



Next steps on the road to a European Banking Union

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Banking Union

- **Single supervisory mechanism (legislative work done)**
 - Milestone
 - Will bring significant benefits already on its own
 - But is incomplete
- **Single resolution mechanism**
- **Fiscal burden**
- **Deposit insurance**



The European Council's Agenda (Dec. 2012)

- **Step 1: SSM and Single Rulebook**
 - SSM Regulation + EBA Regulation
 - CRD4/CRR completion so that ECB enforces Single Rulebook
- **Step 2: BRR and DGS Directives; ESM Direct Recap**
 - Creation/harmonization of national resolution frameworks
 - Operational framework for direct bank recapitalizations by ESM
- **Step 3: Single Resolution Mechanism**
 - Legal basis left unclear, but reference to “co-legislators”
- **Step 4: Completion of Banking Union (implicit)**
 - Fully centralized resolution (more than SRM)
 - Deposit Insurance (ECB: “not urgent”, i.e. necessary long term)
 - Requires fiscal policy integration (single backstop) + Treaty change?
- **Agenda may imply “big bang” in Q2 2014**



Bank Resolution

- **An attractive “third way” between two bad outcomes**
 - Insolvency: risk of disorderly impact / contagion
 - Lehman Brothers trauma
 - Bail-out / public guarantees
 - Large non-banks in the US: Bear Stearns, Fannie Mae, Freddie Mac, AIG;
 - Almost all cases in Europe: IKB, HRE, Sachsen LB, WestLB, Fortis / ABN Amro, Dexia, ING, Northern Rock, RBS, HBOS, Irish banks (except latest news on Anglo Irish), Spanish *cajas*, Greek banks, etc.
 - New trend?: Cyprus
- **Framed legally as an administrative (or hybrid) alternative to insolvency**
- **No magic bullet, but successful track record in the US**
 - Administered by the Federal Deposit Insurance Corporation
 - Almost 500 banks closed since 2007 with creditor losses, including Washington Mutual in September 2008 (> \$300bn of assets)



Addressing Banking System Fragility

- **Since 2007, reactive firefighting**
 - “stress tests” have not fully restored trust
 - But scope for improvement:
 - SSM will allow consistent system-wide solvency assessment
 - Policymakers increasingly acknowledge need to impose losses on senior creditors (ECB change of stance around mid-2012)
 - Experience (Spain and elsewhere) makes case for earlier involvement of DG COMP through tightened state aid rules

- **More proactive approach needed before SRM ready**
 - Cost for European growth and employment is too high to wait
 - Only system-wide action can restore trust
 - Precedents: Sweden 1992-93, Japan 2002-03, US Spring 2009
 - Opportunity with transition to SSM
 - Article 27(4) of SSM Regulation paves the way



The Single Resolution Mechanism

- **Should enable substantial financial participation of existing creditors in bank restructurings**
- **High degree of centralization desirable**
 - Bank resolution requires ability to make high-risk decisions very quickly and under intense pressure.
 - Decentralized resolution may harm the effectiveness and credibility of the supervisor and the ECB.
 - Incentive structure in a decentralized resolution system in conflict with burden-sharing among member states.
- **Yet, a fully centralized system may require significant revision of the European treaties**
 - European bank insolvency regime?
 - Link to fiscal or quasi-fiscal resources?
 - Article 114?



Single Resolution Mechanism

- **Tension between:**
 - Need for rapid, centralized decision-making
 - National insolvency and fiscal frameworks
- **Proposal: SRM should have central body but must operate through national resolution frameworks**
 - Not ECB: mandate, independence/power, geographical perimeter
 - Not ESM: governance, judicial review, conflicted incentives, geography
 - European Commission
 - or new body
 - Operation through national resolution frameworks

