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EU Monitor
European integration

EU Banking Union

Right idea, poor execution

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European Banking Union is progressing from the drawing board to implementation, but difficulties are mounting. There is a strong probability that the institutional arrangements will fall well short of the consistent, effective framework required to attain the objectives of Banking Union.

Single Supervision is the most advanced component. Shifting banking supervision to the ECB, and thus to an institution with a European perspective, may help to overcome the dangerous tendency towards a re-fragmentation of Europe's banking markets and may help dispel some of the doubts over the quality of European banks.

Still, the choice of the ECB as the pan-European banking supervisor is problematic. It has resulted in unwieldy decision-making structures and overlapping competences.

The planned Balance Sheet Assessment (BSA) before the start of the Single Supervisory Mechanism could be a major market-moving event. Before a BSA is done, it must be clear how banks would be re-capitalised if need be.

In the draft Recovery and Resolution Directive a key building block of regulatory reform has finally been presented. It has many sensible elements that will remove some uncertainty and strengthen market discipline. However, it leaves member states with too much discretion, making competitive distortions likely.

The Commission's Single Resolution Mechanism (SRM) proposal is logical, but problematic. Single supervision cannot work without an effective resolution authority and a credible financing mechanism. It also needs effective decision-making structures – all of which the SRM does not deliver.

Member states' lukewarm reaction to the SRM proposal is more than regrettable, because it reveals fundamental opposition rather than mere technical concerns. It reveals that member states are still unwilling to face up to the logical consequences of the Banking Union concept for national sovereignty and its financial implications. Unless this changes, Banking Union will fail.

Timetable 1

February 2014: Completion of ECB's Balance Sheet Review

May 2014: ECB / EBA stress-test

September 2014: Possible start of ESM

January 2014 (and every 3 years thereafter): Review of ESAs

January 2015: BRRD and SRM to take effect

December 2015 (and every three years thereafter): Review of SSM (based on Art. 26 SSM Regulation)

December 2016 (and every five years thereafter): Review of SRM (based on Art. 84 of SRM Regulation)

2018 (still under debate): Bail-in tool to take effect

European Banking Union is progressing from the drawing board to implementation. However, as this process moves forward, the difficulties mount. As things stand at the moment, there is a strong probability that the institutional arrangements that will be put into place will end up as a halfway house and, hence, fall short of forming the consistent, effective framework required to attain the objectives of Banking Union. It appears that member states embarked on an ambitious agenda in June 2012, but that they are now shying away from the consequences of these commitments. By doing so, they risk wasting an important chance to establish a sounder footing for EU financial markets in general and the euro area in particular. This is not to say that Banking Union will be inconsequential – indeed it will have major repercussions on European banks and their creditors – but it will fall short of what was promised as well as of what is warranted.

Rationale for banking union

As a reference point for assessing the steps taken towards Banking Union, it is useful to recall the rationale for the project. Essentially, the rationale is based on two objectives:

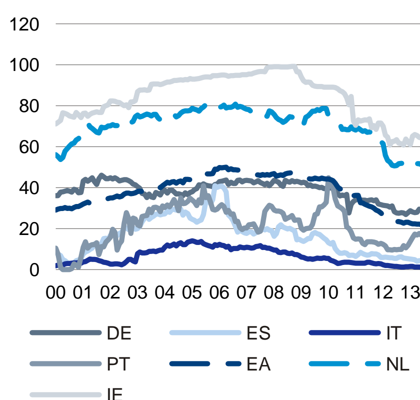
— Preserving the single market for financial services by ensuring consistent, competitively neutral financial supervision across the EU.

— Breaking the sovereign-bank nexus, i.e. the vicious cycle between fiscal and financial instability.[1]

With regard to the first objective, the financial crisis has underlined the "impossible trinity" of simultaneously having integrated banking markets, national supervision and financial stability.[2] This impossible trinity can logically only be overcome in one of two ways: either, one returns to a world of segmented, national banking markets and forgoes the benefits of integration[3], or one moves towards supra-national structures for financial supervision and resolution.

Share of foreign sovereign debt 2

% of total sovereign debt held by banks



Source: ECB

With regard to the second objective, it is important to realise that in order to do the latter, two things need to be ensured: on the one hand, banks should reduce their exposure to sovereign debt issued by their home state; on the other hand, the costs of cleaning up failed banks/banking systems must not be borne by national budgets – or at least not exclusively – but should be shifted onto creditors and, to the extent that this is not possible or deemed sensible, be shared amongst E(M)U members.

It follows logically that whoever supports Banking Union must support the idea of cross-border financial assistance, either via official sector flows (i.e. via ESM) and/or via private-sector resolution mechanisms, such as bank resolution funds, funded by the financial industry, or joint deposit guarantee schemes. Similarly, whoever supports Banking Union must support the idea of a truly integrated Single Financial Market, eschew protectionism and oppose re-fragmentation of market.

In reality, neither of these two conditions seems to be met: On the one hand, banks have recently increased rather than decreased their exposures to their respective national sovereigns (see chart). On the other hand, the envisaged

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[1] As a positive side-effect, the Eurosystem would also be relieved of the task of supporting ailing banks via liquidity operations.

[2] Cf. Schoenmaker (2013).

[3] In the course of the crisis, this has been underlined by the fact that, in the absence of a European recovery and resolution mechanism, cross-border banks (such as Dexia or Fortis) that found themselves in trouble were broken up into their national components, hurting the single market.

rules for bank resolution (see below, pp. 10-18) do not provide for a substantial cross-border sharing of the burden of dealing with failed banks.

Hence, hopes that Banking Union will be a crucial instrument to help countries suffering from the negative repercussions of the sovereign-bank nexus will be disappointed. At best, Banking Union will help to avoid, *in the future,* the accumulation of risks in Europe's banking systems – similar to those that led to the crisis – and to a speedier response to such problems, given that the ECB, as the new pan-European supervisor, will be less susceptible to the temptation of forbearance than national supervisors may have been in the past.

Constituent components

As is commonly understood by now, a comprehensive banking union consists of four interrelated building blocks.

— A single rule book.

