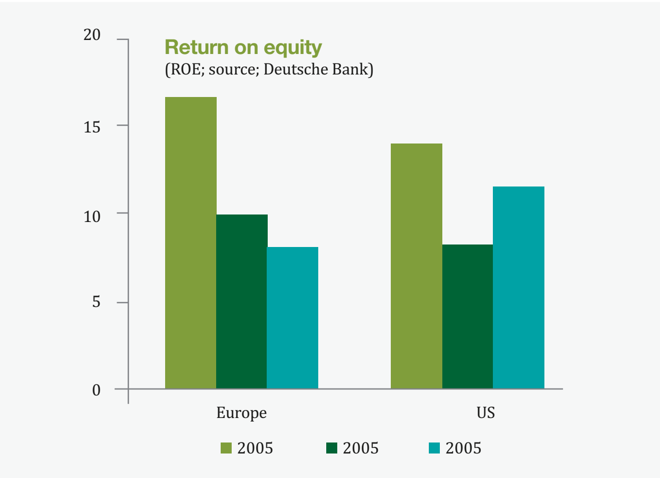


Figure 4: **Persisting low profitability of Europe's banks**



Beyond these key indicators, the multi-year post-crisis regulatory reform programme has led to fundamental changes. These include a much more effective single rulebook in the EU, a sea change in supervisory tools (in particular thanks to the establishment of the Single Supervisory Mechanism) and a greater ability to deal with ailing banks and to allow them to exit the market if necessary (here the creation of the Single Resolution Board has been instrumental), without systemic repercussions and without imposing losses on the taxpayer.

The challenge of low profitability

The above key indicators for the EU banking sector highlight a positive story and testify to the successful reform effort on many fronts. However, if we consider the low profitability of EU banks (both in absolute and relative terms, for instance in comparison with US banks), and the fact that for a significant number of banks the return on equity has been persistently below the cost of that equity[10], it is clear that important challenges remain to be addressed. Given the heavy reliance of Europe's corporates and households on bank funding, this low profitability undermines banks' ability to support those that need access to finance the most. This is a serious problem and a major obstacle to Europe's efforts to accelerate growth.

Several factors contribute to weak profitability. The post-crisis regulatory environment and its more stringent requirements have led to increased capital and funding costs. Certainly, this was, to some extent, the intent of the reforms and the necessary price of a more robust banking system[11]. However, there may also be cases where regulatory reform has had unintended consequences on banks and their clients. It is therefore important that in the coming years a careful assessment of the reforms is regularly undertaken.

Two of the main factors behind weak profitability appear to be over-capacity and a low level of bank concentration in many national markets. Both would be mitigated by the development of a true single market reducing cross-border barriers and minimising fragmentation. Cross-border consolidation would also contribute to the reduction of excessive capacity and help banks not only to gain economies of scale, but also to diversify both revenue streams and risks, as well as to seize more business opportunities. Despite the rationale for greater consolidation, after the crisis, bank mergers have been slowing and have been almost exclusively of a domestic nature. The high levels of market fragmentation and the lack of a complete Banking Union and Capital Markets Union represent significant barriers to cross-border activities.

10 For instance, as highlighted in the latest EBC financial stability review, the return on equity for euro area banks stood at around 6% in 2018, while the cost of equity for most of the largest listed European banks is estimated to lie in the range 8-10%.

11 For instance, it is evident – and a clear sign of the success of the reforms – that the removal of the implicit government support resulting from the "too-big-to-fail" problem has led to higher cost of funding for all banks, which was expected and intended.

Completing the Banking Union: a key priority for the next EU legislature

Transformational changes have been accomplished in Europe with the launch of the Banking Union. In addition to the Single Rulebook, European banks can now benefit from a Single Supervisory Mechanism (the system of banking supervision in the Banking Union, comprising the ECB and the national supervisory authorities) and a Single Resolution Mechanism (which consists of the Single Resolution Board and the national resolution authorities within the Banking Union) which put the system on a stronger footing in terms of greater stability and consistency of the regulatory framework. However, the Banking Union is still not complete. Notably, the Banking Union is still fragmented with capital and liquidity unable to flow freely within European banking groups, and agreement has yet to be reached on an effective deposit insurance scheme across the Banking Union.

