



OBSERVATIONS and PROPOSALS

The integration process of the European banking union: the old open problems and the critical points of the new set of rules





*Consiglio Nazionale
dell' Economia e del Lavoro*

THE ASSEMBLY

(in the 17 July 2019 meeting)

GIVEN the art. 99 of the Constitution;

GIVEN the special law of 30 December 1986, n. 936, containing “*Norms on the National Council for Economics and Labor*” and subsequent amendments and additions;

GIVEN, in particular, the art. 10 of the aforementioned law according to which the CNEL “expresses, at the request of the Government, assessments and proposals on the most important documents and political and economic and social planning documents, also with reference to community policies” and “examines, on the basis of the reports prepared by the Government, the Community policies and their implementation and to this end maintains contact with the corresponding bodies of the European Communities and other Member States”;

GIVEN the art. 14 of the aforementioned law which, among others, establishes the assumption *procedure*, by the Assembly, of the Preliminary rulings of the CNEL;

GIVEN the art. 12 of the same law that regulates the transmission of the rulings of the CNEL to the Government, the Chambers, the Regions and Autonomous Provinces and to the European institutions;

GIVEN the law of 24 December 2012, n. 234, containing “*General rules on Italy’s participation in the formation and implementation of European Union legislation and policies*”, and in particular Article 28, (*Participation of social partners and productive categories in decisions related to the formation of European Union acts*), which requires the President of the Council of Ministers or the Minister for European Affairs to transmit to CNL the projects and acts concerning matters of particular economic and social interest, and to CNEL to send to the Chambers and to the Government the assessments and contributions it deems appropriate;

GIVEN the internal regulations of the bodies;

GIVEN the Program of CNEL activities for the two-year period 2019-2020, approved by the CNEL Assembly in the session of 30 January 2019;

EXAMINED the following related Acts of the European Economic and Social Council (EESC):

Banking sector reform - Credit hierarchy in the event of insolvency - Proposal for a European Parliament and Council directive amending Directive 2014/59/EU of the European Parliament and of the Council regarding the classification of unsecured debt instruments in the credit hierarchy in the event of insolvency - COM (2016) 853 - 2016/0363 COD]

Reform of the structure of EU banks - Proposal for a Regulation of the European Parliament and of the Council on structural measures aimed at increasing the resilience of EU credit institutions COM (2014) 43 - 2014/0020 COD]

Deepening the EMU by 2025 - Opinion - Reflection document on the deepening of Economic and Monetary Union - COM (2017) 291.

Completion of the Banking Union - Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union - COM (2017) 592;

Deteriorated Credit Package - Proposal for a Regulation of the European Parliament and of the Council which amends the EU Regulation n. 575/2013 as regards the minimum coverage of losses on impaired exposures - COM(2018)134 - 2018/0060 COD and Proposal for a European Parliament and Council directive on credit managers, credit purchasers and recovery of collaterals - COM (2018) 135 - 2018/0063 COD;

Complete the EMU: the political pillar - (own-initiative opinion). Banking sector reform, changes in capital requirements and resolution framework - Proposal for a Regulation of the European Parliament and the Council amending EU Regulation no. 575/2013 - COM (2016) 850 - 2016/0360 COD, Proposal for a Regulation of the European Parliament and of the Council amending the EU Regulation n. 806/2014 - COM (2016) 851 - 2016/0361 COD, Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59 / EU - COM (2016) 852 - 2016/0362 COD and Proposal for a European Parliament and Council directive amending Directive 2013/36 / EU - COM (2016) 854 - 2016/0364 COD;

Given the acts of the preliminary investigation Commission III EU Policies and International Cooperation in the sessions of 17 January, 05 March, 26 March, 30 May and 10 July 2019;

Having examined the minutes of the session of the Presidency Office of 3 July 2019 and the minutes of the session of the Presidency Council of 17 July 2019;

GIVEN the report by the President of CNEL, pursuant to the aforementioned rules,

HAVING HEARD the General Secretary,

APPROVES

the joint document of Observations and Proposals concerning *“The process of European banking integration. The critical points of the new set of rules”*.

President

Prof. Tiziano TREU

*OBSERVATIONS AND PROPOSALS*THE EUROPEAN BANKING INTEGRATION PROCESS:
THE OLD OPEN PROBLEMS AND THE CRITICALITY OF THE NEW RULES**1. The framework of banking regulation after the great crisis****a) Objectives of the banking union**

The great financial crisis of 2007-2008 has highlighted the limits of the institutional framework of the credit system and has given impetus to a complex process of reform, still in progress, which has involved the general revision of the rules that constitute the banking supervisory system and the creation a banking union in November 2014.

