The Banking Union: a Panacea for Eastern Europe?

by Ralph De Haas[50]

Abstract

This Q&A Section starts with the evolution of Multinational Banking in Europe and discusses the effectiveness of the actual regulatory framework in favouring the transition to the Banking Union in Europe. What are the main challenges ahead, and is the three-pillar strategy sufficient to favour the implementation of the single banking market?

Questions on Multinational Banking and the Banking Union

How has multinational banking evolved in Europe since the EU Directives on financial market integration of the 1990s?

After the fall of the Berlin Wall in 1989, many Western banks acquired former state banks or established new greenfield subsidiaries in Eastern Europe. Eastern European financial institutions were in desperate need of fresh capital and state-of-the-art know-how. Western banks, confronted with relatively saturated home markets, were eager to invest. As a result about 70 percent of all bank assets in Eastern Europe are nowadays owned by Western parent banks. These multinational parents hold most of their Eastern European subsidiaries on a tight financial leash and operate very active internal capital markets.

50. EBRD, Tilburg University.

The picture is very different in Western Europe, where cross-border banking acquisitions were either less attractive or met with explicit or tacit political opposition. Only about 12 percent of all bank assets in Western Europe are therefore owned by foreign banks at the moment. Instead, cross-border bank integration in Western Europe mainly takes the form of branches or cross-border lending. This has of course been facilitated by the European Capital Requirements Directives and the so-called 'European Passport' which allows banks licensed in one EU country to set up a branch or conduct cross-border business in other EU countries.

What have been the major temporary and long-term effects of the global financial crisis on the integration of the European banking sector?

In the short term, we have witnessed a rapid process of cross-border deleveraging. Western multinational banks have reduced their exposures to Eastern Europe in particular, both in terms of cross-border lending to local counterparts (especially to other banks) and in terms of intra-bank exposures to their own local subsidiaries. At the height of the 2008-09 global financial crises, ad hoc international policy coordination in the form of the so-called Vienna Initiative was able to stem this retrenchment to same extent (De Haas et al., 2015). Deleveraging has nevertheless continued during and in the aftermath of the subsequent Eurozone crisis. On the upside, most multinational banking groups have so far remained committed to Eastern Europe as a 'second home market'. Only few subsidiaries have been closed down or sold. These divestitures mainly concerned relatively recent acquisitions in more peripheral countries: 'last in, first out'.

In the longer term, the global financial crisis has made supervisors and regulators more aware of the nature of the risks associated with financially integrated banking groups. Multinational banks' internal capital markets are a double-edged sword: they stabilize foreign-bank subsidiaries during local financial crises but they also expose host countries to external shocks. This realisation has led to calls for a gradual rebalancing of bank-funding models in Emerging Europe away from cross-border and wholesale funding and towards more local deposit funding (EBRD, 2015). To the extent that local deposits are local-currency denominated, this will also help banks in the region – both domestic and foreign-owned ones – to gradually reduce FX lending.

Against this background, it will be interesting to see whether the new bank-resolution regimes that will come into force over the next couple of years will help or hamper this financial rebalancing process. Subsidiaries of European G-SIBs – globally systemically important banks such as BNP Paribas, Nordea and UniCredit – as well as banks that are domestically systemically relevant (D-SIBs) may be required to issue more liabilities with high loss-absorbing capacity. This will in particular be the case for subsidiaries of multinational banks that will follow a multiple point of entry approach. Such subsidiaries will need to take care of their own external TLAC (Total Loss Absorption Capacity) rather than get internal TLAC allocated to them by their parent banks (as would happen in a single point of entry approach where the parent is part of a global resolution plan). The availability of internal TLAC should in principle give host countries enough confidence that when a subsidiary gets into serious trouble, they can trigger the internal TLAC that the parent bank has pre-committed to the subsidiary. In such as approach, subsidiaries would not need to issue their own TLAC-eligible instruments and this may help them to move towards a balance sheet with more deposit and less wholesale funding.

How did the operating costs and the business and regulatory risks associated to multinational banking activities in Europe change after the financial crisis?

One major change has been a sharp increase in funding costs, in particular for foreign-owned banks. Before the crisis these subsidiaries had easy access to ample and cheap parent-bank funding. Parents actively supported their subsidiaries with intra-group funding in order to help them reach specific market shares in host countries. With the onset of the crisis, parent banks have become more conservative and have significantly increased the pricing of internal liquidity.

Will cross-border and multinational banking expand or shrink under the Banking Union?

