

Policy Paper

Ring-fencing in the Eurozone and the road to the Banking Union

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The Banking Union is one of the most important and ambitious projects launched by the European Union in the last ten years. With supervisory and resolution mechanisms for Eurozone banks now up and running, the current narrative is that most of the work to create the Banking Union is complete. This paper disputes this view, arguing that the persistence of financial protectionism – or “ring-fencing” – at Member State level significantly erodes the effectiveness of the Eurozone’s single supervisory and resolution mechanisms. It formulates concrete recommendations and calls for a political leap of faith from Eurozone Member States to cease ring-fencing practices.

1 Introduction

In the summer of 2012, heads of state and government of the Eurozone asked the European Commission to work on the creation of a single supervisory mechanism for the European banking system: this was the genesis of the Banking Union¹. Since then, the concept of the Banking Union has evolved to include, in addition to single supervision, a single resolution mechanism and a common deposit insurance scheme. While little progress has been made regarding the latter, single supervisory and resolution mechanisms for Eurozone banks are now up and running. As a result, **the consensus is that most of the work has been done in establishing the Banking Union** and efforts should now focus on creating a deposit insurance scheme.

This paper takes a critical look at this assessment, arguing that the work is far from complete on the supervisory and resolution fronts. Indeed, the persistence of financial protectionism – or “ring-fencing” – at Member State level significantly erodes the singleness of supervision and resolution, hindering the cross-border banking integration and private sector risk-sharing that are essential to the Eurozone’s proper functioning.

The paper first reviews why achieving a fully-fledged Banking Union, in particular with regards to single supervision and resolution, should be a priority. It then takes a closer look at ring-fencing and its dynamic within Banking Union: what is it, how does it run counter to single supervision and resolution, and how does it manifest itself in the Eurozone? The last section formulates appropriate recommendations.

2 Why does the Eurozone need a Banking Union?

Establishing a fully-fledged Banking Union in Europe is a complex endeavor, but its *raison d’être* is simple: to ensure the survival of the Euro. This goal is deeply connected to another one, namely breaking the nexus that ties Eurozone banks to their sovereign and their domestic economy.

Currencies are a matter of belief: they can only survive insofar as they are credible. To be credible, a currency’s value must remain stable over time and across the geographical area where it is used. In other words, one Euro should be able to roughly buy the same good today and in five years – and across all Eurozone countries. For this reason, the European Central Bank’s (ECB) main mandate is to target price stability.

However, the ECB cannot achieve price stability on its own; it relies on commercial banks to act as transmission channels of its monetary policy to the real economy. For these transmission channels to work smoothly, **the ECB needs the Eurozone financial system to be stable and integrated:**

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¹ Indeed, although the term “Banking Union” appeared later, its inception dates back to the Eurozone Summit of June 28 and 29, 2012. In addition to single supervision, Eurozone leaders also stated that the European Stability Mechanism should be able to recapitalize banks directly (see [here](#)). That idea was later abandoned.

- A **stable** financial system is essential, because when commercial banks are healthy and trusted to manage citizens' deposits, they can continue to grant loans. Loan creation amounts to (scriptural, non-cash) money creation and is a key transmission channel of a central bank's monetary policy.
- An **integrated** financial system means that capital and liquidity can move freely within the Eurozone; in other words, it means a system where there is a high degree of private sector risk-sharing and where banks are not only exposed to their sovereign state and their domestic economy, but also to other economies. Breaking the vicious cycle – often referenced to as a “doom loop” – that binds together the weaknesses of a country's domestic economy, public finances and domestic banks is key to the effective transmission of the ECB's monetary policy and the survival of the Euro, for two reasons. First, it ensures that banks develop a more diversified risk profile and a more diversified deposit base, allowing them to be more resilient to local shocks. Second, as observed during the crisis, when Eurozone countries find themselves caught in the bank-sovereign doom loop, uncertainty arises as to whether they have sufficient fiscal resources to save their banks. They can quickly lose market access, and pressure mounts to regain national control over monetary policy so as to respond properly to the crisis, whether this pressure is exerted by speculators or by populist parties at home and domestic trends².

