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Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions

"Towards the completion of the Banking Union"

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1. Background

The Five Presidents' Report of 22 June 2015[1] and the follow-up Commission Communication of 21 October 2015[2] have set out a plan for deepening Economic and Monetary Union (EMU). Completing the Banking Union is an indispensable element of that plan. EMU needs a fully-functioning Banking Union to ensure effective transmission of the single monetary policy, better risk diversification across Member States and adequate financing of the economy. In addition, the completion of the Banking Union will reinforce financial stability in EMU by restoring confidence in the banking sector through a combination of measures designed to both share and reduce risks.

The EU has implemented a substantial financial-sector reform agenda in recent years. In this context, the regulatory framework for banks has been strengthened on the basis of common rules, which ensure more consistent regulation and high-quality supervision across the EU. This framework will incentivise more responsible behaviour in the banking sector. For example:

- Stronger prudential requirements for banks, based on new global standards, have been introduced under CRDIV/CRR. In this way, the capacity of banks to absorb adverse economic and financial shocks has been enhanced by increasing the quality and quantity of capital, expanding risk coverage, containing leverage and improving governance and transparency.

- A new recovery and resolution framework for banks that are failing or likely to fail has been established under the Bank Recovery and Resolution Directive (BRRD). This framework will allow Member States to protect taxpayers by managing bank crises in a more timely and orderly manner.

- The functioning of national Deposit Guarantee Schemes (DGSs) has been enhanced by the Deposit Guarantee Scheme Directive (DGSD), which has harmonised their coverage, strengthened their funding arrangements and shortened the time-limit for pay-outs.

[1] The report of the Presidents of the European Parliament, European Council, the Commission, the Eurogroup and the European Central Bank on Completing Europe's Economic and Monetary Union.
See: http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf.

[2] Communication from the Commission to the European Parliament, the Council and the European Central on Steps towards Completing Economic and Monetary Union.
See: https://ec.europa.eu/transparency/regdoc/rep/1/2015/EN/1-2015-600-EN-F1-1.PDF.

This reinforced regulatory framework (single rulebook) constitutes a common foundation for the single market of 28 Member States, but also for the Banking Union.

A key objective of the Banking Union is to reverse the fragmentation of financial markets since the euro crisis, by weakening the link between banks and their national sovereigns (whereby bank failures can imperil public finances, and sovereign stress can destabilise banks). In order to meet this objective, it was decided that the supervision, resolution and resolution funding of significant banks should be conducted at the Banking Union level.

To this end, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) – the first two pillars of the Banking Union – have been established. The SSM became operational in November 2014 and is already delivering independent and uniform prudential supervision. The SRM will be fully operational from January 2016, when contributions to the Single Resolution Fund (SRF) will also begin. However, three years after the European Council agreed on a roadmap for the completion of EMU based on deeper integration and mutual support[3], the third pillar of the Banking Union – a common deposit insurance scheme – is still missing. In addition, it has been agreed that the Banking Union should have an effective common fiscal backstop to be available as a last resort but work on this matter has not yet started (see section 3.2 below).

Action is now needed to ensure full and correct implementation of those elements of the Banking Union that are already in place and to put in place the other missing elements. Member States have agreed to provide the SRF with effective bridge financing arrangements by January 2016 and to establish the common fiscal backstop at the latest by the end of 2023.[4] More recently, the Five Presidents' Report proposed a number of measures to complete the Banking Union; and a Communication from the Commission followed up by focusing on four key requirements:

1. full and rapid transposition and implementation of the already agreed legal provisions which have already been agreed (notably the BRRD and DGSD – see section 2 below);

2. swift agreement on an effective bridge-financing arrangement for the SRF and on a common fiscal backstop which should be fiscally neutral over the medium term, i.e. any use of taxpayers money would be subsequently reimbursed by the banks;

3. a legislative proposal for a European Deposit Insurance Scheme (EDIS); and

4. a parallel effort to further reduce risks in the banking sector and weaken the link between banks and their national sovereign.

