



Brussels, 11.10.2017  
COM(2017) 592 final

**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**

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*"Democracy is about compromise. And the right compromise makes winners out of everyone in the long run. A more united Union should see compromise, not as something negative, but as the art of bridging differences. Democracy cannot function without compromise. Europe cannot function without compromise."*

Jean-Claude Juncker, State of the Union Address, 13 September 2017

## 1. Background and objectives

As highlighted by President Juncker in his State of the Union Address on 13 September 2017,<sup>1</sup> the Banking Union must be completed if it is to deliver its full potential as part of a strong Economic and Monetary Union (EMU). Together with the Capital Markets Union (CMU), a complete Banking Union will promote a stable and integrated financial system in the European Union. It will increase the resilience of the Economic and Monetary Union towards adverse shocks by substantially facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing.

This is a matter on which there is broad support and consensus in the European Union. In the *Conclusions on a Roadmap to complete the Banking Union* from June 2016 (hereafter the '2016 Council Roadmap') and in the *Annual Report on Banking Union* of March 2016<sup>2</sup> both the Council and the European Parliament reaffirmed the importance of the Banking Union with a view of its completion.

It is now time to seize the political momentum – reflected not least by the invitation by President Tusk to the Euro Summit in an inclusive format in December – and transform this widely shared ambition into concrete action, completing the Banking Union by 2019, as called for already by the 2015 *Five Presidents Report*<sup>3</sup> and the *Reflection paper on the deepening of the Economic and Monetary Union (hereafter the 'Economic and Monetary Union reflection paper')*<sup>4</sup>.

The financial and sovereign debt crises experienced in the European Union during the last decade showed that the European Union's incomplete economic and financial framework was not sufficient to prevent the emergence of unsustainable policies during the boom years or to allow negative shocks to be effectively absorbed during the subsequent macro-economic correction phase. In particular, the crises revealed the existence of undesirable links between national banking sectors and their sovereigns – the so-called doom loop. The Banking Union was created to break that link and avoid that taxpayers are first in line to bail out ailing banks.

Common supervision, crisis management and deposit insurance will allow for deeper financial integration underpinned by a stable financial system. This will reinforce financial stability, both within the Member States participating in the Banking Union and in the European Union as a whole. Ultimately, a more stable banking sector will also mean greater financing opportunities for companies of all sizes and more jobs and growth for European citizens. Deeper financial integration is also key to provide a wider choice of services at lower prices. In order to make the benefits of integration tangible for European citizens, as set out in

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<sup>1</sup> [https://ec.europa.eu/commission/state-union-2017\\_en](https://ec.europa.eu/commission/state-union-2017_en): "*If we want banks to operate under the same rules and under the same supervision across our continent, then we should encourage all Member States to join the Banking Union. We need to reduce the remaining risks in the banking systems of some of our Member States. Banking Union can only function if risk-reduction and risk-sharing go hand in hand. As everyone well knows, this can only be achieved if the conditions, as proposed by the Commission in November 2015, are met. There can only be a common deposit insurance scheme once everyone will have done their national homework*".

<sup>2</sup> See EP, Banking Union – Annual Report 2016, available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2017-0041+0+DOC+PDF+V0//EN>.

<sup>3</sup> The Five Presidents' Report: Completing Europe's Economic and Monetary Union, 2015, available at: [https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf).

<sup>4</sup> COM(2017) 291 of 31 May 2017, [https://ec.europa.eu/commission/sites/beta-political/files/publications/reflection-paper-emudeepening-economic-and-monetary-union\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/publications/reflection-paper-emudeepening-economic-and-monetary-union_en.pdf)

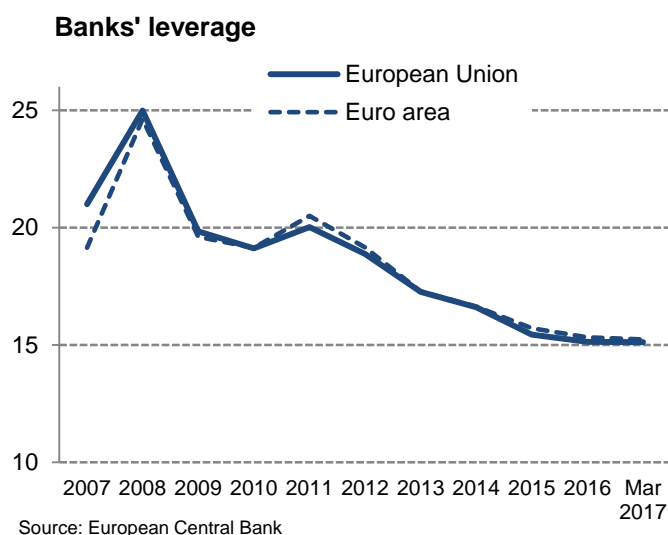
the Consumer Financial Services Action Plan<sup>5</sup>, the Commission is also considering to propose amendments to the Regulation on cross-border payments<sup>6</sup> to reduce charges for cross-border banking transactions in all European Union currencies.