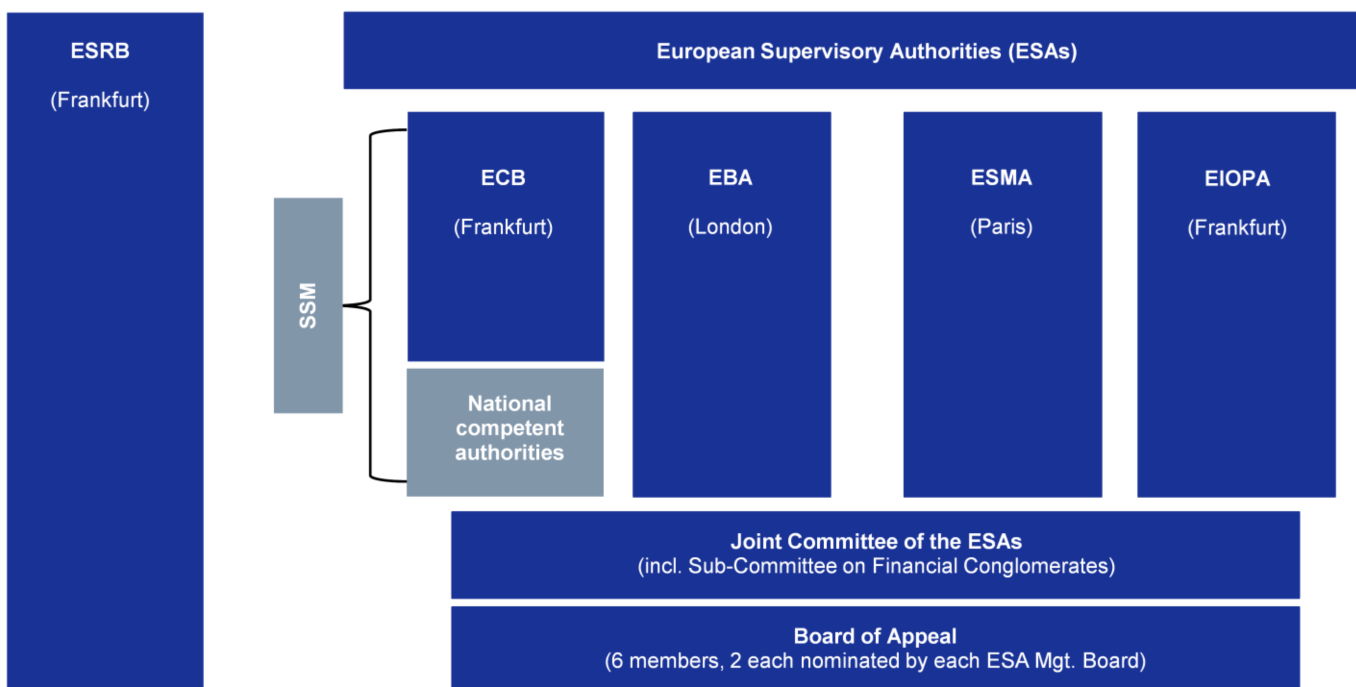
— A single supervisory mechanism.

— A single resolution regime.

— A financing regime for bank failure, including a common resolution fund, a fiscal back-stop and, at least, an alignment of deposit guarantee schemes (DGS).

— As a complementary element to the micro-prudential supervisory system, macro-prudential supervision is necessary and, in the EU, was established in 2010 with the European Systemic Risk Board (ESRB).[4]

The ESFS, multiple players! 3

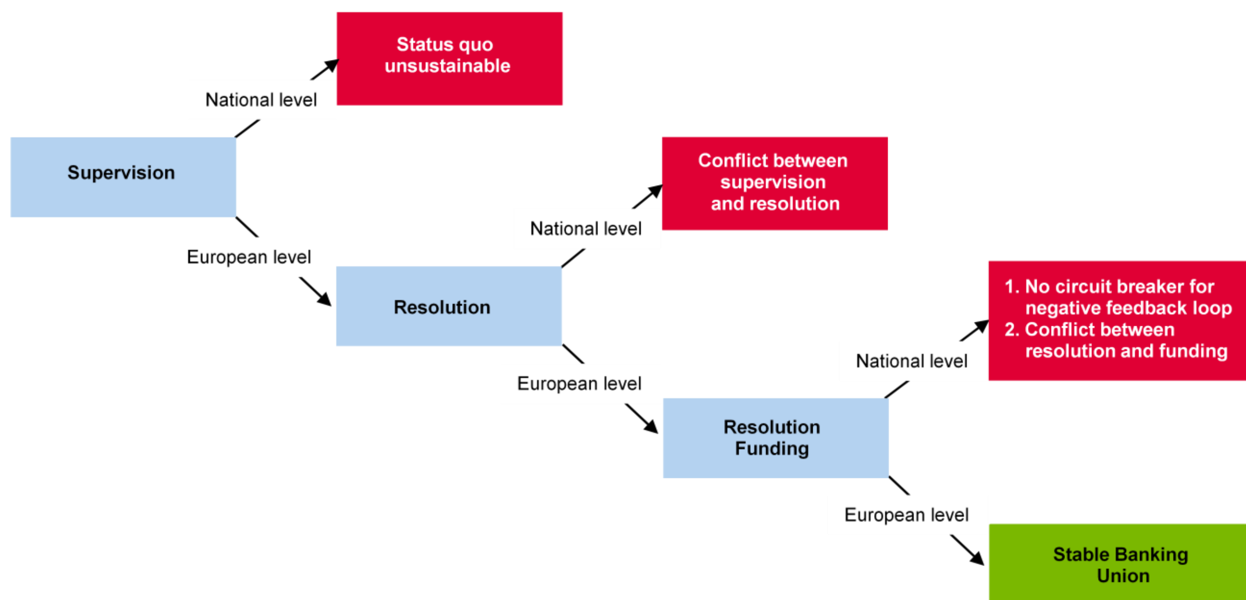


Source: DB Research

[4] We have described the ESRB in detail in Speyer (2011), pp. 4-8.

These elements are strictly interconnected. Supervision without a single rule book would leave supervision fragmented and competition distorted and would incentivise member states to game the rules. Supervision without joint resolution would not break the vicious circle – and neither would resolution without burden-sharing. Finally, joint resolution without joint supervision would create moral hazard.

Without pan-European resolution, Banking Union is unstable 4



Source: DNB

The EU has moved towards implementing these elements. However, far from being a comprehensive package, the different components have been advanced at different speed and with different substance. In what follows, we will review the progress made on the various elements; we leave out the issue of deposit guarantee schemes (DGS) for two reasons: (i) as we have argued elsewhere, DGS are of lesser importance in the institutional design, and (ii) we will cover the review of the DGS directive and how it fits into the design of Banking Union in a separate publication.

Single Supervisory Mechanism (SSM)

The legal basis for the Single Supervisory Mechanism (SSM) consists of a Council Regulation based on Art. 127(6) TFEU, which was adopted in April 2013, and a Regulation of the Council and the European Parliament, which amends the regulation of 2010 that established the EBA. According to the SSM, the ECB is to assume supervision of all credit institutions in SSM-member countries. It will have direct supervisory powers over the largest banks that meet any of the following criteria:

— Assets over EUR 30 bn;

— Representing more than 20% of national GDP, unless total assets of that bank amount to less than EUR 5 bn;

— Being among the three largest banks in the member state concerned.

The above-mentioned thresholds will be handled with some flexibility to avoid hard threshold-effects (e.g. for banks whose total assets fluctuate around

Bodies of the SSM 5

ECB Governing Council

Tasks & Competences

- De facto final decision-taking by means of right of veto to draft decision by Supervisory Board

Supervisory Board

Composition

- Chair (not a member of ECB Governing Council), Vice-Chair (chosen from among the members of the ECB Executive Board), 4 representatives of the ECB; one representative each of competent authority from each participating MS
- Single majority voting; casting vote for chair
- Qualified majority for comitology decisions
- Steering Committee (no more than 10) drawn from Supervisory Board members, to prepare meetings and conduct day-to-day operations

Tasks & Competences

- Prepare supervisory decisions for decision by GC
- Decisions will be deemed adopted if GC does not object

Mediation panel

Composition

- One member per participating MS, chosen by each MS among the members of the Governing Council and the Supervisory Board

Tasks & Competences

- Shall resolve differences of views expressed by the competent authorities of concerned participating MS regarding an objection of the Governing Council to a draft decision by the Supervisory Board

National competent authorities

Tasks & Competences

- Part of network of supervisors
- Exclusive competence for supervision of credit institutions not subject to supervision by ECB
- Exclusive competence for anti-money laundering (AML), consumer protection and 3rd-country branches

EUR 30 bn). In addition, the ECB will have direct supervisory powers over all banks for which ESM assistance has been requested or granted. Moreover, when necessary to ensure consistent application of high supervisory standards, the ECB may at any time, on its own initiative after consulting with national authorities or upon request by a national competent authority, decide to exercise supervision directly itself. Based on these criteria, it is estimated that around 130 banks accounting for some 80-85% of euro area total bank assets will be under direct ECB supervision.

