European Commission - Fact Sheet

Completing the Banking Union by 2018

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1. The Banking Union

What is the Banking Union?

In response to the recent financial crisis, the European Commission pursued a number of initiatives to create a safer financial sector for the Single Market. These initiatives form a Single Rulebook for all financial actors in the EU Member States. They include:

- stronger prudential requirements for banks;
- improved protection for depositors;
- rules for managing failing banks

In addition to this Single Rulebook, which is the foundation of the Banking Union, there was a commitment by EU institutions to implement further measures step by step: shifting supervision to the European level, establishing a single framework for bank crisis management and setting up a common system for deposit protection.

What are its key pillars (SSM, SRM, EDIS)?

On the basis of the European Commission roadmap for the creation of the Banking Union, the EU institutions agreed to establish a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) for banks. While these two pillars are already in place and fully operational, the agreed common backstop to the SRM and a common system for deposit protection have not yet been established. In parallel, there needs to be further progress on risk reduction. The Commission put forward a proposal for a European Deposit Insurance Scheme (EDIS) in November 2015 and a banking package with further risk reduction measures in November 2016. EDIS is essential for the completion of the Banking Union as it would provide stronger and more uniform insurance cover for all retail depositors in the Banking Union, regardless of their geographical location. However, negotiations on these proposals are still ongoing and they have not yet been adopted by the European Parliament and the Council.

2. Rationale for the Communication

Why are you adopting this Communication today?

As indicated by President **Juncker** in his State of the Union address on 13 September 2017,the Banking Union must be completed if it is to deliver its full potential as part of a strong Economic and Monetary Union. It is one of the key elements for the EMU, which underpins our common currency, the euro. The euro is a success story on many levels. Yet the economic and financial crisis exposed weaknesses in the set-up of our monetary union. Much has already been done to address those shortcomings. For the financial sector, this includes, for example, establishing and applying common standards for Europe's banks and reinforcing our regulatory and supervisory architecture. As a result, our banks are better capitalised and asset quality has improved. Work is ongoing to address remaining weaknesses in certain parts of the banking sector.

With the European economy experiencing a sustained recovering, and just over a year left before the end of the legislative term of the European Parliament, now is the time to move forward with completing the EMU. For the Banking Union, this includes further risk reduction and a common European Deposit Insurance Scheme (EDIS) that will guarantee the integrity of the EMU and the euro. EDIS will reduce risks to financial stability and increase risk sharing among Member States via the private sector, thereby reducing the need for public risk sharing. Alongside the Banking Union, building the Capital Markets Union is fundamental to mobilising capital in Europe and strengthening the link between savings and growth.

What are the key features of the Communication?

The Communication takes stock of what has been achieved in creating the Banking Union and what measures are still needed to complete it, with risk reduction and risk sharing measures going hand in hand. The Commission proposed a number of initiatives in the past and most recently adopted a comprehensive package of risk reduction measures for the banking sector in November 2016. The Communication aims to give new impetus to the negotiations on EDIS by offering possible compromise ideas for issues where no agreement could be reached yet. It also maps out the path towards the setting up of the backstop for the Single Resolution Fund. In addition, the Communication sets out how the Commission intends to continue to tackle the issue of NPLs and possibly to help banks diversify their investments in sovereign bonds.

3. Risk reduction

How will the November 2016 banking package help reduce risks while supporting the financing of the real economy?

Following the financial crisis that unfolded in 2007-08, the European Union established robust prudential and resolution rules for banks. These include: the Capital Requirements Regulation (CRR), the Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR). These rules aim to reduce the probability of bank crises and their negative impact on financial stability and public finances.

The Commission adopted a comprehensive package of reforms to reduce risks and further strengthen the resilience of EU banks in November 2016. The overall objective of this package is to complete the post-crisis regulatory agenda by making sure that the rules address remaining challenges to financial stability. At the same time, the reforms will enable banks to continue to fund the real economy.