[3] European Council conclusions on completing EMU adopted on 14 December 2012.
See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134320.pdf.
[4] See Eurogroup and ECOFIN Ministers' Statement of December 2013.

In accompanying the Commission's legislative proposal to establish EDIS, this Communication places the proposal in the broader context of completing the Banking Union and the necessary additional measures of risk sharing and risk reduction in the banking sector.

2. Implementing the rulebook for the Banking Union

CRDIV/CRR, the BRRD and the DGSD provide the rulebook for the Banking Union. These pieces of legislation were all adopted in 2014 and must now be transposed into national law to assure the proper functioning of the Banking Union. While CRDIV/CRR has been fully transposed by all of the Member States, some Member States – including some of those participating in the Banking Union – have not yet met their obligations for full transposition of the BRRD and the DGSD for which the transposition deadlines (31 December 2014 and 3 July 2015 respectively) have already passed. The Commission has begun infringement proceedings against several of these Member States before the European Court of Justice. In this context, the Commission has called for ratification of the Inter-Governmental Agreement on the SRF by the deadline of 30 November, where a number of Member States have not yet completed the ratification procedure. While the majority of Member States are expected to meet their commitments on transposition and ratification by end-2015, the credibility of the Banking Union depends on all of the participating Member States meeting all of their legal commitments.[5] Meanwhile, the Commission will ensure that the secondary legislation required to make the Banking Union operational, e.g. the bail-in provisions of the BRRD, is also adopted in a timely manner.

3. Bridge financing for the SRF and a common fiscal backstop

3.1 A bridge-financing arrangement

Bank contributions to the SRF will begin in 2016, but the SRF will not reach its steady-state size of approximately 55 billion Euros until 2024. Contributions will be mutualised on a progressive basis over an eight-year period. These features, coupled with a complex structure of separate and national compartments during the transition to full mutualisation, will limit the borrowing capacity of the SRF in the coming years. A key concern is that the SRF could suffer capacity constraints, particularly in its early years, and might be unable to provide the required funding for a bank resolution operation(s). In such circumstances, the Member State(s) concerned would be required to provide funding for resolution, thereby retaining the link between banks and their national sovereign.

[5] On 24 November 2015, the Bank Recovery and Resolution Directive had not yet, or only partially been transposed by 11 Member States: Belgium, Czech Republic, Italy, Cyprus, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovenia, and Sweden.
On 24 November 2015, the Deposit Guarantee Directive had not yet, or only partially been transposed by 15 Member States: Belgium, Czech Republic, Estonia, Ireland, Greece, Italy, Cyprus, Lithuania, Luxembourg, Malta, Netherlands, Poland, Romania, Slovenia, and Sweden.
On 24 of November 2015, the Intergovernmental Agreement had not yet been ratified or the instruments of ratification had not yet been deposited by 9 Member States: Belgium, Estonia, Greece, Ireland, Italy, Lithuania, Luxembourg, Malta, and Slovenia.

To address the risk of inadequate SRF capacity, the participating Member States are discussing the establishment of national credit lines to support their respective compartments. As the size of these compartments will fall with progressive mutualisation of contributions, Member States credit lines would be supporting a declining share of the total SRF over time. It is essential, therefore, that the Member States not only take the necessary steps to put these national credit lines in place before 1 January 2016 when the Single Resolution Board becomes fully operational, but that they begin discussion of a more robust mutualised credit line via the European Stability Mechanism (ESM).

3.2 A common fiscal backstop as a last resort

A well-functioning SSM and SRM should significantly reduce the likelihood of bank failures and should ensure that taxpayers are protected from the costs of any bank resolution. Further protection is provided by the wide range of prudential measures, which have been taken in respect of banks, with the objective of strengthening supervision and crisis management, improving the amount and quality of capital, reducing concentration of exposures, fostering deleveraging, limiting pro-cyclical lending behaviour, reinforcing access to liquidity, addressing systemic risk due to size, complexity and interconnectedness, reinforcing depositor confidence and incentivising proper risk management via rules on governance.