The prospect of further Member States joining the Banking Union and the euro area makes the completion of the Banking Union even more compelling. An Economic and Monetary Union that is stable, both economically and financially, and attractive also to other, non-participating Member States, is a major instrument to facilitate broader economic and financial stability, and thus achieve the European Union's objective of improving the lives of European citizens. In this context, the Commission welcomes the discussions in Denmark, Sweden and Bulgaria about the possibility to join the Banking Union. To facilitate such process, all institutional and regulatory elements of the Banking Union should be put in place as rapidly as possible. Several key elements of the Banking Union are already established: First, the Single Rulebook provides a single set of harmonised prudential rules that credit institutions must respect in the Single Market. The Banking Union is firmly anchored on this basis, which applies in all Member States. Second, all banks in the European Union are supervised according to the same standards, with the most significant banks in the euro area being centrally supervised by the European Central Bank (ECB) in its supervisory capacity in the framework of the Single Supervisory Mechanism (SSM). Third, in the case of failure, banks can be resolved centrally and according to the same standards within the Single Resolution Mechanism (SRM), which is backed by a Single Resolution Fund (SRF). The establishment of this new architecture for the Banking Union has been accompanied by a comprehensive asset-quality review, stress test and recapitalisation exercises for participating banks in 2014. Thus, the institutional and regulatory framework for European banks has been fundamentally reinforced, resulting in a substantial reduction of risks in the banking sector. During the last few years, banks' capitalisation levels have starkly increased: the reduction of the leverage across all European Union and euro area banks is possibly the clearest demonstration of the current robustness of the banking sector and of the market buy-in to the supervisory and regulatory reforms that Europe has put forward and implemented with determination.

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<sup>5</sup> 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, Consumer Financial Services Action Plan: Better Products, More Choice, COM/2017/0139 final.

<sup>6</sup> Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community and repealing Regulation (EC) No 2560/2001, OJ L 266, 9.10.2009, p. 11.



Experience to date suggests that the completed parts of the Banking Union are functioning well. Today, the Commission is publishing its first review of the Single Supervisory Mechanism, which shows that the establishment of the Single Supervisory Mechanism was overall successful. The Single Resolution Mechanism is also up and running and has successfully managed its first bank resolution case, with no cost for tax payers. This shows that the new system is able to manage a bank resolution efficiently and in a very short period of time, while at the same time allowing for different crisis management options, as provided for in the legal framework. This allows the specific situation of individual banks to be taken into account, which is particularly important given that there are still significant legacy issues in parts of the European Union banking sector and not all elements of the Banking Union are fully phased in.

Experience from recent cases will help all the involved actors to further improve the practical application of the European Union rules and the functioning of the system. This concerns for example the practical modalities of cooperation and exchanging information between all European and national bodies involved in early intervention and resolution, the procedures leading to a decision whether or not a bank is failing or likely to fail and the use of asset quality reviews in order to determine whether the conditions for a precautionary recapitalisation are met. Also of concern is the rapid build-up of adequate bail-inable liabilities (in the form of Minimum Requirement for own funds and Eligible Liabilities – MREL), which is crucial to facilitate the resolution of non-viable distressed banks and which could be further built up in the current market conditions. Improvement also concerns the issue of ensuring that the necessary liquidity is available before, during and after resolution so as to apply, in the latter case, the most appropriate resolution tools even in the absence of an immediate private buyer for a failing bank. Importantly, the current experience with the Banking Union framework also shows the importance of ensuring that financial instruments which are likely to suffer losses in a banking crisis are held and losses borne by private investors who are sufficiently informed to understand the risks involved.

While a number of practical improvements can be made in the short term by the relevant actors, other issues can only be fully tackled once all the agreed elements of the Banking Union are being fully phased in and the Banking Union is completed.

In this context, a single European Deposit Insurance Scheme (EDIS) remains one of the missing pieces. All depositors within Banking Union should enjoy the same level of

protection. In this way, the European Deposit Insurance Scheme would underpin stability in the banking sector by providing strong and uniform insurance coverage for all such depositors, independent of their geographical location in the Banking Union.

The Banking Union also still lacks an effective, common backstop. The creation of such a backstop for the Single Resolution Fund was agreed by Member States already nearly 4 years ago, in 2013<sup>7</sup>. It needs to be made operational now so as to reinforce the overall credibility of the bank resolution framework within the Banking Union. It is essential that actions taken by the Single Resolution Board enjoy the absolute confidence of all parties concerned if the key objectives of resolution in terms of maintaining financial stability and minimising costs to taxpayers are to be fully achieved. Together with the application of other resolution tools (i.e. bail-in, availability of the Single Resolution Fund), access to a last-resort common backstop should serve to provide such confidence. This would include, for example, using common funding in combination with the European Central Bank instruments to cover liquidity shortfalls and have more time to look for the best buyer of a bank in a specific situation.

At the same time, while important progress has been made and as highlighted by President Juncker in his State of the Union Address on 13 September 2017, efforts to further reduce risk and improve risk management in banks must continue. The Banking Union can only function if risk reduction and risk sharing go hand in hand. A number of initiatives with the aim of achieving this goal are under negotiation by the European Parliament and the Council: In November 2016, the Commission adopted a comprehensive legislative package of risk reduction measures to further strengthen the resilience of European Union banks<sup>8</sup>, some of which are subject to fast-track negotiations in the European Parliament and the Council.

Despite the progress made on risk reduction, the Banking Union is still young. Many risks now visible in banks' balance sheets accumulated before the creation of the Banking Union, when supervision and resolution were exclusively under national responsibility. These legacy issues must be addressed convincingly if the European Union is to proceed quickly towards the completion of the Banking Union. One of the challenges that remains is to decisively continue the recent trend of reducing the high levels of non-performing loans (NPLs) in parts of the banking sector. A lot has been done as a consequence of market forces and regulatory measures, which have already delivered results. However, the competitiveness of some European banks and their ability to lend to the economy is hampered. The Commission will continue to support this process through the adoption of further measures to reduce the level of Non Performing Loans. Risks in the European banking system also need to be further reduced through a further loosening of the interconnection between banks and their "home country", which has been one of the main objectives of the Banking Union from its inception. With supervision and resolution of larger and systemic banks now conducted centrally and no longer at national level, helping banks to geographically diversify their investments in sovereign bonds would further weaken the bank-national sovereign link and thereby strengthen the sharing of cross-border risk via the private sector. While the Banking Union contributes to enhanced financial stability, it is also expected to deliver economic benefits through more integration of the European banking sector and through a geographically

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<sup>7</sup> See Economic and Financial Affairs Council Conclusions of 18 December 2013, 8 December 2015 and 17 June 2016.

