



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **A**  
ECONOMIC AND SCIENTIFIC POLICY



**Economic and Monetary Affairs**

Employment and Social Affairs

Environment, Public Health and Food Safety

Industry, Research and Energy

Internal Market and Consumer Protection

## Banking Union: The Single Resolution Mechanism

### Monetary Dialogue February 2013

COMPILATION OF NOTES





**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Banking Union: The Single Resolution Mechanism**

**Monetary Dialogue 18 February 2013**

**COMPILATION OF NOTES**

## **Abstract**

A Single Resolution Mechanism (SRM) is one of the main pillars of the Banking Union project. The notes in this compilation examine options for a possible future design of a SRM in more detail and put this mechanism into a broader context.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

## **AUTHORS**

Nicolas VÉRON, Senior Fellow at Bruegel, Visiting Fellow at the Peterson Institute for International Economics (Washington DC)  
Guntram B. WOLFF, Deputy Director of Bruegel

Thorsten BECK, Professor of Economics, Tilburg University  
Daniel GROS, Director, Centre for European Policy Studies (CEPS)  
Dirk SCHOENMAKER, Dean, Duisenberg School of Finance (DSF)

Sylvester C.W. EIJJFINGER, Center and EBC, Tilburg University and CEPR with research assistance performed by Louis RAES, Tilburg University

## **RESPONSIBLE ADMINISTRATORS**

Doris KOLASSA  
Rudolf MAIER  
Policy Department A: Economic and Scientific Policy  
European Parliament  
B-1047 Brussels  
E-mail: [poldep-economy-science@ep.europa.eu](mailto:poldep-economy-science@ep.europa.eu)

## **LINGUISTIC VERSIONS**

Original: EN

## **ABOUT THE EDITOR**

To contact the Policy Department or to subscribe to its monthly newsletter please write to:  
[poldep-economy-science@ep.europa.eu](mailto:poldep-economy-science@ep.europa.eu)

Manuscript completed in March 2013.  
Brussels, © European Union, 2013.

This document is available on the internet at:  
<http://www.europarl.europa.eu/studies>

## **DISCLAIMER**

The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the publisher is given prior notice and sent a copy.

## **CONTENTS**

<b>INTRODUCTION</b>	<b>4</b>
<b>1. Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context by Nicolas VÉRON and Guntram B. WOLFF</b>	<b>5</b>
<b>2. On the Design of a Single Resolution Mechanism by Thorsten BECK, Daniel GROS and Dirk SCHOENMAKER</b>	<b>29</b>
<b>3. Single Resolution Mechanism by Sylvester C.W. EIJJFINGER</b>	<b>45</b>

## INTRODUCTION

The European Commission outlined in mid-2012 the concept of a '**Banking Union**' as a major building block for the overhaul and deepening of the Economic and Monetary Union.<sup>1</sup> On 12 September 2012 the Commission published a communication entitled '*A Roadmap towards a Banking Union*'<sup>2</sup> outlining major elements e.g. a Single Rulebook; a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). The Commission's communication '*A blueprint for a deep and genuine economic and monetary union - Launching a European Debate*'<sup>3</sup> of 30 November 2012 outlined the main features of a SRM.

In December 2012 the European Council agreed on a '*Roadmap for the completion of the Economic and Monetary Union*'<sup>4</sup> which envisaged the establishment of a SRM in addition to the adoption of the Commission's proposals for a Single Supervisory Mechanism<sup>5</sup> and new rules on Recovery and Resolution<sup>6</sup> as well as on Deposit Guarantee Schemes.<sup>7</sup> The European Council Conclusions underline the need for a SRM in the following way:

*'In a context where bank supervision is effectively moved to a single supervisory mechanism, a single resolution mechanism will be required, with the necessary powers to ensure that any bank in participating Member States can be resolved with the appropriate tools. [...] The Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM, to be examined by the co-legislators as a matter of priority with the intention of adopting it during the **current parliamentary cycle**. It should safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises. The single resolution mechanism should be based on contributions by the financial sector itself and include appropriate and effective backstop arrangements. This backstop should be fiscally neutral over the medium term, by ensuring that public assistance is recouped by means of ex post levies on the financial industry.'*<sup>8</sup>

On 17 December 2012, ECB President Draghi stated before the ECON Committee:

*'The second priority for 2013 from the ECB's perspective is the completion of financial union with the establishment of a single resolution mechanism. The aim of resolution is to deal with non-viable banks through measures that include their orderly winding down and closure while preserving financial stability. Such a mechanism will make it possible for banks to fail in an orderly manner.'*<sup>9</sup>

The three notes in this compilation describe various options for a Single Resolution Mechanism (SRM) in more detail and put the mechanism into a broader context.

---

<sup>1</sup> MEMO/12/478; [http://europa.eu/rapid/press-release\\_MEMO-12-478\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-12-478_en.htm?locale=en).

