Background

Background note on banking union and bank common rules

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The last plenary session of this legislature will see votes on three key deals to ensure that banks themselves, and not taxpayers, are first in line to pay the costs of their misfortunes. On Tuesday MEPs will vote to approve two laws dealing with restructuring and winding up troubled banks and an update to the scheme which guarantees deposits under €100,000. This note details these three pieces of legislation, which together move the EU many steps closer to completing banking union.

Yet at the same time, in recent months Parliament has also framed other seminal new rules to prevent bank troubles rather than cure them. Key among these were the capital requirements rules and the establishment of a Single Supervisory Mechanism (SSM) for banks, first pillar of the Banking Union. The capital requirement rules - a background note is available here - will ensure that banks are stronger and act more prudently. The single supervisor, led by the European Central Bank, will ensure that banks' problems are spotted and corrected earlier. The - the banking crisis showed that national supervisors often struggled to flag up the problems of their country's banking champions early enough and this greatly aggravated repair costs.

Taken together, these preventive and curative mechanisms should ensure that taxpayers shoulder much less bank risk and that banks, like any other business, may make profits but are also first in line to bear their losses and, in the worst case scenario, can be wound up without risking a general financial meltdown.

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What is going to be voted?

A large part of the banking union plan will be finalised during this plenary session.

Whereas the single supervisory mechanism, the first plank of banking union, has already been finalised, the following draft legislation will be up for a plenary vote in April:

• the Single Resolution Mechanism for banks (SRM), which is the second pillar of the Banking Union. This will establish a European process for determining that a bank (that is part of the SSM) has run into trouble and deciding on steps to resolve its problems. It will also set up a €55bn fund, financed by bank levies, to be used to help resolve bank's problems or wind them up,

• the Bank Recovery and Resolution Directive (BRRD). This establishes a “bail-in hierarchy” whereby a bank's owners (shareholders) and creditors (bondholders and others) are first in line to bear the losses to restore the solvency of the bank. It also establishes national resolution funds, again financed by bank levies for the countries not part of banking union, and

• an update of the Deposit Guarantee Schemes directive (DGS). This sets in stone the guarantee for deposits of up to €100,000. Although this guarantee has been in place since the start of the crisis, it did not have sufficient backing, increasing the risk that taxpayers' money would be required. by national funds or similar arrangements financed through bank levies.

What will the new system change?

It will ensure that banks are stronger, more closely supervised and hence better able to rely on their own collective resources, rather than the taxpayer, to bail them out of trouble.

Banks are essential to a strong economy but when they run into trouble they can destroy it. During the crisis EU countries committed a total of nearly €4.5 trillion and banks soaked up nearly €600 billion (around 6 EU annual budgets) of this public money to stay in business[1]. This unprecedented taxpayer support for an industry was needed because there was no system in place to tackle bank problems.

The crisis showed clearly that it is time to treat banks like any other business. Just as any other business, a bank should take measured risks, provide services, and make profits. But it should also pay for its losses and face the possibility of closure. Until today banks pocketed profits but the risks they ran were often placed on taxpayers' shoulders, since letting a bank fail was considered too risky for the whole financial and economic system. The new systems being put in place through banking union should ensure that banks, not taxpayers, shoulder risks, and pay for losses.

Banking union is also an essential complement to economic and monetary union and a single market. A common currency needs integrated and syncronised economies. This in turn partly depends on banks in all countries playing by the same rules. Banking union will lay down these rules.

[1] IMF Technical note on bank restructuring (2013) - http://www.imf.org/external/pubs/ft/scr/2013/cr1367.pdf and European Commission State Aid Scoreboard (2013) - http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html#tableshttp://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html#tables

How will the new system look?

After the April plenary vote and formal approval by the Council of Ministers, the banking union system will look as follows (please note that this schematic overview omits some minor exceptions and details):

• the ECB bank supervisor will supervise some of the EU largest banks (128 in total) through the SSM. National supervisors will continue to be responsible for the rest, but should take a better-harmonised supervisory approach, thanks to the development of common practices. The ECB may take over direct supervision of any of these banks at any point,

• the banks supervised through the SSM will also come under a single resolution authority, which will be responsible for deciding their fate if they run into trouble. The ECB supervisor will be responsible for sounding the alarm if any of these banks gets into trouble, as the first step in any resolution process,

• national resolution authorities (bodies tasked with winding up/restructuring banks) across the EU will work along similar lines, through a single rule book, thus harmonising responses to bank troubles,

• if a bank in trouble has run up important losses, it will need to place the bulk of these losses on its owners (shareholders) and creditors (bondholders ...) – this is the “bail-in” principle,

• for banking union countries, a single EU resolution fund, financed through bank levies, will be set up and may be used to resolve the affairs any of the contributing banks, once bail-in measures have been applied.