Participation in the SSM will be compulsory for all EMU member states; non-EMU EU member states will be able to opt into the SSM. Indications are that most of the EMU-outs will join; the UK and Sweden are the only ones that already have declared that they do not intend to join. Generally, incentives for non-EMU-countries on whether or not to join will depend on the following considerations[5]: (i) Most obviously, it will depend on their assessment of whether their interests have been sufficiently safeguarded in the institutional set-up of the SSM (see below, page 7). (ii) For countries that intend to join EMU in the foreseeable future, there is a strong incentive to join the SSM straight away in order to influence the process (especially should the ECB become the de facto standard-setter) and to gain experience with the mechanism. (iii) More generally, for all EMU-pre-ins, the decision to join will depend on their assessment of the future development of the euro area. More precisely: if they assume that Banking Union will be yet another step towards successful ever closer Union, then joining at an early stage makes sense. (iv) Countries whose banking markets are strongly interconnected to those of other (SSM) member states should benefit from more efficient and effective supervision at the centre. This holds particularly true for countries where branches and subsidiaries of EMU-area banks have significant market shares, because there is always a risk that the respective home authorities, in the event of a crisis, will not pay sufficient attention to interest of host countries as these authorities are accountable to national authorities and parliaments. By contrast, the ECB has a European view and mandate. (v) For all member states, potential competitive distortions will be an issue when considering whether to join the SSM, especially if being supervised by the SSM is perceived as a badge of honour in financial markets. (vi) Smaller, internationally less well-known markets and their financial institutions could potentially benefit from importing the credibility of the ECB – similar to the credibility such countries gained from joining the EU and, adopting the *acquis*.[6]

As supervisor, the ECB will have a strong status: According to Art. 12(2) of the SSM Regulation the lawfulness of the ECB's decision shall be subject to review only by the Court of Justice of the EU. The authorisation, if needed, of on-site inspections, will have to be given by national judicial authorities, but in deciding on the authorisation they may only review the formality, not the materiality of the ECB's request. National judicial authorities may only control "that the decision of the ECB is authentic and that the coercive measures envisaged are neither arbitrary nor excessive having regard to the subject matter of the inspection". The national judicial authority may not question "the necessity for the inspection or demand to be provided with the information on the ECB's file".

According to Art. 1 of the SSM Regulation, the ECB's supervisory powers will be limited to credit institutions only, excluding not only insurance companies, but also pan-European financial market infrastructures, such as CCPs, for which pan-European supervision would have been the natural thing to do. The background to this is the fact that the SSM is being established on the basis of

[5] Darvas / Wolff (2013) also provide a comprehensive treatment of this issue.
[6] This argument, of course, implicitly pre-supposes that the ECB will be successful as a banking supervisor.

Art. 127(6) TFEU, which allows for the transfer of supervisory powers to the ECB over credit institutions only.[7]

The ECB will have extensive powers over credit institutions, though. Inter alia, it will have the power to authorise banks (and to withdraw those licenses); to check and impose capital and liquidity requirements; to authorise models, to impose early intervention measures, to restrict or limit business of institutions or to request the divestment of activities, and to conduct stress tests. The only powers left for national supervisors will be those connected to consumer protection and anti-money laundering issues as well as the supervision of branches of non-EU banks.

Ultimate decision-taking powers within the SSM will rest with the ECB Governing Council, with decisions being prepared by a yet to-be-created Supervisory Board (see box on page 5 for details on the Supervisory Board). Draft decisions by the Supervisory Board will be deemed adopted unless the Governing Council objects to them in writing. This complex structure was needed, because under European law, only the Governing Council of the ECB may take decisions. At the same time, the Governing Council was not considered to be the appropriate body to guide, supervise and prepare supervisory decisions in order to avoid potential conflicts of interest with the monetary policy role of the ECB.

Additional complexity is added by the creation of a mediation panel (Art. 18 (3b) of the SSM Regulation). This panel is to respond to the concerns of a national authority should such concerns arise following the objection by the Governing Council to a Supervisory Board decision.[8] Interestingly, some have already interpreted the existence of the mediation panel as this forum (rather than the ECB's Governing Council) being the ultimate decision-taker. This interpretation is not entirely implausible given that the mediation panel will include one member per participating member state, chosen by member states represented on the Governing Council and the Supervisory Board, making it, in effect, a small Council, acting by majority vote.[9]

The European Banking Authority (EBA) will remain responsible for developing the single rule book. Against the backdrop of fears about the ECB dominating EBA rule-making, voting procedures in EBA have been revised. Henceforth, a double majority of participating and non-participating member states will be required for standards, as long as at least 4 member states are non-participants in the SSM. The EBA's Management Board is to include at least two representatives from non-SSM-participant member states. The relevance of these changes is somewhat dubious, though: after all, EMU members already have a majority of votes in the EBA today, provided that they vote uniformly.

The ECB, together with the national competent authorities, will exercise supervision on the basis of the Single Rule Book. However, since the CRD IV, as the main component of the Rule Book, contains substantial elements of national discretion, the ECB will de facto have to supervise banks on the basis of 28 rulebooks – or, in the words of Karel Lannoo of CEPS: "Banking Union will start out with capital rules that are more like Emmental cheese than a single rule book."[10]

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[7] We have discussed these limitations in more detail in Speyer (2102), pp 10-11.

[8] For participating states that are not EMU members, the rights go even further: if they disagree with a Governing Council objection to a draft Supervisory Board decision then the participating member state may declare itself not bound by the decision (which may in turn, lead to the suspension or termination of its membership according to Art 6 (6), see page 10).

[9] It is probably not entirely implausible to assume that member states will have a strong incentive to nominate the representative of their respective national supervisory authority as a member of the mediation panel, in other words, representatives who are accountable to national authorities.

[10] Lannoo (2013), p.1.

In its role as banking supervisor, the ECB will be accountable to Council and Parliament. There are reporting requirements (e.g. an annual report) and the ECB is required to answer in writing all questions raised by the EP, the Eurogroup, or national parliaments, which may also invite any member of the Supervisory Board, "together with a representative of the national competent authority" (Art. 17a,3 of the SSM Regulation) for an exchange of views. In light of the fact that there is no administrative court at the EU level where ECB decisions can be challenged, the Regulation stipulates the creation of an internal ECB Panel of Review (Art. 17b) to review the "procedural and substantive legality of the decisions taken". The five Review Panel members will be appointed by the Governing Council. Cases may be brought forward by any natural or legal person that was the addressee of an ECB supervisory decision. A request for review must be dealt with within two months, ending with a decision of the Governing Council, which may either confirm, abrogate or amend the initial decision; an appeal is not possible.

