Position paper on the goals of the banking union

What do we want?
We want a banking union that guarantees financial stability, protects the taxpayer and allows for the greatest possible degree of European market integration while also addressing the risks inherent in a more closely integrated banking union.

Deepening market integration in the area of banking services makes for a European single market that is stronger overall, which in turn lays the foundation for greater prosperity in all Member States. Improving the conditions for the use of capital and liquidity by cross-border banks helps overcome market fragmentation where it still exists. This makes a key contribution to boosting the profitability of European banks and to reducing competitive disadvantages at the international level.

From a macro-economic perspective, overcoming the existing market fragmentation has two advantages: on the one hand, European companies and consumers gain access to financing and other banking services that are better, more efficient and cheaper. This increases Europe's growth potential. On the other hand, an increase in cross-border investments and business activities would mitigate the risks of the sovereign-bank nexus and would result in improved, Europe-wide responsiveness to economic cycles. In the Anglo-American sphere, this question is being discussed as part of a debate on private risk sharing.

Both of the above-named effects were seen in the U.S. when the banking market there was completed from the 1980s and 90s onwards. The possibility of reducing Europe's competitive disadvantage compared to the U.S. clearly illustrates the importance of completing the European banking union.

Finalising the overarching structure of the banking union also requires a European deposit insurance scheme. It is necessary to first reduce and then continuously review the risks, which also determine the likelihood of recourse to the European deposit insurance scheme. This requires a consistent, effective supervisory regime and crisis management, which should be based on harmonised bank insolvency legislation and on the further development of a European resolution regime, which should serve as the foundation for a deeper integration of cross-border EU banking groups. We also need adequate regulation for sovereign bonds. Finally, we should keep working consistently to reduce non-performing loans on bank balance sheets.

However, a complete banking union also opens up arbitrage opportunities, which risks placing a particularly heavy burden on the Member States, which make a big contribution to integration. The Member States, as business locations, diverge not only in terms of deposit insurance, but also, for example, in terms of tax law, which provides for different corporate tax bases in the EU and for differences in the treatment of the deductibility of contributions to the Single Resolution Fund (bank levies).

Such differences would enable some Member States not only to profit from the solidarity of all Member States via a European deposit insurance scheme, but also to use more advantageous tax rules to position themselves as attractive locations for banks – at the expense of other Member States. A banking union that is based on the fair balance of interests must also eliminate such arbitrage opportunities.

What needs to be done?

1. A more efficient supervisory regime and crisis management

The existing regime whereby the Single Resolution Board (SRB) generally functions as the central resolution authority only (a) for significant institutions and (b) to safeguard the public interest has already proven that it works in practice. However, the notion of a European single resolution scheme is undermined in cases where resolution is not found to be in the public interest and where national funds are then used to support small banks or in cases where banks and creditors benefit more from national insolvency proceedings than from a bail-in. It is here that the U.S. model provides a good example of the ways in which supervisory and resolution regimes can be strengthened and improved. The strength of the Federal Deposit Insurance Corporation (FDIC) results in no small part from the fact that it can draw on a foundation of largely harmonised insolvency and resolution legislation as well as the fact that it has sufficient powers to take action in a timely, decisive fashion (preventing forbearance) and to ensure that banks that are not viable are wound down.

a) Supervision and resolution of banks:

Instruments which have so far been available only for the resolution of systemically important banks (e.g. for the transfer of the deposit-taking business or for the establishment of a bridge bank) should also be made available to smaller banks that are not systemically important. The SRB should be involved where there is a risk of distortions of competition on the single market. In light of the Federal Constitutional Court’s recent judgements, it might also be feasible to give the SRB the power to assume responsibility for direct supervision as a pre-emptive measure.

At the same time, it must be ensured that the European Single Resolution Fund (SRF) and Common Backstop cannot be accessed by institutions that have no systemic importance. Rather, the least cost principle must apply: in individual cases where financing resolution measures costs less than compensation payments to depositors, there needs to be the possibility of financing resolution measures for such institutions by using the funds intended for the deposit insurance scheme. The SRB could be assigned responsibility for taking the decision as to whether, based on cost-effectiveness considerations, alternative funds should be used for depositor compensation.

b) European legislation on bank insolvency:
There is very little harmonisation within the EU regarding the main national insolvency rules that apply to banks. So far, only the resolution of systemically important banks has been harmonised; for big banks, resolution has been centralised via the SRB. Smaller banks are generally liquidated in national insolvency proceedings. In contrast, systemically important banks are not liquidated in resolution proceedings. Rather, the goal is to continue the systemically important business via a recapitalisation that is primarily funded by the bank's owners and private financiers.

The lack of harmonisation in this area complicates the resolution of banks with cross-border operations. This becomes particularly problematic when banks and creditors are better placed in proceedings under national insolvency legislation than they would be with a resolution in accordance with the Bank Recovery and Resolution Directive. When this happens, national insolvency legislation undercuts the provisions that are tailored to fit the specific set of interests at play when a bank is wound down.