<sup>8</sup> [http://europa.eu/rapid/press-release\\_IP-16-3731\\_en.htm](http://europa.eu/rapid/press-release_IP-16-3731_en.htm). Further initiatives of the Commission aim at resilient, recoverable and resolvable market infrastructures, in particular in relation to central counterparties, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52016PC0856>, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017PC0331>.

diversified asset allocation. To this end, the Commission will continue to work on deepening the Banking Union with the objective of recognising it as a single jurisdiction.

The The 2015 Commission Communication "Towards the completion of the Banking Union" (hereafter "2015 Commission Communication") and the 2016 Council Roadmap<sup>9</sup> have identified the key steps and, where necessary, the Commission presented legislative proposals in 2015 and 2016. It is now time for the European Parliament and Member States to take political responsibility and agree on the necessary legal acts to complete the Banking Union by 2019.

If European Union leaders collectively lack action and ambition in the year ahead, due to the political calendar, there is a real risk that the European Union will remain for years without a perspective of completing the Banking Union, and with suboptimal levels of ambition as regards the finalisation of the risk reduction and risk sharing processes. The current momentum, following the State of the Union Address, must be used to not let this happen. To strengthen shock absorption through private channels in the Economic and Monetary Union, the European Union must find a win-win equilibrium, with a high level of ambition as regards both risk reduction and risk sharing.

This Communication attempts to set out an ambitious, but realistic path on how an agreement on completing the Banking Union can be achieved, based on existing commitments by the Council. Building on the significant progress already achieved, the necessary measures to complete the Banking Union must be agreed by the end of 2018, while the full application of certain elements will take more time and may be phased-in gradually.

The Commission will issue in December 2017, a comprehensive package of measures to strengthen Economic and Monetary Union. A strong commitment and decisive actions to complete the Banking Union, as set out in this Communication, are an integral part of these efforts.

## 2. Risk reduction through the November 2016 Banking Package

2016 Council Roadmap	<i>Status</i>	Next steps
<p>a. Propose amendments to the legislative framework in view of implementing the Total Loss Absorbing Capacity (TLAC) standard and reviewing the minimum requirement for own funds and eligible liabilities. The Council will seek to ensure consistent rules and adequate amounts for the bail-inable buffers that contribute to an efficient and orderly resolution process in line with the Bank Recovery and Resolution Directive (BRRD) for all credit institutions for which bail-in would be the validated resolution strategy.</p>	<p>Legislative proposal, including all measures indicated by the 2016 Council Roadmap, is under negotiation.</p> <p>On options and national discretions in the Capital Requirements Directive/Capital Requirements Regulation, in addition to the legislative proposal, the European Central Bank has undertaken a comprehensive exercise to harmonise them.</p>	<p>Agreement among co-legislators on the legislative proposal by mid-2018 at the latest</p>

<sup>9</sup> <http://www.consilium.europa.eu/en/press/press-releases/2016/06/17-conclusions-on-banking-union/>

<ul style="list-style-type: none"> <li>b. Put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution.</li>   <li>c. Propose amendments to the Capital Requirements Directive/ Capital Requirements Regulation IV as part of an overall review exercise, which would result in: <ul style="list-style-type: none"> <li>i. harmonisation or further specification of options and national discretions granted to Member States, which could also contribute to the objective of reducing financial fragmentation;</li> <li>ii. implementing and finalising remaining Basel reforms including the introduction of a leverage ratio, possibly set higher than 3% for systemic banks, and the introduction of a net stable funding ratio.</li> </ul> </li> </ul>		
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The November 2016 Banking Package proposed by the Commission will fulfil many of the objectives set out in the 2016 Council Roadmap in terms of further risk reduction in the banking sector. This package, which is currently being negotiated in the European Parliament and the Council, builds on existing European Union banking rules and completes the post-crisis regulatory agenda by making sure that the regulatory framework addresses any outstanding challenges to financial stability, while ensuring that banks can continue to support the real economy. The Commission proposals<sup>10</sup> will strengthen the European Union rules requiring banks to build up buffers of liabilities that can, if necessary, be bailed in, by implementing the Total Loss Absorbing Capacity standard of the Financial Stability Board and integrate it into the existing rules on the Minimum Requirement for own funds and eligible liabilities; and by providing for harmonised rules on where debt instruments eligible to meet the Total Loss Absorbing Capacity / Minimum Requirement for own funds and Eligible Liabilities buffers stand in the bank creditor hierarchy. Recent experience has shown again how important it is that banks hold appropriate buffers of liabilities – available to be bailed-in – held by investors with appropriate knowledge about the risks involved, in order to manage crises without impact on financial stability and without having tax payers first in line to bear the costs. The Commission proposals also provide for harmonised rules concerning the application of moratorium tools applied by supervisors and resolution authorities to stabilise banks, which are equally important based on recent experience. Moreover, the amendments proposed by the Commission provide for harmonisation of remuneration rules, which have been found<sup>11</sup> to overall contribute to curbing excessive risk-taking and better aligning

<sup>10</sup> In addition to the elements mentioned in 2016 Council Roadmap, the Commission proposals also introduce new rules in areas of market risk, counterparty credit risk, large exposures and for exposures to central counterparties (CCPs).

<sup>11</sup> Report from the Commission to the European Parliament and the Council, Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No 575/2013, COM(2016) 510 final.



remuneration with performance, thereby contributing to enhanced financial stability.

Finally, the Banking Package proposes to implement a number of international standards, including the introduction of a leverage ratio and a Net Stable Funding Ratio (NSFR), and the Commission remains committed to close international cooperation on banking regulatory matters, as well as to the implementation of agreed standards, and is following closely their implementation in other jurisdictions.