However, even this extensive menu of prudential and crisis management measures cannot eliminate entirely the risk that public funding may be required to enhance the financial capacity of resolution funds. For this reason, Member States have agreed that the Banking Union requires access to an effective common fiscal backstop to be used as a last resort. Such a backstop would imply a temporary mutualisation of possible fiscal risk related to bank resolutions across the Banking Union. However, use of the backstop would be fiscally neutral in the medium term, as any public funds used would be reimbursed over time by the banks (via *ex-post* contributions to the SRF).

4. A European Deposit Insurance Scheme (EDIS)

4.1 Rationale for EDIS

A common deposit insurance scheme was discussed in preliminary discussions of Banking Union in 2012. The Commission proposed to include mandatory mutual borrowing and lending between national deposit guarantee schemes in its amendment of the existing DGS Directive in 2012, but this proposal was not accepted. The DGS Directive of 2014 introduced improvements to national deposit guarantee schemes by reducing pay-out periods to depositors and requiring guarantee funds to be built-up to a specified target level by 2024. The Directive also provides for voluntary lending arrangements between national schemes, as a source of liquidity support in the event of need.

Despite the improvements brought by the 2014 Directive, the absence of a common deposit insurance scheme for the Banking Union means that depositors remain vulnerable to large local shocks, which could overwhelm national deposit guarantee schemes. At the same time, there is no level playing field within the Banking Union for

depositors and banks seeking to attract their deposits. The divergences between national deposit guarantee schemes may also contribute to market fragmentation by affecting the ability and willingness of banks to expand their operations on a cross-border basis. In particular, the choice of cross-border group structure for banks (i.e. branches or subsidiaries) could be affected, with banks choosing between their home deposit guarantee scheme (branch) or the host scheme (subsidiary), depending on the relative soundness of the two schemes concerned.

EDIS would increase the resilience of the Banking Union against future financial crises by reducing the vulnerability of national deposit guarantee schemes to large local shocks and further reducing the link between banks and their home sovereign. In these circumstances, EDIS can help to reassure depositors across the Banking Union and so reduce the risk of bank runs and increase financial stability. EDIS would also enhance cooperation between national DGSs in responding to cross-border bank failures. EDIS will foster depositor confidence independently of the location of a bank, thus fostering a level playing field and furthering financial integration. In all of these ways, EDIS is the logical complement of elevating responsibility for bank supervision and resolution to the Banking Union level. As responsibility for supervision and resolution are now shared as a result of SSM and SRM, the circumstances in which a national DGS has to pay out insured depositors or contribute to resolution are to a large extent no longer under national control. Accordingly, the Commission has adopted - together with this Communication - a legislative proposal for EDIS.

4.3 How would EDIS work?

4.3.1 The European Deposit Insurance Fund

A European Deposit Insurance Fund ("the Deposit Insurance Fund"), which will be distinct from the SRF, will be established to complement existing national deposit guarantee funds. Contributions will be levied on banks to finance the Deposit Insurance Fund.

In the reinsurance stage of EDIS, where risks largely remain at the national level, an individual bank's risk profile is determined relative to the remainder of its national banking system. Once EDIS becomes a system with joint liability at Banking Union level (as of the first year of co-insurance), an individual bank's risk profile is determined relative to all banks in the Banking Union. This would ensure that EDIS remains cost-neutral overall for banks and national DGSs, and avoid complications in determining banks' risk profiles in the build-up phase of the Deposit Insurance Fund.

A key principle is that all phases of EDIS should not increase the overall costs for the banking sector, as compared to current obligations under the 2014 DGS Directive. In other words, EDIS will improve the economic efficiency of the existing deposit insurance arrangements within the Banking Union by gradually pooling the available funds for payout events without requiring an overall increase in banks' contributions. The banks' EDIS contributions will be deducted from their contributions to national deposit guarantee schemes. Contributions to national schemes will be progressively reduced in parallel with increases in EDIS contributions.