• For non-banking union countries, each will set up a bank-financed fund which could be activated to help in a bank's resolution after bail-in measures have been applied,

• rules are in place to govern how and when public money may be used in the event that this is the best option to prevent problems growing - so-called "preventative recapitalisations" and “government stabilisation tools”,

• banks must draw up contingency plans - so-called “recovery and resolution plans” - together with their respective national authorities which show how potential negative scenarios for the bank would be dealt with. These plans would serva as a basis for any crisis measures, and

• each EU country will set up a bank-financed scheme which would be activated to pay back guaranteed deposits when a bank is not able to do so itself. This scheme could also use resources from the national bank resolution fund, provided that the money tapped from here is used to reimburse depositors.

Please note that this list is not a full portrait of banking union in its final form. Further steps will be needed to complete it. For example, Parliament maintains that a single deposit guarantee system is needed, alongside national ones. Parliament will also be very keen to ensure that rules governing the contributions banks make to the various funds are appropriate.

Building blocks of the Single Resolution Mechanism

The basic elements of the Single resolution mechanism (rapporteur Elisa Ferreira, S&D, PT) are as follows:

• an EU authority will be responsible for deciding what to do with big Eurozone banks that run into trouble. This is important because national prejudice has made it very difficult for a national resolution authority to wind down, restructure, or impose losses on one of the country's champion banks. The ECB bank supervisor will be the main body responsible for determining that a bank is in trouble,

• at the European Parliament's insistence, the decision-making systems have been considerably streamlined, so that a decision on a resolution scheme may effectively be taken within a weekend,

• a single resolution fund will be built up over 8 years, to account for 1% of the covered deposits (around €55 billion). For these 8 years, bank contributions will be paid into "national pots" which will be gradually pooled, so that by year 8 the pots cease to exist and the fund becomes entirely single. The European Parliament ensured that this pooling, or "mutualisation", will be frontloaded, i.e. by year 1, 40% of the contributions will be pooled, and by year 2, 60%. [2] It also increased the fund's ability to borrow, should its firepower need to be increased. Such borrowing would be repaid by the banks,

• The Eureopan Parliament also considerably reduced the scope for political interference, so as to ensure that decisions on the fate of a bank are taken on sound technical grounds. For example, the Resolution Board's plenary session, which due to its composition is prone to national political interference, is to be automatically involved in deciding the fate of a specific bank only if the share of the single resolution fund to be used for its rescue exceeds €5 billion. Although the Board's plenary session – and hence finance ministers - will have broad discretion to determine the overall use of the resolution fund, it will have very little influence over how much money a specific bank is to receive at a given time,

• the Council of Ministers, another source of political interference, will be involved in validating the way in which a troubled bank is to be dealt with (resolution scheme) only at the European Commission's express request, and then only to assess a "public interest criterion" or to approve a greater or lesser use of the fund as proposed by the Commission. Here, too, political influence over specific cases is strictly limited. See here for more information on the decision making process,

• the exact contributions to be paid by the participating banks, including the extent to which those with riskier activities will contribute more, will be decided through two separate vehicles: a Commission delegated act and a Council implementing act.

Why did the single resolution system prove so controversial?

The starting positions of the European Parliament and the Council of Ministers differed markedly, especially with regard to the system's scope, decision-making methods (direct involvement of finance ministries, voting rules within the Resolution Board, and division of tasks between its executive and plenary sessions), rules on transferring bank contributions to the single resolution fund and the Council's insistence on the need for an intergovernmental agreement dealing with the gradual creation of the single resolution fund.

The European Central Bank, many economists, and even banks themselves made it amply clear that the position defended by key finance ministers was unsound, would prove unworkable and would jeoperdise the whole banking union project.

Parliament insisted that it would not sign up to the position defended by Council since it would undermine the most basic goals of single bank resolution: the system would be too weak to deal with large banks and taxpayers would have to foot the bills.

Is the fund not too small?

When assessing whether the single resolution fund might be too small, it is important to consider the wider picture, including the facts that:

• banks will be safer due to the new capital requirement rules,

• banks will also be required to have plans set up to deal with a crisis when they hit one. This should ensure much more timely action and therefore less costly crisis resolution actions

• “bail-in” measures will have to be applied, possibly wiping out up to 8% of a bank’s liabilities to cover losses, before recourse can be had to any outside funds,

• if the fund’s resources are used up, the rules provide for the possibility of levying “ex-post” contributions from banks, in addition to their regular ones, so as to refill the fund to its target level, and

• the fund would be able to tap the markets temporarily to increase its firepower. Such loans would be repaid by the banks themselves.

