FINANCIAL STABILITY CONFERENCE

SEVENTH JOINT CONFERENCE ON EU FINANCIAL MARKETS POLICIES

REPORT 2019

EU BETWEEN REGRESS AND PROGRESS: HOW TO COPE WITH NATIONAL BANKING POLICIES, SINGLE MARKET DEFICIENCIES AND THE UNSOLVED SHARING ISSUE

– political dynamics and their repercussions on regulatory and institutional settings

FINANCIAL
RISK AND
STABILITY

NETWORK

ESMT BERLIN

European University Institute

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

FLORENCE SCHOOL OF BANKING & FINANCE

AMSTERDAM CENTER FOR LAW & ECONOMICS

Single Resolution Board

28 October 2019, Berlin

Dear Conference Participants, dear All,

The Financial Stability Conference 2019 was a good success as regards its aim and motivation. An excellent line-up of speakers and panelists represented an inspiring mix of different views and perspectives, while a large audience of about 200 participants actively and controversially debated the agenda topics.

When outlining first thoughts to this conference beginning 2019, we were still moved by the discussions of our 2018 conference. The issue of risk reduction and risk sharing was passionately debated, leaving substantial disagreements on how to make progress given the divergent positions of policy makers. We also looked at essential worksites for the European Union in the light of changing political conditions. This is why setting the topic of national banking policies and financial integration seemed reasonable to us in addition. And as bank resolution is at risk that believe in it fades away, we put the topic of how to make resolution work as a third indispensable subject on the draft agenda. With this ideas, we developed and finalised a convincing and consistent program. This was reflected at the conference itself, by the enriching debates, and by the appreciation from many participants. Indeed, the discussions gave important and informed insights on the subject matters and revealed different views and positions, especially from policy makers, on controversial and pending issues in the EU, on significant financial integration aspects as well as on the functioning of the bank resolution framework. Furthermore, the event presented a perfect venue to bridge academic and policy making expertise, including as well various stakeholders, institutions and civil society.

In doing so, our intention is to foster policy dialogue with a focus on contributing to advance financial reforms and solve problems in the EU. Against first worries, we succeeded in ensuring a sufficient funding for the conference, the relating research workshop as well as some other activities in 2019. As a unique and credible organiser with a serious commitment and an independent stance we received al lot of encouragement and positive feedback, and I want to express my thanks to all those who engaged. As a very lean non-profit organisation we succeeded to attract oustanding speakers, to develop thoughtful and topical agendas, to enter in cooperations with institutions, and to build up reach and attraction in the European Union throughout the political, institutional and academic landscape.

Let's have a look at our 2019's conference: the outcome of our considerations and reflections resulted in the title „EU between regress and progress: how to cope with national banking policies, single market deficiencies and the unsolved sharing Issue. As a subtitle we put „– political dynamics and their repercussions on regulatory and institutional settings" to illustrate the backdrop and direction of the agenda topics. When drawing up first ideas of the program, we thought that resuming some of the relevant debates in 2018 and driving them forward is reasonable and senseful – as some of the issues that have been touched upon remained contentious, unfinished work. And we completed these with none the less essential, additional topics on financial markets policies in the EU.

At this point, let me make some general remarks on the political settings, which were as well a backdrop to the agenda setting. As our 2018's conference has shown, some of these issues are highly political. The policy conditions and developments shape and affect the strains and tensions between regress and

progress in the EU. And policy making at European levels usually carries grits in its gear. Interferences and blockades by member states are quite normal. But what we experience since some time is more than that. There is a new quality, not to the good, but to the worse: the vigorous propagation of nationalism and the increase of populism in member states – mixed with gains by populist and extreme right-wing parties in various elections. Obstruction of reform projects and the brutalisation of political debates are the actions of the latter groups.

This all means headwinds for progress in the EU and heigthen the obstacles to essential worksites on financial integration. Fragmentation of the single market is one worksite, but there are more: inter alia regulatory ring-fencing and the protection of national banking systems by their governments. These ties are very strong, a fact that has been demonstrated once again in spring 2019 when the German Finance Minister pushed Deutsche Bank and Commerzbank for a merger to create a national champion. Such national interests and interferences also concern the too-big-to-fail issue and the prospects for the application of the resolution framework, for which we experience many impediments in practice. This refers as well to a more fundamental political conflict situation in the EU to which Martin Hellwig alluded in his opening speech. He said that in local and national policy discourses there is hardly anyone who defends the need for the rules of the Banking Union and the interference that they mandate.

In addition, there is a risk, post-Brexit, of intensified competition for financial services between the UK and the EU, resulting in a loosening of regulatory standards in the UK; as it is happening in the United States under the Trump-Administration - Dennis Kelleher clearly pointed this out at our conference in 2018.

All this adds to possibly destabilizing effects under worsening economic conditions, due to open trade conflicts. Legacy issues and problems with non-performing loans in some national banking sectors could pop up quickly if the situation deteriorates. And the room for manoeuvre for monetary and fiscal policies to counteract is limited. Moreover, ECB policies as well as the question on risk distribution in the EU remain points of serious contention between member states, and prospects to advance look poor - though the German Finance Minister recently suggested a compromise proposal on the debated European Deposit Insurance Scheme as the missing part of the Banking Union.

These settings are in particular worrying as we see a widespread mistrust and a lack of confidence, ruling policy making in Europe. They are adding to the fragility of the current state in the European Union, causing a political stalemate at different levels: only look at the time consumed by Brexit negotiations and the related political games as an example. There is a crisis of confidence in policy making, in times where there are major risks and challenges lying ahead. Climate change is a massive issue, with strong repercussions also on financial stability and the financial sector.

Looking at these developments, people ask their representatives to deliver, while populist and right wing parties use it for their disastrous political purposes. I am convinced that the European Union, the Single Market and the Monetary Union are common public goods. They should not be reduced to the economy and big firms only. It has to be a project of solidity and solidarity as well, and not largely a means to fulfill the interests of big business and powerful stakeholder groups. This has to be remembered sometimes when looking at the unrest in societies. I strongly believe that the EU is the future. I cannot see how we can address global problems at national levels in a progressive and positive way. This relates inter alia to the financial system, its centrality to the economies and societes, its global interconnectedness and its interdependencies with national states and policy making.

In my view, there is no reason for relaxation and complacency. We have to get to common understandings and advance reforms. And this is where some motivation of the conference and the organiser lies. What worries me, and what cannot be set aside by optimism shown, is that national one-dimensionalities contain immense potential for conflict for and within the EU. In my view, much more courage, tranparency and responsability are urgently needed at policy making levels. They are the very necessary ingredients for forward-looking policy making, especially in a monetary union, and even more in addressing existing and future challenges.

As to the organiser and his motivation, the idea is to present a critical and independent platform for serious debate on financial reforms and financial stability issues. I am convinced that we do need an open, public discussion format on essential issues of financial markets policies at an ongoing basis, integrating all stakeholders and civil society as a often neglected voice. We shall not leave the debate only to the industry and to closed shops of expert circles in authorities and central banks. In this respect, the conference is indeed unique. Looking back, this is well appreciated. We did set comprehensive agendas and filled controversial discussions.

The event appears to be considerably interesting and attractive also from a scientific perspective – our relating research workshops which were discussing and deepening aspects of the conference topics, financial stability issues and bank resolution clearly confirmed this. A range of policy suggestions and points of reference for policy-oriented, at the same time scientifically based analysis were identified. Also this year we brought together researchers from all over Europe to draft policy papers and present them at the workshop. The feedback was overwhelming positive. Most of the results can be found on our website.

At this point, let me thank those who made the events possible. First, I am very grateful to the endowment „Stiftung Geld und Währung" for their most valuable support since the beginning - regrettably in 2019 for the last time. And I want to thank Linklaters and Moody's for their generous support as premium sponsors. Furthermore, I much appreciated the cost contributions by Amsterdam Center for Law and Economics as well as Florence School of Banking and Finance. And I am greatful to ESMT Berlin for having been the host of the conference in the fifth year. Last but not least let me thank all partners and the members of the organising committee to support our ambition, and for their valuable input when preparing the conference.

I very much appreciate your feedback on the conference and the accompanying activities so far. Thank you

Martin Aehling

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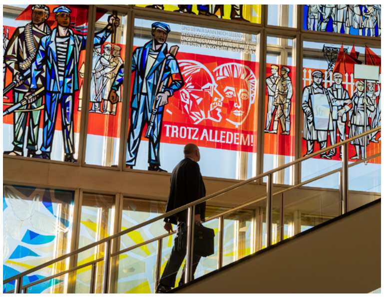

Organiser

Financial Risk and Stability Network
FRS is an independent non-profit organisation based in Berlin focusing on regulation, financial stability and financial sector reforms in the EU.

Co-Organisers

ESMT Berlin
ESMT is a international private business school with the right to grant PhDs and is accredited by the German state, AACSB, AMBA, EQUIS, and FIBAA.

Florence School of Banking and Finance
The FBF is a European platform bringing together practitioners and academics to develop a common culture of regulation and supervision in the EU.

Cooperation Partners

Amsterdam Center for Law and Economics
ACLE is an interdisciplinary research institute founded by the University of Amsterdam in cooperation with the School of Economics and the Law School.

Single Resolution Board
The SRB is the central resolution authority within the Banking Union. Together with the National Resolution Authorities it forms the SRM.

Organising Committee

Martin Aehling, Director, Financial Risk and Stability Network

Prof. Arnoud Boot, Professor of Corporate Finance and Financial Markets, University of Amsterdam

Prof. Elena Carletti, Professor of Finance, Bocconi University

Prof. Stefan Janßen, Professor for Corporate Finance and Banking, Jade University of Applied Sciences

Prof. Bart Joosen, Professor of Financial Law, VU University Amsterdam

Prof. Luís Silva Morais, Professor of Law, University of Lisbon

Prof. Georg Ringe, Professor of Law and Economics, University of Hamburg

Prof. Jörg Rocholl, President, ESMT Berlin

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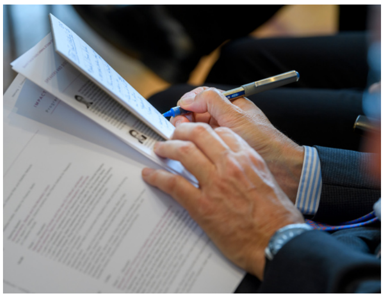
Stiftung Geld und Währung

Figures

26 speakers, panelists and moderators
212 guest registrations
204 attended participants

Motivation



The surge and solidification of populist tendencies challenge the Europen Union at different levels. The results of the elections to the European Parliament, the political stalemate in the United Kingdom and the propagation of national thinking ample demonstrate that the EU is at a turning point with the risk of disintegration. This relates to the Single Market, competition and banking policies in member states. In case of Brexit, the rivalry between financial centers will accelerate with the prospect of lowering regulatory standards in the UK. In the EU an extended use of options and national discretions by national authorities can be observed. And as regards national banking systems we experience a strong protective policy by finance ministries, especially as regards big banks.

At EU level, the efforts in progressing reforms and solving the unfinished Banking Union are facing even more headwinds. In addition, financial markets integration and legal harmonisation in the EU are essential worksites where a lot remains to be done. At the same time, legacy issues, bad assets as well as the problem with unhealthy zombie banks still exist. In contrast, the room for manoeuvre for monetary and fiscal policies to counteract emerging crisis risks is very limited. Moreover, ECB policies as well as the question on risk sharing in the EU remain points of severe contention between member states, and prospects to advance are seemingly poor. This is in particular worrying as we currently observe signs of weakening economies due to open trade conflicts.

Against this backdrop, the organisers take a foremost policy-oriented stance to discuss some of the most crucial issues lying ahead. Central questions will be how current changes in the political landscape impact financial markets integration and resilience, what implications have surging national banking policies on competition, harmonisation and diversity, how to tackle obstacles, legal constraints and policy interferences to bank resolution, and how to achieve common grounds on instruments, frameworks and procedures as regards risk sharing.

The conference brings together regulators, scientists, politicians, industry experts and organisations in an open debate format. We are convinced that generating a critical debate is very reasonable and also necessary to build a sustainable, diverse and resilient financial system which fulfills its vital functions in serving the economy and society as well. In this regard, the conference delivered inspiring insights.