Discussion has, to date, focused on whether risk reduction should be achieved before any risk sharing measures are adopted, or whether the two should be moving forward in parallel. Member States remain split on the matter.

Despite the significant reform efforts that have been made, persisting post-crisis sensitivities lie at the root of this lack of progress. This has resulted in barriers to the free flow of capital and liquidity across the EU preventing the diversification of risk and introducing systemic fragilities. Unlocking the full benefits of Banking Union requires this lack of trust to be addressed. It also requires the huge progress already achieved – through stronger prudential requirements, more effective supervision and resolution, and steep reduction in NPLs holdings – to be acknowledged. The establishment of an effective deposit insurance arrangement in the Banking Union would be a clear and helpful move in that direction and AFME believes that a sufficient level of risk reduction has been achieved to justify restarting negotiations on this in earnest

Encouragingly, the European Council recently agreed on a backstop[12] to the Single Resolution Fund (SRF), which will consist of a maximum of EUR 60 billion credit line provided by the European Stability Mechanism (ESM). The credit line can be activated once the SRF itself is depleted, and it is important that its governance arrangements ensure its effectiveness. The issue of liquidity provision to a bank undergoing resolution remains a priority and it is to a large extent still unresolved. AFME therefore welcomes the work underway on possible arrangements to provide liquidity on a temporary basis. As part of the broader efforts to strengthen the European Monetary Union, important work remains to be done on possible solutions for a safe asset for the euro area[13].

Risk reduction has made important progress:

- A fundamental redesign of global and European prudential and resolution standards has been undertaken.
- The quantity and quality of regulatory capital has significantly increased, short and long-term liquidity standards have been fully implemented,
- Supervision and resolution tools have been strengthened.
- The build-up of "bailinable" buffers (MREL) is well underway.
- Rules on NPL provisioning have been adopted recently which will help banks deal with new distressed assets, while the legacy stock is being disposed of encouraged by supervisory scrutiny and market pressures.

12 The European Stability Mechanism (ESM) is best placed to provide a backstop in the form of credit lines or guarantees to the Single Resolution Fund (SRF) to facilitate the orderly resolution of distressed banks in the event that the SRF does not have enough resources. Any such contributions from the ESM to the SRF would be recouped from the banking sector. This ensures that taxpayers will not be left on the hook for the costs associated with resolving failing banks.

13 A safe asset is a liquid asset that credibly stores value, in particular during systemic crises. They play a central role and the demand for such assets is high: savers need a vehicle to store their wealth; financial institutions use them to have liquid assets and comply with liquidity requirements and more generally to post collateral in many financial operations. Sovereign debt securities can play this role, as long as public finances are considered sound by the markets. After the crisis, several of the bonds from euro-area countries lost this status as safe assets. This exacerbated their ability to fund their debt and put in place countercyclical fiscal policies. Banks holding significant amounts of such sovereign bonds were also put under strain. Ideas on how to create a euro-area-wide safe asset to mitigate these issues are currently being considered (see "The search for a Euro area safe asset", Leandro and Zettelmeyer, 2018, for an overview)

Banking Union and Capital Markets Union: two mutually reinforcing projects

The Banking Union and Capital Markets Union projects are intrinsically linked and mutually reinforcing. A fully functional and integrated Banking Union can help in achieving a more integrated capital market in the EU by removing the pervasive fragmentation in a large part of EU banking markets and by providing the benefits of a large and well-functioning single jurisdiction. This is because banks not only play a key role in mobilising capital and liquidity, but also because they are often key players in capital markets. They help corporates and governments access capital markets (e.g. acting as "primary dealers" and providing underwriting services). In addition, by acting as market-makers, they ensure that capital markets are liquid, which is essential for investing, raising money and managing risks. At the same time, the creation of a fully integrated Capital Markets Union in Europe would provide European corporates and governments with greater access to finance and European investors with a broader range of investment opportunities. This would both mobilise more resources for growth and jobs and allow more efficient allocation of these resources. It would also provide a powerful shock-absorbing mechanism (particularly if combined with greater integration of credit markets), making the European banking sector and the broader European economy much more resilient to asymmetric shocks through the diversification and sharing of risk.