According to the SSM Directive (Art. 27), the start of the SSM will be in March 2014 or 12 months after the entry into force of the Regulation passed by the Council. However, it is really the ECB that holds the keys on the effective start of the SSM, because the SSM Regulation clearly states that the ECB will have the last word: Art. 27(2) states the SSM will not start before the ECB declares its readiness to assume the task. The formal reason for the insertion of this provision into the contract is probably to ensure that the ECB is fully prepared to assume the task in terms of having the required personnel, structure and expertise on board. However, as a side-effect the provision gives the ECB considerable leverage over member states. Specifically, the ECB is put in a position to (i) force member states to deal decisively with weaknesses in their countries' banking systems (see next section on the forthcoming Balance Sheet Assessement) and (ii) to influence the design of Banking Union. Specifically, the ECB will be able to exert substantial pressure for a workable design of the resolution mechanism. The ECB has made repeated reference to the obvious fact that effective financial supervision requires the existence of an effective resolution mechanism.[11] The corollary is that pan-European supervision requires an effective European resolution mechanism, which member states hitherto seem unwilling to establish (see below).

Balance sheet assessment (BSA)

The start of the SSM will be preceded by a Balance Sheet Assessment to be conducted by the ECB (based on Art 27(4) of the SSM Regulation), aided by mixed teams of national banking supervisors and by external accountants. The BSA is, as the word suggests, more comprehensive than a stress test. Whereas the latter only subjects the asset side of a banks' balance sheet to adverse scenarios, the former also examines the viability of a bank's funding structure. The rationale for the BSA is simple: the ECB wanted to make sure that by conducting a rigorous test of banks' health, it started with a clean slate of sound banks, to ensure that it would not face a banking failure soon after taking over the job, lest it suffers reputational damage. Only if capital shortfalls revealed by the BSA are addressed, will the ECB assume supervision. This sets the ECB in direct conflict with member states, most of which will presumably prefer to have a lax test, as they must fear (i) being called upon to recapitalise banks should these be unable to raise fresh private funds and (ii) being seen as having been to lax in their supervision in the past.

The BSA could be a major market-moving event. One thing is clear: before a BSA is done, it must be clear how banks would be re-capitalised if need be.

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[11] See for example Cœuré (2013).

Otherwise, the BSA would lead to severe disruptions in financial markets, if and when the viability of banks were questioned. It should be noted that the compromises reached by member states on the use of the ESM for the purpose of recapitalising banks is not an answer to this dilemma, as this compromise provides only very limited scope for using ESM money to deal with the problem of legacy assets (see below, p.12-13).

Assessment of the supervisory mechanism

On the positive side it clearly has to be noted that moving towards supra-national structures for banking supervision constitutes an unprecedented step of transferring authority towards the supra-national level. Also, the decisions on the SSM have been taken at a surprising pace, confirming that E(M)U decision-makers can act in a timely manner on important issues that seek to stabilise the European economy and EMU in particular. In terms of substance, shifting banking supervision to the EU level and to an institution with a European perspective, may help to overcome the dangerous and negative tendency towards a re-fragmentation of Europe's banking markets, which is being driven especially by national supervisors trying to ring-fence national markets, for example by restricting intra-group transfers of capital and liquidity.[12] Finally, assuming that the ECB will prove to be a tough and respected supervisor, which, over time, will be highly regarded as a supervisor as it is as a central bank, European banks subjected to its supervision will enjoy more confidence from international financial markets. This in turn would help remove some of the uncertainty premia that many European banks currently pay on their refinancing.

Against this, on the negative side of the ledger, there are quite a substantial number of issues, however:

- The choice of the legal foundation of the SSM – Art. 127(6) TFEU – is a bad one. This legal basis has been chosen to speed up the process, but that comes at a high price. Quite apart from the principal concerns, connected to (i) the question of whether Art. 127(6) TFEU is a sufficiently robust legal basis, and (ii) the awarding of supervisory powers to central banks,[13] the choice has led to unwieldy decision making structures, as described above. This is exactly the opposite of what is needed in a crisis situation where clear-cut and speedy decisions are needed. Also, as mentioned, the choice of Art. 127(6) TFEU has the repercussion that pan-European supervision will be limited to credit institutions. This is clearly problematic, not the least in light of the growing importance of pan-European financial market infra-structures, such as CCPs.[14]
- The choice of the ECB as supervisor is also problematic for another reason, because in the event of a bank failure the ECB is likely to be an interested party in the winding-up. If bail-in becomes the norm (see below), it is highly likely the ECB will be among the creditors of a failed institution on account of normal monetary policy operations.
- Unless member states manage – contrary to expectations – to agree on a single resolution mechanism (see discussion below), a disjoint will be established between supervisory powers and liability: while the EU level (i.e. ECB) will be vested with the power to close banks, in the absence of a European restructuring regime, the bill for this will be charged to private creditors and member states. While bailing-in private creditors is in line with the political preferences enshrined in the Bank Recovery and Resolution

[12] Cf. e.g. Bini Smaghi (2013), p. 36.
[13] We discussed these in Speyer (2012), pp 10-11 and p. 7 respectively.
[14] See Kaya (2013), pp. 11-13, 20-21.

Directive (BRRD), the latter is problematic, as it creates a disconnection between power and accountability.

- There are several areas of competing competences in the SSM regulation:
  - Member states prepare the authorisation of banks, but the ECB approves it (Art 13).
  - Member states can object to closure (Art. 13 (2a)), as long as the resolution is national.
  - In the area of macro-prudential supervision (Art. 4a, 1&2), the ECB can object to, but not prevent national measures; at the same time, the ECB may impose its own. Obviously, this is a recipe for overlapping or, at worst, contradictory measures. Moreover, it means that the ECB as supervisor will face a wide range of capital buffers, set by national authorities rather than by the ECB itself.
- Though not de jure, but de facto, the SSM will create a two-tier supervisory regime, as small banks will remain under a separate regime of national supervision. There is a risk that the ECB will not seek or will not obtain direct supervisory powers over an ailing small bank until it is too late. Moreover, there is a risk for the ECB that member states will have an incentive to shift competence to the ECB when trouble is imminent. In addition, the de facto two-tier system will create competitive distortions that will be exacerbated by the fact that small banks will be allowed to remain under national accounting standards, rather than having to use IFRS, as all banks directly supervised by the ECB will have to.[15]
- Competitive distortions are exacerbated by the failure to establish a genuine Single Rule Book and the above-mentioned discretion in macro-prudential tools. While this could theoretically be rectified over time if the EBA is successful in its job, experience to date suggests that this will be a long road.
- For the first time in the history of European integration the SSM legislation contains an explicit exit clause (Art. 6.6a), allowing non-EMU member states that have joined the SSM, to exit it subsequently, of their own volition, after a minimum of three years of membership or in case of a major disagreement with an SSM decision impacting the country.[16] While this may make joining the SSM more palatable to EMU-pre-ins and EMU-outs, it sets a dangerous precedent – all the more so in an area, viz. financial supervision, where reliable and lasting structures are important for building confidence.

All in all then, as we have long argued, many problems that will now plague the current structure would not have arisen had one avoided using Art 127(6) and instead created a European Supervisory Authority (alongside a European Resolution Authority) based on a comprehensive Treaty change.

Bank Recovery and Resolution Directive

On June 27, 2013, the Council agreed on a preliminary version of the Bank Recovery and Resolution Directive, which had originally been tabled by the Commission in June 2012 and will now have to be agreed upon with the European Parliament. It is important to point out that the BRRD is distinct from the SRM (see below), even though they are connected. The BRRD has its origins in the objective to create a framework for orderly banking resolution,

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[15] Obviously, this will also lead to a lack of comparability of banks' balance sheets.
[16] They may re-enter after another three years. Non-EMU countries may also be expelled by the ECB in cases of grave acts of non-compliance (Art. 6.6).

at the national level, in all member states. The BRRD does not – and never was intended to – establish a pan-European resolution regime, but to establish minimum and non-distorting standards for banking resolution in the EU. Obviously, though, these standards will also form the core of the SRM and, consequently, the SRM proposal cross-references the BRRD extensively. In terms of substance, the BRRD covers the three logical components of a recovery and resolution regime, viz. preparatory and preventive arrangements, early intervention, and resolution.