09:00
Opening

Martin Aehling, Director, Financial Risk and Stability Network

09:15
Address

Dr. Matthias Kollatz, Senator for Finance, Berlin

09:30
Opening Keynote

Governments, Banks and European Monetary Union

Prof. Martin F. Hellwig, Director emeritus,
Max Planck Institute for Research on Collective Goods

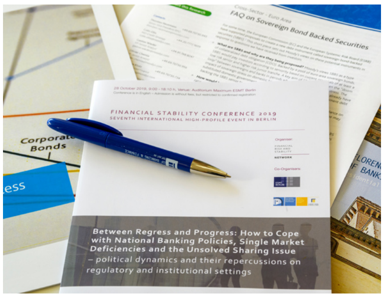
10:00
Panel I – Discussion

National Banking Policies and the new EU Political Landscape: Stuck between Reform Ambitions and Disintegration Tendencies

- Lost in Frustration: Implications of EP Elections and Brexit on EU Financial Integration
- Lost in Temptations: Promoting ‚Champions' and Calls for ‚Pan-European Banks'
- Lost in Sheltering: State Interferences and the Protection of National Banking Systems
- Uneven Policies: Ring-Fencing and the Use of Options and National Discretions

Prof. Arnoud Boot, Professor of Corporate Finance and Financial Markets, University of Amsterdam
Johannes Pockrandt, Head of Government and Public Affairs Germany, Deutsche Bank
Giorgio Gobbi, Head of the Financial Stability Directorate, Bank of Italy
Dr. Korbinian Ibel, Director General Microprudential Supervision IV, European Central Bank
Christian Stiefmüller, Senior Research and Advocacy Advisor, Finance Watch
Moderation: Prof. Elena Carletti, Professor of Finance, Bocconi University, and Scientific Director, Florence School of Banking and Finance

11:45
Panel II



Between Wishful Thinking and Feasibility: How to remove Obstacles to True Competition and a Common Beneficial Single Market in the EU?

- Reasonings: Logic and Benefits of an Integrated Financial Market in the EU
- How did we get here? From the Treaty of Rome to the Banking Union
- Taking Stock: What are the Remaining Practical Hurdles to Further Integration?
- Action: What Steps are Needed to achieve a Fully Integrated Financial Market?

Dr. Srobona Mitra, Senior Economist, European Department, International Monetary Fund
Dr. Peter Grasmann, Head, EU/Euro Area Financial System Unit, European Commission
Willem Pieter de Groen, Head of Financial Markets and Institutions Unit, CEPS
Costanza Bufalini, Head of Regulatory Relations and Group Regulatory Affairs, UniCredit
Michala Marcussen, Group Chief Economist and Head of Economic and Sector Research, Société Générale
Moderation: Prof. Joachim Gassen, Chair of Financial Accounting and Auditing, Humboldt University Berlin

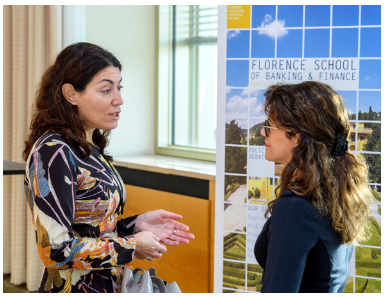
14:00
Panel III – Impulse

Sebastiano Laviola, Board Member, Single Resolution Board

14:15
Panel III – Discussion

Making Resolution Work: How to deal with Legal Loopholes, Institutional Implementation Challenges and Impediments to Practice

- Application Constraints: No-Creditor-Worse-off, Bail-in Cascade and Lawsuits
- Credibility of Bail-in: Can it be properly applied before Believe fades away?
- Liquidity in and after Resolution: Provisions for restoring Market Confidence?
- Current and Incoming Challenges as regards MREL and Impediments to Resolution



Cristina Dias, Parliamentary Research Administrator, European Parliament
Sebastiano Laviola, Board Member, Director of Strategy and Policy Coordination, Single Resolution Board
Dr. Sven Schelo, Partner, Linklaters LLP
Dr. Reto Schiltknecht, Head of International Affairs and Policy Issues, Recovery and Resolution Division, FINMA
Carola Schuler, Managing Director, Financial Institutions Group, Moody's
Moderation: Luís Silva Morais, Professor of Law, University of Lisbon

16:00
Panel IV – Impulses

Giuseppe de Martino, Senior Advisor, Banking and Financial System - Legal Affairs, Italian Ministry of Finance
Dr. Levin Holle, Director General Financial Markets Policy,
German Federal Ministry of Finance
Nicoletta Mascher, Head of Banking, European Stability Mechanism
Sébastien Raspiller, Assistant Secretary for Financial Services, Directorat General of the Treasury, French Ministry for the Economy and Finance
Emiliano Tornese, Deputy Head, Resolution and Crisis Mangement Unit, European Commission

16:30
Panel IV – Discussion

Risk Sharing in the EU:
How to achieve and ensure Common Grounds on Adequate Instruments, Institutional Frameworks and Appropriate Procedures

- What Kind of Institutional Designs create the Right Incentives and Market Discipline to make Risk-Sharing Acceptable and Sustainable?
- Any Discrepancies between Real and Perceived Redistributive Impact of Risk-Sharing Arrangements?
- Implicit versus Explicit Risk Sharing: How much Risk-Sharing is already embedded in the Existing Framework?
- North-South Perceptions: How to find Fair Responses to Burden Sharing and Crisis Management Procedures

Giuseppe de Martino, Senior Advisor, Banking and Financial System - Legal Affairs, Italian Ministry of Finance
Dr. Levin Holle, Director General Financial Markets Policy,
German Federal Ministry of Finance
Nicoletta Mascher, Head of Banking, European Stability Mechanism
Sébastien Raspiller, Assistant Secretary for Financial Services, Directorat General of the Treasury, French Ministry for the Economy and Finance
Emiliano Tornese, Deputy Head, Resolution and Crisis Mangement Unit, European Commission
Moderation: Nicolas Véron, Senior Fellow, Bruegel and
Peterson Institute for International Economics

18:00
Closing

Martin Aehling, Director, Financial Risk and Stability Network

18:10
Get together

Address

Dr. Matthias Kollatz, Senator for Finance of Berlin

Matthias Kollatz opened his address by extending a warm welcome, on behalf of the Berlin Senate, to the participants of the 7th Financial Stability Conference and appreciated the organizer's special effort.

Financial stability concerns have been superseded by worries about the state of the global economy.

Undoubtedly, compared to only a few years ago, the interest in financial stability issues has diminished and is now mainly the subject of expert talks rather than broad political discussions. At the first glance, this may sound like positive news, as it indicates the absence of an acute financial crisis, which is indeed positive. But the public and policy makers alike are aware that this might change overnight. Indeed, other problems have put themselves centre-stage; more specifically, financial stability concerns have been superseded by worries about the state of the global economy. This is understandable as there is a slowdown in global growth, decreasing global trade volumes, lower industrial production, and people are conscious that all of this is interconnected with the financial sector. While there is no crisis, there is a broad understanding that the resilience of financial markets is lower than could be assumed given the absence of intensive debate on financial stability issues. The current worries about global growth have been triggered by political factors, such as the global trade war, which really is another facet of the geopolitical rivalry between the US and China, such as Brexit, such as the ongoing wars and tensions in the Middle East, and such as spreading opposition to openness and the rise of nationalism.

However, there is also a notion that monetary policies and the state of financial markets play a role in causing concerns about the economy. The Bank for International Settlements noted in its latest annual report that, historically, inflation and monetary policy determined the business cycle. However, they now say "financial expansions and contractions have played a more prominent role." In other words, it is the credit cycle that causes expansions and contractions and that is likely to cause crises, as it did in 2008 and thereafter.

It is worrisome that in many market segments behaviour and prices can be observed that appear to be indicative of unhealthy developments.

This is why it is worrisome that in many market segments behaviour and prices can be observed that appear to be indicative of unhealthy developments. To name a few: It is noteworthy that the amount of sovereign debt trading at negative rates stands at a record 15 trillion USD. In mid-October, even Greece was able to sell three month Treasury Bills at a negative yield, which would have been unthinkable a few years ago. Globally, the levels of debt in both the public and private sectors are higher today than they have been in 2007 before the financial crisis.

In the corporate bond markets, yields have dropped below zero – and not just for AA-rated firms. Corporate debt in developed markets looks vulnerable, because a lot of it went into increasing leverage and financing mergers and acquisitions (M&A) rather than funding investment, and because the corporate debt inflation has been funded through leveraged loans with weaker lending standards. Corporate debt in emerging markets, in turn, looks vulnerable due to the high portion of foreign currency lending, which exposes clients to foreign exchange risk.

Financial markets have become highly sensitive to policy tightening, because they have grown used to prolonged monetary policy accommodation.

The dislocation in the US repo market at the end of September was indicative of a larger problem in financial markets. On the one hand, it showed that banks, whether induced by regulation or by their own choice, are reluctant to reduce their liquidity and to increase their risk-weighted assets by engaging in repo and money market transactions. On the other hand, it was a pointer to the difficulties central banks will face when exiting quantitive easing policies. All in all, financial markets have become highly sensitive to policy tightening, because they have grown used to prolonged monetary policy accommodation. This, in turn, reduces the room for manoeuvre that central banks have and make the normalization of monetary policy even more difficult.

Against the backdrop of the long-lasting low-interest environment and the heavily debated negative side effects of this policy, macro-prudential policies will have to play an important role in stabilizing financial markets. Although states that are heavily indebted, including the state of Berlin, and profit from these low-interest conditions, the negative side effects should not be forgotten. As long as monetary policies are committed to pursuing the goal of higher inflation rates and pay less attention to these side effects, there is a great responsibility of macro-prudential supervisors to safeguard financial stability. Indeed, over recent months, central bankers and financial supervisors have repeatedly stressed the importance of macro-prudential supervision. In September, the European Systemic Risk Board issued five warnings, including one to Germany, as well as six country-specific recommendations. These warnings can be considered timely and appropriate.

Indeed, from the local perspective in Berlin, where the local real estate market undoubtedly has displayed signs of overheating and speculative pricing, these measures appear adequate. Some parts of this price movement reflect fundamental demand and supply structures in Germany's biggest and still growing city, while other parts are a reflection of a hunt for higher-yielding assets. Therefore the decision, taken in June this year, by the Ausschuss für Finanzstabilität, Germany's macro-prudential supervisor, to activate the countercyclical capital buffer for Germany with 0.25 percent is welcome. This is a response to the rising risks, not least because contrary to recent years, the rise in real-estate prices now goes along with a rise in lending volumes.

There are vulnerabilities in the financial and in the real sector, which both are also interrelated. Therefore, it is entirely appropriate that a major part of this conference will be devoted to the issue of resolution. The Single Resolution Board (SRB) has done a good job in getting the framework in place and in supervising the process of banks devising their resolution planning. The new framework has also been tested on several occasions over recent years and has proven to be workable. The SRB would surely be the first to admit that orderly resolution remains a huge challenge because of the complexity of the issue. The past cases have highlighted crucial and challenging aspects, such as legal challenges, adherence to the no-creditor-worse-off principle, liquidity in and after resolution, and public opposition to the bail-in principle and the respective pressure on the political sector.

Matthias Kollatz concluded, that given the lessons from the last financial crisis and considering present risks, it is important for politicians that the expert discussions and the exchange of opinions and views at this conference will bear fruits.

Opening Speech

Governments, Banks and European Monetary Union

Prof. Martin F. Hellwig, Director emeritus,
Max Planck Institute for Research onCollective Goods

The most important challenge to European Monetary Union is political, rather than economic, and problems should not be treated as merely technical.

Martin Hellwig opened his speech with the claim that the most important challenge to European Monetary Union is political, rather than economic, and problems should not be treated as merely technical. Money is a source of power. Since central banking is about money, it is ipso facto political and needs political legitimacy. In Germany, the decades of the Bundesbank's preaching about the importance of price stability served to support the political legitimacy of the Bundesbank, as a counterweight to greedy unions and profligate governments. In the European Economic and Monetary Union (EMU), the problem is that politics is either national or local, and therefore, it is difficult to establish political legitimacy for a supranational institution.

These issues can be illustrated in the context of the Banking Union (BU) with two conflicting propositions that firstly, EMU needs BU and secondly, BU lacks political legitimacy. Both propositions are based on the fact that banks are political and politics is national or local but not supranational.

In the first decade of the monetary union there was no problem. By comparison to preceding decades, in fact there was a de-politicization of monetary policy. Discussions were technical rather than political, addressing for example the question whether Otmar Issing's two-pillar policy was appropriate or whether the European Central Bank (ECB) should move to inflation targeting, without looking at monetary aggregates.

The fragmentation of politics along national lines allowed a dissociation of the ECB from politics, but the politics itself came to be hostile to the ECB.