<sup>2</sup> COM (2012) 510 final; [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-510\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf).

<sup>3</sup> COM(2012) 777 final/2, Section 3.1.3 A Single Resolution Mechanism: [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/11/pdf/blueprint\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf).

<sup>4</sup> [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134353.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf).

<sup>5</sup> The Commission proposals for a single supervisory mechanism can be found on the following webpage: [http://ec.europa.eu/internal\\_market/finances/banking-union/index\\_en.htm](http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm).

<sup>6</sup> [http://ec.europa.eu/internal\\_market/bank/docs/crisis-management/2012\\_eu\\_framework/COM\\_2012\\_280\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf).

<sup>7</sup> [http://ec.europa.eu/governance/impact/ia\\_carried\\_out/docs/ia\\_2010/com\\_2010\\_0368\\_en.pdf](http://ec.europa.eu/governance/impact/ia_carried_out/docs/ia_2010/com_2010_0368_en.pdf)

<sup>8</sup> [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134353.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf).

<sup>9</sup> See webstream <http://www.europarl.europa.eu/ep-live/de/committees/video?event=20121217-1530-COMMITTEE-ECON> (agenda point 4.) and <https://www.ecb.int/press/key/date/2012/html/sp121217.en.html>.



**DIRECTORATE GENERAL FOR INTERNAL POLICIES  
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context**

**Nicolas VÉRON and Guntram B. WOLFF**

## **NOTE**

### **Abstract**

The European Council has outlined the creation of a Single Resolution Mechanism (SRM) complementing the Single Supervisory Mechanism. The thinking on the legal basis, design and missions of the SRM is still at an early stage and depends on important other initiatives, including the European Stability Mechanism's involvement in direct bank recapitalisations and the Bank Recovery and Resolution (BRR) Directive. The SRM should also not be seen as the final step creating Europe's future banking union.

Both the BRR Directive and the SRM should be designed to enable substantial financial participation of existing creditors in future bank restructurings. To be effective, the SRM should empower a central body. However, in the absence of Treaty change and of further fiscal integration, SRM decisions will need to be implemented through national resolution regimes. The central body of the SRM should be either the European Commission, or a new authority.

This legislative effort should not be taken as an excuse to delay decisive action on the management and resolution of the current European banking fragility, which imposes a major drag on Europe's growth and employment.

## **CONTENTS**

<b>EXECUTIVE SUMMARY</b>	<b>7</b>
<b>INTRODUCTION</b>	<b>8</b>
<b>1. THE COUNCIL DECISIONS OF MID-DECEMBER 2012: A FOUR STEP APPROACH</b>	<b>10</b>
1.1. Step 1: Integrated supervision	10
1.2. Step 2: Coordinated framework for bank resolution	10
1.3. Step 3: Single Resolution Mechanism (SRM)	11
1.4. Step 4: Completion of the banking union beyond the SRM	11
1.5. Banking structure	11
<b>2. POLICY OBJECTIVES AND SEQUENCING</b>	<b>12</b>
2.1. Short-term objective: Addressing Europe's banking system fragility	12
2.2. Long-term: Complete banking union within Europe's "fourfold union"	13
2.3. Likely sequence of implementation of the December 2012 conclusions of the European Council	14
2.4. Implications for the timing of proactive banking crisis management	16
<b>3. OPTIONS FOR THE FORTHCOMING LEGISLATIVE AGENDA</b>	<b>17</b>
3.1. Step 1: EBA and SSM Regulations, CRR and CRD4	17
3.2. Step 2: BRR and DGS Directives, operational framework for ESM Direct Recapitalisations	18
3.3. Step 3: The Single Resolution Mechanism	19
3.4. Banking structure	22
<b>4. CONCLUSION</b>	<b>23</b>
<b>REFERENCES</b>	<b>24</b>
<b>APPENDIX: RULES FOR STATE AID TO THE FINANCIAL SECTOR</b>	<b>27</b>



## EXECUTIVE SUMMARY

Special resolution regimes for banks and systemically important financial institutions are an attractive alternative to both insolvency and public bailouts, and have a compelling track record. The European Council meeting of 14 December 2012 has outlined a policy sequence that we interpret as three successive steps including the Single Supervisory Mechanism (SSM) with the European Central Bank (ECB) at its core; the Bank Recovery and Resolution (BRR) Directive and the operational framework for direct recapitalisations by the European Stability Mechanism (ESM); and the Single Resolution Mechanism (SRM). We also identify an implicit fourth step of completing a sustainable banking union, which unlike the first three will require treaty changes and deeper fiscal and political integration, and may include a European insolvency regime, a European resolution regime, and a more integrated fiscal and deposit insurance framework supported by enhanced democratic accountability.