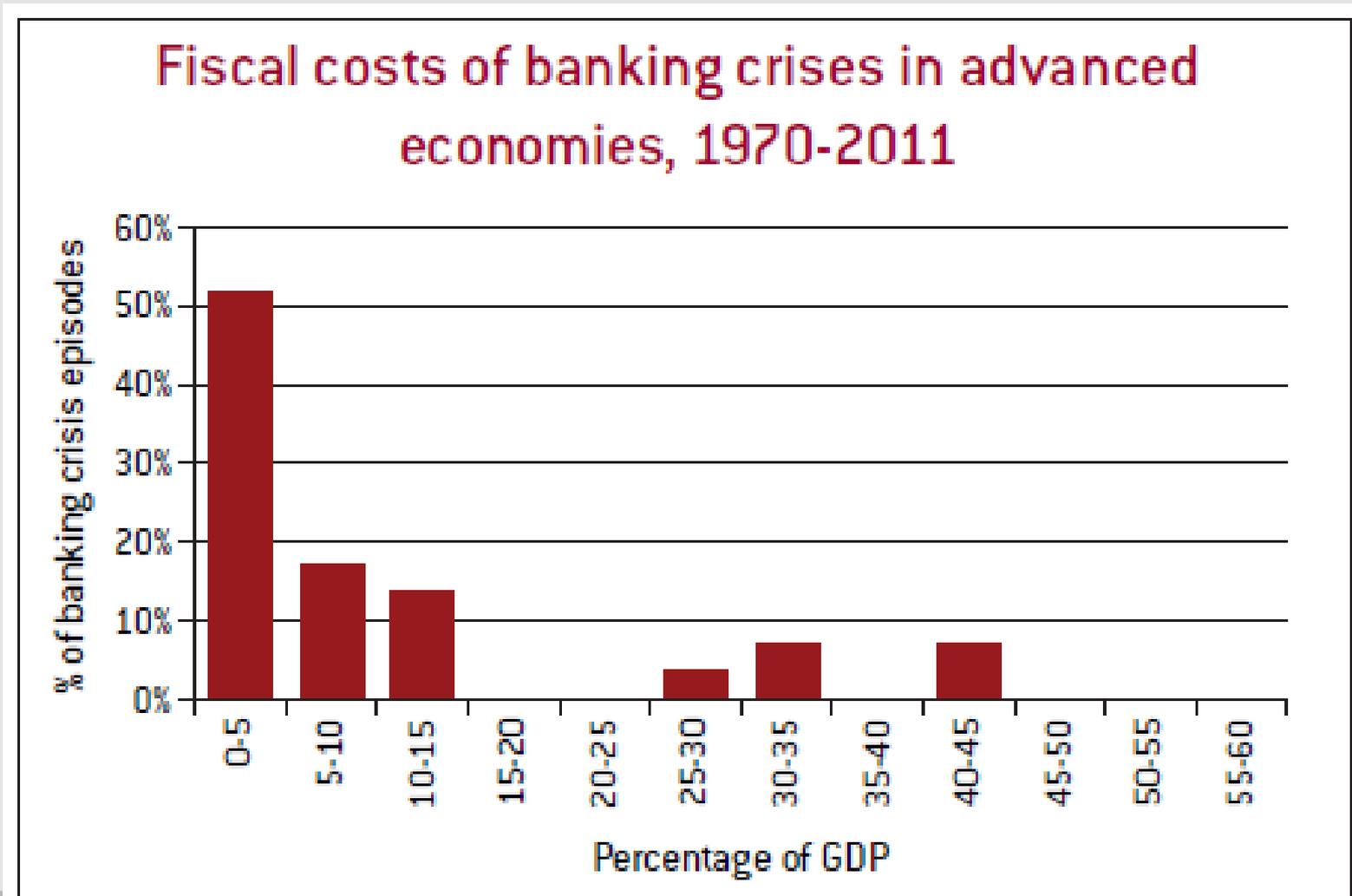


Creditor involvement

- **What to learn from Cyprus?**
- **Legacy costs to be imposed on creditors?**
- **Readiness to afterwards put remaining banks under common backstop?**
- **Readiness to take on unlimited liquidity risk by the ECB?**
- **Fiscal support to ECB risk needed**
- **Confusing debate on bail-in instruments (2015-2018)**



The fiscal issue



Source: Pisani-Ferry and Wolff (2012)



SRM and fiscal resources

- **An industry-funded European resolution fund**
 - Will take time until it has firepower
 - Moral hazard issues
- **ESM resources in future SRM-conducted resolutions.**
 - Good option but ESM not suited to provide guarantees to systemic crisis
- **National funding mechanisms remain important**
 - Reduce moral hazard from economic policies other than banking
- **Agreement on burden sharing of big risks is needed**



ESM Direct Recapitalisation

- **Flexibility needed to address future emergencies**
 - Mix of instruments: common equity / hybrid capital / debt
 - Articulation with recapitalization instruments at national level
- **“Legacy Assets”**
 - Impossible to isolate all “legacy risks” from rest of balance sheet
 - Thus not clear how “definition of legacy assets” is going to help
- **Risk-sharing not loss-sharing?**
 - ESM should intervene at arm’s length in banks that have until then been under exclusive control of national authorities
 - Concessional intervention only national in such circumstances
- **Risk-sharing after big-bang?**



Deposit insurance

- **Common deposit guarantees will be necessary and final building block of BU (Dijsselbloem, May 7 2013)**
- **Considerable political resistance despite relatively small paid-in funds**
- **Depending on depositor preferences more or less necessary**
- **Depositor preference: distinguish short-term desirability with long-term changes in funding structure**
- **Potential solution: insured depositor preference**



Big bang scenario

- **Full-blown asset quality review by ECB before SSM comes in place**
- **Undercapitalised banks need to raise capital or be resolved/recapitalised nationally**
- **Large part of burden on bank creditors**
- **After this big bang, all banks that come under SSM also fall under SRM, which has combination of ESM and national resources as backstop**
- **Clear burden sharing agreement for risks beyond**



Thank you

**Large parts of the presentation are based on
Véron and Wolff (2013), From supervision to resolution,
Bruegel Policy Contribution**



Recommendations to Legislators for 2013

- **SSM Regulation**
 - EP right of consent for Chair, VC and 2 members of Superv. Board
- **EBA Regulation**
 - No changes recommended; await 2014 review
- **CRR/CRD4**
 - Correct non-compliance with Basel III (cf BCBS Report Oct 2012)
- **BRR Directive**
 - Empower imposition of losses on existing senior unsecured debt
- **BRR and DGS Directives**
 - Abandon impractical concept of binding mutual lending arrangements
- **Liikanen Report / Bank Structure**
 - Delay major changes until shape of SRM / banking union is decided