The financial crisis changed all this. Since then we have seen a re-politicization of monetary policy, in which the central bank's supranational character was a source of both strength and weakness. The fragmentation of politics along national lines allowed a dissociation of the ECB from politics, but the politics itself came to be hostile to the ECB. Some of the irritation was due to the crises, but some of it also reflects the deeper fault-lines between national politics and supranational monetary policy making.

Banks enter this field because, on the one hand, they are an integral part of the monetary system, managing the payment system and playing a key role in monetary-policy transmission, and, on the other hand, they are also an integral part of national and regional politics, where important people, politicians in positions of power, as well as various members of local and national elites, always have wonderful ideas that just need funding from banks.

Paradoxically, the Treaty pays hardly any attention to banks. Banking regulation and supervision remained in the national domain. Articles 127(5) and 127(6) of the Treaty on the Functioning of the European Union (TFEU) say that the ECB should assist regulators and supervisors in what they are doing, but the relationship between banks and monetary policy is not addressed. Moreover, the Treaty says nothing about the Lender of Last Resort (LOLR) function of a central bank. In the early 2000s, there were many Memoranda of Understanding (MoU) on the relation between national and supranational institutions in dealing with banks; these MoUs stated that solvency problems of banks and recapitalizations would be dealt with by finance ministers, liquidity problems of individual banks by national central banks under the auspices of emergency liquidity assistance (ELA), and general, system-wide liquidity problems by the ECB's intervening in markets. The notion that finance ministers might be unable or unwilling to deal with solvency problems and recapitalize the banks was not considered. Nor was the nature of liquidity problems that might arise.

In the first decade of monetary union, none of this mattered. There were no concerns about bank insolvencies or liquidity problems. As far as the transmission mechanism was concerned, interbank markets seemed to work without frictions. So the entire question of how precisely central bank money is distributed did not matter much, because the financial system used interbank markets to redistribute funds if the initial allocation had not been appropriate. These markets facilitated huge capital flows, especially from Germany to Ireland, Spain, Greece and Italy. To some extent, these capital flows also balanced current accounts imbalances, which is why in the first years of monetary union target balances were small.

All this changed in September 2008. Following the Lehman Brothers collapse there was a complete breakdown of interbank markets. Capital flows were reversed, interbank loans were recalled or not renewed, and securities were sold – much of it across national borders, i.e. financial systems, which had become more integrated in the run-up to the crisis, fragmented again along national lines.

Many banks to which the Eurosystem lent liquidity, were weak, near insolvency, and there was no way the ECB could weed out those that should not be supported.

For monetary union, these developments posed three challenges: First, the liquidity crunches in 2007/08 and 2011/12; these crunches were successfully countered with huge liquidity injections, for example, the Long-Term Refinancing Operation (LTRO) of 2011/2012. Second, the transmission problem of how to implement monetary policy when interbank markets are not functioning; this problem was solved by moving to a system of full allotment, where the banks' applications for central bank loans were automatically granted – at the conditions fixed by the central bank. This measure plays a role in German political debate because, under full allotment, central-bank funding substituted for interbank funding, enabling a flow of funds back from the periphery countries to for instance Germany, which then appears in the Target Balances of national central banks in the Eurosystem. In Germany, the populist interpretation has been monetary union using Bundesbank money to bail out Irish or Greek banks, without regard to the fact that these "bailouts" really benefited the borrowing banks' creditors, often German and French banks and that, under the Treaty, there is not such thing as Bundesbank money, it is all ECB or Eurosystem money.

Third, many of the banks to which the Eurosystem lent liquidity support were weak, on the brink of insolvency, and there was no way the ECB could weed out those that should not be supported. This weakness raised questions of principle about supporting "zombies", as well as questions about the effectiveness of the transmission mechanism. In the case of the LTRO of 2011/12, many funds went to weak banks, which had a preference for lending to their own governments, rather than the real economy. This behavior hampered the transmission of monetary policy to the real economy, but in contrast to the other two challenges, it was not in the ECB's power to do much about it. Dealing with weak banks was a task for national authorities rather than the ECB. National authorities however were not eager to address the issue.

In recognizing and addressing problems, banks and supervisors always have a certain leeway because the valuation of assets that are not traded in organized markets involves an element of arbitrariness. If a borrower's debt service is in arrears, how much do you write down the value of the loan? If you believe that the borrower's problems are temporary, perhaps not at all because you "are sure" that he will eventually pay up. If you suspect that he will never repay, you may still resist a write-down because a write-down makes you look bad. And who is there to challenge your assessment that the borrower will "surely" end up paying? The supervisors may have the same incentive to procrastinate because when the problems are laid open, they also look bad, especially if they have no ready remedy for dealing with them.

If weak banks get funding from the central bank and pass the money on to the government, it gets an indirect access to the printing press, which it may like.

Governments may also like procrastination because it enables them to avoid using public funds for recapitalizing the banks in question. If public budgets are squeezed, they may not even be able to provide for the recapitalizations. In contrast, if weak banks get funding from the central bank and pass the money on to the government, the government gets an indirect access to the printing press, which it may like. The central banks themselves may not be averse to procrastination, because they also like to avoid turmoil.

All such delays are costly however, because eventual cleanups are much more difficult after long procrastination. There also is a cost to not having enough exit from the industry, i.e. to maintain excess capacity in the industry, inducing aggressively competitive behavior, squeezing margins, and causing significant systemic risk.

BU was created to deal with the problems and the incentive distortions involved in weak banks' being fully left to national authorities. The Single Supervisory Mechanism (SSM) took supervision out of the national domain, introduced the ECB as a single supervisory institution and gave independence to national supervisors cooperating with the ECB in the implementation of European law. Given the scope for conflict between the different participants, I see the experience of the SSM as positive. It has contributed significantly to loss recognition and recapitalization in European banking.

I see the experience of the SSM as positive. It has contributed significantly to loss recognition and recapitalization. But resolution remains a problem.

But resolution remains a problem. The new rules of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) are not working well. The SRM was applied only once, in the case of Banco Popular Español (BPE). In this case, the failing bank was sold to another bank. The sale took place overnight and there were no alternatives because BPE was subject to a run by large depositors and the SRM had no way to replace the funding that was disappearing. The legal norms, the BRRD and the SRM Regulation, simply do not provide for any funding that the bank might need while the resolution authority is choosing its strategy. Perhaps the drafters of these norms thought that funding in resolution might work like funding in an insolvency procedure, where new creditors are often willing to come in because they are given priority over all previous creditors.

For a bank, however, the problem is more serious because so much of a bank's debt is short-term, provided by institutions that have short-term funding themselves, e.g. money market funds. If this short-term debt is frozen in resolution, the lenders themselves may be in trouble, for example, because their own funding breaks away, as in the case of Reserve Primary and other US money market funds after the Lehman Brothers bankruptcy. If this short-term debt is not frozen, prioritization of new creditors does not work well because there are too many of them relative to the presumed remaining value of the bank's assets, and, moreover, if they are themselves run upon, they do not have a choice but must withdraw anyway. Without solid funding, however, there is no time for the resolution authority to choose its strategy.

Cases so far show national authorities going to great lengths to avoid having "their" banks go into resolution and investors in "their" banks subjected to bail-in.

Resolution under the BRRD and SRM Regulation is also impeded by political resistance. The cases of Monte dei Paschi di Siena, Banco Popolare di Vicenza and Veneto Banca, as well as HSH Nordbank and Nord LB all show national authorities going to great lengths to avoid having "their" banks go into resolution and investors in "their" banks subjected to bail-in, i.e. to a sharing of losses if there is not enough equity to absorb them. They prefer to use taxpayer money for "precautionary" recapitalizations rather than to apply the rules and make investors share the losses. They prefer even more not to be forced to acknowledge losses so that recapitalization needs to not become apparent. This is why last year there was so much resistance to the SSM's proposing to tighten the rules for provisioning against risks from non-performing loans. Since the beginning of Banking Union, volumes of non-performing loans have declined somewhat, but they are still high, somewhat below 600 billion euro versus one trillion euro in 2014; in crisis-affected Cyprus and Greece and in Italy, they still pose significant risks to the entire financial system. Remarkably, throughout these years, the notion of using the resolution mechanism to deal with the problem does not seem to have been considered. Instead there were proposals to put problem loans into government-funded asset management companies, "bad banks", with clawback provisions making the originating banks pay for eventually remaining losses – if they are able to do so.

From EMU perspective, improvements in resolution are essential to making BU work. And BU is essential if monetary transmission is to get back to normal.

From the perspective of EMU, improvements in resolution are essential to making Banking Union work. And Banking Union, with a well-functioning supervisory mechanism and a well-functioning resolution mechanism, is essential if monetary transmission is to get back to normal, with a workable symbiosis of the central bank and commercial banks in the creation of money. While many call for the creation of a European Deposit Insurance Scheme, the reform of resolution is actually much more important because deposit insurance does not matter much if the institutions do not even enter into resolution.

However, Banking Union lacks political legitimacy. Political legitimacy is a result of public political discourse. In the EU, such discourse usually takes place at the local level and at the national level but not at the supranational level. This is particularly true of banks. Banks are an important part of local and national political systems for several reasons. First, they are a source of money. Everybody, citizens and politicians alike, has an idea of what the banks' should be used for, for example a house for me or an investment in wind energy. A German Landesbank provides the head of its regional government with the power to move a few million without asking a parliamentary committee; this power is worth every euro of taxpayer money, so the regional government will hardly agree to put the bank into resolution!

From the perspective of national politics, the BRRD and the SRM are politically illegitimate.

Second, banking itself is an area of industrial policy. Cyprus, Ireland, the UK, Iceland, and to some extent Switzerland promoted the financial sector as a way of enhancing economic growth. Third, investors in banks may be politically important. In the case of the German bank Hypo Real Estate, which was bailed out in 2008/09, investors included not only Deutsche Bank and Allianz, which might be thought of as systemic risks, they also included the established churches, the public television system, many municipalities and pension institutions, so the bailout forestalled a discussion of quite a different kind of systemic risk. In the case of BPE, the large depositors were mainly local and regional governments, so a bail-in would also have created significant political problems. In the case of the Venetian banks, the bail-in of equity and subordinated debt involved many small entrepreneurs who had invested their savings in preferred stock of the banks on the grounds that such provision of capital was allowing the banks to maintain or even increase their lending to them. The bail-in imposed serious losses on these entrepreneurs and contributed to the revulsion against EMU and Banking Union that shaped the result of the 2018 election in Italy. From the perspective of national politics, the BRRD and the SRM are politically illegitimate.

The notion that banks should provide funding for the government's pet projects is a subversion of parliamentary budget authority.

For someone used to Sunday school teaching, all this is really smelly. The notion that banks should provide funding for the government's pet projects is a subversion of parliamentary budget authority. To be sure, there is no direct involvement of government money, but there are risks for taxpayers. The risks are kept hidden until they are realized, and then the taxpayer has to pay the bill. By then, it was just bad luck even though, with proper governance and proper foresight about risks, the "bad luck" could have been avoided. The same criticism applies to mercantilist industrial policy using "light touch" regulation to promote a country's financial industry at a risk of serious damage to the country if there is a crisis. And the mis-selling of hybrid liabilities – and its toleration by the authorities – is altogether scandalous. The bailouts violate a fundamental principle of a market economy, namely that everyone should be responsible for the consequences of their own actions. This principle is a necessary correlate of the freedom to act as one likes as long as one abides by the rules of the law.

In local and national policy discourses there is hardly anyone who defends the need for the rules of the Banking Union and the interference that they mandate.

However, political legitimacy is not the same as legitimacy in the eyes of Sunday school teachers. Political legitimacy is established in political discourse. Political discourse at local and national levels however is driven by some of the very parties that benefit from conflicting with Sunday school teaching. From their perspective, Frankfurt and Brussels are illegitimate intruders. The European Commission, the SRB, the SSM and the ECB unfortunately are not present in local and national policy discourse, where blaming outsiders is a prominent strategy. At this level, there is hardly anyone who defends the need for the rules of the Banking Union and the interference that they mandate.

The sense of illegitimacy has been even stronger in those cases where the ECB has used its power over banking systems in order to take sides in distributive conflicts. In the case of Ireland, the letter written by the president of the ECB to the Irish government in the fall of 2010 demanding that there should be no bail-in of senior unsecured creditors (mainly German banks and the ECB itself), did a lot to de-legitimize the ECB with the Irish population. In other cases, such as the letter to the Italian prime minister in August 2011 or the ECB's role in the Greek crisis in 2015, there also was a view that the ECB was too much aligned with the creditors. To be sure, the typical German assessment was just the opposite, The very difference between the different national discourses in the EU shows that the interplay between the supranational institutions and national policies is highly dysfunctional.

namely the ECB was (and is) seen as a mechanism of distribution of resources from Germany to the debtors in the peripheral countries. But the very difference between the different national discourses shows that the interplay between the supranational institutions in the monetary union and national policies is highly dysfunctional.