The Commission is aware that its proposals to allow supervisors to waive certain requirements on a standalone basis for subsidiaries of cross-border groups, which is a logical step of the Banking Union and the Single Market, is met with significant concerns by a number of Member States. The Commission is willing to engage in constructive discussion on this matter, with a view to facilitate finding a solution that preserves the benefits of the proposal while taking into account the need for an acceptable home-host balance in an appropriate way.

With a view to swift progress and reach an as rapid adoption as possible, the European Parliament and the Council are encouraged to maintain the clearly defined scope of the package. Further outstanding issues beyond the scope of the package, could be considered in later legislative reviews, once the ongoing negotiations on the 2016 Banking Package are concluded.

### 3. Moving forward towards a European Deposit Insurance Scheme (EDIS)

2016 Council Roadmap	Status	Next steps
Continue constructive work at technical level. Negotiations at political level will start as soon as sufficient further progress has been made on the measures on risk reduction.	Technical work is ongoing but with limited political progress.	Political negotiations must now be started with a view to agreement as rapidly as possible in the course of 2018.

The 2015 *Five Presidents' Report* identified a European Deposit Insurance Scheme as an essential step to complete the Banking Union. As subsequently recalled in the *Economic and Monetary Union Reflection paper*, it remains a priority to ensure the stability of the European Union banking system and the functioning of the internal market in banking services. By reducing depositors' vulnerability to large local shocks (for which national deposit guarantee schemes have more limited financial means) and the link between banks and their home sovereign, a European Deposit Insurance Scheme would increase the resilience of the Banking Union against future financial crises by providing strong and uniform insurance coverage for all depositors independently of their geographical location within the Banking Union.

The proposal put forward by the Commission in November 2015<sup>12</sup> provides a very comprehensive solution to achieve these goals through the progressive transfer, according to a

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<sup>12</sup> [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme_en).

defined timeline (which should have started in 2017), of funds and of the management of payout events to the European Deposit Insurance Scheme from national Deposit Guarantee Schemes. Such central fund with an enhanced financial capacity would be better equipped to deal with bank failures. At the same time, the misalignment of centralised bank supervision and resolution in the Banking Union, on the one hand, and national deposit insurance, on the other hand, would be overcome.<sup>13</sup>

While the ambition of the Commission remains strong, discussions in the European Parliament and the Council have revealed divergent positions as regards the design of the system at its final stage (re-insurance, co-insurance or full insurance), the timing of the setting up of such a system, and the different degree of legacy issues and moral hazard risks present in the various national banking systems. Concerns have been expressed about the need to ensure that banks are sufficiently robust on a standalone basis, before sharing the potential burden of bank failures within the Banking Union.

The 2016 Council Roadmap confirmed that the Council would continue constructive work at technical level and that negotiations at political level would start as soon as sufficient progress had been achieved on risk reduction measures.

Two years after the presentation of the European Deposit Insurance Scheme proposal, which remains on the table unchanged, the time has definitively come to move ahead, since without the European Deposit Insurance Scheme, the Banking Union may still be vulnerable to future crises. To reinvigorate the negotiations, it could for example be considered by the European Parliament and the Council, in the current negotiations, to introduce the European Deposit Insurance Scheme in a more gradual manner, commensurate to progress achieved with regard to risk reduction and the tackling of legacy issues, starting with a more limited re-insurance phase and moving gradually to co-insurance.

In a first re-insurance phase, the European Deposit Insurance Scheme could provide only liquidity coverage, and no loss coverage.

In case of a default of a bank, national Deposit Guarantee Schemes would have to deplete their funds first before a possible intervention by the European Deposit Insurance Scheme. The European Deposit Insurance Scheme would only provide liquidity to the national Deposit Guarantee Schemes (which is in reality a loan since it should be fully recovered from the banking sector afterwards) and would cover up to 30% of liquidity shortfall in the first year (2019), 60% in the second year (2020) and 90% in the third year (2021).<sup>14</sup> The rest would be covered by national Deposit Guarantee Schemes with the resources not transferred to the European Deposit Insurance Scheme during this phase or via ex-post contributions from banks. By leaving losses to be covered nationally and providing liquidity assistance for national schemes if needed, this solution would on the one hand ensure depositor protection from the beginning (for which liquidity is needed) and, on the other hand, take into account legacy and moral hazard concerns.

The joint Deposit Insurance Fund (DIF), managed under the auspices of the existing Single Resolution Board and financed by contributions from banks would be built-up gradually.

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<sup>13</sup> Also the Effects analysis, available at [https://ec.europa.eu/info/publications/effects-analysis-european-deposit-insurance-scheme-edis\\_en](https://ec.europa.eu/info/publications/effects-analysis-european-deposit-insurance-scheme-edis_en).

<sup>14</sup> See table 1.

Another idea for consideration could be that at the end of the re-insurance phase, the move to the co-insurance phase would not be automatic, but be contingent on a set of conditions. To address concerns related to legacy risks and moral hazard, the start of the co-insurance phase, and therefore the access to loss coverage by the European Deposit Insurance Scheme, could be linked to conditions to be assessed by a Commission decision, which would include a targeted Asset Quality Review (AQR) to address Non Performing Loans and Level III assets<sup>15</sup> followed by the solution of the problems identified (e.g. active portfolio reductions). Such Asset Quality Review should be conducted during the re-insurance phase (i.e. before 2022 at the latest), to ensure that legacy risks are addressed within the banking sectors where they were generated before the start of the co-insurance phase, based on the significant progress in tackling legacy assets that is being made and is expected to continue. This second phase would start only once such conditions are met. For instance, as regards the Asset Quality Review, a threshold could be set (e.g. a certain level of Non Performing Loans ratios and Level III assets) and banks not meeting the threshold would be required by supervisory authorities to prepare appropriate strategies on these issues.

The actions envisaged by the Commission and in the European Union Action Plan on Non Performing Loans (see section 5) will facilitate the implementation of such individual strategies.