Implementing this sequence will involve a complex balancing of short-term, medium-term and long-term objectives. The creation of the SRM will be a key milestone and should take place as early as possible, not least to forestall risks to the credibility of the SSM and of the ECB in its absence. Nevertheless, some of these objectives should be addressed even before, and others cannot be met until a later stage. In the very short-term (2013 / early 2014), proactive initiatives (involving system-wide bank balance sheet assessments, state aid control, imposition of losses on creditors of failed banks and proportionate involvement of the ESM in bank recapitalisations) should be deployed to reverse the gradual 'zombification' of Europe's banking system.

We make a number of recommendations for the three steps explicitly outlined in the European Council conclusions, including:

- Granting the European Parliament a right of consent over the appointment process of the Chair, Vice-Chair and two other members of the supervisory board of the SSM;
- Finalising the Capital Requirements Regulation by removing its elements of material non-compliance with the international Basel III Accord;
- Finalising the BRR Directive with enhanced discretion for national authorities to take prompt corrective action on weak banks and impose losses on creditors in bank restructurings;
- Abandoning the provisions for binding mutual lending arrangements among national funds in both the BRR and DGS Directive;
- Finalising an operational framework for direct recapitalisations by the ESM while leaving it substantial discretion for future intervention, including the assumption of some risks (but not of losses or near-certain losses) incurred under past supervision by national authorities;
- Creating the SRM with a central body at its core, either within the European Commission, with appropriate governance design to ensure sufficient independence, or as a new temporary or permanent organization;
- Empowering the SRM to make binding decisions that are implemented through national resolution regimes;
- Creating mechanisms to mobilise an adequate mix of national and European financial resources to the extent needed for the implementation of SRM decisions;
- Delaying radical decisions on banking structure regulation, at both the national and the European levels, until after the creation of the SRM.

## INTRODUCTION

### *European banking union*

The European Council meeting of 28-29 June 2012 marked the starting point of an ambitious project to create a **European banking union** as part of a collective European effort to resolve the current crisis and build a more resilient policy infrastructure for Europe's financial system (European Council, 2012a). The first step will be the creation of the Single Supervisory Mechanism (SSM), now being finalised following an agreement at the Economic and Financial Affairs Council meeting of 13 December 2012 (ECOFIN, 2012). In its subsequent meeting on 14 December 2012, the European Council outlined a tentative vision for the next steps towards the aim of creating a banking union, which will involve significant legislative work alongside other policy initiatives (European Council, 2012b).

The aim of this note, prepared in anticipation of the Monetary Dialogue session of 18 February 2013, is to help clarify key policy options for these next steps, including the possible objectives and timetable for the creation of a Single Resolution Mechanism (SRM). At this early stage, the SRM agenda cannot be considered in isolation from other pieces of the legislative jigsaw. Therefore this note puts particular emphasis on challenges of sequencing, coordination, and identification of respective responsibilities among different processes and actors.

### *Bank resolution*

"*Bank resolution*" refers to specific legal regimes for the orderly restructuring and/or liquidation of certain financial institutions. For such institutions, the general-purpose insolvency process can be unsuited given their importance for the economy, the existence of systemic risk and the possibility of contagion that is specific to financial activities including banking. The experience of past crises has convincingly demonstrated both the unsuitability of insolvency processes for such financial institutions, at least in some situations and given the delays and uncertainties associated with insolvency courts, and the ability of well-designed special resolution regimes for banks to enable an orderly process that safeguards the interests of the public.

Much of this experience comes from the US, where a special resolution regime for banks was introduced decades ago and reformed following the Savings and Loan (S&L) crisis of the 1980s, in contrast to most European countries which had not introduced special resolution legislation until the current crisis<sup>1</sup>. The US resolution regime for banks is administered by the Federal Deposit Insurance Corporation (FDIC), a federal agency created in 1933 and headquartered in Washington DC. In the recent crisis it has operated reasonably well, as the FDIC has overseen the resolution of close to 500 banks, including very large ones at times of systemic instability such as Washington Mutual (which had more than USD 300 billion in assets) in late September 2008, without large-scale disruption in spite of significant losses imposed on creditors including senior unsecured ones. The Dodd-Frank Act of 2010 has extended the resolution authority of the FDIC to systemically important non-bank financial institutions, a category that would have included firms that were judged "*too-big-to-fail*" and were bailed out in 2008 (Bear Stearns, Fannie Mae, Freddie Mac, AIG, and GMAC) as well as Lehman Brothers. In April 2011, the FDIC published an analysis that suggests that, had the Dodd-Frank Act been in place in

---

<sup>1</sup> The Winding-up Directive (2001/24/EC) is about cross-border coordination of insolvency processes, but does not introduce special resolution regimes as alternatives to insolvency.

September 2008, it would have been possible to resolve Lehman Brothers in an orderly manner, as was the case for depositary banks (FDIC, 2011).