This conflict is ultimately irresolvable. One often hears that the bank-sovereign nexus must be cut. This formulation was used at the Summit of June 2012 that decided in favour of Banking Union, and it has been used in discussions about an European Deposit Insurance Scheme (EDIS) ever since. But there always is a bank-sovereign nexus. Member States are sovereign and have sovereign powers over "their" banks, not just over supervision and resolution but also over employment law, tax codes and even ownership. (Remember that Mr. Varoufakis thought of nationalizing Greek banks!) Transnational or trans-European banks, as promoted by some, would alleviate the problem. But then the government of the country where such a bank has its seat still has sovereign power over it, and the governments of other countries where it has subsidiaries may want to impose their sovereign power as well.

What can be done? "Muddling through" with some small improvements. First, we need some strengthening of political legitimacy at the supranational level.

What can be done? The answer is "muddling through", perhaps with some small improvements. First, we need some strengthening of political legitimacy at the supranational level. At the supranational level, we need more public political discussion, which presumes more powers of the legislature and an executive that provides a counterweight to the regulatory administrations. In this context, we should think about a European finance minister and a European budget in terms of political processes and political legitimacy, rather than technocratic management. Second, the BRRD and the SRM need to be reformed to take account of the fact that bailouts are sometimes needed and, moreover, that the Commission's state aid control may not be well suited to controlling such bailouts. State aid control is aimed at competition policy, rather than financial stability. In the case of the Italian banks, negotiations with the Commission about state aid control have contributed significantly to procrastination, which is harmful for financial stability. Reliance of state aid control on the private investor rule is inappropriate if some of the private investor participation is based on bail-in, as in the case of Banca Monte dei Paschi di Siena. Moreover, the judgement that exit makes bailouts acceptable because there is no more threat to competition is inappropriate if investors take the government's bailout of some investors in the current case as a signal of its stance in future cases.

The entire system of legal norms for bank resolution needs to be rethought.

Third, we need to take account of the loss of information capital of banks that are closed, especially when a crisis covers an entire region and many banks are affected. The question then is how to deal with an entire regional banking system, when the region and its banks are subject to an asymmetric shock, e.g. from changes in world trading conditions, as experienced by some of the industries in northern Italy whose competitiveness in European and world markets was strongly affected by the accession of Eastern European countries to the EU and by the expansion of Chinese exports. Given their experience in 1992, Swedes would say: nationalize, re-organize, and re-privatize, leaving the government to bear residual losses, but the BRRD does not leave room for such a strategy. In summary, the entire system of legal norms for bank resolution needs to be rethought.

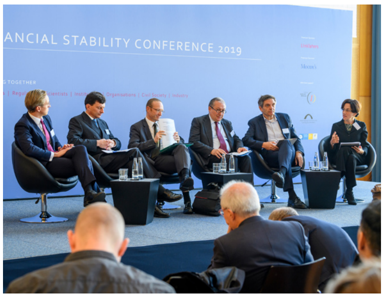
We must hope that Europe will also find ways to muddle through in the matter of Banking Union.

Martin Hellwig concluded that ever since its beginnings in the 1950s, academic economists had reacted to European integration the way an engineer would react to a bumblebee. Just as engineers "know" that bumblebees cannot fly because they are too heavy and their wings are too small, so economists have always known that European integration cannot fly. But somehow bumblebees can fly despite the engineers' assessments, and European integration has muddled through despite the economists' skepticism. We must hope that Europe will also find ways to muddle through in the matter of Banking Union.

Panel I - Discussion

National Banking Policies and the new EU Political Landscape: Stuck between Reform Ambitions and Disintegration Tendencies

with **Prof. Arnoud Boot**, Professor of Corporate Finance and Financial Markets, University of Amsterdam; **Giorgio Gobbi**, Head, Financial Stability Directorate, Bank of Italy; **Dr. Korbinian Ibel**, Director General Microprudential Supervision IV, European Central Bank; **Johannes Pockrandt**, Head of Government and Public Affairs Germany, Deutsche Bank; **Christian Stiefmüller**, Senior Research and Advocacy Advisor, Finance Watch; moderated by **Prof. Elena Carletti**, Professor of Finance, Bocconi University, and Scientific Director, Florence School of Banking and Finance



Elena Carletti opened the panel by introducing the panelists and outlining the discussion topics on tensions between the promotion of national champions versus pan-European banks, national discretions versus European integration and the European elections and Brexit as obstacles to integration.

In his introductory remark, Arnoud Boot observed a strong preference among European policymakers for pan-European banks and cross-border mergers and acquisitions (M&As). These mergers are beneficial as they can potentially break the nexus between local banks and their domestic governments and provide necessary risk sharing within the Euro area and the EU. Complementary recommendations point towards completing the Banking Union (BU), which besides the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) should include a pan-European deposit insurance. Regarding this agenda, Arnoud Boot identified the problems of political legitimacy and prioritization given that cross-border mergers result in overly complex and too-big-to-fail (TBTF) institutions while the track record of successful mergers is typically dismal. Banks' legacy issues regarding their government connections and the physical as well as technological infrastructure contribute to this issue, especially because banks are entrenched in society.

Banking is not a technocratic exercise and therefore technocratic solutions will fail if Europe`s political institutions do not take into account the political realities.

Arnoud Boot argued that Europe's political institutions failed to understand that banking is about politics. Banking is not a technocratic exercise and therefore technocratic solutions will fail if they do not take into account the political realities, he said. Banks should not be pressured by policy makers into taking over a large established foreign institution, but instead, they should gradually expand by buying up smaller maybe even technological institutions across Europe, which could give them a foothold in the upcoming digitalization that will change the market structure endogenously. Finally, the Capital Market Union (CMU) with persistent cross-border flows of long-term debt, equity and foreign direct investments can provide adequate integration against an overly bank dependent financial sector. Quality financial integration will not come from the banking sector, because streams of capital between countries via highly-leveraged financial institutions are by definition unstable, he underlined.

Giorgio Gobbi considered cross-border M&As in Europe to be beneficial for financial integration, especially for retail banking, where currently no common intermediaries offer the same financial services across Europe. However,

Banking performance varies hugely across countries, for which some jurisdictions have to increase competition in some previously sheltered segments.

underperformance of European banks presents a less noble reason for cross-border mergers. In the past, national mergers were the safest way to reduce over-capacity, but this is no longer a viable solution because the banking sectors in some Member States are already highly concentrated and further mergers would be undesirable for competitive reasons. On the other hand, banking performance varies hugely across countries, for which some jurisdictions have to increase competition in some previously sheltered segments. While pan-European banks remain debatable, respective obstacles for the BU should be removed nonetheless, which include the lack of political legitimacy and a Single Rulebook in contrast to excessive National Options and Discretions (NODs) due to banking rules formulated as directives instead of regulations.

It can also be criticized that not Europe but national industries are considered a relevant jurisdiction when identifying G-SIBs and that regulatory treatment under Basel III does not recognize geographical diversification of banks. How TLAC and MREL measures are applied to subsidiaries constitutes another obstacle. Moreover, there is an asymmetry given that the ECB can supplement macro-prudential policies by national authorities if they are insufficient to cope with stability risks in the European Monetary Union. However, there is no guarantee against nationally decentralized macro-prudential policies being used in favor of national champions and thus there is no well-defined objective to preserve the single market for banking. Still, there are several pragmatic steps to overcome these market barriers given an adequate level of political will. On a final remark, Giorgio Gobbi referenced a recent study that by looking at price-to-book ratios found investors to penalize diversification in the current political framework. This implies that investors evaluate the cost of complexity for pan-European banks higher than advantages from diversification.

Excessive national options and discretions and different regulations across countries prevent cross-border mergers and hence much-needed economies of scale.

Korbinian Ibel identified the balance between European and national interests and regulatory ring-fencing as core issues. The European banking market is subject to low rates of market capitalization, a high cost basis, low profitability, over-banking, unhealthy competition, entering bigtechs and public support for only a few market exits. Excessive NODs and different regulations across countries prevent cross-border mergers and hence much-needed economies of scale. Besides language barriers at the national level of public administration authorities and tax issues, the yet missing EDIS is especially problematic, because supervision and resolution measures need to be aligned at a common European level for the right incentives to avoid bail-outs using taxpayer money.

All of these issues need to be solved jointly in order to overcome barriers to cross-border mergers. Some progress has been made with the fit and proper assessments for banks' board members, but as they do not constitute a regulation, requirements differ across countries. Capital and liquidity waivers have been introduced, but there is a lot of blockade leading to excess liquidity and reduced market efficiency. And while over 100 NODs were harmonized in a 2016 SSM project, Member State options need to be addressed even further. Finally, Korbinian Ibel pleaded for the European idea and for moving forward on integration, because it is the only way to achieve economies of scale, lower costs for customers and increased welfare. Especially in view of global market forces, the EU with its huge market potential has a greater chance to succeed compared to isolated Member States. Imagine a vision where not the US but the European banking market is strong. We have all the elements to actually get there. We just need to be brave enough to do it and take mutual trust, he said.

As long as Member States insist on rescuing their banks when politically convenient there is no level playing field.

Christian Stiefmüller recapitulated that the financial crisis was the major driver behind creating the BU in 2012 and it showed that financial stability and the eurozone's survival could only be achieved if all Member States implement robust rules so that banks' balance sheets are no longer underwritten by blank checks from the taxpayer. In the EU's unique cross-border set-up, fragmentation and ring-fencing, which for some embodies the notion that the BU is held back by excessive regulation, arguably present the original state of affairs. Whenever a bank consists of more than two legal entities it is fragmented and if those entities are located in different jurisdictions and subject to different regulators they are effectively ring-fenced. Ring-fencing is widely accepted when the BRRD requires resolution authorities to ensure a bank's critical functions are set up to survive its failure or if regulators oblige banks to structurally separate plain vanilla deposit-taking and lending from other high-risk activities. Hence, for the BU to work, a more differentiated perspective and vocabulary are needed, for instance, the concept of a level playing field implying that regulators, customers, depositors and taxpayers across Europe can expect banks to be prudent in their lending and deposits to be safe.

But in contrast, significant over-capacity prevails and the expectation that poorly performing banks exit the market under the BRRD has not been fulfilled at any scale while banks continue to be bailed out with public funds. As long as Member States insist on rescuing their banks when politically convenient there is no level-playing field, he said. It is questionable whether Europe's systemically important and TBTF banks are resolvable or rely on implicit home country guarantees. Regulators object to further consolidation that concentrates even more market power and systemic risk in a handful of systemically important financial institutions.

For a horizontally integrated market, in which banks of different sizes and with different business models compete for vertical customers segments, the playing field needs to be leveled further by harmonizing regulation, especially bank insolvencies and liquidation at the national level according to the BRRD. For a European banking landscape to be united in diversity, other measures include reducing over-capacity, removing poorly performing banks from the market, addressing the TBTF conundrum and ensuring the resolvability of all systemically important banking groups financially via sufficient MREL and structurally via legal setups that allow resolution. We need to keep up the fight for political legitimacy and muddle through in that quest, Stiefmüller said.

The agenda of political parties in Brussels is to increase integration in a structured and visionary manner instead of muddling through.

Johannes Pockrandt expressed concern over considering European integration and legislation for financial services as not legitimized given the clear majority for more integration in the recent EU elections. The agenda of political parties in Brussels is to increase integration in a structured and visionary manner instead of muddling through, even though compromises might be more difficult in a now fragmented European Parliament. Especially when focusing on investors, customers and savers the example of Brexit clarified that fragmentation is to be avoided by all means and integration is the way forward. In the wake of Brexit, the EU is fortunate to depart from a situation with a strictly identical rulebook, greater financial stability, potent tools and equivalence assessments to contain fragmentation as good as possible. In contrast to Christian Stiefmüller's notion of fragmentation and ring-fencing as the natural state of affairs, fragmentation used to exist due to the lack of trust between supervisors and government authorities.

A credible system with sensible rules for an orderly market exit of weak institutions, minimizing the use of public funds, still needs more fine-tuning.