What is more, the SRB also needs to take into account 19 different national insolvency regimes when performing a resolution due to the no-creditor-worse-off principle, which stipulates that no creditor may incur greater losses as a result of a resolution than they would have in national insolvency proceedings. This is complex, increases legal and compensation risks and results in groups of creditors receiving different treatment despite being fundamentally the same.

For this reason, we need a single European set of laws on bank insolvency.

c) Deeper integration of EU banking groups:
Host countries, i.e. countries whose banking sectors are dominated by the subsidiaries of foreign banks, fear that a crisis in the parent company could result in a liquidity drain and thus impact the host country's real economy. In order to protect themselves in case the subsidiary (which is resident in the host country) fails, these countries advocate maintaining the status quo, whereby capital and liquidity requirements as well as the minimum requirements for own funds and eligible liabilities (MREL) must be met on an individual basis for the event of a resolution, and where limits on large exposures also apply within the same group ("ringfencing").
Home countries, i.e. Member States where the parent companies are resident, believe that such national ringfencing requirements prevent the parent companies from efficiently managing their capital and liquidity. Home countries therefore strive for the fully flexible deployment of capital and liquidity within cross-border corporations by having provisions

whereby only the group as a whole would be obliged to meet the capital and liquidity requirements and MREL. If market integration is to progress, we need to strike an appropriate balance between the interests of both the host and home countries.

The German banking sector has its own set of specificities. It continues to be characterised by a large number of small banks with a regional outlook. However, the share of foreign subsidiaries in the German banking sector has been rising steadily (and is likely to continue to do so). At 5%, this share is roughly twice as high as the total liabilities of German banks' foreign subsidiaries in all EU Member States. To build business models that are sustainable in the long term, German banks will need to further expand in other EU countries. A stronger banking union will also facilitate this.

A forward-looking solution needs to take into account host countries' interests while also achieving the greatest possible degree of integration. One approach would be to combine a maximum of flexibility for a group-wide deployment of funds within the European banking union with comprehensive safeguards for the host countries in the event of a crisis. In ordinary times, capital and liquidity could be allocated flexibly within the group throughout the European banking union. Only in the event of a crisis would capital and liquidity be made available to the subsidiaries in the host countries, regardless of where they were previously held in the group. This would occur via a case-by-case decision based on a waterfall payment scheme within the group that would be set out by a legal text. Such provisions would provide the ECB and the SRB with guidelines on how available funds should be distributed within the group in the event of a crisis, which could also be of decisive importance for the distribution of SRF funds.

Where necessary, special provisions for banks under company law should also be harmonised so as to complement or adjust to the supervisory changes. Such a harmonisation would remove any barriers that might currently exist under company law and that could hinder the free flow of liquidity within the ordinary course of business or hamper the cross-border distribution of funds by the ECB/SRB in the event of a crisis.

One option would be to create a European legal form for banks or to further develop the European Company (SE), all the while respecting participation rights.

<u>2. Further reduction of risks</u>

a) "Safe portfolio"/regulatory treatment of sovereign bonds:

The financial crisis and the sovereign debt crisis showed that sovereign bonds are not a risk-free investment. Currently, however, banks do not need to assign an appropriate risk-based valuation to sovereign debt that they hold (zero-risk weighting); neither do regulatory restrictions on concentration exist (limits on large exposures). Banks therefore hold large amounts of sovereign bonds on their balance sheets without the corresponding risk provisioning. In addition, banks mainly hold sovereign bonds issued by their home country ("home bias"). During a crisis, this sovereign-bank nexus presents a large risk to financial stability in the monetary union.

The introduction of risk-based concentration charges would create incentives to reduce home bias and spread risks with regard to sovereign bonds. In this case, banks would also have to make provisions for risks arising from sovereign debt.

This type of model would be based on the introduction of base risk weighting for different qualities of loans, measured using ratings, for example. This would include a certain allowance for sovereign debt, which would be exempt of the capital, requirements irrespective of the rating (e.g. up to a concentration of 33% of the Tier 1 capital of the individual bank). This type of exemption for a "base concentration" would reflect the need for banks to maintain, due to regulatory requirements and for refinancing purposes within the central bank system, a certain quantity of safe, liquid assets, which generally consist of sovereign bonds.

The size of the degree of concentration of sovereign debt issued by a single country on banks' balance sheets could then be addressed using a concentration factor, which would increase with increasing concentration. Multiplying the concentration factor by the base risk weighting would give the risk-based concentration charges, based on the rating and the degree of concentration. Hence, the lower the quality of the loan and the higher the concentration of the liabilities from individual countries or borrower units on the bank's balance sheets, the higher the applicable risk-based concentration charge would be.

This type of model can be calibrated in such a way that it would not involve excessively large additional capital requirements for Eurozone banks in comparison with the status quo. Nevertheless, in this case there would already be an incentive for banks to more intensively diversify their sovereign bonds portfolios and hence function better as a buffer in crisis situations. In addition, challenges resulting from the transition could be mitigated by having an appropriate phase-in period (5 to 7 years).