A bank resolution regime should not be seen as a magic bullet that would as of itself put an end to moral hazard and systemic risk. There are cases of fairly effective resolution of a systemic banking crisis without a prior resolution regime in place for crisis, such as in Sweden in the early 1990s. Conversely, a country may have introduced a special resolution regime in its legislation but fail to use it when appropriate, or use it in a manner that does not avoid systemic contagion. Even with well-designed processes to impose losses on creditors, a resolution regime cannot guarantee that no use of public money will ever be necessary, especially in very severe crisis scenarios. A number of EU Member States have passed legislation that creates special bank resolution regimes since 2007, but most of these remain essentially untested yet. International coordination is recent in this area of banking policy, and has met a significant milestone with the first-time publication by the Financial Stability Board of *"key attributes of effective resolution regimes for financial institutions"* (FSB, 2011). Crucial factors of effectiveness include the speed of the process, which requires carefully designed decision-making processes and very professional management, and its ability to intervene early. As noted by an experienced observer, *"Whatever the mechanism for resolving a bank, the sooner that is done, the less the likely burden that will have to be subsequently met"* (Goodhart, 2012).

In Europe, the difficulty of introducing an effective framework for bank resolution is compounded by a number of specific factors: the EU is in a state of systemic banking fragility and of unusual institutional uncertainty; its financial system is dominated by banks, with a high degree of banking sector concentration in many of its Member States; its insolvency framework is fragmented along national lines, and so is its fiscal framework for most purposes in spite of recent tentative steps towards fiscal integration in the euro area; its policymakers and investors have almost no experience of orderly bank resolution, as most past cases of bank failures have been handled through public bail-outs and/or nationalisations (Goldstein and Véron, 2011).

Conversely, a powerful motivation to create or strengthen effective resolution regimes in Europe is provided by the *"doom loop"* that has developed in the euro area between credit conditions that apply to vulnerable countries as sovereign issuers on the one hand, and to banks included in these countries on the other hand. The reality of this *"doom loop"* or vicious circle is illustrated by the high correlation between credit ratings and credit market indicators between these sovereign and banks (Angeloni and Wolff, 2012), and its acknowledgement has prominently driven policy initiative since at least early 2012. Well-designed resolution regimes hold the promise of both limiting banking sector instability, and minimising the fiscal cost of future bank failures.

## 1. THE COUNCIL DECISIONS OF MID-DECEMBER 2012: A FOUR STEP APPROACH

The European Council Conclusions of 14 December 2012 include dense and somewhat complex content which justifies a detailed analysis. In our analysis, the European Council has defined an approach to the build-up of a European banking union that includes four successive steps, the first three of which are explicitly framed in the European Council Conclusions, and the fourth one kept voluntarily implicit.

### 1.1. Step 1: Integrated supervision

This first step, which the European Council conclusions imply should be completed by March 2013, is centered on the Single Supervisory Mechanism. In addition to the adoption of the Council regulation establishing the SSM (SSM Regulation; Council, 2012), this includes the adoption of the regulation reforming the European Banking Authority (EBA Regulation)<sup>2</sup> to adapt it to the new situation created by the advent of the SSM, as well as the adoption of the Capital Requirements Regulation (CRR)<sup>3</sup> and its complement the fourth Capital Requirements Directive (CRD4)<sup>4</sup>, so that the SSM can implement a harmonised supervisory "rulebook" based on the Basel III accord, instead of the currently applicable (and often divergent) national regulations. The operational build-up of the SSM would follow; actually its initial phase has already started at the ECB with the cooperation of national supervisors.

One important parameter in this build-up phase is the question of which non-euro area Member States will enter "close cooperation arrangements" that would make them participating members of the SSM. While Sweden and the United Kingdom have indicated they did not consider entering such arrangements in the foreseeable future, other non-euro area Member States still have to make a decision. Another significant operational question is the pace of expansion of the ECB's supervisory staff and the specific arrangements it will establish with national supervisors.

### 1.2. Step 2: Coordinated framework for bank resolution

Beyond supervision, the Council identified two initiatives that it wants completed before the end of June 2013. They are:

- First, an "operational framework" for the direct recapitalisation of banks by the ESM, the euro area crisis management fund created in 2012, which is mentioned in connection with the "imperative to break the vicious circle between banks and sovereigns". In the language of the Council conclusion, this document, which is currently under negotiation among Member States, should "include the definition of legacy assets" and "be agreed as soon as possible in the first semester 2013";
- Second, the adoption of two pieces of legislation whose initial proposals predate the June 2012 Council decision to create a banking union: the proposed Bank Recovery and Resolution (BRR) Directive<sup>5</sup>, adopted by the European Commission in early June 2012, which would create or reform national bank resolution regimes along a harmonised pattern in compliance with the Financial Stability Board's recommendations (FSB, 2011), including a provision for the "bail-in" of unsecured bank debt; and the proposed recast of the Deposit Guarantee Schemes (DGS)

---

<sup>2</sup> COM(2012) 512.

