EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

Public consultation on the draft Guide on the supervisory approach to consolidation in the banking sector

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General comments

I am satisfied to see that the European Central Bank is clarifying its guidelines to encourage the consolidation of the European banking sector. In spite of several years of “progress” towards a banking union, the European banking sector is more fragmented along national lines than it was when the process started. This guidance can help mitigate the situation, and to that extent, it is welcome. I have two main misgivings about these guidelines (see next page).

General comments (continued)

1. Too big to fail.

The guidelines may result in excessive consolidation within, rather than across, national boundaries, in this way creating so called “too big to fail” entities. To the extent that the Banking Union is still not a reality, such too big to fail entities will pose serious risks for financial and fiscal stability.

It is indeed the case that European institutions have been working for almost a decade to ensure that resolution are done at the European level and that their cost does not fall on the taxpayers’ shoulders. However, this effort has not been successful. As I have indicated elsewhere[1] our Single Resolution Mechanism has failed to intervene in a very wide number of instances where we would have expected European resolution to be the norm. Two recent instances are NordLB and the Italian Veneto banks. In the first, excessive discretion within the State aid framework was granted, in my view unjustifiably, due to the specific ownership structure of the bank, and regulators hesitated to declare the bank failing or likely to fail for the same reason. In the second, European Resolution was considered (by the SRB) not to be “in the public interest”. In these, and other instances, national authorities have been compelled to bail-out the failing banks instead of using the European framework, which would have required European intervention and the appropriate burden sharing.

Under these circumstances, it is to be feared that the potential failure of ever-larger national banking institutions will continue to be dealt with according to national legislation, with the losses falling on national taxpayers. For this reason, absent some significant progress towards a true banking union, we should be extremely careful before encouraging further national consolidation.

2. Regulatory treatment of badwill

It appears to me that the most potent incentive for consolidation in the guidelines is the regulatory treatment of “badwill”, as given by guideline 32. The guidance says:

“ECB Banking Supervision recognizes duly verified accounting badwill from a prudential perspective, expecting it to be used to increase the sustainability of the business model of the combined entity, for example by increasing the provisioning for non-performing loans, to cover transaction or integration costs, or other investments. It is generally expected that the potential profits from badwill will not be distributed to the shareholders of the combined entity until the sustainability of the business model is firmly established.”

This paragraph, I fear, confuses the accounting and economic profits in a way that can be damaging to the sustainability of the combined entity. In my view, the proposed supervisory treatment of badwill can indeed be useful for increasing provisions or offsetting restructuring charges. However, I fear that there is a lot of discretion on the clause that forbids its distribution: “badwill will not be distributed to the shareholders of the combined entity until the strategy of the business model is firmly established”. These conditions are hard (impossible!) to verify in practice and could result in excessive capital distributions to shareholders, potentially endangering the genuine capital position of the merged entity.

Thus, I would suggest making it clear that badwill that will be distributed to shareholders will not be recognized from a prudential perspective under any circumstances.

[1] Garicano, L (2019): “Two proposals to resurrect the Banking Union: the Safe Portfolio Approach and SRB”, paper prepared for ECB Conference on “Fiscal Policy and EMU Governance”, Frankfurt, 19 December.