As a preventive and preparatory tool, banks will be required to draw up recovery and resolution plans (aka "living wills"). Member states will have to establish national resolution authorities, if these do not yet exist. Resolution authorities shall have at their disposal the full range of resolution tools, i.e.

— Sale of (part of a) business,

— Establishment of a bridge institution as the temporary home of a "good bank",

— Asset separation,

— Bail-in measures.

The BRRD is to take effect in 2015; it is still a matter of negotiations between the Council and the Parliament when the bail-in provision will take effect (EP pressing for 2016; Council arguing for 2018 only). The overarching theme of the BRRD is that, in future cases of banking sector failures, bail-in should become the rule and bail-outs the exception. The winding-up or recovery of the bank concerned will be based on a pre-defined cascade of liability.[17] Losses will be covered by recourse to the following sequence of bail-in:

— Shareholders,

— Subordinated creditors,

— Senior unsecured bond-holders and certain groups of depositors not covered by DGS,

— Other depositors not covered by DGS.

Insured deposits are exempted from a bail-in – clearly a reflection of the lessons learned in the disastrous episode earlier this year, when initial plans aimed at a bailing-in of protected depositors in Cyprus caused substantial uncertainty and political resentment. Deposits above the insured amount can in principle be bailed in, but within this group deposits by individuals, micro, small and medium-sized enterprises and liabilities to the ECB will have preference in the creditor hierarchy over deposits by large corporations, which will rank on a par with other unsecured creditors. Covered deposits and secured liabilities, such as covered bonds, will be exempted from a potential bail-in, too. Liabilities to the EIB, to employees (i.e. salaries and pension benefits) and suppliers required for the daily functioning of the bank (such as security, data services, telecommunication and IT services, for example) will also be exempted, and so will be funds in payments systems with a remaining maturity of seven days and interbank deposits of less than 7 days original maturity. The latter provision is to ensure that, in case of a bank failure, repercussions to crucial parts of the financial systems that cover vital services to the economy can continue to function uninterrupted. Banks will also be obliged to hold minimum required eligible liabilities (MREL) that are available for bailing in. This provision is to avoid a Cyprus-type scenario where depositor bail-in became inevitable because of a lack of other liabilities that could be bailed-in. MREL levels will be defined based on an institution's size, risk, and business model.

[17] Cf. Council (2013).

Governments in all EU member states will have to set up national resolution funds (if these do not yet exist);[18] these will in principle exist alongside national DGS, though member states may decide to merge resolution funds and DGS. These funds have a target volume of 0.8% of covered deposits, to be reached after a maximum of ten years. The funds will be financed by levies on banks, based on their liabilities and adjusted for risk. Recourse to resolution funds will only be possible if at least 8% of liabilities have already been bailed-in, and would in principle be limited to a maximum of 5% of the bank's liabilities. National resolution funds are allowed to lend to each other on a voluntary basis – which in effect will in all likelihood mean that they won't.

The cascade of liability is not an automatic process, however. Rather, the proposed directive leaves open the possibility for authorities to avoid the bailing-in of sub-groups of creditors if they cannot be bailed in "within reasonable time", to "ensure continuity of critical functions", "to avoid contagion" or to "avoid value destruction".[19]

Importantly, what has largely gone unnoticed is that the European Commission issued a communication[20] by its DG Competition in July 2013 revamping the rules for state support to financial institutions. The communication largely mirrors the provisions in the BRRD. Effectively, it stipulates that equity and sub-ordinated bondholders must definitively be wiped out before any state assist-ance can be contemplated. EU state aid control will thus effectively constitute the basis for bank resolution well before the BRRD and the SRM take effect.

Using the ESM for bank recapitalisation

In parallel to the compromise found on the BRRD, member states also agreed on an operational framework for using the ESM as a fiscal backstop for banking resolution. In principle, ESM recap money will not be available before the BRRD and the revised Deposit Guarantee Scheme Directive have been finalised, and will only be available for future cases. This goes back to the insistence of creditor nations that effective control must exist at the EU level (rather than merely form national supervisors) over the banks receiving ESM money. However, the agreement leaves some room for a retroactive provision of funds "on a case-by-case basis and by mutual consent" – meaning that ESM money could be made available for banks in the programme countries (Ireland, Portugal, Spain, Greece and Cyprus).

The ESM will be entitled to provide up to EUR 60 bn to recapitalise insolvent banks; this maximum can be reviewed by the ESM Board of Governors, "if deemed necessary". Capital will, as a rule, provided as Common Equity tier 1 capital, thereby establishing ownership rights for the ESM. Shareholders, as a first line of defence, creditors under the bail-in rules as the second line, and governments in the countries affected will still need to co-finance the recapital-isation. More generally, the advancement of ESM funds is subject to a number of conditions:

— First, it will only be provided to systemically important bank that cannot raise private capital, but do have a viable plan for returning to health.

— Second, ESM money will only be made available if a recapitalisation by the member state concerned (assuming all private sources have been ex-

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[18] It is not entirely clear at this stage what the relationship will be between national resolution funds, to be set up based on the BRRD, and the European Resolution Fund, as proposed by the Commission under the SRM, see page 16. The only certainty is that member states that do not join the SRM and do not, at present, have a national resolution fund will have to establish one.
[19] Cf. Council (2013).
[20] European Commission (2013).

hausted and proved insufficient) would overwhelm the sovereign and endanger its own market access. In other words, a direct recap by the ESM will only be available if it is the cheaper alternative to an ESM programme for the country concerned.

— Third, even if approved, the sovereign concerned must provide co-financing. Specifically, the government must inject sufficient capital to bring the core tier 1 ratio of the bank to 4.5% under a sufficiently prudent stress scenario. For any capital injection above that, the government will have to co-finance 20% (this share will drop to 10% two years after entry into force of the ESM direct recap instrument); however, this co-financing obligation can be waived partially or fully "by mutual agreement" between the member state and the ESM Board of Governors, if the country was fiscally unable to make such a contribution.

— Fourth, decisions to grant ESM direct recapitalisation will be reached by mutual agreement.