[2] The process regulating the 8 year transitional period is regulated in a separate intergovernmental agreement.

Building blocks of the Bank Recovery and Resolution Directive

The basic elements of the Bank recovery and resolution directive (rapporteur Gunnar Hokmark, EPP, SV) are as follows:

- it creates the so-called “bail-in” principle which requires that first a bank's own money must be used to deal with its problems rather than outside money (resolution funds and eventually public money). Bail-in establishes a hierarchy providing which parties involved with a bank will be called on first to mop up the bank’s losses – the first target are the shareholders, followed by the bondholders. This would mean that the bank's shareholders and bondholders would take a big hit before other loss absorbing methods can be considered (including outside funds),

- in non-banking union countries it requires banks to finance a resolution fund in the country where they are established. This fund could be called upon *after* the bail-in system has been activated for up to 8% of the bank's total liabilities

- it lays down strict rules on how and when public money may be used to shore up a bank, e.g. using a “government stabilisation tool” or “precautionary recapitalisation”.

Examples of how bail-in would work (based on a calculation of 8% of each bank's total liabilities).

Barclays: would need to bail-in up to a maximum of €142 billion in liabilities.

Santander: would need to bail-in up to a maximum of €102 billion in liabilities.

Societe Generale: would need to bail-in up to a maximum of €100 billion in liabilities.

ING: would need to bail-in up to a maximum of €93 billion in liabilities.

UniCredit: would need to bail-in up to a maximum of €74 billion in liabilities.

Building blocks of the update to the Deposit Guarantee Scheme Directive

The basic elements of the update to the deposit guarantee scheme (rapporteur Peter Simon, S&D, DE) are as follows:

- banks are required to finance national deposit guarantee schemes which will be called on to guarantee deposits up to €100,000,

- unlike the previous system, this will ensure that there are sufficient funds to guarantee deposits, not leaving governments (i.e. taxpayer money),) exposed

- at the European Parliament's insistence, 'temporary large balances' in deposit accounts will also be guaranteedguaranteed - i.e. if you have just sold a house and have € 200,000 on your account for a short time, the whole amount will be protected, and

- also at the European Parliament's insistence, depositors should have the guaranteed part of their deposit reimbursed quickly, i.e. within 7 working days, and even sooner to receive a small amount of funds for basic living expenses.

Building blocks of the Single Supervisory Mechanism (legislative process already finalised in September)

The basic elements of the Single Supervisory Mechanism (rapporteurs Marianne Thyssen, EPP, BE and Sven Giegold, Greens, DE) are as follows:

• creates an EU supervisor for banks within the ECB which will supervise 128 large (mostly Eurozone) banks. This is important because national prejudice has made it very difficult for a national bank supervisor to effectively supervise one of the country's champion banks, In a more integrated EU banking market brought about by banking union, an overarching supervisor is also useful since it will benefit from a more holistic view

• it establishes a more uniform culture of bank supervision so as to ensure equal treatment of banks, while upholding the diversity of the EU banking sector,

• at the European Parliament’s insistence, the bank supervisor will have to meet strong transparency and accountability requirements. National parliaments will also have a bigger role than initially forseen, and

• it ensures the European Banking Authority gets the information it needs to carry out good stress tests. Previous stress tests lacked credibility because banks were able to hide too much from the EBA.

Key dates

November 2014	ECB supervisor takes over direct supervision of 128 banks around the EU and oversight of 6,000 or so other banks
January 2015	Bank recovery and resolution system begins to apply, except for “bail-in” provisions.
January 2015	Provisions setting up the single resolution board take effect
Approximately May/June 2015 (depending on publication in OJ)	Updated deposit guarantee system begins to apply
January 2016	Bank Recovery and Resolution Directive “bail-in” system begins to apply
January 2016	Provisions for setting up the single resolution fund take effect
May 2016	Final elements (details on bank contributions and payout deadlines for guaranteed deposits) of the updated Deposit Guarantee Scheme begin to apply in those countries which opted for a slower pace
2024 (after 8 years from start)	Single resolution fund fully capitalised (around €55 billion)
2025 (after 10 years from start)	National deposit guarantee fund fully capitalised (around €44 billion for all funds)
2025 (after 10 years from start)	National bank recovery and resolution funds (for non-banking union countries) fully capitalised - period can be extended by 4 years if a fund has made a considerable disbursement during this 10 year run-in period