Once these conditions are met and the *co-insurance* (second phase) has started, the European Deposit Insurance Scheme would also, in addition to full liquidity coverage, progressively cover losses provided that all conditions are continuously met. Regarding losses, national Deposit Guarantee Schemes and the European Deposit Insurance Scheme would contribute in parallel from the first euro of losses, according to a key which would develop progressively, starting with a 30% European Deposit Insurance Scheme contribution as of the first year of the co-insurance phase.

This would effectively address concerns related to legacy risks and moral hazard, while still ensuring full liquidity and losses coverage by the European Deposit Insurance Scheme at the final stage. It would make any move to loss coverage by the European Deposit Insurance Scheme contingent on Member States addressing legacy issues, provide the relevant Member States with adequate time to take necessary measures and ensure, in its final stage, that the European Deposit Insurance Scheme provides the strongest protection for depositors and, at the same time, safeguards for financial stability. A single European Union fund is superior in terms of risk absorption capacity and of breaking the sovereign-bank loop than any national system. The central fund administration would also ensure a more rapid and efficient management of default cases, which could better cope with crisis situations.

Some additional aspects have also emerged during the negotiations of the 2015 European Deposit Insurance Scheme proposal with regard to some of the options and discretions included in the Deposit Guarantee Scheme Directive that could be included also in the European Deposit Insurance Scheme (e.g. scope of the European Deposit Insurance Scheme, target level, use of Deposit Insurance Fund funds for alternative measures). These matters will have to be considered taking into account the fact that in a common system of deposit insurance, all participants will be affected by the way these options and discretions are implemented. Hence, a balanced solution must be reached that takes account of national and

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<sup>15</sup> Assets which are typically very illiquid, and their valuation cannot be determined by using observable measures such as market prices or models.

regional specific characteristics, while ensuring equal treatment for all participating banks that contribute to the European Deposit Insurance Scheme.

The Commission stands ready to actively discuss as soon as possible the above-mentioned ideas with the European Parliament and Council, within the framework of the negotiations of its proposal.

In the transition to the European Deposit Insurance Scheme co-insurance phase, there is scope for further improvements with regard to the coordination among national Deposit Guarantee Schemes and a more coherent implementation of rules. The Deposit Guarantee Scheme Directive<sup>16</sup> adopted in 2014 has enhanced the functioning of national Deposit Guarantee Schemes and offers better protection to depositors through a harmonised coverage of depositors across the European Union and a shortened time-limit for payouts. As indicated in the 2015 Commission Communication, accompanying the European Deposit Insurance Scheme proposal, harmonisation of national deposit schemes needs to advance in parallel with the establishment of the European Deposit Insurance Scheme to ensure the correct functioning of that Scheme<sup>17</sup>. Some important differences remain across Member States in the implementation of the Deposit Guarantee Scheme Directive rules, for example on the conditions to declare deposits unavailable, the eligibility of deposits, the financing of Deposit Guarantee Schemes or the use of Deposit Guarantee Scheme funds. For the Banking Union, greater harmonisation of these differences is needed since they will be financed through a common fund to which all banks in the Banking Union will contribute but greater harmonisation will also be for the benefit of the internal market as a whole.

The exchange of information and instruments to promote coordination among national Deposit Guarantee Schemes need also to be improved because for the European Deposit Insurance Scheme to work properly, national competent authorities and Deposit Guarantee Schemes will have to coordinate among themselves and with the Single Resolution Board, in some circumstances within very tight deadlines. The powers entrusted to the Single Resolution Board by the European Deposit Insurance Scheme proposal are not general, do not encompass certain aspects related to deposit insurance activities which are relevant to perform its tasks (e.g. declaration of deposits as unavailable) and are limited to Member States participating in the Banking Union. Adjustments to the Deposit Guarantee Schemes Directive are needed to facilitate cross-border interventions by such Schemes, foster convergence and improve the exchange of information among national Deposit Guarantee Schemes, competent authorities, the Single Resolution Board and the European Banking Authority (EBA). The European Banking Authority, the authority in charge of safeguarding the integrity, efficiency and orderly functioning of the banking sector across all Member States, shall be given the powers to assist in and promote such processes. This will enhance deposit protection within the internal market and, as a consequence, facilitate the functioning of the European Deposit Insurance Scheme. Better cooperation and exchange of information between national authorities and the Deposit Guarantee Schemes from different Member States, through the European Banking Authority, will also smoothen the interaction with national Deposit Guarantee Schemes and national authorities of non-Banking Union Member States and the European Deposit Insurance Scheme, as well as the accession of non-euro Member States to the European Deposit Insurance Scheme.

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<sup>16</sup>[https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en).

<sup>17</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0587&from=EN>.

Filling this gap will also align the architecture of the three pillars of the Banking Union (supervision, resolution and deposit insurance) since in all three there will be an European Union central institution or an agency (the European Central Bank, the Single Resolution Board and the European Deposit Insurance Scheme, respectively) in charge of the implementation and an European Union agency (the European Banking Authority) coordinating national authorities operating in their respective fields.

Finally, the harmonisation of some national options and discretions set out in the Deposit Guarantee Schemes Directive, will contribute to further reducing financial fragmentation and simplifying the coordinating role played by the European Deposit Insurance Scheme and the European Banking Authority.

**4. Completing a backstop to the Banking Union**

2016 Council Roadmap	<i>Status</i>	Next steps
<p>Takes note of the intention of Member States to start work in September 2016 if and when all participating Member States have fully transposed the Bank Recovery and Resolution Directive.</p> <p>Reaffirms the need to have the common backstop fully operational at the latest by the end of the transition period of the Single Resolution Fund, or earlier depending on progress with risk reduction measures.</p>	<p>Technical work started in November 2016.</p>	<p>Political negotiations should be finalised by 2018.</p>

When the Single Resolution Mechanism was set up, Member States agreed to develop a common backstop to the Single Resolution Fund, which should be fiscally neutral over the medium term as contributions would be recouped by way of contributions from the banking sector. It was also agreed that this backstop had to be fully operational at the latest after ten years<sup>18</sup>.