In a context where discussions on the creation of "public" risk-sharing tools (from the proposed European Deposit Insurance Scheme, EDIS, to a potential future Euro zone budget) remain contentious, focussing on "private" risk sharing means focussing on the prevention of future crises and on making them smaller should they happen. It means therefore, reducing - and to some extent, addressing - the concerns around the possible fiscal transfers linked to the creation of "public" risk sharing tools[14].

Achieving substantial risk reduction in the system is understandably considered a necessary condition for any progress on EDIS; and it is fair to say that a lot of risk reduction has already been achieved. It should be stressed, however, that the contrast between risk reduction and risk sharing is unnecessary. In fact, achieving effective risk reduction depends to a very large extent on the existence of risk sharing mechanisms.

These considerations should encourage EU legislators to prioritise the removal of the significant fragmentation in the EU and to complete the Banking Union as a matter of utmost importance and urgency.

Results need to be achieved both in terms of greater public risk sharing and effective private risk sharing (this includes allowing cross-border groups to manage their capital and liquidity requirements at group/consolidated level, instead of imposing the allocation of such resources at subsidiary/local level; this also includes achieving progress on CMU).

Such progress would help to reduce key risks and help to put the EU banking system on a solid and stable footing. It would also put the EU economy on a path to stronger growth.

14 For an overview of the different forms of risk-sharing see: ECB Economic Bulletin, Issue 3, 2018, Risk sharing in the euro area, p. 86.

Risk sharing: to what extent are shocks absorbed or amplified in the EU? A comparison with the US

Risk sharing, in all the various forms it can take, enables spreading the costs of negative shocks in between countries/regions within a broader and integrated area. Such costs are consequently significantly mitigated, and deep crises prevented. Risk sharing can occur through multiple channels: cross-border transfers (public risk-sharing), labour income (e.g. remittances), credit markets, and capital markets. Credit and capital markets can play a huge role in enabling diversification cross-border. In the credit space, deposits raised in one country can help fund economic growth in others through cross-border bank lending. When international banks operate in a country's economy, the supply of credit to its business is less affected by domestic shocks, and the volatility of lending and income streams is reduced. In capital markets, financial and non-financial firms can issue equity or debt into European capital markets and thus reach a wider investor base, which can also help lower their funding costs. Furthermore, households and institutional investors alike can directly invest in economies different from their own, which would provide a buffer against country-specific shocks.

The degree of cross-country risk sharing in Europe has traditionally fallen short of other federations, notably the United States. While in the US about 60-80% of state-specific shocks are smoothed via (private or public) risk sharing channels, the corresponding figure in the euro area has never been more than 20%[15]. It is also important to note that in the US risk sharing takes place mainly via private channels, with the capital market channel explaining the largest share of the overall cross-state smoothing of shocks. **This means that economic shocks have been larger than they would have been in a less fragmented market.**

- In the US 60-80% of state-specific shocks are smoothed via (private or public) risk sharing channels
- The private financial markets channel explains the largest share of the overall cross-state smoothing of shocks
- A smaller, but significant, role – 10-15% – is played by fiscal transfers from the central/federal level for the absorption of state-specific shocks
- In the US the credit channel (banks' ability to lend cross-border) play an important role, accounting for about 20% of risk sharing

- In the EU, less than 20% of state-specific shocks are smoothed via (private or public) risk sharing channels
- The private financial markets channel's role in smoothing of shocks is well below its potential, due to fragmentation
- There is no central macroeconomic stabilisation function in the Euro area. Shock absorption through transfers from the EU level is negligible
- In the Euro area the credit channel plays a negative role. This means that – due to fragmentation – cross-border lending decreases exactly when it is needed the most to absorb shocks, contributing to a greater shock

The global financial crisis triggered a sharp decline in international bank capital flows, and Europe witnessed a sharp decline in cross-border exposures[16]. Banks located in EU countries reduced their cross-border claims by around a quarter in the years 2008-2016, with a particularly sharp decline in intra-EU claims[17]. Furthermore, mergers and acquisitions have been on a steadily declining trend and are increasingly of a domestic nature.