<sup>3</sup> COM(2011) 452.

<sup>4</sup> COM(2011) 453.

<sup>5</sup> COM(2012) 280/3.

Directive<sup>6</sup>, adopted by the Commission in July 2010, which would further harmonise national deposit guarantee systems. The Council *"urges the co-legislators to agree"* on these proposals *"before June 2013"*.

### 1.3. Step 3: Single Resolution Mechanism (SRM)

The December 2012 European Council Conclusions states that *"the [European] Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM, to be examined by the co-legislators as a matter of priority with the intention of adopting it during the current parliamentary cycle"*. The SRM should *"safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises"*, and should be based on *"contributions by the financial sector itself and include appropriate and effective backstop arrangements"*. The Commission has announced it would publish a proposal *"before the summer"* of 2013 (Barroso, 2013), and the adoption of the final text is desired in advance of the European elections scheduled in June 2014. Other documents from the Commission and the Council suggest that the SRM proposal will be published only after the adoption of the BRR and DGS Directives (e.g. Van Rompuy, 2012b). The reference to *"co-legislators"* in the European Council conclusions is a hint that the SRM may take the form of a directive and/or regulation of the European Parliament and the Council, but with no indication of the underlying Treaty base.

### 1.4. Step 4: Completion of the banking union beyond the SRM

The December 2012 European Council Conclusions leave implicit the need for any further initiatives beyond the SRM. However, the banking union would remain incomplete and arguably unstable without further integration, particularly in the areas of insolvency, resolution and deposit insurance (Pisani-Ferry et al., 2012). The need for steps beyond the SRM has been obliquely acknowledged by European policymakers, including the acknowledgement by ECB executive board members that further integration of deposit guarantee schemes beyond the DGS Directive will be needed but is not urgent (e.g. Constancio, 2012 and 2013). The European Commission has also referred to the desirability of future Treaty changes to perfect the design of the SSM (European Commission, 2012, 4.3). For the sake of simplicity we bundle all these post-SRM steps into a single fourth step, even though a longer and more complex sequence might also happen, and discuss their possible objectives and content in the next sections.

### 1.5. Banking structure

The reform of banking structures has taken high political prominence in Europe as well as in the US, where the Dodd-Frank Act of 2010 introduces the *"Volcker Rule"* of separation of proprietary trading, even though the implementing regulations are still being discussed by federal agencies. At the level of individual EU Member States, it has given rise to legislative initiatives in the UK, France and Germany. At the EU level, the European Commissioner for the Internal Market and Services has commissioned a report that also recommends a form of structural separation (Liikanen, 2012). The December 2012 European Council Conclusions include the sentence *"The European Council looks forward to the Commission's rapid follow up to the proposals of the high level expert group on the structure of the EU banking sector"*, but do not set a deadline. As a consequence, this issue is on the agenda and may interact with the previously outlined four steps, but when and at which stage exactly remains unspecified.

---

<sup>6</sup> COM(2010) 368.

## 2. POLICY OBJECTIVES AND SEQUENCING

The complexity of the agenda outlined in the previous section justifies a specific focus on the timeline and sequencing, and how it responds to the objectives that policymakers should set themselves, before we move to specific (and non-exhaustive) policy recommendations for the previously identified three steps in the next section.

The EU bank resolution agenda combines short-term and long-term challenges at once: in a nutshell, **resolve the current banking crisis** (which includes the objective of breaking the "*doom loop*", accepted by the European Council as a short-term "*imperative*") in the short-term; and **build a sustainable EU banking policy framework**, or banking union, in the longer term. The combination of short- and long-term aims is well known to be both unavoidable and exceedingly difficult in a context of systemic financial crisis. Too much focus on the short-term challenges can sow the seeds of future disruption. Conversely, excessive focus on the long-term challenges carries the risk of ignoring the urgency of the situation at hand, and the usually high cost of delaying decisive action.

### 2.1. Short-term objective: Addressing Europe's banking system fragility

Europe's banking problem is an essential element of the "*doom loop*" but is also harmful in its own right, in a way that predates the sovereign debt crisis (Posen and Véron, 2009). Unaddressed banking system fragility, often the result of the bias of many policymakers towards supervisory forbearance, results in a vicious cycle of its own in which banks keep extending credit to insolvent borrowers to avoid the pain of recognising losses on non-performing loans (ESRB, 2012). The banks' lending is increasingly absorbed by borrowers who will not repay, while creditworthy new borrowers are starved of credit: while aggregate credit figures may show no evidence of credit contraction, in reality the allocation of credit is increasingly dysfunctional and results in an increasingly severe drag on economic growth, and on employment as a consequence. This perverse spiral has been vividly described as "*zombie banks lending to zombie borrowers*", a metaphor coined in the US S&L crisis (Kane, 1987) and often applied to the Japanese crisis of the 1990s (e.g. Caballero et al., 2008). Sadly, the same pattern is increasingly recognisable throughout Europe.