Although the European supervision and resolution frameworks have significantly reduced the likelihood and potential impact of bank failures, the need to access a common fiscal backstop to enhance the financial capacity of the Single Resolution Fund for coping with bank resolutions cannot be entirely ruled out. The main objective of such a backstop is to instill confidence in the banking system by underpinning the credibility of actions taken by the Single Resolution Board and ensuring that those actions enjoy absolute confidence among all parties concerned. As a last resort tool, it would only be activated in case the Single

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<sup>18</sup> Statement of Eurogroup and Economic and Financial Affairs Council Ministers on the Single Resolution Mechanism backstop, 18 December 2013.

Resolution Fund's immediately available resources prove to be insufficient for capital or liquidity purposes.

It remains equally important that there is sufficient liquidity available for systemic banks facing problems in resolution, to ensure that bank depositors, as well as other stakeholders and the market overall, are sufficiently resilient. Without prejudice to the availability of liquidity from central bank operations and in combination with them, the mechanism should be sufficiently robust and with a capacity large enough to reassure bank stakeholders and the overall market that it can contribute to possible liquidity needs of a bank facing adversity.

The *Economic and Monetary Union reflection paper* identifies certain criteria that the backstop should meet to be operational in the event of a crisis: it should be of an adequate size to be able to fulfil its role; activated in a swift manner which is essential in times of crisis; and fiscally neutral given that the Single Resolution Mechanism Regulation stipulates that the banking industry repays any potential disbursements from the Single Resolution Fund. No room should remain for national considerations or segmentation. The financial and institutional architecture should ensure full efficiency in achieving the backstop's objectives. The *Economic and Monetary Union reflection paper* identified a credit line from the European Stability Mechanism (ESM) as the most effective option.

It is equally important that the backstop ensures equivalent rights and obligations across all participating Member States of the Banking Union regardless of whether they are member of the euro area or not. This will ensure that the Banking Union continues to be open for participation of all Member States, in principle as well as in practice. In addition, the existing concept of conditionality for stability support from the European Stability Mechanism would need to be adjusted for the backstop function, taking into account that in the context of the Banking Union, incentives for banks to act prudently and reform where necessary are already provided through the tools of the single rule book, of single supervision and single resolution.

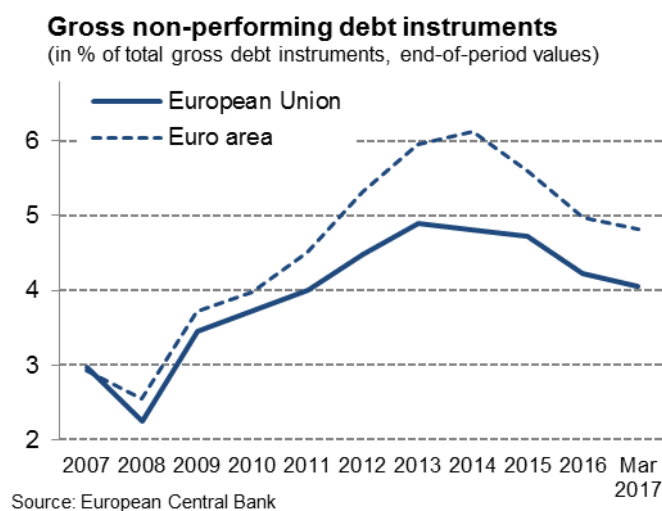
Work on the common backstop has started, and the 2016 Council Roadmap indicated that the backstop may become operational ahead of the end of the transition period, subject to progress being made on risk reduction measures.

The Commission will continue to insist that the backstop must become operational as rapidly as possible. Against that background, the Commission supports the ongoing work of the Task Force on Coordinated Action (TFCA) with regard to a credit line from the European Stability Mechanism, work that should be pursued as a matter of priority. This work stream will need to be articulated with the Commission's forthcoming package of proposals for the deepening of the Economic and Monetary Union, which will include a proposal to transform the European Stability Mechanism into a European Monetary Fund, within the framework of Union law. In this context, it will also be important to ensure an efficient decision-making process that will allow for a swift deployment of the backstop, in those last resort situations where this might become necessary.

## 5. Additional new measures: Actions to address Non-Performing Loans

2016 Council Roadmap	Status	Next steps
Propose a legislative proposal for minimum harmonisation in the field of insolvency law in the context of the Capital Markets Union, which may also support efforts to reduce levels of Non Performing Loans.	Legislative proposal for new approach on business insolvency under negotiation <sup>19</sup> .	Agreement among co-legislators on the legislative proposal by end of 2018.
		Implementation of the 2017 Council Action Plan on Non Performing Loans.

In addition to the actions envisaged in the 2016 Council Roadmap to complete the Banking Union, a number of significant additional measures have been envisaged during the last year that will further reduce risks in the Banking Union. Since the adoption of the 2015 Commission Communication and the 2016 Council Roadmap, the need to focus risk reduction efforts on Non Performing Loans has become increasingly clear. Non Performing Loans weigh on the profitability and viability of affected banks and thereby constrain those banks' ability to lend and might ultimately hamper economic growth. It is a good sign that levels of Non Performing Loan are going down. Even in the most affected Member States, levels of Non Performing Loan have been materially reduced. This trend should be accelerated, and the build-up of new Non Performing Loans must be prevented.



While Member States and banks themselves have a primary responsibility in tackling Non Performing Loans, integrating national and European Union level efforts is warranted to make an impact on Non Performing Loan stocks and prevent the future build-up of new Non Performing Loans on banks' balance sheets. This work can usefully build on the significant attention that has already been dedicated for several years to the workout of Non Performing

<sup>19</sup> [http://ec.europa.eu/information\\_society/newsroom/image/document/2016-48/proposal\\_40046.pdf](http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf).