The 2016 proposals incorporate the remaining elements of the rules agreed within the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). They include:

- more risk-sensitive capital requirements, in particular in the area of market risk, counterparty credit risk, and exposures to central counterparties (CCPs);
- a binding Leverage Ratio (LR) to prevent institutions from building up excessive leverage;
- a binding Net Stable Funding Ratio (NSFR) to address banks' excessive reliance on short-term wholesale funding and to reduce long-term funding risk;
- a requirement for Global Systemically Important Institutions (G-SIIs) to hold minimum levels of capital and other instruments which bear losses in resolution. This requirement, known as 'Total Loss-Absorbing Capacity' or TLAC, will be integrated into the existing MREL (Minimum Requirement for own funds and Eligible Liabilities) system, which is applicable to all banks, and will strengthen the EU's ability to resolve failing G-SIIs while protecting financial stability and minimising risks for taxpayers;
- a harmonised national insolvency ranking of unsecured debt instruments to facilitate banks' issuance of loss-absorbing debt instruments for resolution purposes. This category of unsecured debt would be available in all EU Member States and rank just below the most senior debt and other senior liabilities. Harmonised rules on the position of bond holders in the bank creditors' hierarchy in insolvency and resolution would facilitate the way bail-in is applied, by providing greater legal certainty and reducing the risk of legal challenges.

In addition, these proposals introduce more proportionate and flexible reporting and remuneration requirements for smaller and less complex banks. They create more flexible conditions for lending to SMEs and funding of infrastructure projects.

With this Communication, the Commission urges the European Parliament and the Council to now quickly adopt the measures proposed in the 2016 Banking package. The Commission will continue to engage in constructive discussions to find a solution that preserves the benefits of the proposal while taking national concerns into account in an appropriate way. With a view to swift progress, the Commission also encourages the co-legislators to maintain the clearly-defined scope of the package.

4. A European Deposit Insurance Scheme (EDIS)

What is EDIS?

In November 2015 the European Commission put forward a legislative proposal to establish a single European Deposit Insurance Scheme (EDIS) that would complement existing national deposit guarantee schemes. EU legislation already ensures that all deposits up to €100 000 are protected, through their national deposit guarantee scheme (DGS), in case of a bank failure.

Through a single fund, EDIS would also ensure equal, high quality protection of all depositors across the Banking Union in case of banks' failures. It would have more resources than national deposit guarantee funds to cope with large local shocks.

EDIS would mark an important step towards reinforcing financial stability by further weakening the link between banks and their national sovereigns and by delivering even greater trust in the safety of retail bank deposits, regardless of a bank's location in the Union. Co-legislators have not yet adopted the proposal.

What is new in today's Communication?

The Commission is today considering possible ideas in an attempt to address the diverging views and concerns that emerged during the negotiations and to steer the discussions in the European Parliament and the Council. In particular, EDIS could be introduced by the co-legislator more gradually:

- In the **reinsurance phase**, EDIS would provide liquidity to national Deposit Guarantee Schemes (DGS) in case of a bank failure, which would have to be paid back by the national DGS. Liquidity support is the most essential element to ensure that depositors are paid out.
- In the **coinsurance phase,** EDIS would also cover losses, without recouping them from the national DGS. This would further reduce the link between banks and their Member States. However, moving to this second phase would be conditional on progress achieved in reducing the level of NPLs and other legacy assets assessed through an Asset Quality Review (AQR).

Further adjustments to the Directive on deposit guarantee schemes (DGSD) could also be considered. These national schemes have been essential in offering better protection to depositors, though differences remain from one country to the next. The harmonisation of national deposit schemes needs to progress in parallel with the establishment of EDIS. This would ensure the correct functioning of EDIS and favour the exchange of information and cooperation among national DGSs, the Single Resolution Board (SRB) and the European Banking Authority (EBA). National options and discretions could be further reduced to reduce financial fragmentation.

5. Setting up a backstop to the Banking Union

What is a backstop?