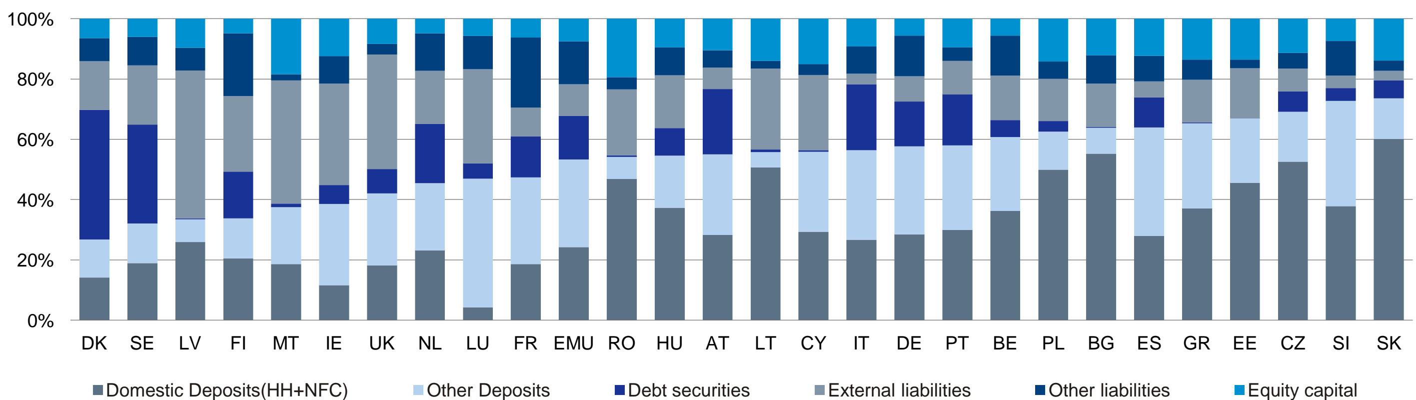
The above constitutes a combination of conditions that together amount to quite a hurdle, especially in light of the fact that decisions in the ESM require consent in the ESM Board of Governors. Consequently, the sovereign-bank-nexus will be weakened rather than broken. Also, for a fiscally weak government, the stringent pre-conditions create an incentive to shift the burden onto creditors rather than to try to receive ESM assistance.

Assessments and consequences

— On a positive note, the BRRD will represent a key building block of regulatory reform finally falling into place. That member states were able to agree on a joint approach is by no means a small achievement and shows that member states are still able to reach a consensus on important dossiers. Prior to reaching the compromise, member states held different views on how bank resolution should be structured which is unsurprising in light of the differences in financing structure. Obviously, a uniform cascade of liability will have a different effect – and, above all, different distributional consequences! – depending on the financing structure of banks.[21]

Balance sheet of European banks: Liabilities side 6

Percentage shares, Q2 2013



External: for euro members – creditors domiciled outside the euro area; for non-euro members – all non-residents

Sources: ECB, DB Research

[21] For instance, it was reported that France, where bonds constitute a large share of banks' liabilities, argued for more flexibility in the liability cascade in order to be able to avoid a bailing-in of bond creditors.

— The BRRD should also be welcomed because it provides a transparent, consistent framework for bank resolution, thereby removing some of the uncertainty that was raised by the rather diverse approaches seen in Ireland, Spain, the Netherlands, Portugal and Cyprus. Establishing the principle of bail-in in case of bank failures will also help to strengthen market discipline – though electorates may take a different view on the virtue of bail-in once they are directly or indirectly affected as creditors in the next crisis rather than as taxpayers as has been the case under bail-out. Ultimately, public acceptance of the new regime will hinge on (i) whether it will make future crises less likely due to enhanced discipline on banks, their owners and creditors, and (ii) on the assessment of distributional issues. As to the latter: banking failure always causes welfare losses and, leaving aside the important incentive effects, the difference between bail-in and bail-out regimes lies in the inter-temporal, inter-personal, and, for internationally active banks, international distribution of these losses.

Bank resolution: extent of bail-in 7

	Ireland	Spain	Cyprus	Netherlands (SNS Reaal)	Portugal
Equity	✓	✓	✓	✓	
Hybrids / preferred stock		✓		✓	
Subordinated debt	✓	✓	✓	✓	
Senior debt			✓		
Uninsured deposits			✓		
Insured deposits					

Source: DB Research

— It is also positive that the BRRD does not establish, as some member states wished, a general depositor preference over senior unsecured debt and that there is no national discretion on this. This will help to avoid too grave distortions between different funding sources.

— In terms of impact on banks' and sovereigns' funding costs, predictions are difficult to make. For banks, on the one hand, funding costs should rise as (i) a bail-in becomes more likely, (ii) as deposits become less sticky, and (iii) as senior unsecured creditors, who have hitherto almost always escaped a bail-in, will demand higher risk premia.[22] On the other hand, clearer rules on bank resolution should remove some of the uncertainty premium that currently hangs over the market in light of the very diverse approaches taken in the crisis countries, as described above. It should be noted that for banks in countries that already have national restructuring laws which include bail-in provisions (such as Germany or the UK) the effect will already have been priced in.

— Looking beyond the cost dimension, the new regime should also have repercussions on the funding structure of banks more generally. Thus, for instance, the emphasis of bail-in over bail-out will have repercussions on depositors' behaviour. Two reactions appear most likely. Firstly, deposits will become less sticky, as depositors will probably react more quickly to negative news and heightened apprehension about the stability of individual banks or banking systems. Secondly, individual and corporate depositors will seek to limit their exposure to a possible bail-in. Specifically, this would entail individuals and corporates limiting the deposits held in any one bank to the insured amount and holding more of their liquidity in assets other than deposits (which in turn would obviously have repercussions on banks'

[22] It is also probable that investors who have hitherto bought unsecured bank debt will shift to covered debt. See Zähres (2012) for this and a broader discussion of the changing refinancing structures for European banks.

refinancing situation). More generally, the MREL regime will entail that banks will have to adjust their liability structures to meet MREL requirements and that discretionary supervisory intervention can be exerted on funding structures.

— On the negative side, while uninsured depositors are not excluded from a potential bail-in, they will nonetheless enjoy a preference in the hierarchy of debtors. So will be interbank claims up to 7 days original maturity and liabilities in payment systems. The exception for inter-bank claims is understandable, but creates incentives for shorter-run interbank lending, which runs counter to the objective of putting banks' funding on a firmer, more long-term footing. [23]

— Member states will, once at least 8% of liabilities have been bailed in, retain substantial discretion to exempt further liabilities from bail-in based on weasel arguments such as "to avoid value destruction" or to "prevent contagion", and to use resolution funds to recap a bank instead of winding it up. While some level of discretion is undoubtedly a good thing for authorities to respond to the specific circumstances of a crisis at hand, the discretion left by such ill-defined terms threatens to create uncertainty in times of crisis and to distort competition in favour of larger banks and stronger countries. Member states that are in the fiscal position to afford a bail-out will be tempted to make use of this discretion, in order to avoid disrupting their domestic financial markets (and disgruntled domestic creditors/voters!). Member states that are not in such a position will be forced to bail in. This raises the risk of disruptive deposit flows in times of an impending crisis, as depositors in countries with less fiscal capacity are likely to shift their deposits to fiscally stronger jurisdictions in times of heightened market tension. Obviously, leaving substantial discretion also opens up the possibility of differentiated treatment depending on the creditor structure: for instance, it would seem plausible that governments will be less opposed to a bail-in if the creditor base mainly comprises foreign creditors.[24]

— While in future all EU banks will have to pay a bank levy, member states have discretion to decide whether to establish resolution funds or instead have the levy flow into the general budget (from where it would certainly not be available in times of crisis).

— It is sensible that the ESM will be made available as a back-stop for the resolution regime. It is however, doubtful, whether it will actually be used, given the reluctance of creditor countries to provide funds for rescuing banks in other countries and the reluctance of countries with banking sector problems to subject themselves to the discipline of an ESM programme. In addition, the co-sharing agreements are obstacles to a meaningful use of the ESM. While these arrangements are logical and sound instruments to deal with moral hazard concerns connected to legacy assets and the incentives national authorities face, they simultaneously reduce the usefulness of the ESM for dealing with the current problems. In any case, taking a longer term perspective, the role of the ESM will be temporary, because, to the extent that the SRM Resolution Fund is built up, the ESM will no longer be needed.