Downstream of this process, we are in the presence of a new institutional architecture of coordination and convergence mechanisms, and of a European system regulatory *corpus* that redesigns the regulation of financial markets and the activity of banks. The interventions put in place have made the banks more capitalized than a decade ago and, at least in the traditional credit sector, the risk appears more contained. This is certainly a positive factor, because recessions are deeper when they are accompanied by a credit crisis, which amplifies the recessionary effects.

The impact of the long financial crisis on the economic and social system in the medium/long term has created the need to anticipate the alarm and attention thresholds of the recessive phases of the cycle, and the urgency of rules in the banking sector capable of responding to the following objectives:

- guaranteeing the stability of the banking sector and containing systemic risk;
- increasing the capacity of the European Union, a macro-area largely and structurally dependent on bank credit, to withstand exogenous *shocks*, and help strengthen its solidity;
- discouraging the behaviors deriving from the assumption of excess risk and/or opportunistic ones.

b) The new structure of the banking union and its effects on the economic and financial system.

The European Union has set the new regulatory process on three pillars:

- 1) the control activity on credit intermediaries (single supervision and surveillance mechanism by the ECB through the SSM-*Single Supervisory Mechanism*),
- 2) crisis management (single resolution mechanism through the *Single Resolution Board-SRB*)
- 3) deposit insurance.

These three pillars have the objective of ensuring a “fair balance” between the containment of risks and the capacity of the banking system to ensure the continuous financing of businesses and families. To date, the first two - the single supervision and resolution mechanisms - are being implemented, whereas the third is still in the preliminary stage.

The new framework has strengthened the powers of intervention of the supervisory authorities and introduced rules of immediate and uniform application in all EU countries, through which the international prudential requirements were rigorously adopted and the burden of the procedures of bank resolution shifted from the public to the private sector.

However, the increase in capital requirements, introduced to activate greater guarantees against risks, has produced **two main effects**:

- it has inevitably reduced the financing margins of the banking system as a whole;
- has fueled various reactions in the countries of the Union regarding the *trade-off* between the push towards European uniformity and the safeguarding of national specificities.

It is objectively difficult to intervene with uniform rules on very different economic systems and financial structures. This calls into question not only the methods of implementation of the new banking regulation at European level, but the objectives that the Union intends to achieve with these rules. From a strictly credit point of view, we try to make the rules more effective to allow the early management of crises. At the European system level, we try to “square the circle” between the need to guarantee a competitive equality for intermediaries and to support the effective capacity of the banking sector to fuel growth, taking into account, as far as possible, the characteristics of the individual local economic and legal contexts.

The dilemma is, therefore, to find the “right balance” between the RISK that the credit activity inevitably entails - and hence the regulatory system of the banking union that tries to limit its excessive expansion - and the need to guarantee the GROWTH of the real economy which, to this day, is still and largely based on the banking credit flow.

c) Critical issues and proposals for reform of the banking union

The CNEL reports that the framework for more effective containment of the risks of contagion and losses within the economic system does not sufficiently take into account the dimensional data of the banking company and specific mechanisms for smaller banks are still lacking. The process of normalization and rationalization of the regulatory system must become clearer and inspired by principles of proportionality, to ensure the stability and resilience necessary to secure an adequate capacity to finance the economic system even in the presence of future *shocks*.

This is accompanied by the need to create a European “*Single Rule Book*” that harmonizes the various national legal systems and the complementary disciplines to the banking one (eg bankruptcy and criminal law, fiscal legislation, accounting rules), to favor the consolidation process of the European banking sector and comparability at supranational level.

A further criticality of the European regulatory framework concerns the difficulties in stabilizing and systematizing the regulatory framework itself. The main problems consist in fixed costs (*compliance* costs) and in the high level of complexity that the banking system, in the various national offices, must support in terms of organization, adaptation and monitoring imposed by the succession of regulatory changes and by a fragmented normative framework. It would therefore be desirable to develop *ex ante* impact assessment methods (cost/benefit analysis) and *ex post* rules, to identify the positive and negative effects of the same ones.

It is also necessary to bear in mind the interactions of the innovations introduced with the provisions in force. It is essential to guarantee intermediaries adequate time to adapt to the new rules, taking into account both the organizational effort required to implement the new regulatory framework and the time needed to develop the possible effects on the collection, products and services markets

With regard to the *governance* of regulatory and supervisory processes, clear critical issues emerge regarding the role and functions performed by the authorities and institutions involved.