A backstop is a "safety net". In the Banking Union context, a backstop would be activated in cases when, in spite of high-quality supervision, one or more banks are in crisis, and even after imposing losses on the banks' shareholders and creditors, there is a need for further resources because the Single Resolution Fund ran out of money. This safety net is not meant to be used as a default option. Rather, it aims to instil confidence in the European banking sector in that it would be available as a last resort, should less favourable conditions materialise, and will thereby further increase the protection of taxpayers. It would enhance the financial capacity of the Single Resolution Mechanism to cope with several bank resolutions at once. Importantly, such a backstop would be fiscally-neutral as the banking industry would repay any potential disbursements over the medium term.

Why does the Banking Union need a backstop?

When the Single Resolution Mechanism was established, Member States agreed to develop a common backstop to the Single Resolution Fund. In the European Council Conclusions of December 2012, they agreed that the SRF should be fiscally neutral over the medium term as contributions would be recouped from contributions from the banking sector. The European Parliament also called "for rapid progress in the work by the Council and the Commission on a common fiscal backstop for the SRF" in its 2016 annual Banking Union report.

The SRF is funded by ex-ante contributions from the banking sector. In case those are not sufficient, extraordinary ex-post contributions can be raised. However, both ex-ante and ex-post contributions are limited. A backstop would significantly strengthen the credibility of the Banking Union by ensuring that the SRB can fully safeguard financial stability and protect taxpayers even with limited ex-ante funding.

Resolution authorities may only use the backstop as a last resort. In their resolution plans, the SRB and the National Resolution Authorities identify banks' recapitalisation and liquidity needs, and how they should be funded. In principle resources from the bank's shareholders and creditors should cover those needs. They can be supplemented by the SRF. Only in case these resources are insufficient, would the backstop come in as a last resort.

What backstop is the Commission considering to the Banking Union?

The Commission supports the ongoing work with regard to a credit line from the European Stability Mechanism. This work stream will need to be pursued and articulated with the Commission's forthcoming package of proposals for the deepening of the Economic and Monetary Union, which will include a proposal to transform the European Stability Mechanism into a European Monetary Fund, within the framework of Union law. In this context, it will also be important to ensure an efficient decision-making process that will allow for a swift deployment of the backstop, in those last resort situations where this might become necessary.

6. Measures to address Non-Performing Loans (NPLs)

Why are you announcing new measures to address non-performing loans (NPLs)?

NPL ratios stopped increasing or have declined in many Member States, thanks to determined action by banks and by Member States. However, progress remains slow. The level, structure and causes of NPLs differ across national banking sectors.

Tackling NPLs is primarily the responsibility of the affected banks and of Member States, which are and will remain competent for many of the required policy tools. At the same time, the NPL issue has a European dimension. Weak growth in some Member States due to high levels of NPLs might affect economic growth elsewhere in the EU. And investors' perception of the value and soundness of all EU banks often stems from weak balance sheets in just some banks.

Therefore national authorities and European institutions need to join forces to address high NPL ratios. This was recognised by Member States in the Action Plan to tackle non-performing loans in Europe adopted by the ECOFIN Council in July 2017. The Commission has been working on this matter for some time already, and in accordance with the ECOFIN action plan, the Commission is today announcing a comprehensive package of further measures to tackle NPLs to be delivered in the first quarter of 2018.

NPLs are a legacy of the crisis. Why are you only acting now?

The Commission has been working for a long time, in cooperation with Member States, to tackle NPLs. However, now is the time to accelerate and join efforts. We now have a comprehensive set of actions agreed at the ECOFIN that both European institutions and Member States must work on.

Over the past years, the Commission has been working constructively with the concerned Member States to reduce banks' NPLs, including through the European Semester progress. Some Member States have already made great strides in cleaning up bank balance sheets since the crisis. In other Member States the reduction of NPLs has been slower.

What are Asset Management Companies (AMCs) and why do we need a European blueprint?