Loans. Since the outset of the financial crisis, the Commission has incentivised banks, via its State-aid control, to manage and reduce their impaired assets via market mechanisms rather than shifting the burden to tax payers. For ailing banks whose viability was threatened by those impaired assets, the Commission has assisted Member States in setting up ad-hoc and system-wide measures with the objective of reducing banks' Non Performing Loan stocks (sometimes as part of a financial assistance programme) through solutions compatible with State aid rules<sup>20</sup>. The need to take determined action to address Non Performing Loans has also been underlined in the European Semester recommendations to relevant Member States.<sup>21</sup> Banking supervisors have played a decisive role in enhancing the reporting and supervision of Non Performing Loans in Europe. Work in this area must be based on a comprehensive approach combining a mix of complementing policy actions, at national level and at Union level where appropriate, involving actions in four areas: (i) supervision, (ii) reform of restructuring, insolvency and debt recovery frameworks, (iii) development of secondary markets for distressed assets, and (iv) fostering restructuring of the banking system. Addressing remaining risks in the European banking sector is of the greatest importance and the Commission is committed to take the necessary measures within its remit to continue driving this process forward.

As one important measure to deal with Non Performing Loans, the Commission presented in November 2016, in the context of the Capital Markets Union work, a legislative proposal on business insolvency, restructuring and second chance<sup>22</sup>. The key features of this proposal, in particular the availability of restructuring procedures enabling viable companies in financial difficulties to avoid insolvency as well as measures to enhance the effectiveness of restructuring and insolvency proceedings, would contribute to reducing Non Performing Loans as well as preventing their accumulation in the future. Swift progress by the European Parliament and the Council on this file is encouraged and necessary and should be a priority. The Council Action Plan on Non Performing Loans issued in July 2017<sup>23</sup> goes beyond the commitments on risk reduction set out in the 2016 Council Roadmap and includes specific steps different actors must take to reduce the risk to financial stability due to Non Performing Loans, both by tackling the legacy Non Performing Loans and reducing the risk of build-ups of Non Performing Loans in the future. The Commission welcomes this comprehensive approach which is consistent with its own longstanding calls to tackle Non Performing Loans and will swiftly take the necessary actions within its remit of competence.

The measures set out in the Action Plan represent a significant step forward on risk reduction, additional to the ones agreed in the Council Roadmap of 2016. Progress in this area would support the completion of the Banking Union by removing legacy risks from the European

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<sup>20</sup> These measures included transfer of Non Performing Loans to asset management companies (such as in Ireland, Spain and Slovenia). They were associated with recapitalisation aid to the banks. In all those cases, state-aid was approved by the Commission under the European Union State aid framework, which require in-depth restructuring and adequate burden sharing. For the banks whose viability could not be restored, other measures approved under state aid rules included specific bank actions like orderly liquidation plans approved by the Commission under state aid rules, which entailed a reduction of the Non Performing Loan stock present in the banking sector. Finally, more recently, the Commission also facilitated the setting up of state aid free schemes, such as schemes to facilitate the securitisation of Non Performing Loans.

<sup>21</sup> See most recently Commission Communication 2017 European Semester: Country-specific recommendations, COM(2017) 500 final of 22 May 2017.

<sup>22</sup> Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, 22 November 2016, COM(2016) 723 final.

<sup>23</sup> Action Plan To Tackle Non-Performing Loans In Europe; <http://www.consilium.europa.eu/en/press/press-releases/2017/07/11-conclusions-non-performing-loans/>.



banking sector and will render European banks more stable and competitive. The Commission will therefore move quickly with these measures.

As a first step, the Commission is clarifying in the Single Supervisory Mechanism Review Report, accompanying this Communication, the interpretation of the relevant Articles of the Capital Requirement Directive (CRD) and the Single Supervisory Mechanism Regulation. The Commission is confirming that the supervisory powers enshrined therein allow the competent authorities to influence a bank's provisioning policy with regard to Non Performing Loans within the limits of the applicable accounting framework and to apply specific adjustments where necessary for prudential purposes.

By Spring 2018, the Commission will adopt a comprehensive package of measures to address Non Performing Loans and a first Report on the implementation of the Action Plan. This package will consist of the following measures:

- *A Blueprint for how national Asset Management Companies (AMCs) can be set up within existing banking and State aid rules by building on best practices learned from past experiences in Member States.*
- *Measures to further develop secondary markets for Non Performing Loans, especially with the aim of removing undue impediments to loan servicing by third parties and the transfer of loans following the ongoing impact assessment.*
- *Measures to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans. Work in this area will be determined by the Impact Assessment and remain consistent with and complementary to the Commission proposal of November 2016 for a Directive on, *inter alia*, preventive restructuring frameworks and would not require harmonisation of actual insolvency provisions.*
- In addition, since the management of Non Performing Loans would benefit from more efficient and more predictable loan enforcement and insolvency frameworks, the Commission is also undertaking a benchmarking exercise of loan enforcement regimes to establish a reliable picture of the delays and value-recovery banks experience when faced with borrowers' defaults, and invites close cooperation from Member States and supervisors to develop a sound and significant benchmarking methodology. In this context, the Commission proposal for a Directive on business insolvency, restructuring and second chance lays down obligations on Member States to collect comparable data on insolvency and restructuring proceedings and communicate it to the Commission which would be crucial in order to demonstrate the efficiency of the regulatory framework in Member States as regards insolvent debtors.
- A Report, accompanied if appropriate with the necessary legislative proposals to amend the Capital Requirement Regulation, with regard to the possible introduction of minimum levels of provisioning which banks must make for future NPLs arising from newly originated loans, as requested by the Council Action Plan. Such *statutory* (so-called *Pillar 1*) *prudential backstops* will prevent the build-up and potential under provisioning of future NPLs stocks across Member States and banks via time-bound prudential deductions from own funds. In this context the Commission will also consider introducing a *common definition of non-performing exposures (NPE)* in accordance with the one already used for supervisory reporting purposes<sup>24</sup> in order to

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<sup>24</sup> See Commission Implementing Regulation (EU) No. 680/2014.

establish a sound legal basis for and ensure consistency in the prudential treatment of such exposures.