— The retroactive use of the ESM is rather unlikely, not least because of the sums involved. Support for Greek banks alone, in the context of the Assistance Package for Greece amounted to EUR 50 bn and Spanish banks have received another EUR 41 bn.

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[23] It may be instructive to recall the implications of the exemptions for short-term (i.e. less than 1yr original tenor) inter-bank lending under Basel 1, which led to a growth in such lending which was rolled over continuously – until panic struck. Cf., e.g. Calomiris / Litan (2000), pp. 308/9.

[24] Arguably, this may have been an argument in dealing with the Cypriot banking sector problems.

Single Resolution Mechanism (SRM)

In July 2013 the European Commission published a proposal for a Single Resolution Mechanism (SRM) as a logical complement to the SSM. The SRM will apply in all SSM-participating member states. The plan is for the SRM to be passed by May 2014 (i.e. before the current EP legislature ends) and for the SRM to take effect in parallel to the BRRD, from 1 January 2015. (As in the BRRD, the so-called "bail-in tool", i.e. the power to bail-in creditors, will only take effect by 2018) This timetable looks ambitious, to put it mildly, given the lack of political agreement on some of the key building blocks of the SRM (see below).

The proposed SRM comprises the following components

— The Single Resolution Board will have the power to require, review and monitor resolution planning by all banks subject to the SSM. Specifically, the Board can require changes in organisational structure, in business activities and exposures, or in business model (Art. 8(8) and 9 of the SRM proposal).

— The Single Resolution Board is to prepare and monitor the resolution of any bank (i.e. not just those under direct ECB supervision) in SSM-participating countries based on the Recovery and Resolution Directive with the final decision resting, for legal reasons[25], with the European Commission and execution resting with national authorities. The latter reflects the absence of a pan-European (bank) insolvency law and regime, which, by implication, necessitates that resolution must be based on the existing national laws.[26]

— All banks in SSM-participating countries will have to pay into the Single Bank Resolution Fund (target: at least 1% of covered deposits[27] in participating member states, or around EUR 55 bn, over 10yrs[28]). Contributions will be based on banks' liabilities, taking a bank's risk profile into account, and will have to be paid ex ante.[29] The EU resolution fund would replace corresponding national funds in those countries participating in the SSM and SRM. The Fund will invest in "highly liquid assets of high credit worthiness" (Art. 71.3) issued by participating member states or supra-national Union organisations, such as the EIB.

— The Fund may only use its funds to enable an orderly resolution, for example by financing a bridge bank. It is explicitly not allowed to recapitalise an ailing institution. Any funds advanced by the resolution fund, and a fortiori, by the public sector would be recouped from the banking sector ex post via higher levies. In other words, the SRM is designed to be fiscally neutral.

Any resolution process would start with the ECB, as the supervisor, or a national resolution authority signalling the non-viability of an institution and the systemic relevance of the institution. The Single Resolution Board, in a composition comprising only those national resolution authorities where the bank in trouble is based or has subsidiaries or branches, would prepare the resolution, indicating the appropriate instruments for resolution from the BRRD tool-box, with the final decision resting with the Commission and execution resting with national

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[25] Under the EU Treaty, only an EU institution under the Treaty can take such a decision. The Board is not an institution, nor is the EBA, which is an agency. The ECB is an institution under the Treaty, but as it may be subject to conflicts of interest it was sensibly considered unsuited to assume the role of the resolution authority.

[26] See also Véron / Wolff (2013), p.12.

[27] Note that under the BRRD, national resolution funds have a target size of 0.8% of covered deposits.

[28] This can be extended to 14 years if the Fund has to make disbursements within the first 10 years that exceed half of the target size of the Fund.

[29] The Commission estimates that the 17 largest banks in participating countries will pay around 40% of the levies.

authorities. If the failing bank is headquartered in a non-participating member state, the Single Resolution Board will participate in the resolution college for this bank on behalf of all national authorities in the SSM-area where the bank has subsidiaries.

Single Resolution Board (as proposed by COM) 8

Structure: The Board will either act in plenary or in executive session. Plenary session will be for administrative and budgetary matters; executive session for concrete resolution matters.

Members: In plenary session, members will be: Executive Director, Deputy Executive Director, one representative each nominated by European Commission and ECB; representatives of national resolution authorities of participating countries. In executive session, in addition to the four afore-mentioned members, only those national authorities will be represented where the bank in question is headquartered and, if applicable, where it has subsidiaries and branches.

The Executive Director and the Deputy Executive Director will be appointed by the Council, upon proposal by the Commission and after a hearing in the EP. The Executive and Deputy Executive Director can be removed by the Council, upon proposal by the Commission and after hearing the EP, in the case of gross negligence.

The terms of office for the Executive Director, the Deputy Executive Director, and the representatives nominated by European Commission and ECB are five years and non-renewable. To ensure continuity in leadership, the term of office of the first Deputy Executive Director will be three years only, and will, exceptionally, be renewable.

Voting: In plenary, there will be simple majority voting; except for decisions on voluntary borrowing between the Resolution Fund and resolution funds of non-participating members states. In executive session, simple majority voting will apply, too, one vote for home authority and one vote collectively for host authorities, equally divided by the number of them. There will be no veto rights.

Budget and personnel: The Board is to have some 300 employees (240 of them in permanent positions) and an annual budget of around EUR 65 m. It will be financed by levies on the institutions supervised.

Seat: The Board is to be located in Brussels.

Initial reactions to the SRM proposal

While the SRM proposal is supported by supra-national institutions such as the ECB and the IMF, the reaction by European governments has been more muted, if not highly critical. The German government has been particularly vocal in its criticism, citing three legal (sic!) objections. (i) It objects to the proposal to have the European Commission have the last word on the closure of a bank arguing that this constitutes an incommensurate transfer of power to the EU level not covered by the legal basis chosen (viz. Art. 114 TFEU); (ii) it is concerned about potential liabilities to national budgets under the SRM and calls for much stronger budget protection to be given to participating member states, and (iii) it questions the legality of levying bank levies at the EU level. To be fair, it should be noted that the German government does not (and never has) rejected the idea of the SRM in principle, but only argues that such a pan-European regime, as proposed by the Commission, would not be possible under the existing Treaty. In fact, in formulating its opposition, Germany explicitly accepts the need for Treaty change as well as the need for timely interim arrangements.[30]

The German position, which is presumably shared by several, if not many member states, reflects two fundamental issues that have plagued the Banking Union project right from the start: (i) Opposition to ceding power to the

[30] Having said this, the German position on this point is actually slightly inconsistent: while it makes the point that the envisaged transfer of power to the SRM requires a Treaty change, it, at the same time, calls for a Treaty change on the basis of the simplified procedure only (i.e. without the need for having the revised Treaty be endorsed by national parliaments and / or referenda). However, the simplified procedure is only available for changes to the Treaty that do not alter the balance of power between the EU level and the national level – but, according to the German government, the SRM does change that balance, which is why it calls for a Treaty change in the first place.