Over the past couple of years we have seen a clear trend from cross-border to multinational banking in Europe as cross-border lending turned out to be much more sensitive to economic uncertainty than lending through brick-and-mortar foreign-bank subsidiaries. Countries that before the crisis relied a lot on cross-border bank lending – for instance because they had not allowed foreign strategic investors to buy local banks – experienced relatively sharp reductions in the supply of credit to local firms and households. This trend will probably level off over the next couple of years, as cross-border lending slowly picks up again and foreign-bank subsidiaries may to some extent be held back by ring-fencing initiatives.

Questions on the regulatory framework

What features and/or national laws have so far hindered the development of a single banking market in Europe (e.g., different bankruptcy procedures and laws, limitations on cross-border liquidity transfers within multinational banks, lack of coordination among national supervisors)?

An important unresolved problem is the unwillingness and sometimes legal inability of supervisors in home and host countries to actively share information on multinational banks. At a more fundamental level there remains a misalignment between the incentives of home country supervisors and host-country supervisors. This limits the ability of authorities to share accurate information in a timely manner. Efficient information sharing may only emerge if a bank subsidiary has systemic relevance in the host country *and* that host country is also significant from the perspective of the bank group. If both conditions are not met, cooperation will most likely break down (D'Hulster, 2015).

Regulatory cooperation may be particularly challenging for host countries *outside the EU* (see Lehmann and Nyberg, 2014). For these countries, the European Banking Authority (EBA) will be the key counterpart to facilitate access to the "core" supervisory colleges of EU bank groups. It remains to be seen, however, whether the EBA will be able to play this connector role effectively. It also still remains to be seen to what extent common ECB supervision will be an adequate replacement for previous regulatory mechanisms for countries *outside the Eurozone but inside the EU*. Host countries had built op cooperation with the main EU supervisor responsible for large systemic bank subsidiaries in their country (such as Austria and Italy) and this has now been replaced by common ECB supervision.

Another issue is the still substantial leeway for national authorities to resort to ring-fencing measures. In particular during home-country crisis episodes, such as the recent global financial crisis, host-country supervisors have a strong incentive to ring-fence subsidiaries to prevent capital or liquidity from 'escaping' the country in support of the parent bank. Typical measures include restrictions on paying (super) dividends to parent banks or limiting intra-group funding more generally. Such ad hoc and unilateral ring-fencing measures were introduced in various Eastern European countries when deleveraging by parent banks continued during the global and Eurozone crises (EBRD (2012), Box 3.4). In addition to such formal measures, informal moral suasion by local regulators plays a role as does the slightly more formal 'guidance' permitted under the second supervisory pillar.

Would the full establishment of the three pillars of the Banking Union – Single Supervisory Mechanism, Single Resolution Mechanism and Harmonized Deposit Guarantee schemes – effectively allow for the creation of a single banking market in Europe?

Among other things, this will depend on how both non-Eurozone EU countries and non-EU countries will be linked up to the Single Supervisory Mechanism (SSM). Opting in may provide benefits for EU countries outside the Eurozone, such as Poland, in terms of better access to information and a more transparent framework for crisis management. By opting to 'cooperate closely' with the SSM, and effectively tie their own hands, non-Eurozone countries can buy some credibility at the cost of basically accepting supervisory instructions from the ECB. Unlike euro area members, however, these countries will have much less impact on the decision-making process within the ECB.

The overall balance of pros and cons will differ on a country-by-country basis. So far only Romania has announced that it intends to 'opt in'. A worry shared by many countries is that the ECB might devote less attention to the supervision of a small country's banking sector than a national supervisor (Zettelmeyer, Berglöf and De Haas, 2012). In practice the ECB may focus its supervision on large banking groups – even though it has explicit supervisory responsibility for individual financial institutions, including subsidiaries.

For non-EU countries in the Eurozone's periphery (such as Serbia) the options for cooperation are more limited, though the interests in close collaboration may be equally strong (as Eurozone banks also hold large stakes in some of the main systemic banks in these non-EU countries).

Questions on the implementation of Multinational Banking in Europe

Will the European Banking Union work effectively even before a Common Deposit Guarantee Scheme is established?

Most likely not. Without some form of mutualisation of bank risk, and as long as national governments and domestic deposit schemes remain the ultimate back-stop in case of severe banking problems, countries remain exposed to the 'death loop' in which sovereigns are exposed to domestic banking losses and banks remain (in)directly exposed to sovereigns. In many European countries, the domestic deposit base covered by some form of insurance is very sizable. This suggests that in case of a potential failure of a systemic bank it is highly likely that governments still need to provide some kind of backstop, especially when paid-in resources are low. Some form of European deposit insurance will therefore be necessary to complement the Banking Union. This could be done in various ways though. There could be either a fully-fledged European deposit insurance system or, alternatively, national deposit systems could re-insure themselves through a European fund (and potentially a fiscal backstop through the ESM).

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