The Banking Union seeks to foster the stability and integration of the Eurozone financial system. It rests on three pillars: common supervision to ensure that all banks are treated equally no matter which Member State they are in; **a common resolution** framework to make sure banks can be wound down in an orderly way at the European level; and **common deposit insurance** to guarantee that a Euro in a deposit in Slovakia is as safe as one in France.

Common supervision and resolution were approved soon and the Single Supervisory Mechanism (SSM), with the ECB at its helm, and the Single Resolution Mechanism (SRM), with the Single Resolution Board as its central decision-making body, are now fully functional. Only the common deposit insurance scheme remains at a political standstill. **As a result, the assessment usually given is that two-thirds of the work has been done** (since two of the three pillars have been created). Policy discussions thus largely prioritize the EDIS and the conditions that need to be met financially and politically to create this public sector risk-sharing mechanism. However, the assessment that most of the work is complete on the supervision and resolution fronts is not accurate. **In reality, the SSM and SRM cannot fully meet their mandates, because Eurozone Member States retain the capacity to ring-fence capital and liquidity.** Therefore, ending ring-fencing should be a priority at least on par with creating the EDIS. The next section takes a closer look at this issue.

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² For a more detailed description of the linkages at work in the doom loop, see SCHNABEL Isabel and VERON Nicolas, “Completing Europe's banking union means breaking the bank-sovereign vicious circle”, Bruegel, May 2018.

3 What is ring-fencing and how does it affect the Banking Union?

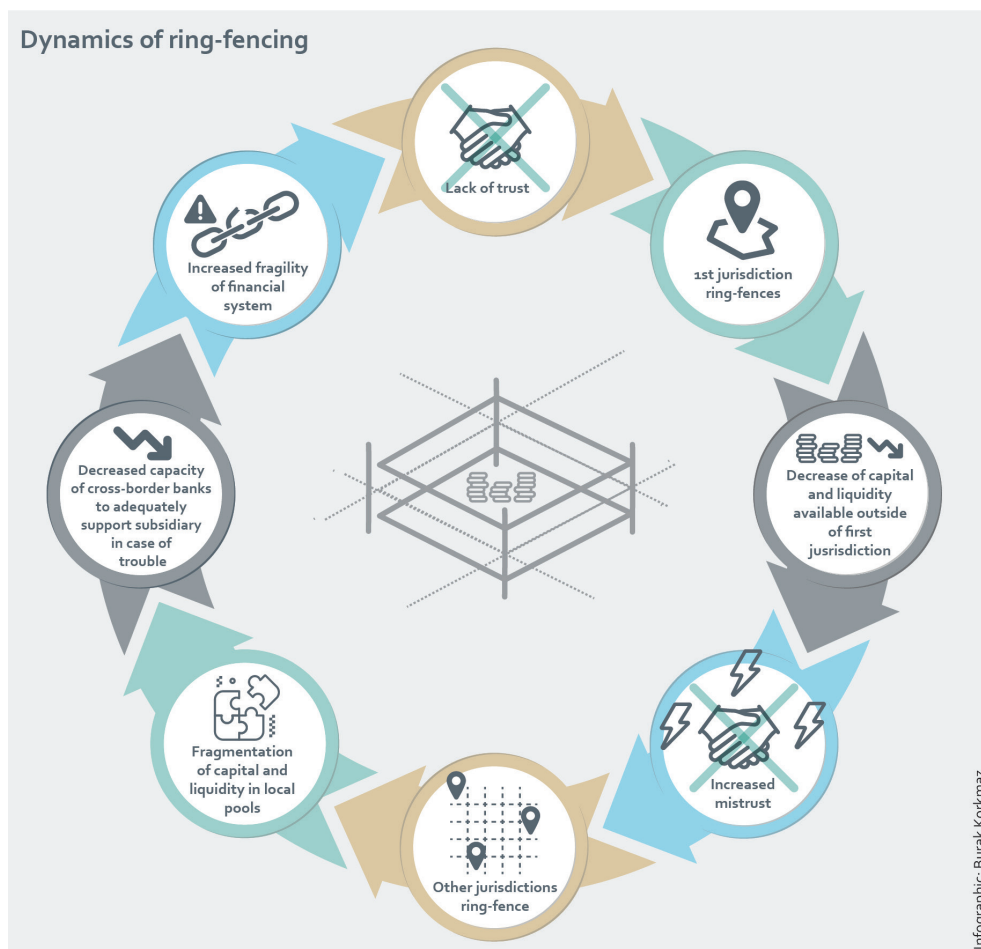
Ring-fencing can take many forms, but essentially amounts to restrictions on transfers of capital and liquidity across national borders within regionally- or internationally-active banking groups. In other words, ring-fencing occurs when the regulator of a specific jurisdiction requires that banks operating on its territory maintain a minimum amount of capital or liquid assets locally, even if these banks already hold capital and liquidity dedicated to the same purposes at the central/consolidated level. Ring-fencing requirements are usually imposed on the subsidiaries of a banking group located overseas, by the legislator or regulator of the “host country”. They can be imposed during a crisis, or when there is none.