Experience in several Member States has demonstrated that national asset management companies (AMCs) are an effective tool to help banks clean up their balance sheets. Transferring bad loans from banks to an AMC allow viable banks to focus on their core task of lending and offering services to households and firms.

AMCs can be set up to deal with NPLs from individual banks or to manage bad loans from many banks in a Member State. An AMC can be privately or publicly owned and can receive various degrees of public support. Public support can only be given if it complies with European state aid and bank recovery and resolution rules.

AMCs can perform a useful role for society and contribute to the repair of the banks' balance sheets. They can also take a pivotal role in selling NPLs to private investors by:

- improving information and transparency in the secondary market for NPLs; and
- encouraging new investors to enter the market, which is currently dominated by a few large buyers with sometimes significant pricing power.

By making use of the existing market experience, we need to develop a solution that Member States can implement in line with the EU legal framework. The ECOFIN Action Plan tasked the Commission with developing a blueprint on how to best devise national asset management companies (AMCs). The blueprint will set out best practices on how AMCs can be established and managed, drawing on the experience and expertise gathered in some Member States during the crisis.

Why do you want to develop secondary markets for NPLs? What obstacles are you targeting?

A functioning secondary market would allow banks to clean their balance sheets by selling NPLs. In the absence of such a market, banks are obliged to keep NPLs on their balance sheets until they are fully written off. This reduces their profitability and their capacity to lend to new customers.

Currently there are too few investors willing and able to buy NPLs relative to the large amount of NPLs on European banks' balance sheets. Market entry is difficult for new investors because the business of loan sales is complex and the relevant rules differ considerably across Member States. The Commission is therefore analysing how to facilitate access to this market.

There is also a need to review entry conditions for loan servicing firms. Usually, NPL investors do not ask the bank from which they bought the NPLs to continue administering and collecting the loans. Instead, they often delegate these activities to independent firms called loan servicers. A lack of loan servicers discourages NPL investors from entering the market. Therefore, entry conditions and conduct rules for loan servicers play a crucial role in developing a secondary market for NPLs.

Why are you going to propose European rules to enhance the ability of secured creditors to recover value from loans?

Enabling secured creditors to recover value more swiftly from loans granted to companies and entrepreneurs is a priority action of the Mid-term Review of the Capital Markets Union Action Plan. Effective out-of-court enforcement mechanisms can help deal with NPLs, as they provide secured creditors with legal instruments to enforce their rights against collateral. However these solutions do not exist in all Member States. Recent work performed by the SSM shows that "the legal frameworks for collateral enforcement across the euro area Member States are divergent. One-third of those countries consider the topic as being a challenge for NPL resolution, largely due to the lack of a modern legal framework enabling timely out-of-court collateral enforcement".

The purpose of a measure on an accelerated enforcement of collateral is to provide banks in all Member States with a swift and effective out-of-court mechanism to enforce secured loans against companies and entrepreneurs, subject to common agreement. This would complement and be consistent with the 2016 Commission proposal on preventative restructuring frameworks. Secured loans include mortgages, pledges and other comparable contractual or legal instruments granted to companies and entrepreneurs (excluding natural persons, householders, consumers, non-professional borrowers).

An accelerated enforcement of collateral would strengthen the EU banking system and prevent the accumulation of NPLs on banks' balance sheets in the future. Convergence in enforcement of secured loans in the EU would increase lending to companies, including to small and medium-sized enterprises (SMEs). It would improve the functioning of the Single Market by improving the competitiveness of EU banks and providing incentives for the provision of cross-border loans to companies.

Why are you considering statutory prudential backstops against new NPLs? What would be their purpose and rationale?

The Commission is following up on the ECOFIN Council conclusions, which asked it to look into the possibility to amend EU legislation and introduce prudential backstops to address potential under-provisioning of new loans.