The European banking system has required increasing life support from the ECB and national central banks, including Longer-Term Refinancing Operations (LTROs) programmes with maturities increased from an initial three months to six months (March 2008), one year (June 2009) and eventually three years (December 2011), with the banking fragility then sharply made worse by doubts about the risks of euro exits or breakup and national supervisory actions that curtailed cross-border financial flows. Several coordinated initiatives, such as Europe-wide "*stress tests*" in September 2009, July 2010 and July 2011, and a recapitalisation effort coordinated by the EBA in 2011-12, may have brought marginal improvement but have generally failed to restore normal conditions in the European interbank market following the initial shock of 2007-08. The European Commission's control of state aid has enabled it to act to some degree as an EU-wide coordination mechanism of Member States' responses to banking crises, but has been generally able to intervene only at a late stage and in a reactive manner.

Europe's banking problem has been further compounded by the general willingness of policymakers, particularly in the early years of the crisis, to guarantee all bank creditors and avoid imposing losses to any of them or at least to senior unsecured ones (Goldstein and Véron, 2011). However, European policymakers have gradually woken up to the political and practical unsustainability of this approach as it entails spiralling risk-taking by governments and exacerbates the "*doom loop*" for those countries whose fiscal



sustainability becomes questionable. This realisation has led an increasing number of EU Member States (including in chronological order, Ireland, the UK, Denmark, Spain, and most recently the Netherlands with SNS Reaal) to force subordinated creditors of failing banks to incur losses. For now, however, almost all Member States have stopped short of imposing losses on banks' senior unsecured creditors<sup>7</sup>. This can be attributed partly to general concerns about systemic contagion in the event of "haircuts", especially given the prominent role played by unsecured senior debt in the financing of European banks, and partly to each country's fear of putting "their" banks at a financial disadvantage in a context of pan-European market integration and competition. But the sheer size of the potential contingent cost is increasingly prompting European policy leaders, including at the ECB<sup>8</sup>, to envisage a financial participation of senior unsecured bondholders in future restructurings, in spite of the potential destabilising effects this may entail.

The experience of earlier crises in Europe and elsewhere suggests that the objective of addressing systemic banking fragility and restoring trust can only be achieved through a hands-on, centralised approach of system-wide balance sheet assessment (triage), recapitalisation and restructuring. The creation of the SSM holds the promise of a genuinely consistent triage process, something that the EBA could not achieve as it lacked direct access to bank-level information and supervisory authority of its own. The newfound emphasis on burden-sharing with bank creditors holds the promise of keeping the collective public cost of restructuring at a politically manageable (though probably still high) level, while the prospect of banking union should increase the stability properties of the system as a whole, thereby reducing the financial stability risk emanating from the imposition of losses on senior unsecured bondholders. Finally, the proclaimed aim to break the "doom loop" makes it possible to envisage some sharing of residual public financial burden between national budgets and the European level (Pisani-Ferry and Wolff 2012), with a possible role for the ESM as an instrument of financial risk-sharing.

For all these reasons, the prospects for addressing banking crisis fragility are now better than at any time at least since the start of the euro area sovereign debt crisis in early 2010. The early steps of implementation of the Spanish programme are encouraging in this respect. It involved an initial system-wide stress test followed by speedy triage and restructuring/resolution of banks found undercapitalised, including the imposition of losses on subordinated creditors. This appears to have eased the pressure on the Spanish sovereign, and suggests some broader lessons on how to deal with failing banks, even though it is too early to consider the Spanish banking system restructuring as complete.

## 2.2. Long-term: Complete banking union within Europe's "fourfold union"

The long-term aim, which has gathered remarkable acceptance in Europe's policy community through 2012, is to complete Europe's banking union as part of a broader agenda deemed necessary to ensure the integrity of the single financial market and the sustainability of the euro. A seminal moment in this process was the release of the European Council President's report "Towards a Genuine Economic and Monetary Union" on 26 June 2012 (Van Rompuy, 2012a), which envisaged the eventual crisis resolution agenda as consisting of four "building blocks", now commonly referred to as banking union, fiscal union, economic union, and political union (e.g. Draghi, 2012). The multiple

---

<sup>7</sup> The only relevant exceptions appear to have been Denmark for a brief time in 2011, and Ireland to a limited extent in the recent case of Anglo Irish bank, according to Mary Watkins and Matt Steinglass, "Burden of banking losses poses threat to bondholders", *Financial Times*, 8 February 2013.

<sup>8</sup> Sakari Suoninen, "ECB's Draghi: senior debt burden sharing evolving", *Reuters*, 17 July 2012.

interdependencies among these dimensions of a desired "*fourfold union*" are a helpful way to analyse the unique complexity of Europe's crisis and to understand why it may take so long to be eventually resolved (Véron, 2012).