Elena Carletti summarized the panel's agreement on the over-capacity and low profitability problem in European banking and asked how to efficiently solve it considering market exit versus domestic consolidation. Secondly, digitalization presents an opportunity for banks but also requires them to invest and overcome legacy issues raising the question of whether banks have enough time. Finally, how can trust be rebuilt in the light of fragmentation due to national discretions, ring-fencing and distrust among the Member States.

On market exit versus consolidation, Giorgio Gobbi responded that despite the BRRD's and SRM's accomplishments, a credible system with sensible rules for an orderly market exit of weak institutions, minimizing the use of public funds in the process, still needs more fine-tuning. To deny any use of public money in a systemic event is simply not credible, when in fact it is the last resource to be used. Thus, a credible exit strategy would allow for the much-desired market contestability and new entries. Market diversity should originate from what banks' customers demand, instead of preserving the already existing diversity and thereby protecting small incumbents. Christian Stiefmüller noted that, despite benign conditions and being warranted by market over-supply, no market exit occurred over the last years. While cost and revenue synergies, economies of scale, lower funding costs and reduced overhead present low hanging fruit for domestic M&As, they are notoriously tricky in a mature market. Instead, it is much harder for banks to seek better asset quality, risk management, better controls and more attractive and innovative products. Korbinian Ibel clarified that on the flip side of over-capacity and over-banking, low margins and non-profitable banks also benefit customers in terms of cheap banking products.

On the opportunity of digitalization, Arnoud Boot noted that banks still have time but a long way ahead to overcome digital legacy issues and the overall progress is slow. However, in the example of the Dutch banking market, some fairly rapid adaptations took place due to enormous pressure on incumbent institutions to lower their cost base in the competitive environment of digital banking. Korbinian Ibel highlighted the importance of solving banks' legacy systems, especially as many banks and their critical functions depend on end-of-life systems with ceased technical support by the IT industry, which makes them vulnerable to cyber attacks. Johannes Pockrandt criticized that under current deductibility conditions, European banks are being penalized for making costly investments into software, which is especially problematic in the context of global competition.

On the issue of trust, Korbinian Ibel put forward that the idea of a trustworthy regulatory banking system differs across countries, with tough rules and market exit on the one hand and customer protection and creditor orientation on the other. In this regard, trust can be generated by learning from one another's different regulatory approaches while being open-minded and considerate about country-specific needs. In contrast, Christian Stiefmüller characterized trust to be an emotional category, whereas he would prefer to see whether policy makers buy into the common rules that they helped drafting. As for political legitimacy, the rules and their country-specific implications for customers and depositors should be communicated honestly to recipients. Johannes Pockrandt insisted that despite trust being an emotional category it is nonetheless at the core of how individuals and ergo institutions interact.

Currently, a great lack of trust between home and host supervisors can be observed given a crisis situation, in which sometimes the accomplishments of policy institutions and tools created post-crisis appear to be forgotten.

Regulation should not overly standardize banks' business models because this would reduce some much-needed diversity and create systemic risks.

Take overs by US or other global banks would entail more issues of home-host and who eventually pays than within the euro area.

Moreover, a high level of trust is essential, since national regulators will always demand flexibility on the time frame to implement regulations and on issues, which they consider insufficiently addressed by international standards. Currently, a great lack of trust between home and host supervisors can be observed given a crisis situation, in which sometimes the accomplishments of policy institutions and tools created post-crisis appear to be forgotten.

Finally, Arnoud Boot warned against regulation to overly standardize banks' business models such that they confront stability, legacy and digitalization challenges in a similar way, because this would reduce some much-needed diversity and create systemic risks while contestability of markets is key. Korbinian Ibel replied that when regulation cuts off certain edges from banking business models, which were unhealthy and contributed to the 2008 financial crisis, then the issue of greater uniformity might be negligible, especially when these measures ensure stability through liquidity coverage ratios, long-term funding or rules on banks' governance. Along these lines, Christian Stiefmüller argued that regulation does not reduce diversity, but instead it places greater emphasis on incumbent banks to think harder about their customers, revenue base, business propositions and innovations.

The first remark from the audience referred to the case of the German Nord LB and whether its recapitalization by state-owned banks given the lack of private investors can be considered state-aid, which might impact the European debate on circumvention of resolution rules and the BRRD. Giorgio Gobbi responded that as long as there is no solution to the issue of European banks living internationally but dying nationally, the current policy set-up will continue to generate struggles over existing rules until they are properly fine-tuned. Another more provocative question asked why not simply let US banks take over European banks, for which Johannes Pockrandt considered the problem of a level playing field for European banks as the core issue. Insights from corporate clients show that international banks have withdrawn from markets other than their home in the wake of the financial crisis, which implies that Europe still has a long way to go towards a more level playing field.

Korbinian Ibel welcomed competition induced by US or other global banks but noted that their predominance would entail more issues of home-host and who eventually pays than within the euro area, where there are one supervisor and one resolution authority. On the risk of having more TBTF banks due to more concentration, Korbinian Ibel replied that TBTF was a relative term given that pan-European banks should not only be considered as home banks in their small domestic country, in which by comparison they might be TBTF, but rather as European banks relative to and supported by a European GDP.

On the question of how banks deal with protests from consumer associations against increased prices due to greater concentration, Christian Stiefmüller suggested that consumers do violently complain when prices increase due to unjustified and hidden charges, that is for transfers within the EU, against which they need to be protected by the regulator. However, most customers and borrowers would understand when loans are being repriced to realistic levels. Arnoud Boot admitted that it is difficult to implement cost-based prices for customers in a banking system where clients are accustomed to having bank accounts for free except for defined fees, since banking is deeply entrenched in society.

Finally, on the controversy around greater diversity in European banking, Johannes Pockrandt suggested that given the high degree of diversification in European banking, with 1.600 banks in Germany alone, there is no risk of losing diversity anytime soon. Christian Stiefmüller agreed that even though at the moment there is no shortage of diversity in European banking regarding banks' size, business model or their customer base, it is important that this continues to be the case.

Panel II

Between Wishful Thinking and Feasibility: How to remove Obstacles to True Competition and a Common Beneficial Single Market in the EU

with **Costanza Bufalini**, Head of Regulatory Relations and Group Regulatory Affairs, UniCredit; **Willem Pieter De Groen**, Head of Financial Markets and Institutions Unit, CEPS; **Dr. Peter Grasmann**, Head, EU/Euro Area Financial System Unit, European Commission; **Michala Marcussen**, Group Chief Economist and Head of Economic and Sector Research, Societe Generale; **Dr. Srobona Mitra**, Senior Economist, European Department, International Monetary Fund; moderated by **Prof. Joachim Gassen**, Chair of Financial Accounting and Auditing, Humboldt University Berlin

Joachim Gassen stated the panel's topic of transparency and how to overcome obstacles to true competition in the EU Single Market and initiated the first round of introductory remarks by the panelists.

Srobona Mitra started with some brief insights into the Capital Markets Union (CMU) from a recently published IMF paper. The European capital market in terms of listed stocks and bonds only covers 28 percent of funding sources. It is further segmented along national lines, as equity portfolios of insurers and pension funds mainly originate from their national corporates. This kind of fragmentation is costly and translates into higher debt funding costs of up to 30 to 60 basis points for Spanish, Italian or Portuguese firms in contrast to a similar firm in Germany. Moreover, there is less private risk sharing, and consumption in Europe is four times more sensitive to asymmetric shocks compared to the US. Deficiencies in regulatory and auditing quality in addition to insolvency frameworks constitute the main concerns for financial market participants.

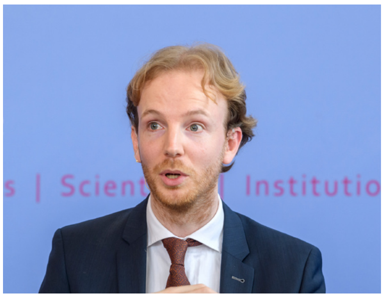
Deficiencies in regulatory and auditing quality in addition to issues of insolvency frameworks constitute the main concerns for financial market participants.

In contrast, removing these obstacles would be highly beneficial, for instance, upgraded insolvency frameworks in Italy could reduce its corporate funding costs by 25 basis points. Improving regulations and harmonizing insolvency regimes could double cross-border intra-EU portfolio flows and increase the interconnectedness of banks' balance sheets resulting in deeper integrated capital markets and improved risk sharing. Therefore, in terms of the European stock market, it is advisable to provide and increase transparency through a centralized, standardized and on-going reporting framework by all issuers.

On the regulatory front, it is further suggested to have a more independent board of the European Securities and Markets Authority for greater pan-European supervisory convergence as well as a more centralized oversight of systemic intermediaries like central counterparties (CCPs) and investment firms. The tax and cost treatments of the proposed pan-European pension product should be revisited and lowered, while the case of Brexit shows that the EU needs close regulatory cooperation with all third countries. Finally, insolvency processes should have a ‚name and shame' approach as well as centralized minimum standards and provide more comparable data of insolvency regimes for bench-marking purposes.

Since 2008 banks retreated to national borders for stability reasons having left the common market less integrated and vibrant as we might wish.

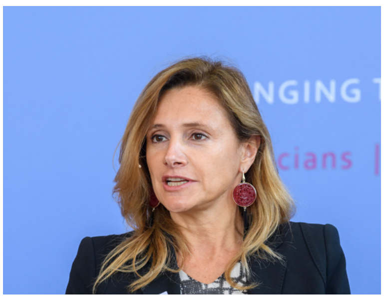
Resonating with the first panel, Peter Grasmann considered European banking to be much more stable than in 2008 but also less profitable and over-banked. Neither the provision of cross-border services nor mergers and acquisitions result in deeper market integration. Since 2008 banks retreated to national borders for stability reasons having left the common market less integrated and vibrant as we might wish, he said. The relationship between stability, integration and competition is ambivalent, especially as the financial sector is far from textbook assumptions on perfect competition due to scale economies in the financial infrastructure, which CCPs, credit rating agencies, central securities depositories and investment banks benefit from. While the global integration of these European sectors is profound, the provision of services to European finance and economy is increasingly provided by third countries, which hence can be explained by imperfect competition and scale effects. Moreover, Brexit has forced Europe to concentrate more on those Member States, where banking intermediation prevails and capital markets are shallow or in some segments close to non-existent, instead of promoting integration by using the UK's financial hub. In relative terms, it has become less about integrating capital markets, but rather developing them in the first place, he said.



Fintech entrants overcome differences in the level-playing field, disrupt and succeed in markets, and thus are more likely to induce structural changes.

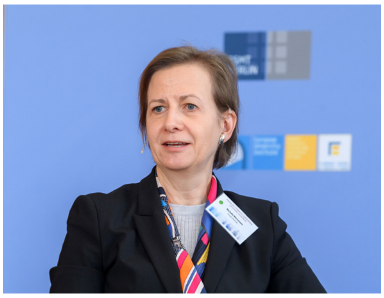
In line with Peter Grasmann, Willem Pieter De Groen agreed that after the last financial crisis the focus has been on stability. He argued that the previous fragmentation between 19 different countries was replaced with a single supervisory system that in practice separates larger significant from smaller less significant banks thereby resembling a two-tier system. This system also distinguishes between resolutions worthwhile in the public interest versus those that should fail under the insolvency regime.

Digitalization changes the dynamics in banking with new entries like Monzo, N26 and Revolut offering a broad range of banking services across borders and even the EU. They do not replace established banks yet, but they also show that banking services no longer require a physical network with branches. As these smaller and new or existing entrants overcome differences in the level-playing field, disrupt and succeed in the markets, they are more likely than M&As to induce structural changes in the banking sector. These new entrants can operate in the Single Market even though it is not yet a true common market in terms of harmonized rules and implementations across Member States, he said.



Single Rulebook, harmonized rules and less National Options and Discretions as well as ring-fencing are important for greater market integration and stability.

Subsequently, Costanza Bufalini stressed the importance of a Single Rulebook, harmonized rules and reducing National Options and Discretions (NODs) as well as ring-fencing for greater integration and stability in the Single Market, albeit there being little progress or even regress on these topics. As a consequence of fragmentation, banking groups cannot fulfill their role of local shock absorbers, since they are limited in allocating capital and liquidity, which has adverse stability effects on the banking sector as a whole. Especially in the context with low profitability, a truly European banking sector regulated by one set of rules is urgently required to attract investor's money from abroad. In contrast, regulation has not yet eliminated NODs that are most detrimental to banks' capacity to manage liquidity. Therefore, policymakers need to tackle this problem and revise the latest Banking Package that requires subsidiaries of fairly integrated banking groups, which are resolved under the single point of entry resolution strategy, to hold more loss-absorbing capacity than subsidiaries of third-country banks or US banks.