Insufficiently provisioned NPLs regularly pile up on banks' balance sheets, which in turn may cast doubt on the bank's future profitability, solvency and thus its long-term viability. Although average provisioning levels have recently increased in certain Member States with high NPL stocks, loss recognition is sometimes still too slow and low to allow for effectively resolving NPLs. Statutory prudential backstops against NPLs arising from newly-issued loans would set for the future common minimum levels of capital set aside by EU banks to cover incurred and expected losses on NPLs. It would be a prudential tool (under the so-called "Pillar 1", i.e. minimum capital requirements directly applicable to all banks). Banks would need to continue to recognise accounting provisions in line with their assessment and applicable accounting standards. Those provisions, including potential increases in provisions as a result of IFRS9, would be taken fully into account for the purposes of the prudential backstops, including potential increases in provisions as a result of IFRS9. But without common prudential rules on provisioning for NPLs, loan loss coverage might vary across banks which essentially bear the same underlying risk. This can limit the comparability of capital ratios and undermine their reliance.

The purpose of statutory prudential backstops would be to prevent the build-up of future NPL stocks with insufficient loan loss coverage, thereby ensuring banks' financial soundness.

7. Sovereign Bond-Backed Securities (SBBS)

What are sovereign bond-backed securities (SBBS) and what advantages can they bring?

One aim of the Banking Union is to reduce financial stability risks by making it easier for banks to diversify their sovereign portfolios. This will further weaken the link between banks and their governments (or sovereigns). So-called sovereign bond-backed securities (SBBS) could be a first step towards this.

Such instruments could enhance cross-border risk sharing by spreading risks more widely across investors and across borders in the EMU. By pooling and possibly tranching sovereign bonds from different Member States, SBBS could support further portfolio diversification in the banking sector.In a first step, i.e. pooling, a special entity (a private institution which can be a Special Purpose Vehicle) buys a portfolio of different euro-denominated sovereign bonds. In a second step, i.e. tranching, the special entity may tranche the pooled assets and issue different bonds. Investors can buy them according to their risk profile. The senior tranches would help banks diversify their portfolios and at the same time expand the supply of safe assets in euro area financial markets.

What is the Commission doing in this field?

Already in the 2017 Reflection Paper on the Deepening of the Economic and Monetary Union (EMU), the Commission identified the development of sovereign bond-backed securities (SBBS) as one possibility of promoting greater diversification of banks' balance sheets.

The Commission is closely following and contributing to the ongoing work on SBBS within the European Systemic Risk Board (ESRB). Following the completion of this work in December 2017 and in consultations with relevant stakeholders, the Commission will consider putting forward a legislative proposal for an enabling framework for the development of sovereign bond-backed securities in 2018.

8. SSM Review Report

What is the objective of the Commission's Report on the SSM Regulation?

Regulation (EU) No 1024/2013, setting-up the SSM, requires the Commission to undertake a broad review of the overall application of the Regulation. The review focused on identifying the potential impact of the regulation on the smooth functioning of the Single Market. This is the first Commission assessment of the SSM Regulation since the ECB took over its supervisory tasks in November 2014.

What are the Commission's views on the performance of the SSM so far?

The establishment of the SSM was successful overall. The ECB, with the support of National Competent Authorities, has the necessary tools to supervise significant banks and to exercise its coordination and oversight functions. The ECB has managed to establish in a short time a good reputation as an effective and rigorous supervisory authority. This represents a remarkable achievement, especially in light of the diversity of bank supervision in the 19 participating Member States. There were some organisational challenges in the initial stage, but the ECB and the National Competent Authorities have managed them well, demonstrating a high capacity to react and adapt. The Report also concludes that there is no reason to change the SSM Regulation at this point in time.

Does the report find that the ECB already has tools to address the existing NPLs?

Existing supervisory powers already include several tools that can be and are used by supervisors to address NPLs in specific banks. Most notably, competent authorities can influence a bank's provisioning levels within the limits of the applicable accounting framework. They can apply the necessary adjustments if accounting provisioning is not sufficient from a supervisory perspective.

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