Among the four, banking union is actually the one that currently draws the largest consensus in terms of definition (Pisani-Ferry & al., 2012; Goyal et al., 2013). By contrast, fiscal union, economic union and political union mean very different things to different people, resulting in a lack of consensus on how close they are to being reached (Vaisse & al., 2013).

An additional source of complexity is the long-term uncertainty about the geographical perimeter of the EU, reinforced by the possibility of an in-or-out referendum in the UK by 2017 (Cameron, 2013), and about whether the boundaries of the four "*unions*" will ultimately coincide with those of the EU, the euro area, or somewhere in between as is likely for the SSM at its launch.

Considered in this light, the eventual completion of banking union is affected by multiple linkages with the other components of the fourfold agenda, among others:

- *Banking union / fiscal union*: even assuming extensive burden-sharing by creditors, there will always remain cases or scenarios in which systemic crisis resolution requires extended access to public money, and the aim to break the "*doom loop*" means that at least some such money must come from the European level (Pisani-Ferry and Wolff, 2012; Wolff, 2012);
- *Banking union / economic union*: certain economic policies, including housing policy, aspects of tax policy, and personal and corporate insolvency legislation, can have significant impact on the accumulation and distribution of risk in the banking system and justify adequate "*macro-prudential*" oversight (Wolff, 2011);
- *Banking union / political union*: bank crisis management and resolution can have widespread economic and social consequences and therefore must be subjected to appropriate mechanisms of political accountability (Véron, 2012).

We view further and significant progress on fiscal union, economic union, and political union as a necessary condition for Europe to eventually resolve its current crisis and find a sustainable footing.

### **2.3. Likely sequence of implementation of the December 2012 conclusions of the European Council**

A literal reading of the December 2012 Council conclusions would suggest that all the initiatives outlined, while negotiated in a clear chronological sequence, could actually become effective at around the same time in the first half of 2014. As for Step 1, the Council's communication of its position on bank supervision (13 December 2012) states that "*The ECB will assume its supervisory tasks within the SSM on 1 March 2014 or 12 months after the entry into force of the legislation [SSM Regulation], whichever is later, subject to operational arrangements*". As for Step 2, the European Council conclusions state that the BRR Directive and DGS Directive "*should be implemented by the Member States as a matter of priority*", which, assuming enactment in June 2013 and a six-to-nine-month national transposition lag, imply effectiveness in the early spring 2014; moreover, the ability of the ESM to recapitalise banks directly is delayed to "*when an effective single supervisory mechanism is established*", i.e. at the same time as the entry into force of Step 1. As for Step 3, the "*intention*" is of adopting the legislation creating the SRM "*during the current [European] parliamentary cycle*", i.e. during the spring of 2014 at the latest. If these intentions were all fulfilled, and assuming that the legislation creating the SRM



(unlike the SSM Regulation) is immediately applicable, then Steps 1, 2 and 3 would all become operational between March and June 2014, amounting to a *"big bang"* transformation of the European policy framework.

However, in the real world the implementation of the three steps is likely to be phased and to give rise to significant transition issues.

- The EBA Regulation, CRR and CRD4 are all in *"trilogue"* phase, and the SSM Regulation is likely to be enacted together with the EBA Regulation. A realistic timeframe for their final adoption is in March or April 2013, but it cannot be ruled out that part of this package may be delayed to May or even June 2013.
- The proposed DGS and especially the BRR Directives raise very complex legal and financial issues, partly but not exclusively linked to the untested nature of the proposed bail-in mechanism. Combined with the possible delay in adopting the *"Step 1"* legislation, this would suggest that their final version is more likely to happen in the third or even the fourth quarter of 2013 than in the second quarter as called for by the European Council.
- Conversely, the wording about the possibility for the ESM to recapitalise banks directly makes it conceivable that this instrument might be mobilised earlier than the assumption by the ECB of its full supervisory authority in 2014, if the euro area leaders so decide. This is unlikely to happen before the German general election of September 2013, but may be implemented in the last quarter of 2013, especially if justified by a situation of emergency.
- The above mentioned idea that the legislative work on the SRM should only start after the BRR Directive has been adopted appears logical from a political standpoint and, if confirmed, would introduce a clear sequence between Step 2 and Step 3. The SRM itself is likely to give rise to unprecedented legal, financial and political questions that may lengthen the time needed for its legislative discussion. The European Council's objective of having the SRM adopted *"during the current parliamentary cycle"* therefore appears ambitious to say the least. The ECON Committee Chair was recently reported as commenting that *"It's unrealistic to expect that we will have a resolution authority or resolution fund [under the SRM] in time for the new ECB bank supervision in March 2014"*<sup>9</sup>.