Commission (or indeed any other central resolution authority) plays out against the background of a wider dispute about the right balance between supra-nationalism and inter-governmentalism as the governance model for the EU. (Of course, in the case of opposing the SRM this is somewhat illogical given the fact that the SSM already agreed upon constitutes, by definition, a major step towards supra-nationalism and that, logically, member states, once they have decided on this step should have an interest in establishing viable structures.) (ii) Similarly, insistence on full control over national budget reflects domestic policy pressures, constitutional limits and a general reluctance to commit national funds – whether fiscal or semi-fiscal such as in resolution funds and DGS – to the EU level. Behind this lies the fact that many policymakers, not only, but especially in Germany, have never really accepted the logical connection between pan-European supervision and pan-European resolution. While the German government called for the former – in order to gain control over countries with banking sector problems requiring EU assistance – it simultaneously wants to ensure that member states hold the purse strings on resolution – evidently ignoring the fact that supervision cannot be credible without credible resolution powers that are backed by appropriate financial arrangements. While being inconsistent as a position, these two issues confirm a pattern seen frequently in recent times, i.e. that when crisis decisions create actual or contingent liabilities for national taxpayers, then European governments and national parliaments will assert their prerogatives over EU institutions.

Assessment

The Commission's SRM proposal is logical and sound: As mentioned before, single supervision cannot work without an effective resolution authority[31] that has sufficient financial tools and means at its disposal. To avoid moral hazard, pan-European supervision by the ECB requires that resolution is also at the EU level – and at the same time, a credible pan-European resolution mechanism requires pan-European funding to break the bank-sovereign nexus and disruptive capital flows in times of tension. Against this background, member states' lukewarm reaction to the Commission's proposals is more than regrettable.

Admittedly, critics have a point that the legal basis for the SRM proposal is rather weak – though the same critics ignore that the Commission was forced to choose this basis because member states did not want to consider a Treaty change.[32] (It is safe to assume that nobody would have voluntarily designed an unwieldy structure such as the Board of Resolution, if a simpler design had been available!) As a consequence, the Commission bases its proposal on Art. 114 TFEU, designed to protect the Single Market, arguing that the SRM would remove the competitive disadvantage that banks in SSM-participating countries would have vis-à-vis non-participating member states, due to the lack of an effective, centralised resolution regime. As argued above, effective resolution regimes undoubtedly have an impact on banks' refinancing costs by reducing investor uncertainty. However, it is unclear how quantitatively important this is. Economically, the case for pan-European resolution really ought to and can be built on the fact that pan-European supervision cannot work without an effective resolution regime. As we have long argued, the debate on the SRM and the

[31] This view is shared by the IMF, whose most recent Art IV assessment of the euro area states starkly that "(…) without a strong SRM complementing the SSM, the credibility and effectiveness of the banking union would be jeopardized.", IMF (2013), p.17.

[32] Moreover, it is not without irony that member states, including Germany, were quite happy to establish the SSM based on a doubtful legal basis (Art. 127(6) TFEU) while they now express concern about an equally weak legal basis in the case of the SRM.

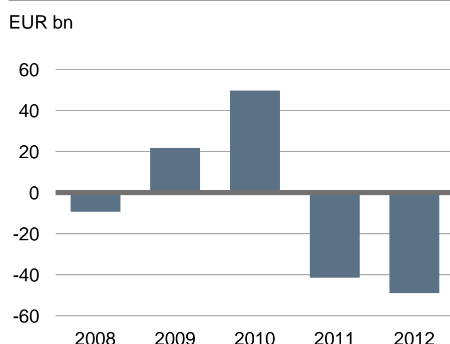
initial reactions to it show that, ultimately, Banking Union requires a Treaty change that opens up the possibility of establishing a pan-European Resolution Authority, including a joint funding mechanism. It would also allow the creation of a pan-European Supervisory Authority, thereby solving all the problems arising from allocation the supervisory task to the ECB (see above for these problems).

Of course, Treaty changes entail difficult processes, and acceptance of Treaty changes is far from certain given the need for parliamentary approval and negative sentiment towards European integration. Moreover, trying to achieve a Treaty change to establish the SRM would open a Pandora's box of requests by member states to include changes of other Treaty provisions, too. However, given that neither the status quo nor the current proposals provide a stable institutional arrangement, this is a risk that needs to be taken.

On the funding issue and the alleged need to safeguard the interest of national taxpayers, the opposition by member states is actually far harder to understand. After all, the entire SRM structure is explicitly built on the principle ("the SRM will be fiscally neutral") that any losses are to be borne by shareholders and creditors and that any state support should only be transitory and be recouped ex post by levies on the banking sector. Hence, to oppose the SRM on the basis of wanting to protect national taxpayers is either illogical or an implicit acknowledgement (of the inconvenient truth) that bail-outs will always be a possibility, if circumstances so require.

After-tax profits of euro-area banks 9

EUR bn



Source: ECB

Looking at the potential impact on the European industry, and leaving aside the impact on funding costs and structures already discussed in the context of the BRRD, the major impact of the SRM will come from the annual contributions to the Fund, scheduled at EUR 5.5 bn p.a. This will have a material impact on banks' profitability; especially in light of the fact that euro area banks collectively suffered a massive loss in 2012. There will also be a competitive effect here, as banks in non-participating member states will not be under an obligation to pay (though they will have to establish national resolution funds according to the rules of the BRRD, where contributions will only amount to 0.8% rather than 1% of covered deposits, though). Incidentally, it is a bit questionable why non-participant banks must not pay into the fund, considering that they, too, benefit from greater stability in the Single European Financial Market. Banks will also be affected by higher expenses for supervision considering that, in future, they will have to pay for the Board of Resolution (planned budget EUR 66 m), the SSM, the EBA (2012 expenditure EUR 18.3m), and their respective national supervisors.

Conclusions

The idea of Banking Union has a sound economic rationale and would, if it were implemented in a consistent fashion, substantially strengthen financial stability in Europe and in the euro area in particular.

However, while sound in theory, the implementation is flawed and Banking Union is therefore likely to disappoint many expectations. The design and implementation of the EU Banking Union and its constituent components suffer from two very fundamental contradictions. On the one hand, there is schizophrenic attitude of member states with regard to the necessary degree of supra-nationality to preserve a financially stable internal market for financial services. And on the other, there are the contrasting expectations and motives of member states with regard to Banking Union.

As to the former, member states are apparently unwilling to draw the logical conclusions from the impossible trinity: they neither want to completely forego the benefits of integrated financial markets (or at least they do not want to be

seen as openly undermining the holy principle of the Common Market as the economic foundation of the EU) and condone market refragmentation, nor do they want to truly transfer power over their national financial markets and financial institutions to the EU level. Clearly, this contradiction cannot be sustained forever.

As regards the latter, there have been differing motives for Banking Union: while some member states have seen Banking Union as a cheap option to clean up their ailing banking systems without losing sovereignty over financial supervision, others see Banking Union as one lever to control the economic behaviour of deficit countries and as part of the preventive framework. Or put differently, the debate on Banking Union is an unhealthy mixture of short-term objectives (i.e. dealing with an ailing EU banking sector) and medium-term objectives (i.e. putting EMU on a sounder footing for the future). To the extent that the latter view prevails – which is likely to be the case as creditor countries have greater leverage in the negotiations – it is unsurprising that there is no progress on supra-national mechanisms for crisis management and little or no coverage of “legacy assets” under the possibility of direct ESM recaps. Put differently, the design of Banking Union will be negatively affected by unclear objectives and Banking Union as it is now being implemented may help to prevent the next banking crisis, but it will not help in dealing with the current one.

Member states and other European law makers still have the chance to put Banking Union on a sound footing. The chance should not be wasted.

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