

POLICY AREA:
Financial Resilience

Transposition frictions, Banking Union, and integrated financial markets in Europe

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Abstract

In response to the financial crisis of 2007/2008, policymakers implemented comprehensive changes concerning the regulation and supervision of banks. Many of those changes, including Basel III or the directives pertaining to the Single Rulebook in the European Union (EU), are agreed upon at the supranational level, which constitutes a key step towards harmonized regulation and supervision in an integrated European financial market. However, the success of these reforms depends on the uniform and timely implementation at the national level. Avoiding strategic delays to implement EU regulation into national laws should thus constitute a main target of the G20.

Challenge

Enhanced policy coordination as well as an effective and efficient global financial architecture were identified as pivotal objectives at the G20 meetings in Hangzhou 2016 to provide the foundation for stable growth patterns. Regulatory and supervisory changes to the financial architecture that are based on international agreements therefore represent a critical achievement towards integrated financial markets and an internationally effective regulatory framework.

Prominent examples include new rules on capital and liquidity regulation as specified in Basel III and the establishment of the European Banking Union in the Euro Area, which is codified in the Single Rulebook that applies to all member states of the EU. The European Banking Union consists of three pillars: the Single Resolution Mechanism, the Single Supervisory Mechanism, and the harmonization of Deposit Insurance Schemes. The objective is to improve existing resolution and recovery mechanisms and to ensure uniform supervision of the largest and systemically important banks in the Euro Area.

The inception of these three pillars is still incomplete. For example, how to harmonize exactly existing deposit insurance schemes in a way that balances interests to grandfather pre-funded, voluntary

insurance schemes maintained by some banking sectors in selected EU countries, such as the savings bank sector in Germany, with the ability of a new insurance scheme to constitute a credible backstop in case of distress in some other member states, for example those that were subject to sovereign debt market turmoil in the past like Italy or Greece, remains unresolved. Clearly, interests, objectives, and constraints faced by different member states remain very different up and until today.

Reaching supranational agreements that represent the foundation of pan-European regulations as a first step are thus an achievement that cannot be overestimated. For example, G20 leaders support the implementation of Basel III, which is like the Banking Union partially implemented based on directives stemming from agreements made by the European Commission in the EU. This procedure corroborates that international coordination can be successful.

The main challenge after reaching agreements remains, however, to ensure timely and orderly implementation of these directives into national legislation. Otherwise, the pursuit of (short-run) national interests might give rise to strategic delays that might ultimately challenge the successful completion of steps towards integrated financial systems, and thus a unified Europe altogether. Monitoring the implementation of supranational regulation into national law following international agreements is therefore crucial. This holds both for the timing and the content-wise accuracy of regulatory reforms decided on at the supranational level, but implemented by national authorities.

Special attention is necessary if international agreements are not binding for individual national authorities. For example, Basel III sets up a regulatory framework that should be internationally applied but it is not legally binding across jurisdictions. Also, an important feature of EU directives in contrast to EU regulations is that national member states have some degree of flexibility regarding the implementation of those directives. This can result into severe differences in regulatory standards across countries and consequently pose a threat to the effectiveness and efficiency of the newly established financial architecture.

Proposal

On the importance of a harmonized level playing field

Financial markets of the G20 countries are characterized by a high degree of integration. This allows for risk-sharing possibilities and the efficient allocation of capital, thus fostering sustainable growth. However, in integrated markets, country-specific regulatory shocks can result in international spillovers (Buch and Goldberg 2017). This implies that cross-border distortions in banks' risk-taking and lending decisions can arise; in particular, if regulatory standards as well as changes to regulation and supervision are not aligned across countries (Aiyar et al. 2014; Houston et al. 2012).

Yet not only decisions of bank managers can be influenced by international loopholes in regulation. Similar considerations apply to national regulators' incentives to tighten or loosen regulatory standards, which can be affected by the regulatory tightness abroad. Without doubt, allocating regulatory power to national authorities has the advantage that country heterogeneities can be accounted for. However, in contrast to a supranational regulator, national authorities might not take cross-border externalities of a multinational banks' failure into account imposing the threat to step in too late when it comes to the rescue of a globally important bank in distress (Beck et al. 2013).

The establishment of a level playing field in the financial sector, that is the alignment of regulatory and supervisory standards across countries, counters the before mentioned threats to financial stability.