Without advanced public risk sharing it is hard to fully cut the sovereign-bank doom loop only through private risk sharing.

With insights for the European context, Michala Marcussen elaborated that public support played a major role in US history to develop deep and liquid capital markets. This support referred to the removal of obstacles to cross-state banking such as regulatory issues or limited types of financial activities that were allowed. Moreover, the development of the mortgage market as an integral part of the US capital market relied heavily on government-sponsored enterprises like Fannie Mae and Freddie Mac. Administrations for public support to help securitize SME loans, a pension benefits guarantee scheme and common deposit insurance through the FDIC were set up. Most importantly, the US has a single risk-free yield curve, whereas in the Europe system the risk-free rate is located along national lines, such that flights to national borders in terms of liquidity and risk-free rates will occur during crises.

To deepen the CMU, Michala Marcussen proposed that a sequential approach to a fiscal union and propositions on Eurobonds will need to be discussed. Without advanced public risk sharing it is hard to fully cut the sovereign-bank doom loop only through private risk sharing. Besides the main motivations of smoothing shocks, efficient monetary policy transmission and enhancing economic growth, a strong European financial sector is very much a strategic aspect today, especially in the light of global trade conflicts.

Summarizing the panel, Joachim Gassen questioned whether stability is the current most pressing issue in Europe or whether an alternative narrative is needed to push forward regulatory changes towards financial integration. Coming back to the issue of Italy's insolvency regime worthy of improvement, he insisted on further explanatory factors in terms of national inefficiencies.

Srobona Mitra noted that the IMF paper confines to the cost-benefit analysis that allows describing opportunities for improvement instead of political guidance, especially in the case of highly political insolvency regimes. One way to by-pass the political process and gain insights would be to conduct centralized benchmarking with newly collected data, while the ‚name and shame' approach can increase transparency on the effects of the regulatory environment in a given country. Peter Grasmann pointed out result-oriented benchmarking studies, however, are difficult due to the lack of data, for instance on how much time banks need to get collateral backing. Moreover, gradual improvements as threshold effects are often not good enough, such as when a bank reduces the time to realize its collateral from nine to six years, which presents an effective deterrent to cross-border banking.

Distrust might result from an insufficient acknowledgment of the substantial progress already made on risk reduction.

In response to Joachim Gassen questioning why there is low motivation for regulatory reforms at the national level, Willem Pieter De Groen noted that the last financial crisis conveyed an acute pressure for regulators to make changes upon creating the Banking Union (BU), which at the moment is not the case. Moreover, the current system creates uncertainty on whether a SME bank faces resolution under the single point of entry strategy or the national regime, which leaves national supervisors uncertain about their interests being sufficiently protected in a crisis scenario. Referring to Costanza Bufalini's previous point, the resulting lack of trust may be at the core of why supervisors uphold NODs and oblige subsidiaries ex-ante to hold sufficient capital. In contrast, Costanza Bufalini suggested that this distrust, which roadblocks the Single Rulebook and completion of the BU, might result from an insufficient acknowledgment of the substantial progress already made on risk reduction.

Referencing the ECB's financial stability report, ratios of Common Equity Tier 1 as well as short-term and long-term liquidity have increased, while non performing loans' ratios decreased. Regulation was warranted in the past, but is now likely to be excessive, which is to the disadvantage of the economy. EU institutions should rather evaluate the full effects of the already enacted regulations and conduct a comprehensive impact assessment. Finally, to move forward and increase trust between the Member States it might need a clear roadmap of what is still needed, but without raising the measuring stick along the way and requiring ever new risk reduction measures, she stressed.

The danger we face today is that citizens will lose trust in the ECB. Now it is up to the governments to extend more trust and take us forward.

Michala Marcussen added that in Europe, historical crises typically convinced people of the value of cooperation, for example, the creation of the single currency following turbulences in currency markets or the financial and debt crisis of 2011/12 for creating the Banking Union. But seeking unity just because of difficulties is not the most reliable approach towards integration and trust. There is no reason to be complacent, as the UK is about to leave the EU, partly also because its citizens might have lost trust in the EU. So far, markets had trust in Mario Draghi, who in his last ECB meeting highlighted the need for a fiscal union and warned against overburdening the ECB. The biggest danger we face today is that European citizens will lose trust in the central bank. Now it is up to the governments to extend more trust and take us forward, she emphasized.

The first question from the audience was about what kind of banking product might enhance more integration similar to what the EU roaming option is to the telecommunication sector. Willem Pieter De Groen replied that cross-border current accounts of payment present such a product, but considered European banking to be already better integrated than telecommunication markets, as respective networks and providers heavily stick to national rules.

On the relationship between rules and principles in banking supervision, Srobona Mitra responded that while regulations specify rules, financial sector assessments analyze the principle of supervision in terms of what day-to-day principles are used for instance when looking at balance sheets on-site or monitoring off-site. These principles of supervision vary a lot within the EU but could be more centralized at the SSM.

On the question of whether Member States are now resilient against subsequent recessions given their level and growth of NPLs, Peter Grasmann replied that with low NPL ratios around three percent across the EU banks are much better equipped than in 2008. However, critical NPL levels of above 44 percent in some Member States also indicate that policies and moral hazard issues can drive NPLs more powerfully than the business cycle.

A final remark questioned whether to address the trust issue between Member States, uncertainty implicit in EU legislation should be tackled first. Willem Pieter De Groen said that a recent study on deposit insurance schemes found that many NODs exist, such as Italian NPLs that used to be treated without ever touching upon the insolvency regimes thereby greatly reducing losses. Whether these kinds of measures can be used under the deposit insurance, however, remains uncertain, as the Banca Tercas case showed. Hence, it is partially the task of the Commission and authorities like the ECB to increase transparency and communicate more proactively, what they potentially are going to do, even though this might potentially reduce their room for manoeuvre in a crisis.

Panel III - Impulse

Making Resolution Work:
How to deal with Legal Loopholes, Institutional Implementation Challenges and Impediments to Practice

Sebastiano Laviola, Board Member, Director of Strategy and Policy Coordination, Single Resolution Board

Sebastiano Laviola started his impulse speech on how to make resolution work anticipating that there is no silver bullet for it. While the Single Resolution Board (SRB) has done a substantial amount of work in terms of resolution, this enterprise is in line with a 'marathon, not a sprint' analogy. Banks have to progressively get up to speed and to the level of being resolvable utilizing suggestions by the SRB authorities, which in turn have to continuously push towards this goal.

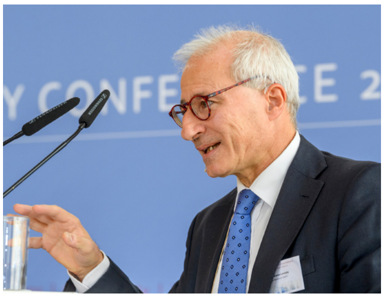
In 2020 the SRB will be in the steady-state with the entirety of banks covered with decisions concerning the approval of the resolution plans and MREL decisions.

So far, the SRB has built several policy guidances and orientation papers to account for different aspects of resolution, and to then progressively develop resolution plans. As has been declared, in 2020 the SRB will be in the steady-state with the entirety of banks covered with decisions concerning the approval of resolution plans and MREL decisions at the consolidated and internal level. Subsequent measures include firstly, effectively implementing the rules via the Banking Package as devised by the political masters. Secondly, communicating the tools, time frame and direction of travel to banks, and thirdly, assessing what is working and what still needs fine-tuning. In this regard, the SRB profits from an open and constructive dialogue with stakeholders characterized by transparency to jointly achieve the goal of resolution.

Elaborating on the panel's first topic of legal loopholes, Sebastiano Laviola emphasized the need to harmonize national insolvency laws as otherwise an EU administrative bank liquidation or regulation framework will have to be implemented. This lack of harmonization in the EU liquidation regime is an obstacle to completing the Banking Union (BU). For instance, a no-resolution decision by the SRB would require national authorities to apply their insolvency procedures, which widely differ between the 19 different countries. Therefore, the analysis of the insolvency counterfactual is a challenge, especially given the ‚no-creditor-worse-off' criterion, and may result in diverging outcomes depending on the home country of the institution. As a second consequence, the definition of failing or likely to fail (FOLTF) is a forward-looking concept and if its definition is not common among national insolvency frameworks, there is a risk of declaring a bank FOLTF, when this is not the case according to a judicial procedure in that country.

A step forward in the new BRRD is that NRAs and the SRB commit to undertake everything possible to have an orderly resolution or liquidation.

A step forward in the new BRRD is that national resolution authorities and the SRB commit to undertake everything possible to have an orderly resolution or liquidation. Beyond that, it proposes an EU bank administrative procedure, possibly following the FDIC model, which is equipped with a range of tools and under a purchase and assumption procedure can provide for the exit of the bank's liquidated part and the selling to a competitive procedure, thereby respecting the least cost criterion. For the issue of funding, the deposit guarantee schemes (DGSs) might be used while providing for issues of arbitrage and state aid. If this was to become a centralized tool, it could pave the way for a European deposit insurance scheme (EDIS).



While the common backstop will cover all uses of the SRF to provide liquidity, it is not enough to address the liquidity needs of mid-sized to large banks in resolution.

On the panel‵s second topic of institutional implementation challenges, Sebastiano Laviola noted that even with a functioning resolution measure, following the resolution weekend a bank might be well-capitalized, but still faces a liquidity issue as the market needs time to regain confidence in that bank. The SRB needs to bridge this time-confidence gap and ensure financial continuity. While the common backstop will cover all uses of the Single Resolution Fund (SRF) to provide liquidity, it is not enough to address the liquidity needs of mid-sized to large banks. Therefore, discussions to find a solution for liquidity in resolution are ongoing at the European level. On the other hand, banks have to do their part as well, and private resources need to be mobilized first before public tools are being used. Banks have to be able to measure and identify all the sources of funding and liquidity that are needed in resolution, particularly concerning the mobilization of collateral including cross-border.

The issue of financial continuity led Sebastiano Laviola to the panel‵s final topic of impediments to practice stating that among other resolvability elements, loss-absorbing and recapitalization capacity are especially crucial to a successful implementation of a resolution strategy. While the SRB already specifies consolidated and internal levels of MREL, new regulation provides a significant change in terms of quality and quantity, calibration of the entire amount, subordination and precisely defined internal MREL. The SRB works hard to release the final paper on SRMR2/BRRD2 MREL policy by the first quarter of 2020, which will form the basis for the MREL setting under the new framework. As of January 2021, the legislation will come into force, provided that the BRRD2 has been implemented at the national level.

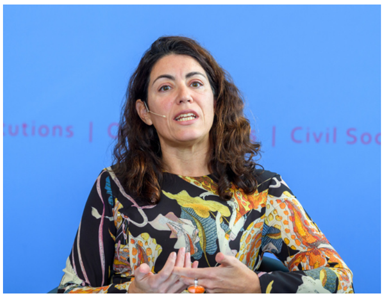
Building up MREL can be challenging for medium-sized banks that have no history in issuing unsecured debt. Therefore, the SRB pursued a gradual approach to MREL with transition periods for each bank.

Building up MREL can be particularly challenging for medium-sized banks that have no history in issuing unsecured debt in the wholesale markets. Therefore, the SRB consistently pursued a gradual approach to MREL with transition periods adapted to each bank‵s funding ability. Despite difficulties, data for the first half of 2019 indicate a substantial gross amount of MREL-compliant liabilities. Under the current favorable conditions and buoyant financial markets, banks should exploit the maximum level possible to continue on the path towards resolvability, which would otherwise be much harder once the cycle turns. Sebastiano Laviola concluded that ensuring resolution is a process that takes time, and eleven years after the beginning of the crisis, significant work remains for the SRB to be done.

Panel III - Discussion

Making Resolution Work: How to deal with Legal Loopholes, Institutional Implementation Challenges and Impediments to Practice

with **Cristina Dias**, Parliamentary Research Administrator, European Parliament; **Sebastiano Laviola**, Board Member, Director of Strategy and Policy Coordination, Single Resolution Board; **Dr. Sven Schelo**, Partner, Linklaters LLP; **Dr. Reto Schiltknecht**, Head of International Affairs and Policy Issues, Recovery and Resolution Division, FINMA; **Carola Schuler**, Managing Director, Financial Institutions Group, Moody's; moderated by **Prof. Luís Silva Morais**, Professor of Law, University of Lisbon



Transparency and disclosure are key elements to ensure the credibility of resolution frameworks.

Luís Silva Morais welcomed the various expertise on the panel to critically assess the obstacles to resolution and to discuss how to ensure an orderly market exit for banks opening with a round of observations.