It is first of all necessary that the European Supervisory Authorities act in the framework outlined by the European sources. It is essential to reduce the overlapping areas of competence between the European and national authorities, in order to have a clear demarcation of their respective responsibilities. It must be outlined with greater clarity the role of the European Banking Authority, which since 2011 has been supervising the banking market with mainly regulatory interventions, while limiting this function to the preparation of analyzes and methodologies. The limits of

the powers of the Single Supervisory Mechanism (the European system that includes the ECB and the national supervisory authorities of the participating countries) must be limited in the issuing of documents that in fact assume the rank of secondary legislation in European law.

On the methodological level, the sector operators request interventions in supervisory activities aimed at increasing the degree of transparency on the methodologies (*stress tests*) used in the risk measurement exercises of individual banks (exercises that summarize the results of the analysis for a given year and indicate to the bank the actions to be undertaken). Finally, the accounting rules are not harmonized and the consistency between these and the supervisory regulations has decreased. Interventions are required for coordinating forecasts which - in the mechanism that foresees write-downs of pre-established bank loans and growing over time - significantly penalize Italy with regard to the legal procedures for the recovery of debts.

2. Further measures being introduced

a) The measures introduced by the “banking package”

The described framework is subject to changes for the measures to be introduced with the new package of provisions, which updates the structure outlined in 2013-14 regarding prudential requirements, *governance* and supervisory mechanisms, reorganization and resolution of failing institutions, the functioning of the resolution. This package is called the “banking package for risk reduction”.

This new reform process, which ended in 2018 and which is expected to issue the definitive texts, has two objectives: transposing in the EU legal system many elements of the regulatory context already decided by the Basel Committee for Banking Supervision and by the *Financial Stability Board* (which is composed of institutions, including non-European ones), and introducing tools to enhance the lending capacity of banks with a view to supporting the European economy.

The package in question includes the following new features:

- It introduces the **proportionality in matters of risk** with respect to the type of credit institution, with the notion of “small and less complex banks” which would become recipients of fewer obligations and a simplified regime for managing long-term liquidity;
- extends **the prudential treatment of favor for loans to small and medium-sized enterprises** and for those destined for the construction of **infrastructures**;
- introduces **precautionary measures to prevent the massive sales of impaired loans**, solicited by the European and national supervisor,

- from negatively affecting the calculation of capital requirements;
- introduces a **standard to include the value of *software* in capital**, in order not to penalize the investment of banks in technological innovation;
 - introduces **measures that facilitate the European harmonization of the criteria used to define the hierarchy of bank creditors**, helping to adequately quantify - in the event of the application of the *bail-in* - the own funds and liabilities of the banks' balance sheets, and to update the process of estimating prudential accounting provisions for the risk of impairment/non-collection of credits. In detail, it is a matter of expanding the instruments that can be used to calculate the minimum requirement of own funds and eligible liabilities, which all banks must satisfy, in compliance with proportionality. The new framework aims to align the minimum prudential requirement with the analogous criterion currently envisaged only for banks classified as "global systemic institutions".

b) Other measures to complete the banking union

With regard to the new hypotheses for the management of non-performing loans, Italian banks request the extension of the timescales envisaged for the achievement of hedging *targets*, and pose the need for a uniform and balanced discipline (in terms of supervision and regulation) of all the types of risks (given that impaired loans are only one of the types shown), therefore also of the risk deriving from derivatives and so-called "toxic" securities. Criteria for estimating provisions that avoid excessive capital absorption, which allow an equitable distribution of these among the various risks and which reduce superfluous restrictions to the banks' ability to provide credit are also requested.

To complete the banking union with the "third pillar", the reform process continues with the aim of achieving European deposit insurance and implementing in European legislation the new *standards* set by the Basel Committee on credit risk, market risk, and operational risk. The regulation of digital finance and commercial activities through *online* platforms, the regulation of *crowdfunding* and *blockchain*, fiscal interventions on European financial transactions through digital services and sustainable finance are still to be implemented.

3. The possible reform of the "bail-in"

As known, the tool introduced in 2016 (*bail-in*) to allow the authorities to reduce the value of the shares and some credits to absorb losses and re-

capitalize credit institutions, upon recourse to the termination conditions, determine the participation of investors and/or savers - and no longer tax payers - for the recovery/resolution of institutions in difficulty.