While similar standards are of importance in an international context, this applies the more so to highly interconnected markets like they exist in the EU and especially in the Euro Area. The reason is that different national regulatory frameworks can give rise to regulatory arbitrage and associated adverse outcomes in banking systems across countries. For example, higher regulatory costs in one country might result in increased borrowing costs, reduced loan supply, and increased risk-taking. Such differential treatments might consecutively undermine the uniform transmission of monetary policy across Euro Area countries.

Under this perspective, we comment in the following on key issues arising from the implementation of the directives of the Single Rulebook within European countries. These directives include the “Capital Requirements Directive IV” (CRD IV), the “Bank Recovery and Resolution Directive” (BRRD) and the “Deposit Guarantee Schemes Directive” (DGSD). More details on the directives are provided below. These EU directives have to be transposed into national law by all member states until the transposition deadline set by the European Commission. In contrast to EU regulations, they are not immediately legally binding and the European Commission can initiate an infringement process if national member states delay the implementation of the directive beyond the transposition deadline.

Pitfalls of harmonization due to existing loopholes

Delay of the implementation across countries

To render the European Banking Union an effective policy tool, EU member states first have to set up a legal framework, the Single Rulebook, based on which the three pillars of the European Banking Union are operationalized. Every member state should implement these harmonized regulatory rules as specified in the EU directives into national law until a transposition deadline. However, almost all member states failed to transpose the three directives of the Single Rulebook within the stipulated time. Despite impending infringement procedures by the European Commission, such delays are common practice if underlying directives are very complex and have to be evaluated by several (national) entities.

Transposition delays are problematic for a number of reasons. First, delays undermine the idea of a regulatory level playing field since latecomers can postpone regulatory costs which early transposers already carry. Second, delays might open the door for regulatory arbitrage if economic agents take advantage of the transition period to circumvent the new rules. Third, the Single Resolution Mechanism (SRM) illustrates that regulatory and legal uncertainty can emerge. Although the SRM has been officially effective since 2016, some countries had not yet implemented the underlying “Bank Recovery and Resolution Directive” until the start of the SRM. Strictly spoken, this implies that the SRM has not been effective across all Euro Area countries despite its officially announced implementation. The reason is that the SRM would not be operational in countries in which the legal foundation is missing.

Distinct content wise implementation across countries

Apart from the abovementioned transposition delays, EU directives are to some extent discretionary. Member states are provided with a considerable amount of flexibility to implement EU directives. As the case of the new bail-in regime of the European Banking Union shows, member states can alter the bail-in hierarchy. They can also choose the resolution authority. For example, Germany amended the ranking of liabilities in favor of deposits and specific other senior unsecured liabilities. Also, some member states have rejected the recommendation as specified in the “Bank Recovery and Resolution Directive” that the central bank should be the resolution authority. Instead, the prudential regulator,

the debt management office, or the deposit insurance scheme has been empowered to restructure and resolve banks in distress. This flexibility comes with considerable drawbacks:

First, if discrepancies in regulation across countries relate to critical issues such as bank resolution, the resulting loopholes undermine the credibility of the whole regulatory reform. One recent example is the injection of public money into the ailing Italian bank “Banca Monte dei Paschi di Siena” with limited contribution from their creditors. This occurred at a time when the SRM has already been operational. Furthermore, this is of high relevance because even small discrepancies across countries can open leakages and possibilities of cross-border arbitrage. In particular, accounting for the high degree of integration in banking markets in the Euro Area, the probability that banks make use of cross-border arbitrage is not to underestimate (Buch and Goldberg 2017; Danisewicz et al. 2015; Aiyar et al. 2014; Houston et al. 2012).

Second, choosing national institutions rather than supranational institutions as resolution authority, might result in a national inaction bias as well as national forbearance. National authorities might exploit their regulatory powers to protect the domestic banking system and thereby threaten the establishment of a level playing field as well as the effectiveness of the regulation. Recent experiences during the financial crisis have shown that national supervisors might not take externalities of the failure of a multinational bank that arise abroad into account (Colliard 2015; Beck et al. 2013; Dell’Arriccia and Marquez 2006). In addition, restructuring and resolving banks that are active across borders might remain subject to coordination failures if several national authorities are involved (Calzolari et al. 2016).