Cristina Dias highlighted transparency and disclosure as key elements to ensure the credibility of resolution frameworks and acknowledged the decisive steps of the Single Resolution Board (SRB) at the institutional level to ensure an adequate resolution regime, while doing important educational work of explaining resolution to market participants.

Still, the main issue remains on whether capital markets have enough information to assess the resolvability of an institution. In this respect, resolution plans are crucial for investors, but still not publicly available in the EU in contrast to the US and UK. However, increasing transparency is also a balancing act between forgone investments due to insufficient resolution information and the risks from disclosing information that investors do not understand. Therefore, transparency has to be linked to financial education, and market participants have to understand exactly what the information is about, also in terms of risks, to avoid bank runs and disruptions of the financial system. Nonetheless, with greater transparency, resolution authorities need to be able to make decisions that differ from their originally provided guidance given the circumstances of the case.

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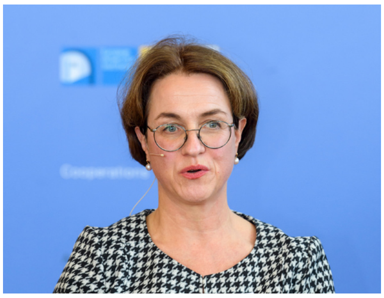
Every system of transparency and disclosure on resolution needs to be coupled with a number of safeguards. Insights from stress tests before and during crisis demonstrated that to disclose non-confidential parts of resolution plans it requires a clear time framework for disclosure, a simultaneous publication of information on all banks, and coordinated communication between the various authorities involved.

Sven Schelo focused on the large number of mid-sized banks across Europe, which are refinanced by deposits, have limited access to capital markets and ergo little opportunity to build up MREL capital for bail-in. They are less likely to be in the public interest of resolution and therefore subject to insolvency at the national level. However, for a bank with 30 to 40 billion Euro on its balance sheets, no national deposit scheme would be refunded to such an amount

One solution to facilitate ordinary insolvency proceedings is to find some form of pre-financing for this deposit protection, possibly through EDIS or the ESM.

to ensure all deposits of up to 100.000 Euro. In this context, national banks would have to refill the deposit protection scheme via ex-post contributions. Consequently, the deposit base of mid-sized banks constitutes a challenge that has to be solved to avoid a state aid situation. One solution to facilitate ordinary insolvency proceedings is to find some form of pre-financing for this deposit protection scheme, possibly through EDIS or the European Stability Mechanism. Alternatively, liquidation that is fully funded by the assets on the banks' balance sheets presents another option to avoid insolvency, as the capital ratios of mid-sized banks are typically sufficient to cover all liabilities, though not enough for shareholders. Sebastiano Laviola added that while a full harmonization of insolvency frameworks would take too much time, an administrative tool is needed now, especially for cases where there is no resolution decision for a mid-sized bank, which is also a cross-border level playing field issue.

On Luís Morais's question of how to overcome difficulties related to MREL requirements, Sven Schelo remarked that MREL has evolved to an almost obligatory capital requirement that is more difficult for mid-sized banks to meet. The problem with MREL in the form of material ready for bail-in ready at resolution in the form of subordinated liabilities is that banks would have to take up those liabilities at the bond market, to which they have no access. Alternatively, MREL waivers in the case that no resolution strategy can be applied lead back to insolvency, either in the form of an open bank bail-in or a sale/transfer of business to an investor. For this, however, senior liabilities have to be written off, which possibly destroys confidence and makes it more difficult for a bank to operate. On these grounds, a workable solution for smaller banks to comply with MREL is difficult.



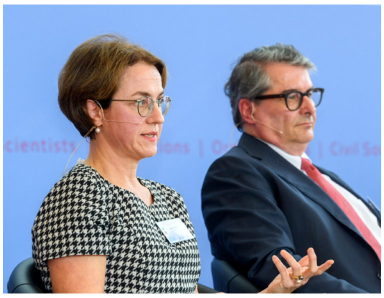
Favorable conditions for absorption of senior non-preferred bonds are given by a highly liquid market where there are a search for yield and low interest rates.

In this regard, Carola Schuler made the observation that recently capital markets appear to appreciate small to mid-sized banks that start to communicate their MREL gap and a plan on how to close it. They start by issuing Tier 2 and Additional Tier 1 (AT1) capital getting ready to eventually issue senior non-preferred bonds. Favorable conditions for absorption are given by a highly liquid market where there is a search for yield in a low interest rate environment. On a more cautious note, she emphasized that banks, either small or large, need a high creditworthiness in order to convince investors to buy their resolution capital instruments. So, given today's interest rates, size alone is no longer the only barrier.

Subsequently, Reto Schiltknecht provided a Swiss perspective on handling the two domestic GSIBs, UBS and Credit Suisse, which have an estimated two-thirds of their balance sheets abroad primarily in the UK and the US. On the first aspect of funding in resolution, he stressed that free flows of funds in capital and liquidity are essential to overcome a crisis scenario. Therefore, Swiss authorities estimated a respective liquidity need by defining a stress test scenario with a gradual outflow of liquidity coverage ratio (LCR) over 90 days. As a result, a relatively large deficit of liquidity was observed at the parent bank level, while at the same time there was a substantial liquidity surplus in the UK and the US. To improve upon these results, solutions include increasing the LCR, discussing workable management actions to create additional liquidity, forcing banks to build up more sophisticated models for their liquidity needs, and introducing a public backstop. Reto Schiltknecht then explained that, at the end of the day, resolvability is a test of whether the machine with all its different components works; that is to say, it is the proof of the pudding. Substantial work and

Substantial work and unsolved challenges remain in the area of the after restructuring and after bail-in phase given the structure of wholesale banks.

unsolved challenges remain in the area of the after restructuring and after bail-in phase given the structure of wholesale banks with large trading books outside as well as inside Switzerland. In this regard, the UK, as well as shared experiences with the US, serves as an orientation as far as insurance and testing are concerned.



Investors and markets need reliability, credibility and a clear understanding of what would happen in resolution. If they cannot understand the real risk, they are likey to not invest or demand a premium.

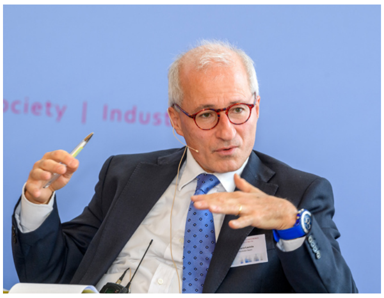
From a creditor's perspective, Carola Schuler considered the lack of disclosed resolution plans to be one of the largest barriers to the credibility and effectiveness of resolution. Investors and capital markets need reliability, credibility and a clear understanding of what would happen in resolution, she underlined. To hold back resolution plans from the public domain limits the understanding of respective processes, loss-absorption requirements and the distribution of loss-absorption material among group entities. If investors cannot understand the real resolution risk, they are likely to not invest or to demand an additional risk premium. Authorities can always change their mind as unexpected barriers to the execution of a resolution plan might arise, which the market would not mind. But some planning certainty is necessary, she said.

Regarding liquidity in resolution as another obstacle, Carola Schuler explained that the recapitalizationo of a bank is not enough to restore market confidence. Therefore, it needs the public sector, access to the central bank and liquidity to get banks back into the market. Moreover, markets need to have the confidence that authorities have access to these tools ahead of time. Lastly, she considered inconsistencies in insolvency legislation and creditor hierarchies across Europe as the most contentious issue. Modifications in form of the BRRD 2 still entail too many deviations constituting a real barrier to resolution, particularly for cross-border groups. In addition, Sebastiano Laviola highlighted the negative repercussion for the ‚no-creditor-worse-off' criterion, as some countries have a different hierarchy between resolution and insolvency.

Investors might need to accept that there is no silver bullet for resolution, and in reality resolution can never be fully predictable.

With respect to Cristina Dias and Carola Schuler, Sven Schelo expressed concern about publishing bank-specific resolution plans, as it might have unforeseeable consequences and destroy trust, which is essential for banks and difficult to restore. Investors might need to accept that there is no silver bullet for resolution, and in reality resolution can never be fully predictable, he pointed out. While acknowledging the balancing act between as much transparency as possible and respecting the roles and responsibilities of different actors, Carola Schuler replied that nonetheless the market is desperate for more information, and the lack of it leads to volumes and pricing of bail-in liabilities not coming along and hence deviating prices, which is neither in the interest of banks nor financial stability. Reto Schiltknecht distinguished between two fundamentally different levels of transparency regarding what authorities should publish about the state of a bank's resolvability in contrast to measures they would take in resolution. From a Swiss perspective, he indicated that an upcoming resolution report will cover taken measures, potential loopholes, assessment of banks' progress on resolvability and partial information on resolution plans in the limited scope of the Swiss emergency plan.

Luís Morais summarized the panel's topics of transparency, communication policy, the particular issue of mid-sized banks between resolution and insolvency as well as the issues of liquidity in insolvency proceedings and resolution.



The BRRD framework was designed for idiosyncratic cases, while authorities are working on an analytical framework for issues of contagion and indirect effects.

On the first remark from the audience on the measure of early intervention for mid-sized banks instead of either resolution or liquidation, Sven Schelo responded that such precautionary recapitalization measures might be a way out of this dilemma but also present a loophole as it is some kind of bail-out. Prior to the BBRD, precautionary recapitalization might have worked in cases of some Southern European banks, but this is likely to be different in the future. Sebastiano Laviola added that overall the BRRD framework was designed for idiosyncratic cases, while authorities are working on an analytical framework for issues of contagion and indirect effects on the real economy. Regarding another comment on the Emergency Liquidity Assistance (ELA) for mid-sized banks, Sebastiano Laviola ensured that while there is no discrimination towards mid-sized banks to be subject to ELA, they still have to face the condition of adequate collateral. Sven Schelo noted that this issue constituted a political balancing act, as ELA might sometimes appear to delay the inevitable. Reto Schiltknecht added that before ELA comes into play, there are other possibilities for the central bank to inject liquidity, and he raised the question of the quality of collateral.

The final question referred to whether a US-like reversal of the burden of proof should be introduced when calling for greater transparency in Europe, as more transparent jurisdictions typically have a resolution system with a higher level of legal certainty. Though possibly convenient for regulators, Cristina Dias considered a reversal of proof would put excessive pressure on investors, which is unwarranted. While transparency and certainty are important, public authorities need to be able to stand for scrutiny and explain their decisions without benefitting from more favorable legal conditions..

Panel IV - Discussion

Risk Sharing in the EU: How to ensure Common Grounds on Adequate Instruments, Institutional Frameworks and Appropriate Procedures

with **Giuseppe De Martino**, Senior Advisor, Banking and Financial System - Legal Affairs, Italian Ministry of Finance; **Dr. Levin Holle**, Director General Financial Markets Policy, German Federal Ministry of Finance; **Nicoletta Mascher**, Head of Banking, European Stability Mechanism; **Sébastien Raspiller**, Assistant Secretary for Financial Services, Directorat General of the Treasury, French Ministry for the Economy and Finance; **Emiliano Tornese**, Deputy Head, Resolution and Crisis Management Unit, European Commission; moderated by **Nicolas Véron**, Senior Fellow, Bruegel and Peterson Institute for International Economics

Nicolas Véron opened the panel by appreciating the Financial Stability Conference as a matter of public service, as it brings together important actors in the setting of Berlin, which is highly relevant for European politics. Starting in a first round of impulse statements, Emiliano Tornese highlighted that the final objective of the Banking Union (BU) was to establish a single market for banking to benefit from synergies and prospects for financial stability. In this regard, several EU banking packages have been adopted to create a coherent framework with instruments including capital buffers in terms of the minimum requirement for own funds and eligible liabilities (MREL), increased liquidity ratios and an extended scope of the total loss-absorbing capacity (TLAC). These efforts led to an increase in overall safety but also to fragmentation, over-banking and low profitability in the banking system.

To break the sovereign-bank nexus it requires a complete Banking Union with a common system for deposit protection and a common backstop for the SRF.

In a way, despite all these rules we have failed to achieve the internal market for banking. Moreover, the BU architecture consists of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) as the first two pillars, on top of which the important component of the European deposit insurance scheme (EDIS) has to be implemented and coupled with a backstop. Liquidity in resolution remains a major challenge in this framework, which would require a specific facility, while the BU architecture can partially tackle this issue by creating more trust and allowing free capital and liquidity flows within banking groups, which enhances private instead of public risk sharing.