The “*bail in*” is a formally preventive operation (prior to bankruptcy) with which it is intended to prevent the rescue operations from being carried out with public funds and affecting the public debt, and requires the participation of the holders of specific financial assets issued by the institution in crisis to the financial losses suffered by it. Its introduction arose from the observation of the excessive recourse to public bailout during the acute phase of the crisis, which was attributed to the aggravation of the sovereign debt crisis in the EU. The tool changed the perspective from which the banking crisis management mechanisms moved, which was to minimize the impact on customers and on the banking system as a whole, adopting solutions such as the acquisition by larger and more solid intermediaries, the use of extraordinary administrations and/or liquidations, the preventive and precautionary intervention of the Interbank Deposit Protection Fund or the establishment of *bad banks*.

The worsening of the crisis and the raising of prudential requirements led to the decision by the European Commission to assimilate the interventions of the interbank fund to state aid. On the other hand, the preliminary analyzes - including those of the Bank of Italy - on the possible outcomes of the bail-in tool had highlighted the risks of systemic instability and, above all, the negative impact in terms of household and companies trust in the banking system, in view of the orientation of Italian banks to traditional retail brokerage - which makes them resilient to financial crises but very sensitive to economic recessions - and to favor the trust relationship with savers (especially small ones).

Further considerations arose from an excessively rapid application of the new crisis management rules (which requires intermediaries to structure their liabilities in order to absorb losses in a credible manner and without generating “savings expropriations” in case of termination), from the non-contractual nature of the *bail-in*, from the retroactivity of the effects on the securities already issued to 2016 and from the non-inclusion of alternative instruments, perhaps less burdensome (for example the intervention of the FITD, the Interbank Deposit Protection Fund).

Experience has shown other dysfunctions of European rules:

- the absence of proportionality in the application of the framework, to the detriment of the smaller or less interconnected institutions;
- lack of discretion in resolution procedures regarding the definition

- of public interest;
- the application, in cases not subject to resolution, of liquidation procedures according to national and non-harmonized rules, which results in jeopardising the public trust in the banking system.

The Government has included in its agenda the revision of the European resolution system and crisis management mechanisms, with particular reference to *bail-in*. The intent is to contribute to the ongoing discussion at European level on the completion of the banking union and the strengthening of the monetary union, to be carried out through the rectification of the regulatory system outlined with the first two pillars and identifying a solution that reconciles the need to combat moral hazard practices (connected to *bail-out* expectations) with the need to contain the risks of financial and banking instability.

With specific regard to the Italian case, the CNEL considers unacceptable a transfer of the burden of the crises to the tax payers, in consideration of the questionable level of equity of our tax system and the margins of evasion and avoidance that it allows.

It should also be emphasized that the crisis of confidence which has been affecting the European project for some years, fueled by the great crisis, involves not only and not specifically the single supervisory mechanism, but the entire operation of the central bank system of the euro area, its ability to ensure the stability of the Union's financial system, promote its integration and effectively contribute to the pursuit of the common objectives of the Union, according to the rules of decentralization, i.e. with the participation and cooperation of Member States.

In fact, if the supervisory framework outlined in the single mechanism constitutes a single *corpus* of rules, principles and practices applicable to all Member States, through which the Union intends to guarantee an equal playing field and treatment for all supervised credit institutions, it is still debated the role of the European Central Bank as an EU monetary policy authority, fully recognized, which would entail the transfer by the States of the "monetary sovereignty".

The CNEL shares the critical positions centered on the evidence that European monetary policies, despite the expansive monetary policies ("Quantitative Easing-QE") and the extraordinary operations for the support of the European banking system (TLTRO) operated by the ECB in recent years, do not appear to be sufficient to support growth. The dilemma derives from the well-known fact that by mandate the ECB has officially only the obligation to maintain price stability - and therefore inflation - but it doesn't have the mandate to operate in order to also guarantee the

macroeconomic growth of the euro area, contrary to what is true for the US *Federal Reserve*. Therefore, in the absence of the necessary and desired political decisions by the European Council in favor of greater convergence and harmonization of fiscal policies at European level, the ECB and its monetary policies cannot but act on a heterogeneous system on the fiscal level, devoid of countercyclical adjustment mechanisms to contain unemployment and an instrument that works towards convergence and sharing of risks between States.