- A way forward to *foster the transparency on Non Performing Loans in Europe* by improving the data availability and comparability as regards Non Performing Loans, and potentially supporting the development by market participants of Non Performing Loan information platforms or credit registers.

## 6. Additional new measure: An enabling framework for the development of Sovereign Bond-Backed Securities (SBBS)

2016 Council Roadmap	<i>Status</i>	Next steps
-	-	In light of the work of the European Systemic Risk Board, Commission may decide to introduce an enabling framework for sovereign bond-backed securities.

The objective of reducing risks to financial stability by facilitating the diversification of banks' sovereign portfolios and further weakening the bank-sovereign nexus is of high importance for the completion of the Banking Union. As regards the regulatory treatment of sovereign exposures, the Commission will come back to the issue in due course, as mentioned in the 2016 Council Roadmap, which agreed to await the outcomes of the Basel Committee, and the Reflection Paper on the Deepening of the Economic and Monetary Union.

In order to make tangible progress on this matter, so-called sovereign bond-backed securities (SBBS) could as a first step have the potential to contribute to the completion of the Banking Union and the enhancement of the Capital Markets Union. By pooling and possibly tranching sovereign bonds from different Member States, Sovereign Bond-Backed Securities could support further portfolio diversification in the banking sector, while creating a new source of high-quality collateral particularly suited for use in cross-border financial transactions. Moreover, this new instrument could eliminate damaging flights away from some sovereigns, which obstruct an economically efficient allocation of funds. Also, it could render bonds issued in otherwise small and less liquid markets more attractive for international investors. This would foster private-sector risk sharing and risk reduction and promote a more efficient allocation of risks among financial operators.

The Commission is closely following and contributing to the ongoing work on Sovereign Bond-Backed Securities within the European Systemic Risk Board (ESRB). Building on the outcome of this work, in December 2017 and consultations with relevant stakeholders, the Commission will consider putting forward a legislative proposal for an enabling framework for the development of sovereign bond-backed securities in early 2018.

## 7. Continuing to ensure high quality supervision

The Single Supervisory Mechanism has now been fully implemented and is fully operational, with clear benefits in terms of level playing field and confidence emerging from the integrated supervision of credit institutions. The report from the Commission to the European Parliament

and the Council adopted on the same day as this Communication, highlights that the European Central Bank has taken up fully its supervisory role and has managed to establish a good reputation as an effective and rigorous supervisory authority since it took over supervisory tasks in November 2014. This represents a remarkable achievement especially in a context where timelines were extremely challenging and the underlying supervisory realities of the 19 participating Member States were very diverse.

The functioning of the Banking Union system may be undermined if loopholes in the supervision emerge. Recent structural market developments show a trend for banking groups to have increasingly complex structures, operating through entities that escape bank supervision, but undertake largely the same activities as banks. Particularly, large investment firms carry out investment banking activities similar to those of credit institutions that raise financial stability concerns. As announced in September 2017,<sup>25</sup> these concerns will be addressed in the upcoming Commission legislative proposals reviewing the prudential treatment of investment firms.

## 8. Way forward

Taking into account the progress made so far and the remaining steps needed to complete the Banking Union, both as regards risk reduction and risk sharing measures, the path towards the achievement of the agreed finalisation of the Banking Union could be envisaged as follows:

### 2017

- Agreement by co-legislators on first items included in the 2016 November banking package (International Financial Reporting Standard N.9 - IFRS9, creditor hierarchy and large exposure for foreign denominated debt) and significant progress on the rest of the package.
- Clarification by the Commission of existing supervisory powers to address risks related to Non Performing Loans in the framework of the Single Supervisory Mechanism Review Report.
- Commission legislative proposal regarding the investment firms review.

### 2018

- Achievement of a European Parliament position and a Council general approach (Q4 2017/Q1 2018) and adoption by co-legislators (Q2 2018) of the 2016 November Banking Package.
- Achievement of a European Parliament position and a Council general approach (Q2 2018) and adoption by co-legislators (Q4 2018) of the European Deposit Insurance Scheme proposal.
- Agreement on a common backstop (2018).
- Commission proposals on measures addressing issues linked to Non Performing Loans (Spring 2018 – to be adopted by co-legislators by early 2019 at the latest).

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<sup>25</sup> See Commission Communication on Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment, 20 September 2017, COM(2017) 542 final.

- An enabling framework for the development of Sovereign Bond-Backed Securities (SBBs) (early 2018).

### **Spring 2019**

All foreseen risk reduction and risk sharing measures should be in place and the implementation phase should start.

## **9. Conclusions**

Despite significant progress made since the financial crisis, the Banking Union remains incomplete and does not therefore play its full role as a mechanism of shock absorption through private channels in a strong Economic and Monetary Union. All issues are well-known and on the table for some time already. The moment to take bold but realistic actions is now, mending the roof while the sun is still shining and while the European economy is experiencing a sustained recovery. All Member States stand to lose if the current momentum is not used. To strengthen shock absorption through private channels in the Economic and Monetary Union, the European Union must find a "win win" equilibrium, delivering with regard to risk reduction as well as risk sharing. As the end of the legislative term is approaching, clear political decisions are needed in the coming months to ensure agreement on all the outstanding key elements by the end of 2018. Hence, the Commission calls upon the European Parliament and all Member States to reach a political agreement in the coming months on a renewed commitment to complete the Banking Union by 2019. The Commission stands ready to actively contribute to and facilitate these discussions.