15 ECB Economic Bulletin, ibidem

16 ECB, Cross border banking in the EU since the crisis: what is driving the great retrenchment? Working Paper Series, p. 4

17 ECB, Cross border banking in the EU since the crisis, p. 5

Overcoming fragmentation in the EU and globally

Despite the progress being made on the risk reduction agenda and on the institutional framework, the benefits of the Banking Union have yet to materialise for the European banking sector. Cross-border capital and liquidity flows remain restricted and the Banking Union is not yet recognised as a single jurisdiction.

Other examples of regulatory fragmentation are the rules for internal MREL, which require a full allocation of loss-absorbency at the subsidiary level, contrary to the spirit of the globally agreed standards which provide for greater flexibility. Moreover, transactions between entities within the same banking group (intragroup transactions) do not receive any regulatory relief in the European prudential framework, and are applied at the level of every subsidiary of the bank (at "solo level", as opposed to the group/consolidated level). Whereas, they are calibrated by the Basel Committee for application at the "consolidated level". This imposes additional costs on firms and hampers the flow of funds within banking groups.

Creating the right regulatory incentives for cross-border banking would also help remove the barriers to bank consolidation, which is a shared objective in the EU, which suffers from being "overbanked". This, in turn, would increase the benefits of cross-border mergers and acquisitions and help increase the current low profitability.

Alongside the retrenchment undertaken by banks after the financial crisis, authorities have adopted ring-fencing policies. There are multiple studies showing that ring-fencing is characterised by a "prisoner's dilemma" effect, whereby the advantages for a ring-fenced jurisdiction in the form of a reduced probability of local failure only materialise if no other jurisdiction adopts similar decisions. If all jurisdictions enact similar ring-fencing policies, the benefits of a central "reserve pool" of capital held at parent group level are lost and they are all worse off[18].

It is also vital to ensure that the EU remains open and closely connected to global capital markets and that a level playing field is maintained. It is important that EU headquartered firms are able to diversify risks, by accessing liquidity and seizing opportunities both in the EU and at global level. Also, financial firms headquartered outside the EU provide a significant contribution to financing the European economy and they represent an important share of European capital markets activity.

18 Wilson Ervin, The risky business of ring-fencing, Working Paper, 12 December 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649

Upcoming banking reforms – CRD6/CRR3 package

Finalisation of Basel III - The December 2017 Basel Committee agreement complemented the initial set of the Basel III reforms announced in 2010, thus finalising the post-crisis prudential framework for banks. The European Commission is likely to present legislative proposals aimed at implementing this agreement during the first half of 2020.

An accurate assessment of the impact of the reforms is necessary, to avoid unintended effects and unnecessary overlap and inconsistencies with previous and ongoing reforms. A recent industry study undertaken by the Global Association of Risk Professionals shows that the likely increase in CET1 capital could reach almost EUR 300 billion. This clearly represents a departure from the Basel Committee's stated aim (and the Economic and Financial Affairs Council commitment) not to significantly increase capital requirements. Furthermore, the impact of the reforms is geographically concentrated as the aggregate RWA increase amounts to circa 28.4% for European banks[19].

The reforms will have an impact in a number of specific areas, including those outlined below:

Credit risk - Banks can decide whether to use the Standardised Approach (SA) or the internal-ratings based (IRB) approach to estimate risks and hence calculate risk-weighted assets (RWAs). While risk weights under the SA are determined by the supervisor, banks that have advanced risk management capabilities (and if authorised by their supervisor), can use IRB approaches, where banks' internal models are used to estimate RWAs. Under the Basel III final agreement, the risk weightings for real estate exposure have been changed, and reliance on external credit ratings has been constrained. Moreover, advanced IRB approaches have been removed for exposures to large corporates and financial institutions, while all IRB approaches have been removed for equity exposures.

