The new EU bank resolution framework: Will it work?

TOPIC: Europe
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Major progress toward banking union was achieved with the April 15 adoption of three key texts by the European Parliament. The agreement goes a long way towards breaking the link between undercapitalized banks and over-indebted sovereigns, which cost taxpayers hundreds of billions of euro and deepened the Euro-area debt crisis.1 The three texts are interconnected:

First, the Bank Recovery and Resolution Directive (BRRD) is the single rulebook for the resolution of EU banks and large investment firms. It harmonizes and upgrades the tools for dealing with bank crises across the EU. Banks will be required to prepare recovery plans to overcome financial distress, while authorities will lay out plans to resolve failed banks in a way that avoids taxpayer bailouts. The Single Resolution authority is equipped with comprehensive powers and tools to restructure failing banks, allocating losses to shareholders and creditors according to a clear pecking order.

Second, focusing on the Euro area, the Single Resolution Mechanism (SRM) Regulation is a necessary complement to the Single Supervisory Mechanism (SSM), which will take effect when the European Central Bank (ECB) takes over the supervision of systemic banks in the Euro area in November 2014. The SRM will ensure that if a bank faces serious difficulties, its resolution can be managed efficiently with minimal costs to taxpayers.

The SRM will apply to all banks in the Euro area and any other member states that opt to participate. A Single Resolution Fund (SRF) will be set up with contributions from banks in the participating member states. The Fund has a target level of €55 billion, to be reached over eight years, and can borrow from the markets if its governing board so decides. During the transition the fund will comprise national compartments that will be progressively mutualized, with 40 percent of the funds available to all participating countries from the first year.

Third, the European Parliament also adopted a Directive on Deposit Guarantee Schemes (DGSs) aimed at harmonizing EU rules on deposit protection, including coverage and pay-out arrangements. With pre-funded guarantee schemes in each member state, the directive seeks to ensure that depositors will benefit from a guaranteed coverage of €100,000 in case of bankruptcy, backed by funds to be collected in advance from the banking sector. In case of insufficient ex ante funds, the DGS would collect immediate ex post contributions from the banking sector and, as a last resort, the DGS would have access to loans from public or private sources. The directive should be viewed as just a first step toward common EU deposit insurance since a common backstop is not envisaged.

The SRM broke a deadlock between competing visions of the bank resolution framework proposed by the European Parliament and the European Council last December. At the heart of the disagreement was the fiscal backing that a banking union requires and its distributional implications. The SRM is a clear improvement over last December's European Council proposal because it shortens the period over which the banking union will be fully operational from 10 to eight years and streamlines the decision-making process to address bank failures. It would enter into force on Jan. 1, 2015, if ratified by member states that represent 80 percent of contributions to the SRF. Bail-in and resolution functions would apply in all EU member states from Jan. 1, 2016.

The bail-in tool of the BRRD will enable resolution authorities to write down or convert into equity the claims of a broad range of creditors. This tool will be essential to achieve orderly resolution without exposing taxpayers to losses, while ensuring continuity of critical functions to avoid any disruption in the financial system. The 2013 Cyprus rescue was chaotic because no clear pecking order had been agreed in advance. The order in which creditors, after shareholders, would be affected by a bail-in has now been agreed: subordinated liabilities, unsecured and non-preferred liabilities, and preferred liabilities. Covered deposits up to €100,000 are excluded from bail-in, but the deposit guarantee scheme (DGS) would step in and make a contribution for covered deposits if needed.

Here is where the exemptions begin. In exceptional circumstances, the BRRD allows resolution authorities to exclude or partially exclude other liabilities if: (a) it is not possible to bail them in within a reasonable time; (b) it is strictly necessary to achieve the continuity of critical functions and core business lines; (c) it is strictly necessary to avoid giving rise to widespread contagion; or (d) if bailing them in would cause a destruction of value such that the losses borne by other creditors would be higher than if these liabilities were excluded from the bail-in.

However, in order to avoid having the exemptions abused to shield creditors from losses, the resolution fund cannot be used, as a general rule, to cover any excluded liabilities until an amount of at least 8 percent of the total liabilities of the ailing bank have been bailed in. Beyond this, resolution funds could assume 5 percent of the losses. Public funds could either be provided to give limited backup support to the resolution fund at this point or, in extraordinary circumstances, directly to cover losses after the 5 percent contribution from the resolution fund.

In order to make sure that there are sufficient liabilities to bail in at the point of resolution, the resolution authorities will, in consultation with the supervisors, determine a minimum requirement of eligible liabilities (MREL) and own funds for bail-in for each bank. The MREL will be determined as a percentage of total liabilities with which banks must comply. For most EU banks, the work to determine MREL levels and to develop resolution plans will begin in 2015, when both the BRRD and the SRM regulation will be applicable. However, for the global systemically important banks under the G20/Financial Stability Board's agenda to end the too-big-to-fail problem, preliminary results will be discussed at the FSB's Brisbane summit in November 2014.

The decision-making process to resolve a failing bank has been streamlined, but remains quite complex. In most cases the procedure will start with the ECB notifying that a bank is failing to the Single Resolution Board, the Commission, and the relevant national resolution authorities. The board will then adopt a resolution scheme including the relevant resolution tools and any use of the Single Fund. Before the board adopts its decision, the Commission will assess its compliance with State aid rules.

Only if the Commission significantly modifies the amount of resources drawn from the Fund, or contests the public interest in resolving the bank, would its decision be subject to approval or objection by the Council. If the Council or the Commission object to the resolution scheme, the board would have to amend it.

It remains to be seen whether the decision-making process to resolve a failing bank can be completed over a weekend, and whether it will be subject to political interference. It is also unclear (a) who will fund any capital shortfalls identified by the ECB's asset quality review later this year; (b) whether direct bank recapitalization from the European Stability Mechanism (ESM) would be permitted; and (c) whether the SRF would be allowed to borrow from the market from day one, if needed.

For now, however, these texts complete the legislation underpinning the banking union. The SRF was set up through an intergovernmental agreement, just like the ESM, so member states will retain veto powers over any subsequent changes. The agreement is a compromise between the original German vision of coordinated national resolution schemes and a system with shared euro-area risk from the outset. With Germany unlikely to agree to any further compromises, we should expect the impact of the agreement on bank-sovereign links and fragmentation to appear only gradually over time.

ENDNOTES

1 See "EU Resolution Post-Cyprus", Cayman Financial Review, July 12, 2013.