The specific circumstances that lead a host country to ring-fence during a crisis vary, but ring-fencing when there is no such event generally stems from the host country’s desire to protect itself ex-ante against “walk away risk”, i.e. the risk that foreign subsidiaries operating on its territory would run into trouble and that the mother company would “walk away”, leaving its subsidiary to fail. In other words, ring-fencing is rooted in a lack of trust that cross-border banks can be wound down in an orderly way – one that does not leave the host country and its taxpayers footing the bill. It is also rooted in a lack of trust that policymakers of various jurisdictions can cooperate to support such an orderly resolution.

The reason why ring-fencing of capital and liquidity outside of crisis circumstances is so appealing is that it offers first-mover advantage: whichever jurisdiction ring-fences first reaps significant benefit in terms of protecting the stability of its local financial system. Indeed, the first jurisdiction to ring-fence not only ensures that foreign subsidiaries operating on its territory have local resources dedicated to absorbing potential losses but can also access more resources available at the consolidated level if needed.

This benefit, however, is short-lived. Indeed, ring-fencing triggers a vicious cycle of non-cooperation which has often been compared to the “prisoner’s dilemma” model in game theory: once one jurisdiction has ring-fenced and begun to deplete resources available at the central/consolidated level, other jurisdictions may start to worry whether sufficient resources would be available to support foreign subsidiaries active on their territory in case of a crisis, and may respond with ring-fencing as well. With every new ring-fencing requirement, the risk increases that internationally active banking groups may find themselves unable to support a subsidiary in need. Indeed, crises and the magnitude thereof are difficult to predict, and it is likely that a subsidiary’s need for financing, whether capital or liquidity, would be superior to the amount of locally ring-fenced resources; but once everyone has ring-fenced capital and liquidity in separate pools, the mother company simply no longer has adequate resources available centrally to support a subsidiary in need, nor does it have the capacity to move resources from one ring-fenced jurisdiction to another. This affects financial stability and ultimately leaves all participants worse off. The diagram below illustrates this dynamic³.

³ For a similar description of ring-fencing and the sub-optimal outcome it generates, see ERVIN Wilson, “The Risky Business of Ring-Fencing”, working paper, December 2017.