Recommendations

Monitoring by supranational authority

To circumvent the aforementioned pitfalls in implementing supranational regulation at the national level, our recommendations are twofold. **First, we propose stricter monitoring of the authorities that are responsible for the implementation at the national level by the supranational authority.** In case of the Single Rulebook, this would imply transferring more power to the European Commission in gaining insights into the status of the transpositions process of EU directives into national law. The European Commission can start infringement processes against member states that delay the implementation of directives with respect to the transposition deadline. Nevertheless, a common finding is that delays are rather the rule than the exception as concerns the implementation of EU directives (see, for example, König and Luetgert 2009, Kaeding 2006). This questions whether transposition deadlines are set in a too ambitious way or whether existing penalties are too soft to provide sufficient incentives for member states to transpose a directive in time.

Transparency about national implementation

Second, monitoring should not only be related to the timing of the implementation of supranational regulations but also evaluate whether the concrete national execution deviates from the general suggestion on how to implement the directive.

The usage of directives by the European Commission is driven by the reasoning that countries can adopt the regulation in accordance with their institutional setting or existing regulatory framework. Thus, some degree of flexibility in the concrete implementation at the national level is intended and can also increase efficiency. However, it raises problems if national deviations from the general suggestion are hidden in the legislative process and bear the risk of cross-country distortions. Hence,

we recommend complementing the Single Market Scoreboard of the European Commission by making all national discretions transparent.

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Implementation Overview

Harmonizing financial markets in the EU has been the key objective of the [Financial Services Action Plan](#) (FSAP) in 1999. The action plan aimed at “establishing a single market in wholesale financial services, making retail markets open and secure and strengthening the rules on prudential supervision.”¹ After the financial crisis starting in 2007/2008, reforming the regulatory and supervisory framework of the financial sector included the adjustment of capital and liquidity requirements. The Basel Committee on Banking Supervision presented a new regulatory framework ([Basel III](#)) in December 2010. The G20 leaders have agreed on the Basel III framework during the G20 Seoul Summit. Recently, harmonization of regulation and supervision of banks located in EU countries is taking place through the introduction of the [Single Rulebook](#), respectively the [European Banking Union](#) for banks located in Euro Area countries.

Existing Agreements

¹ <http://eur-lex.europa.eu/legal-content/CS/ALL/?uri=URISERV:l24210>

G20 Hangzhou Summit 2016

Existing agreements related to this proposal include the G20 leaders' communique in 2016 pointing out the relevance of policy coordination and the establishment of a resilient financial framework based on BASEL III, standards on total-loss-absorbing capacity and the establishment of international resolution regimes.

G20 Saint Petersburg Summit 2013

Related issues have also been referred to in the G20 leaders' communique in 2013, in which an agreement has been reached to build resilient financial institutions and counteract the too-big-to-fail problem in the banking system.

G20 Pittsburgh Summit 2009

Furthermore, the leaders of the G20 have already raised in the 2009 meetings the point that the resilience of the international financial system has to be strengthened by raising high quality capital, reducing pro-cyclicality, and finding a solution for the resolution of international and systemically important banks.

Existing Policies and Monitoring

Single Rulebook

The legal framework of the European Banking Union is based on the Single Rulebook. The Single Rulebook foresees the unification of supervision and resolution of banks in EU countries. It consists of three main directives and one regulation [More Information](#):

- Capital Requirements Directive IV (CRD IV): 2013/36/EU directive with the transposition deadline being 31.12.2013.
- Capital Requirements Regulation (CRR): 575/2013/EU regulation in place since 01.01.2014.
- Bank Recovery and Resolution Directive (BRRD): 2014/59/EU directive with the transposition deadline set to 31.12.2014.
- Deposit Guarantee Schemes Directive (DGSD): 2014/49/EU directive with the main transposition deadline set to 03.07.2015.

European Banking Union

The European Banking Union constitutes the new regulatory framework for the banking system of the Euro Area. EU countries outside the Euro Area can opt in on a voluntary basis. The European Banking Union has three main pillars [More Information](#):

- Single Supervisory Mechanism (SSM) effective since 04.11.2014.
 - Single Resolution Mechanism (SRM) operating since 01.01.2015.
 - European Deposit Insurance Scheme (EDIS) as outlined in a legislative proposal by the European Commission on 24.11.2015.
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