These changes represent a significant overhaul of IRB approaches and the overall impact of these will be particularly felt in Europe, where corporates mostly rely on bank lending to source funding. Financing will also become more expensive for EU corporates because the vast majority of them are unrated, which implies higher risk weights. There will also be significant operational challenges linked to changes and decommissioning of internal models. Other issues are the proposed use of the origination value for the calculation of LTVs (loan-to-value) for property exposures, which fails to reflect fluctuations in property markets, and equity investments, which will be heavily penalised thus hindering the advancement of the CMU agenda in Europe. Furthermore, the lack of a granular risk-sensitive approach in the revised Basel III framework for Specialised Lending (both under the standardized and advanced approaches), will negatively impact the financing of projects linked to critical aspects of the real economy and the climate transition, such as infrastructure, aircraft and shipping, as well as exporting and importing among many other things.

Output Floor: Under the December 2017 agreement, the output floor sets a floor to total RWAs calculated under internal models at 72.5% of those calculated under standardised approaches. The output floor will represent a binding constraint for many banks in Europe, especially larger ones, which currently use internal models to calculate a substantial proportion of their capital requirements. To avoid unwarranted impacts on certain business lines and knock-on impacts on corporate financing and the real economy, it is essential that the floor is calculated and applied at the highest consolidation level. Furthermore, attention needs to be paid to the EU specificities already built into the credit risk Standardised Approaches (e.g. the SME supporting factor or trade finance) and going forward to the impacts on Specialised Lending and Corporates RWAs. Although the output floor is to be phased in over the period to 2027 it is likely that the market will require much earlier adoption.

Operational Risk: The Basel Committee decided to rule out use of internal modelling and developed a new Standardised Measurement Approach (SMA) for the purposes of calculating Operational Risk capital requirements. The approach strongly penalises size and past loss experience, and considers neither changes to business models nor forward-looking risk mitigation techniques such as insurance, thus misrepresenting the potential future operational risk.

19 Source: EBA Basel III monitoring exercise – March 2019. The 28.4% increase in the EU compares with 8% for North America.

Counterparty credit risk – Revisions to the Credit Valuation Adjustment[20] (CVA) framework issued by the Basel Committee removes banks' ability to use internal models. However, certain fundamental aspects of CVA have to be reconsidered to avoid disproportionate effects on corporates and other clients. A better recognition of hedging transactions and a closer alignment with accounting practices would improve the calibration of the framework. The introduction of the Standardised Approach for Counterparty Credit Risk (SA-CCR) and its use in the calculation of the output floor will further increase the cost of banks' derivatives exposures for corporates and other clients.

Minimum Securities financing transactions (SFTs) haircuts regime – SFTs (including repurchase agreements or "repos" and securities lending) play a crucial role in the capital markets. For instance, securities lending is an essential way for pension and other funds to earn low risk additional returns on assets that they hold. It is also a necessity for functioning secondary markets, making securities otherwise held for long term investment available for trading and short selling, enhancing market liquidity, price discovery and reducing costs of intermediation. It is vitally important that the SFT minimum haircuts regime is not applied to these transactions in a way that would stop banks from borrowing securities and intermediating in this market. Therefore, these transactions should be scoped out of the minimum haircut requirements, particularly when the counterparties are already regulated mutual and pension funds.

20 Credit Valuation Adjustment (CVA) is the price that an investor would pay to hedge the counterparty credit risk i.e. the risk that a counterparty may default on the obligations arising from a derivative instrument.

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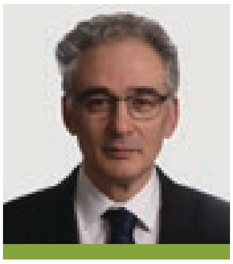

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July 2019

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