Ring-fencing within the Eurozone is particularly problematic. Beyond the reasons just described, it actively discourages private sector risk-sharing. In fact, ring-fencing is an important contributing factor of the so-called “great retrenchment”, i.e. the reduction of European banks’ cross-border claims observed since the crisis, in particular within the Eurozone. Indeed, how can banks be expected to develop their network of subsidiaries across other Eurozone non-domestic markets, or lend to other Eurozone banks, if this leads to higher capital and liquidity requirements? If they cannot so much as develop their own network of subsidiaries, helping them understand the nature and needs of non-domestic Eurozone markets, how can they be expected to engage even deeper in cross-border integration through non-domestic mergers and acquisitions? Since 2008, the proportion of interbank cross-border lending in the Eurozone has decreased, in favor of interbank domestic lending: interbank cross-border loans within the Eurozone accounted for roughly 24% of total interbank EU loan activity in 2008, versus roughly 15% in 2018⁴. This, of course, makes it difficult to develop the kind of diversification needed to truly break the nexus between banks, their sovereign state and their domestic economies. **By hindering the “one currency, one market” dynamic discussed in section 1 that is key to the survival of the Euro, ring-fencing runs counter to what the Banking Union seeks to achieve. Two symptomatic cases of ring-fencing in the Eurozone are described below.**

“Ring-fencing within the Eurozone is particularly problematic. By hindering the ‘one currency, one market’ dynamic that is key to the survival of the Euro, ring-fencing runs counter to what the Banking Union seeks to achieve.”

The first example pertains to liquidity ring-fencing and the large exposures framework. The large exposures framework seeks to set prudent limits to bank lending

⁴ *Indicators of financial integration in the Euro area*, ECB, January 2020.

to a single counterparty. It was established in 2013 through the Capital Requirements Regulation (CRR), which means that it applies directly to all Eurozone Member States. However, intra-group lending – i.e. lending from, say, a French banking group to one of its subsidiaries incorporated in Italy – represents a significant portion of cross-border activity in the Eurozone, so having the large exposures requirement apply both at the consolidated and sub-consolidated levels in the Eurozone would strongly impair the free flow of liquidity. To avoid this, the CRR contains dispositions waiving the application of the large exposure requirement at the Eurozone intragroup level. The problem is that the CRR did not create a straightforward waiver, but a dual-regime in the form of concurrent “options”, opening the door to ring-fencing. In EU law, an option refers to a case where the competent authority (in this case, the ECB/SSM) or Member States are given a choice on how to comply with a certain provision of EU law.

The two concurrent options regarding the large exposures regime are as follows:

- On the one hand, the CRR contains an article⁵ that gives the “competent authority” – i.e. the ECB/SSM – power to waive the application of the large exposures requirement at the intragroup level of Eurozone banks.
- On the other hand, the CRR contains another article⁶ that gives Member States’ legislative authorities the power to waive – or only partially waive – the application of this requirement. This option is available to Member States until 2028.

The ECB exercised its option liberally: in 2016, it published a Regulation on the exercise of options available in EU law, supporting the exemption of intragroup exposures on certain conditions, as required by the CRR⁷. However, this stance has been overruled by several Member States of the Eurozone, that chose to grant a partial exemption only (e.g. Belgium, Germany), or to condition an exemption on qualitative requirements that are more or less strict⁸. Understanding the specific circumstances that led these Member States to make this decision – beyond perhaps a fundamental lack of trust in the robustness of the Banking Union and a political choice to opt for stronger national control – would require more in-depth analysis, given the differences in these Member States’ banking sectors, and the different experiences these Member States have had of the crisis.

This liquidity ring-fencing effect is compounded by another regulatory requirement, namely the Liquidity Coverage Ratio (LCR). As with the large exposures requirement, EU law requires that the LCR be met by all of a banking group’s entities, including its Euro-area located subsidiaries, unless a banking group applies for a waiver (that can be granted by the ECB on certain conditions). However, because of the strong liquidity constraint that the large exposures requirement creates, Eurozone banking groups do not have any incentive to apply for the available LCR waiver. In the words of Giovanni Bassani, who wrote an extensive analysis of this

⁵ *Capital Requirements Regulation*, European Parliament and Council of the European Union, 2013, article 400(2)(c).

⁶ *Capital Requirements Regulation*, European Parliament and Council of the European Union, 2013, article 493(3)(c)

⁷ *Regulation of the ECB on the exercise of options and discretions available in Union law*, ECB, March 2016.