A strong and independent authority at Banking-Union level would be required to administer EDIS, decide on the risk-adjusted contributions from the banks, monitor contribution inflows and manage pay-out cases. This role could be played by the Single Resolution Board (Board), with an appropriately modified governance structure for its new DGS tasks in order to manage any potential conflict of interest between the resolution and deposit guarantee functions. The Board could administer the SRF and the Deposit Insurance Fund together, thereby creating synergies when combining responsibilities for resolution and deposit insurance. This should enable consistency and efficiency in the decision-making process and swift decisions. This arrangement would establish the Board as the key first point of contact in a crisis, facilitating swift crisis management by the Board, and thereby limiting the possibility of contagion. It would, however, be necessary to address potential conflicts of interest by ensuring that the Deposit Insurance Fund would be appropriately segregated from the SRF.

4.3.2 Reinsurance moving to co-insurance

The proposal for EDIS combines the reinsurance and co-insurance approaches as sequential steps, beginning with the re-insurance approach, then moving to a system of co-insurance which would gradually increase the rate of mutualisation until a full insurance scheme ("full insurance") is achieved. The Commission proposes that EDIS would initially be based on the principle of reinsurance, and will not in the short term fully mutualise risk.

In order to limit the liability for the Deposit Insurance Fund, reduce moral hazard at the national level and address the possible divergences in the capitalisation level of the existing national DGSs, in the re-insurance phase, the national DGS could access the Deposit Insurance Fund only when Member States have fully complied with obligations under the DGS Directive and it has first exhausted all its own resources and under the condition that it complied with the DGS Directive. Moreover, the Deposit Insurance Fund would only contribute a certain amount of any pay-out, providing assistance to the national DGS up to a specified percentage of the shortfall faced by the DGS and subject to a specified overall cap. These conditions for receiving assistance from the Deposit Insurance Fund are necessary to address moral hazard risk and to avoid the possibility of “first-mover advantages” and of a national DGS receiving more EDIS assistance simply because action had not been taken to build up sufficient national funding. Member States would need to continue to build up their national DGSs. As pay-outs by the Deposit Insurance Fund would be dependent on compliance with the DGSD, the system would provide additional incentives for Member States to fully comply with the DGSD. This safeguard would ensure thay DGSs do not take advantage of EDIS when they are depleted. Moreover, caps for the intervention of EDIS are also provided to ensure that it is not depleted by individual payout events.

This re-insurance approach would weaken the link between banks and their national sovereign, but it would not provide a comprehensive insurance for national schemes to fall back on, nor ensure that all retail deposits in the Banking Union enjoy an equal level of protection.

So after a phase of operation as a re-insurance scheme, EDIS would become a progressively mutualised system ("co-insurance"), still subject to appropriate limits and

safeguards, to become full insurance by 2024. Over the period to 2024, the relative contribution from the Deposit Insurance Fund to depositor pay-outs would gradually increase to 100 percent, implying full insurance of depositor risk across the Banking Union.

The key difference in the two approaches of reinsurance and co-insurance would be that co-insurance implies that pay-outs would be shared between national DGS and the Deposit Insurance Fund as of the first euro of loss. However, the reinsurance and coinsurance approaches would enjoy many common features, so the evolution between the two approaches should not present major problems from an operational perspective. In particular, in both approaches, pay-outs from the Deposit Insurance Fund would continue to be dependent on national DGSs complying with the DGSD and the national DGS would be obliged to reimburse EDIS if it subsequently received *ex-post* contributions from its banks and/or received funds from an insolvency procedure.

The architecture of EDIS would follow the typical Banking Union construction: a single rule book in the form of the existing DGS Directive, for all 28 Member States, complemented by EDIS, which would be mandatory for Euro area Member States and open to non-Euro area Member States wishing to participate. In view of the close links between EDIS and single supervision and resolution, non-Euro area Member States joining the Banking Union would be required to participate in all three parts of the Banking Union.