With the contagion of the financial crisis of 2007-2008 to the sector of the real economy, and subsequently to the widening of the crisis to the public finance sector, the debate invests the possible functions of the European Central Bank as a last resort lender towards the Member States in a liquidity crisis, and the possible equalization of this function to state aid. In the absence of reform of the European Treaties which do not currently allow the ECB to lend direct aid to the euro area Member States due to the clause which prohibits the mutualisation of risks and debts at European level, it should be noted, on the other hand, that the existing *Outright Monetary Transactions* - the activities with which the ECB provides liquidity to States in difficulty, subject to the subscription of a specific adjustment program - are in fact already functioning as last resort loans. In this perspective it would be inconsistent with the rules of the Union the unlimited acquisition by the Central Bank of public securities on the primary market, since it would determine a form of monetization of the debt and the deficit of a State.

It should be noted that several member countries in difficulty proposed the overcoming of the current limits imposed on the ECB, considering the expansion of its attributions as a barrier against the speculative attack on the markets not only to be well founded but desirable. Therefore, on the one hand, there would be a task of “Last resort lender “ to insure the public debt of a state, convince the markets of its solvency and defuse speculative maneuvers. The Central Bank would undertake to purchase government bonds in unlimited quantities to reassure the markets of the constant presence of a holder of such assets and the reliability of the issuing country, without conditionality mechanisms taking effect.

As a “macroeconomic stabilizer” and monetary policy authorities, it would be necessary to outline new tasks for the ECB in supporting growth through expansive operations, to be carried out in compliance with the primary objectives set by the Treaties (price stability and inflation *targets*) and by efficient transmission mechanisms capable of countering any effects of a “liquidity trap”.

4. Council recommendations on the current regulatory framework

The CNEL, taking into account the observations presented, the positions of the social partners and the criticisms formulated in the debate currently underway at international level, makes proposals to modify the regulations in the areas indicated below.

- 1.1 With regard to the *bail-in* mechanism, the CNEL believes that, although rightly aimed at minimizing the impact on financial stability and on public accounts of banking crises, it has in fact highlighted a negative impact in terms of trust of families and businesses towards the banking system. It is also essential to identify the types of financial assets that can be subjected and in any case abrogate their retroactivity, providing that the resolution procedure applies only to securities issued starting from 2016.
- 1.2 The type of instruments that can be activated in the presence of a crisis must be expanded and the possibility of preventive and precautionary intervention of the Interbank Deposit Protection Fund restored.
- 1.3 It is necessary to provide for procedures for compensation of pecuniary damage caused to innocent savers through a more rapid final judicial assessment of the liabilities.
- 1.4 Massive initiatives must be launched, also for preventive purposes, quickly designed specifically to promote financial education, not only at school level, but also outside and towards civil society c.d. mature or “third age”.
- 1.5 With regard to the supervisory and resolution mechanisms, the CNEL requests the introduction of a principle of proportionality relating to the size and relevance of the intermediary, both for the purposes of resolution and for the purposes of bureaucratic-administrative *compliance*.
- 1.6 The CNEL deems it necessary to identify procedures aimed at harmonizing the criteria of bankruptcy hierarchy at European level, while at the national level it is necessary to make the judicial and extrajudicial procedures more streamlined and effective, in order to reduce the vulnerability of Italian banks in terms of impaired loans.
- 1.7 It is essential to introduce adequate tools to assess the impact of banking crisis management on employment levels and to ensure an adequate system strategy to protect savings.
- 1.8 We also urge a decisive action to combat moral hazard behaviors, thereby strengthening the implementation of the European MifidII directive on transparency as well.
- 1.9 The CNEL deems the discussion about the introduction of a clear separation of the rules of the commercial bank from that of the invest-

ment bank not to be postponed. At the same time, a correct analysis of the costs/benefits of such a separation should also be initiated, especially in view of the new technological and digital challenges of *Fintech*.

- 1.10 With regard to the role of the ECB, the CNEL first of all recognizes the positive role played by the latter in the monetary policy of recent years. However, it believes that it is appropriate to overcome the current European Treaties, and therefore to complete its current functions as a “last resort lender”, to convince the markets of the solvency of national public debts and defuse any speculative operations.
- 1.11 In the new global scenario that emerged after the great crisis, it is necessary to overcome a model based exclusively on the proposition of structural reforms marked by austerity and which mainly affect the weakest sections of society. In order to actively contribute to the development of the Union and trigger appropriate stimuli for the economy, monetary policy should be coordinated with fiscal policy through “federal” operations, in order to prevent the increase in sovereign bond rates of the riskiest countries.

A choice in this direction, however, requires the ability to build trust between member countries, in the belief that cooperation is the only action capable of responding to the problems of a global economy, and that the absence of cooperation between states would bring down the weight of a possible new crisis again on the shoulders of the weaker countries.





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