In this way, banks in all countries would build up a "safe portfolio" of sovereign bonds over time. This would also help countries with weaker credit ratings.

b) <u>Reduction of non-performing loans:</u>
The reduction of non-performing loans (NPLs) on banks' balance sheets that was agreed as part of the banking package must be implemented consistently. An NPL ratio of 5% gross / 2.5% net should be reached in all Member States.

c) Money laundering:
In addition to the systematic implementation of the Anti-Money Laundering Action Plan, measures should also be taken – based on a thorough "post mortem" analysis of the most recent cases – to further improve the combating of money laundering and terrorist financing across the EU.

3. European deposit insurance scheme

Ultimately, a European deposit insurance scheme will also become realistic within the framework of a stronger overall banking union architecture. The aim of such a scheme is to stabilise the financial system by counteracting bank runs caused by depositors losing confidence in the capacity of the national banking system. In the course of deeper market integration, the varying capacities of the national deposit guarantee schemes (NDGSs) could be balanced out within a European reinsurance scheme. To this end – once the target level set out in the EU Deposit Guarantee Schemes Directive has been achieved, and on the basis of an intergovernmental agreement – resources would be accumulated in a European deposit insurance fund in addition to the NDGS resources. The European deposit insurance fund, which would have national compartments and be administered by the SRB, could provide liquidity to the NDGSs when needed, in the form of repayable loans. Furthermore, it must also be ensured that the target level for the NDGSs and also the contributions from banks continue to be increased in line with the overall level of deposits, in order to counteract an exponential attraction of deposits at the cost of other banking sectors.

In order to ensure that NDGSs in Member States with small banking sectors (which therefore have limited possibilities for repaying liquidity loans) can also access sufficient resources, a reinsurance model could also be considered during the steady state of the banking union (in other words in a second phase, once all the other elements of the banking union have been implemented). The reinsurance model could involve, in addition to liquidity provision, a – limited – loss-bearing component. In this way, more resources could be provided to the NDGS than in the case of a model which involves a complete repayment of the loan.

In order to avoid creating the wrong incentives (shifting of liability to the European level), national responsibility must however continue to be a central element. Hence it would only be possible to call on the European reinsurance scheme once national resources had been exhausted[1]. The European contribution would also be capped; a need for resources that exceeded this contribution would have to be covered by the Member State in question.

If the Member State did not have sufficient capacity, then the European Stability Mechanism (ESM) could also support the Member State with normal programme resources, on the basis

[1]The German deposit guarantee schemes could fulfil this requirement by means of an equalisation mechanism among each other.

of a case-specific decision and with suitable requirements (conditionality), as is standard practice in such cases.

4. Prevention of arbitrage

Key factors leading to distortion of competition among Member States can be found in the area of tax law. Hence, the common corporate tax base (CCTB) represents an important step in the fight against profit shifting within the EU, which is aimed exclusively at minimising tax payments. For this reason, Germany, working together with France, is pushing for the CCTB, so that Europe will have fair conditions for the taxation of companies. In particular, the CCTB would create a level playing field within the EU and therefore also enhance the competitiveness of the European single market as a whole. In addition, Germany and France are also pushing for a minimum effective tax. This is an attempt to end the race to the bottom in the area of tax rates, which is detrimental to Member States' budgets. This type of minimum tax would also lead to more tax equity with regard to the differences between the traditional and digital economies.

Outside of this discussion, further progress with the banking union cannot be allowed to lead to a situation where competition-distorting tax arrangements, especially for profit-shifting purposes, continue to be promoted. This involves arbitrage possibilities with regard to tax rates as well as tax bases. For this reason, we absolutely need uniform taxation of banks within the EU.

In the intergovernmental agreement on the Single Resolution Fund, the Member States expressed their wish to achieve a level playing field with regard to the tax treatment of bank levies. This should now be implemented.

Next steps

1. There is already a Commission proposal on EDIS that has been discussed in detail. In the areas of crisis management (home/host) and sovereign bond regulation, more technical work is needed:

- Expert groups have been tasked with writing up in-depth analyses by December 2019. Their reports will contain:
  a) proposals to (i) fine-tune and strengthen the supervisory regime and crisis management, and (ii) create a single market for banking services, including safeguards for hosts (this includes special company law rules for banks, if necessary as an accompaniment to adjustments in supervisory law).
  b) calibration models for the adequate regulation of sovereign bonds.

  The Commission should then propose rules based on these in-depth expert reports.
- The Commission should also propose bank insolvency legislation that can then be discussed in the Council. This needs to happen soon.

- The Commission could also submit a new proposal for a European deposit reinsurance scheme.

2. The Commission should propose legislation ensuring the uniform taxation of banks. In addition, we expect the Council to engage in deliberations on a common corporate tax base (CCTB) and a minimum tax. These deliberations must be results-oriented and aimed at advancing international negotiations, and they should lead to well-designed Commission proposals.

- Furthermore, member states should make voluntary commitments to standardise their tax treatment of bank levies.