Nicolas Véron remarked that there were two policy narratives of the BU, one being the imperative to break the sovereign-bank nexus and the other being the creation of the Single Market enshrined in the 1957 Treaty of Rome. Emiliano Tornese considered these two fairly different narratives to be complementary and strictly related. Regulation and the institutional infrastructure have to create the right incentives for cross-border activities and an internal market, which in turn facilitates the provision of credit to the real economy and efficient resource allocation. Finally, to break the sovereign-bank nexus it requires the infrastructure of a complete BU with a common system for deposit protection and a common backstop for the Single Resolution Fund (SRF) providing liquidity in resolution at the European level.

The goal of any risk sharing mechanism is to increase the system's overall resilience and capability to absorb local shocks.

Giuseppe De Martino referenced a recent ECB paper, for which a stress scenario assuming a fully-fledged and funded EDIS was simulated to understand whether it would withstand multiple banking crises. As a result, even under a conservative loss scenario, the specified EDIS was sufficient to cover payouts to depositors. Merely a non-systematic but crisis-specific redistributive impact occurred and without any cross-subsidization, no Member State benefited disproportionately from the EDIS mechanism. The real goal of any risk sharing mechanism is to increase the system's overall resilience and capability to absorb local shocks. Nicolas Véron critically reflected that this result of non-permanent transfers and merely crisis-specific redistributions counters the popular narrative of EDIS as a transfer mechanism.

Sébastien Raspiller noted that breaking the sovereign-bank vicious circle and creating a genuine single market are two essential and mutually reinforcing elements to complete the BU and the overall goal of resilience of the Economic and Monetary Union. While it is difficult to break the doom loop, diversification via cross-border mergers helps to avoid spill-over risks and to provide shock absorption capacity thereby contributing to a genuine single market, in which eventually some form of a residual doom loop might even be negligible. Well-designed risk sharing with proper incentives to avoid moral hazard presents another useful measure to enhance resilience, though it is neither the ultimate solution nor a goal by itself.

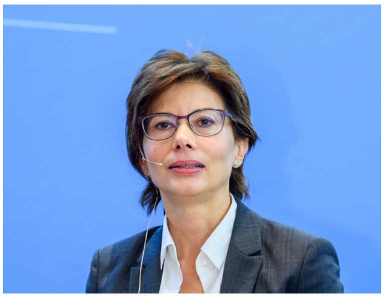
Diversification via cross-border mergers helps to avoid spill-over risks and to provide shock absorption capacity thereby contributing to a single market.

But before talking about EDIS, the SRM and effective resolution have to be ensured to function properly. And while the SSM has done a good job, more intrusive supervision on less significant institutions is needed for EDIS to rebuild trust. On the other hand, the BU has proven beneficial to make the banking system safer at the national level with risk reduction measures of increased supervision and capital buffers. Other issues of governance, market fragmentation, low profitability and limited financial diversification, for which additional buffers are not always effective, should be addressed at a transversal instead of supervisory level.

Levin Holle went on to explain why the much needed progress on the BU is comparably slow. Basel III and increased capital levels for banks present a yet unfinished legislative piece of work. Low interest rates and technological change put massive pressure on the profitability of European banks. Transitioning to a European resolution regime under the BRRD remains difficult due to different political preferences and its technical complexity. The completion of the BU to increase resilience in the Monetary Union requires pending solutions to mutualize risks and funds. Finally, the issue of money laundering impedes the rebuilding trust and has to be addressed. Nonetheless, a comprehensive agenda, better understanding of the SRM and its required improvements, increased risk reduction with higher capital buffers as well as the start of a new Commission are promising factors for further progress on the BU.

Nicoletta Mascher emphasized the importance of risk sharing as defined by the absorption capacity of a country to insulate its disposable income from idiosyncratic regional shocks given that a recent IMF paper found 80 percent of idiosyncratic regional shocks in the Euro area to go unsmoothed impacting income and consumption in a given country. Private risk sharing by means of risk diversification via financial market integration could substantially contribute to making economies less vulnerable to local shocks and hence achieve the

BU's objective of a safe and sound banking system with profitability for all intermediaries. The more private risk sharing, the less public intervention is needed to absorb the impact of shocks. Therefore, it needs more financial integration with a complete BU and CMU. As a result, investors could freely move resources, banks have access to financing even when local markets are under distress, consumers benefit from less expensive services and more importantly, market players could better compete on a global scale. In terms of public risk sharing, the short-term agenda for EDIS is to rebuild trust and confidence by overcoming fears of contagion or systemic transfers, which requires an open discussion involving the industry in the design of EDIS.



The more private risk sharing, the less public intervention is needed to absorb the impact of shocks. Therefore, it needs integration with a complete BU and CMU.

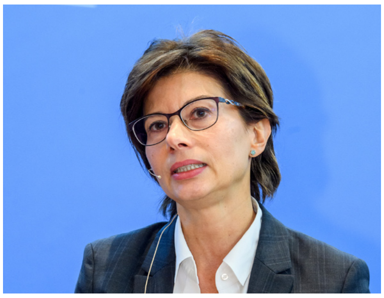
Subsequently, Nicolas Véron collected reactions from the panel on the assessment that European supervision works while resolution does not. Giuseppe De Martino conceded that resolution has not yet been applied at European level, given that the Banco Popular case was quite particular, and agreed with Emiliano Tornese that the resolution framework needs to be improved in order to remove constraints preventing authorities from effectively applying resolution.

Using a different label for early intervention measures could help to avoid putting public blame on a bank and restrain potential deposit flights.

Levin Holle made the observation that common European supervision was easier to establish because it was merged from existing rules and institutions, whereas new institutions had to be formed for resolution, which naturally takes more time. He further suggested that supervision has a role to play in making the second pillar of resolution work. On behalf of the supervisor, it is questionable whether previous early intervention measures for banks adequately prevented excessive liquidity coverage ratio outflows and subsequent replacements by emergency liquidity assistance (ELA) or government-guaranteed bonds, which overall made it politically more difficult for resolution authorities to bail-in. Admittedly, to define the right point in time for the proper instrument is a challenge for any banking supervisor. Using a different label for early intervention could help to avoid putting public blame on a bank and restrain potential deposit flights. Nicoletta Mascher agreed that loopholes already exist concerning the first pillar of supervision and its linkage to resolution. As a consequence, supervision requires a better design of early or normal interventions, better coverage of risk with a more forward-looking approach and an equivalent regime for non-bank financial institutions.

National DGSs could play a more active role in liquidation by conducting alternative and more efficient measures.

Nicolas Véron then referred to a recent paper by the Bank of Italy, which suggests that Member States should create national regimes similar to the one applied to the two Venetian banks. Thus, a regime specifically for banks not entering EU resolution as they failed the public interest assessment of the Single Resolution Board (SRB). Giuseppe De Martino explained that the disorderly piecemeal liquidation for banks presents the worst outcome of any crisis management framework because it detrimentally impacts the real economy. To prevent this, national deposit guarantee schemes (DGSs) could play a more active role in liquidation by conducting alternative and more efficient measures. However, the current framework restrains the national DGSs from doing so as it is based on the least cost assessment and the super-priority for covered deposits. Therefore, alternative DGS measures demand specific regulatory amendments, for instance, to include indirect costs from domestic liquidation in the least cost assessment.



EDIS is crucial to ensure the same level of deposit protection across the BU. It is not possible to rebuild trust and confidence without EDIS.

EDIS is a necessary element to provide more safeguards to the host Member States, while it is not sufficient by itself to overcome ring-fencing.

Finally, Nicolas Véron asked the panelists whether it was possible to overcome national ring-fencing in the eurozone without EDIS, which he referred to as an effectively European deposit insurance in contrast to the Commission's proposition. Nicoletta Mascher suggested that EDIS is crucial to ensure the same level of deposit protection across the BU because the current DGSs still rely on national resources, for which the sovereign-bank nexus cannot be solved. It is not possible to rebuild trust and confidence without EDIS, she underlined.

Levin Holle replied that while there is a strong political connection between the two elements, in practical economic terms EDIS is hardly helpful to overcome ring-fencing. This is because most cross-border activities take place in large banks that are under the remit of the SRB. In a crisis scenario, those banks will be resolved at the European level with granted access to the SRF. The key concern of bail-in for competent authorities in the host Member State is then to ensure and trust that sufficient capital and liquidity can move freely to where the crisis happens within a banking group. In contrast, deposit insurance and its super-priority for covered deposits are only economically relevant for smaller banks that do not enter European resolution.

Sébastien Raspiller suggested that in a steady-state BU with an integrated single market for banking, EDIS could assure all supervisors of the reliable protection of national DGSs against being used in a systemic event in the eurozone and therefore avoid ring-fencing. However, while the eurozone currently falls short of being fully integrated, EDIS is neither a means to make progress on integration nor the home-host issue. Emiliano Tornese considered EDIS as a necessary element to provide more safeguards to the host Member States, while it is not sufficient by itself to overcome ring-fencing or to ensure free intra-group capital and liquidity flows.

Giuseppe De Martino agreed that EDIS is not sufficient but necessary, because as long as national authorities have a mandate to protect national deposits they are prone to ring-fence. In addition, the system is not credible as long as deposit insurance cannot take alternative measures, for which a general depositor preference based on a tiered approach is needed. This last aspect marked a separate debate in contrast to whether national resolution regimes for banks are sufficiently swift.

According to Levin Holle, alternative measures given to DGSs make sense economically, if according to the least cost assessment the payout would be more expensive for a deposit insurance than respective alternatives. Still, the European system should adhere to a strict least cost principle and super-priority of covered deposits. Nicolas Véron clarified that the pure payout EDIS is different from an EDIS with alternative measures and that the latter is specifically linked to a policy proposal of general depositor preference. Nicoletta Mascher summarized that a common deposit insurance is in any case necessary to have a properly functioning BU.

As the core feature of this panel, Nicolas Véron summarized the extraordinary technical complexity of the discussed issues with remaining problems to be solved at the technical level as well as the fact that EDIS was a necessary though not sufficient part of the package towards completing the BU.

The first question from the audience referred to the missing elements needed to get to EDIS at the end of the process. Nicoletta Mascher replied that a recent ESM discussion paper proposed a roadmap with a sequential approach of 20 steps, which were attentively crafted to account for all interlinkages between the different issues to achieve the final goal of a common deposit insurance by 2028. Among these, crisis management tools, the harmonization of creditor hierarchy as well as the alignment of burden sharing rules with the bail-in criteria were critical elements. Levin Holle identified the regulatory treatment of sovereign debt, targeted harmonization and bank insolvency law as well as anti-money laundering (AML) efforts as the missing elements.

Additional administrative liquidation instruments would be useful at the SRB and, independent of the public interest test, helpful to deal with smaller banks.

On the issue of whether additional administrative liquidation instruments would be useful at the SRB, Levin Holle agreed that such instruments independent of the public interest test would be helpful to deal with smaller banks. The BRRD integrated the public interest assessment as a threshold, for if a bank meets all criteria of being threatening to financial stability, the SRB is allowed to apply certain instruments and to access the SRF. This implied the legislative intent for smaller banks to be subject to national insolvency procedures instead of resolution initiated by the SRB. However, these regimes were too cumbersome in some Member States, which could be addressed by either modifying those national regimes or via legislation to introduce special EU-wide instruments. Sébastien Raspiller argued that the BRRD is a good piece of legislation and that the political will to apply the available tools exists. Before installing further regimes trying to correct resolution, it is necessary to fix the legislation that is already in place and implemented.

With regards to whether capital waivers with guarantees were an appropriate way to overcome the problem of limited capital and liquidity circulation in a cross-border context without having some form of EDIS in place, Giuseppe De Martino replied to that this would not be an option unless these guarantees were fully collateralized as a kind of internal MREL mechanism.

The final question referred to whether anti-money loundering should be effectively addressed at a European level through a new supervisory authority, as this risk is not sufficiently addressed at national level. Levin Holle admitted that up until now, AML has been treated as an EU instead of BU issue in term of legislation. Eventually, AML supervision should be conducted directly from a European institution that is closely connected to the executive part of the justice system, such as general law enforcement. But before jumping ahead, the role and set of rules for such an institution have to be clarified vis-a-vis existing EU supervisory authorities like EBA and SSM, and existing national authorities such as Financial Intelligence Units. Sébastien Raspiller added that AML should be addressed in terms of regulation instead of directives to avoid a regulatory race-to-the-bottom. Moreover, creating a supervisory EU body, either new or inside an existing authority, is first and foremost about having an EU governance that is independent of national supervisors. This can be problematic as the aspects of police and justice will probably remain at the national level in the foreseeable future.

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