Finally, the Commission will make sure that no distortions occur in the single market by the consistent application of State Aid rules. Funds used by DGSs, including the Deposit Insurance Fund, to repay depositors for unavailable covered deposits in accordance with the DGS Directive do not constitute State aid or Fund aid. However, where those funds are used in the restructuring of credit institutions and constitute State aid or Fund aid, they must comply with Article 108 of the Treaty on the Functioning of the European Union and, respectively, with Article 19 of the SRM Regulation, as amended. Moreover, it is very much the Commission's expectation, not least because the deadlines have already expired, that the BRRD and all its applicable rules should be fully transposed by all Member States and implemented by the authorities responsible for resolution proceedings well before EDIS comes into force.

5. Further reducing risk in the Banking Union

The Commission is committed to further reduce risks and ensure a level playing field in the Banking Union by weakening the link between banks and their national sovereign. In terms of specific risk reduction measures, it is important to restate, once again, the importance of implementing agreed measures: so the first priority is to ensure that Member States deliver full transposition of the BRRD and the DGSD. To this end, infringement proceedings against the relevant Member States are underway. The Commission has also urged Member States to ratify the IGA on bank contributions to the SRF.

Adequate bridge-financing arrangements for the SRF, a common fiscal backstop and a common deposit insurance scheme would assure the most effective functioning of the Banking Union. A common feature of these measures is that they reduce the bank/sovereign link at the national level by means of risk sharing among all the Member States in the Banking Union. However, the risk sharing implied by these measures must be accompanied by measures to reduce risk in the banking sector taken in parallel with the stages of establishing EDIS. If the costs associated with bank failures and insolvencies are to be mutualised, it is essential that the risk of incurring such costs is contained to the maximum extent possible. This is not a new concern and many far-reaching measures to reduce such risks have already been taken (see section 1 above). Indeed, the ECB has confirmed that the balance sheets of the banks covered by its Comprehensive Assessment of 2014 are now sufficiently resilient even under significant economic and financial stress. Nevertheless, additional risk-reducing measures will be needed in parallel with work to establish EDIS.

- First, further action is needed to ensure that the SSM can function as effectively as possible. While the SSM has been operational for more than a year and has rapidly established its credentials as the single supervisor for the Banking Union, there is a need to reduce national options and discretions in the application of prudential rules. In this context, substantial progress is being made in eliminating many of these options and discretions in respect of micro-prudential rules (i.e. in the CRDIV/CRR) that apply to banks under its responsibility: on 11 November 2015, the SSM launched a public consultation on harmonising the exercising of supervisory options and discretions within the Banking Union.[6] However, there remains scope to eliminate some of the remaining options and discretions through EU regulatory measures. The Commission will work with Member States and in close coordination with the SSM to propose regulatory measures with a view to aligning, as necessary, the use of national options and discretions. In the course of the SSM review, the Commission will also examine the functioning of the SSM in other areas and consider any possible improvements. Concerning national options and discretions in the application of macro-prudential rules, the Commission will also consider possible revisions to the current regime, while retaining the necessary flexibility to respond to country-specific circumstances.

- Second, the harmonisation of national deposit guarantee schemes will need to advance in parallel with the establishment of EDIS. This harmonisation will be essential for EDIS to operate correctly in the full insurance stage. Despite the further harmonisation measures introduced by the 2014 DGS Directive, some important differences remain between national deposit guarantee schemes and these should be addressed within the context of the Banking Union. As part of the EDIS proposal, access to coverage by EDIS presupposes compliance with fully harmonised funding requirements.

- Third, the Single Resolution Board must be enabled to operate as effectively as possible. The Board will be fully operational from 2016 and has been working since March 2015 to prepare resolution plans for banks under its responsibility. It is

[6] See: https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/reporting_options.en.html.

essential that the Board can respond in a timely and effective manner in the event that a bank(s) is failing or likely to fail, so as to safeguard financial stability and limit the potential costs to the wider banking sector and the taxpayer. To this end, the availability of adequate "bailinable" liabilities through the proper implementation of the minimum requirement for "own funds" and eligible liabilities (MREL) requirements will be crucial. In addition, the TLAC (Total Loss Absorbing Capacity) requirement has been developed at the international level by the Financial Stability Board. The Commission will bring forward a legislative proposal in 2016 so that TLAC can be implemented by the agreed deadline of 2019. Implementation of TLAC would represent an additional harmonised minimum requirement to ensure that banks have sufficient loss absorption and recapitalisation capacity. The operation of the SRF should also begin smoothly, with contributions from all relevant banks flowing into the SRF on a timely and complete basis from 2016.