⁸ *Overview of options and discretions set out in Directive 2013/36/EU and Regulation (EU) N° 575/2013*, European Banking Authority, 2018.

complex legal subject: “the apparent conflict between the conditions for granting a cross-border liquidity waiver and the other prudential requirements (in particular the intragroup large exposures exemption) lead, almost unavoidably, to supervisory ring-fencing within a Member State preventing the establishment of a truly European prudential supervisory jurisdiction”⁹. In addition, the ECB took a prudent stance with regards to the LCR waiver: for subsidiaries that are deemed significant, only 25% of the liquidity requirements created by the LCR can be waived¹⁰. This also discourages banking groups from requesting an LCR waiver from the ECB.

This continued application of the LCR at the intragroup level is highly problematic: fundamentally, duplicating liquidity requirements at the sub-consolidated level is inefficient as discussed above. In addition, the design of the LCR itself inhibits inter-bank lending, and thus bottom-up financial integration in the Eurozone and private risk-sharing¹¹. The ECB estimated in 2018 that up to €130bn of liquidity was locked in cross-border subsidiaries of systemic Eurozone banks as a result of this¹².

The internal minimum required eligible liabilities – or internal MREL – is a second example of ring-fencing, this time pertaining to capital. The issue here is more straightforward. Simply put, in a true Banking Union with harmonized resolution, Eurozone banking groups operating on a cross-border basis should not have to hold capital dedicated to resolution purposes at the sub-consolidated level, as is currently the case; this, of course, is an instance of capital ring-fencing. Should a financial institution opt for a centralized resolution strategy, holding capital for resolution purposes on a consolidated basis should suffice.

4 Policy recommendations

The following three actions should be prioritized in order to improve the state of the Banking Union:

1. **The European Commission should propose an amendment to the Capital Requirements Regulation so as to modify the design of the LCR.** Specifically, the Regulation should allow the expected repayment of cross-border interbank loans in the Eurozone to count, at least partially, as an expected inflow. Eurozone banks would be incentivized to lend to one another if this activity didn’t engender extra liquidity buffers.

⁹ BASSANI Giovanni, *The Legal Framework Applicable to the Single Supervisory Mechanism: Tapestry or Patchwork?*, Kluwer Law International, February 2019. The Chair of the Supervisory Board of the ECB summarized this issue in similar terms; see NOUY Danièle, *Questions for Eurofi Newsletter*, ECB, April 2018.

¹⁰ *ECB Guide on options and discretions available in Union law*, ECB, November 2016.

¹¹ The EU version of the LCR (the LCR is a standard that was designed by the Basel Committee on Banking Supervision, but its transposition may vary from one jurisdiction to another) strongly discourages cross-border interbank lending because when a bank lends to another bank on a cross-border basis with expected repayment under thirty days, the loan cannot count, for the lending bank, as an expected inflow.

¹² “*The Benefits of European Supervision*”, speech by Mario Draghi at the ACPR Conference on Financial Supervision Paris, September 2018.

2. The ECB should review its policy stance regarding the LCR waiver for significant subsidiaries and increase it beyond 25%. This course of action, now under consideration by the ECB, could incentivize banks to apply for the waiver and encourage movement of liquidity across the Eurozone.
3. Fundamentally, however, what is required is a political leap of faith from Eurozone Member States, where they would collectively and concomitantly agree to let go of remaining discretionary powers to ring-fence. Concretely, this would mean that national legislators of Eurozone Member States review provisions pertaining to the large exposures framework, whenever those override the SSM's policy stance as discussed in section 2. In addition, the co-legislators should change internal MREL requirements and its pre-positioning within Eurozone subsidiaries. These could be good starting points; as discussed, there are other instances of ring-fencing, so these recommendations are necessary but far from sufficient to strengthen single supervision and resolution in the Eurozone.

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More generally and in light of the above, the focus on the EDIS appears excessive. Undoubtedly, establishing the EDIS is essential and much progress is still needed on that front. However, focusing on the matter of ring-fencing is also required. It would therefore be helpful for policy discussions to continue to ask another hard question, namely: are Member States of the Eurozone truly committed to single supervision and resolution in the first place?

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