- Fourth, it is essential that the use of public funds to sustain a solvent and resilient banking sector should be minimised and be available only as a last resort. To this end, there must be a consistent application of the bail-in rules under BRRD so as to ensure that the costs of resolving banks that are failing or likely to fail are borne primarily by their shareholders and creditors. To the extent that public funds or funding from the SRF are used, the application of EU State Aid and Fund Aid rules will be essential. Therefore, such rules will continue to be enforced, making sure that the use of public funds is minimised through appropriate burden sharing measures; that aided banks are viable; and that competition in the single market is not distorted.

- Fifth, there is a need for greater convergence in insolvency law and restructuring proceedings across Member States, as identified in the Commission's Action Plan on Building a Capital Markets Union of 30 September 2015[7]. Inefficiency and divergence of insolvency laws make it harder to assess and manage credit risk. The Commission will consider bringing forward proposals enhancing legal certainty and encouraging the timely restructuring of borrowers in financial distress, which is particularly relevant for the success of strategies to address the problem of non-performing loans (NPLs) in some Member States. In the context of the European semester the Commission will also call for increased attention from Member States to settle NPLs, including by upgrading insolvency regimes towards best practices.

- Sixth, a number of further targeted prudential measures addressing identified weaknesses should be put in place. These measures include the remaining elements of the regulatory framework agreed within the Basel Committee, and in particular measures to limit bank leverage, to assure stable bank funding and to improve the comparability of risk-weighted assets. As a follow up to the outcome of the discussions within the Basel Committee, the Commission intends to make proposals for amendments to the CRDIV/CRR.

[7] See: http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf.

- Finally, the adequacy of the prudential treatment of banks' exposures to sovereign risk should be re-considered. Work on these matters is currently underway at the international level. In this context, the Five Presidents' Report refers to the possibility of the introduction of limits on banks' exposures to individual sovereigns, as a means to ensure that their overall sovereign risk is sufficiently diversified. The Commission will come forward with the necessary proposals on the prudential treatment of sovereigns, drawing on quantitative analysis under preparation in the Economic and Financial Committee and the Basel Committee and paying particular attention to financial stability aspects.

6. Conclusion

The Banking Union was established primarily in response to the financial crisis that evolved into a sovereign debt crisis in particular in the euro area. The crisis was driven by the link between banks and their respective national sovereign; and breaking this direct link has therefore become a key objective in putting together the different elements of the Banking Union. While some components of the Banking Union are already or will soon become operational, the overall construction is clearly incomplete. One of the missing elements, as underlined in the Five Presidents' Report and set out in this Communication, is a common deposit insurance scheme.

The Commission is therefore now proposing a common deposit insurance scheme for the Banking Union, based on a reinsurance approach that will be progressively converted to a full insurance scheme over a number of years. Member States should also begin work to reinforce the agreed bridge-financing arrangements for the SRF and on developing a common fiscal backstop. These steps to complete the Banking Union are logical in the context of efforts to deepen EMU. A common feature of these steps is that they reduce the bank/sovereign links in individual Member States by means of risk sharing among all the Member States in the Banking Union, and thereby reinforce the Banking Union in achieving its key objective. However, the risk sharing implied by steps to reinforce Banking Union must be accompanied by risk reducing measures designed to break the bank-sovereign link more directly.

The Commission will work to ensure that further measures to reduce risk are taken in parallel with ongoing work to establish EDIS, including any necessary regulatory changes.

The Commission will continue the dialogue on the overall package of EDIS and risk reduction measures with the European Parliament, Member States and all interested parties.