Transitional considerations will be crucial in this context<sup>10</sup>. Given the sensitivity of banking issues to matters of trust, reputations and expectations, all new arrangements must be fully effective from their very first day of operation. This is inevitably challenging as there is no direct precedent or working model of a supranational banking policy framework. The smooth introduction of the euro in 1999-2002 attests that large-scale unprecedented policy projects can be successful if carefully designed and planned, but the necessities of the crisis impose a compression of the planning and preparation phases that creates important risks as regards both design and execution. Among the concerns:

- The credibility of the ECB during the likely phase when the SSM is up and running and has to operate without the SRM may be endangered, if a situation arises in which the ECB may have to delay supervisory decisions due to the unwillingness or inadequacy of the national resolution system to take appropriate actions.

<sup>9</sup> John O'Donnell and Eva Kuehnen, "Cracks appear in European banking union scheme", *Reuters*, 8 February 2013.

<sup>10</sup> Goyal et al. (2013), which was published just as this note was being finalized, presents a similar analysis of the transition risks.

- Another risk is related to the possibility of wide cross-country differences in resolution practices. Following a supervisory decision of the ECB and in the absence of a clear SRM framework, the concern is that national resolution authorities may undertake resolution action in a way that is harmful to the single financial market.

## 2.4. Implications for the timing of proactive banking crisis management

Given Europe's worrying current growth prospects, the above observations lead us to conclude that Europe's policymakers should not wait until the creation of the SRM before decisively tackling Europe's banking system fragility. This fragility has been with us since 2007, and each month that passes increases the economic, social and political cost of its implications in terms of credit scarcity and misallocation, and ultimately a drag on growth. Even assuming that an operational framework for the ESM to recapitalise banks directly would be in place by mid-2013, the risk is that bank restructuring would happen only in a reactive fire fighting mode, as has been the case so far in most Member States since 2007.

As mentioned above, the entry into operation of the SSM, combined with harmonised bank resolution regimes and a growing acceptance of the need of burden-sharing with senior unsecured creditors, can mark a significant improvement in the quality of Europe's banking policy framework. Thus, a more proactive approach to Europe's banking problem could be adopted without waiting for the eventual implementation of the SRM. It will require, however, a more centralised process for steering a system-wide process of triage, recapitalisation and restructuring (Posen and Véron, 2009). It appears logical in this context to rely on the legal tools as well as the experience accumulated by the European Commission and particularly its Directorate-General for Competition (DG COMP) in the assessment of state aid cases<sup>11</sup>. Here again, the Spanish programme, in which the disbursement of ESM funds was made contingent upon the Commission's approval of bank restructuring plans, appears relevant and offers lessons for Europe as a whole. A revision and tightening of state aid rules (see Appendix) including a systematic ex-ante involvement of DG COMP in cases of individual banking fragility may significantly improve the EU's crisis management in this respect.

One juncture that may foster such a proactive approach is the phase that will immediately precede the assumption of direct supervisory authority by the ECB. Article 27(4) of the proposal for the SSM Regulation, as amended by the Council in December 2012, states that the ECB "*shall carry out*" "*a comprehensive assessment, including a balance-sheet assessment*", of all the banks that will be brought under its direct supervisory authority "*in view of the assumption of its tasks*" (Council, 2012). This assessment could be complemented by a stress test, possibly involving the EBA as well as the ECB. Presumably, those banks that would be found undercapitalised following this system-wide assessment process would be asked to improve their balance sheet and, if unable to do so, be restructured in a process that may involve national authorities as well as possibly the ESM in accordance with its Operational Framework for direct recapitalisations. This sequence, if properly planned and executed, could contribute decisively to the restoration of trust in Europe's banks.

---

<sup>11</sup> An early analysis of the articulation between state aid control and resolution processes is developed in Dewatripont & al. (2010).

### 3. OPTIONS FOR THE FORTHCOMING LEGISLATIVE AGENDA

This Chapter is specifically about the legislative agenda at the EU level<sup>12</sup> and options that need to be considered in this context. Our strongly held impression is that, in spite of the relatively precise language of some sentences of the European Council's Conclusions in December 2012, in fact a number of key questions remain undecided and even partially unexplored, even at the level of general principles. Our expectation is thus that some aspects of the December Conclusions may require adjustments or modifications as their implications gradually become clearer, and we have correspondingly assumed a degree of flexibility in our analysis. Specifically, we are unsure a comprehensive legal analysis has been undertaken and always supports the chosen wording. We expect more clarity on some of these aspects, including legal but also financial and political ones, to emerge in the course of the next weeks and months.

#### 3.1. Step 1: EBA and SSM Regulations, CRR and CRD4

As previously mentioned this step is now close to completion.

The EBA and SSM Regulations form a single package in practice, even though in principle the European Parliament only has a consultative voice in the adoption of the latter. In our opinion, the Parliament should not seek to disrupt the general balance of the compromise found by the Council on 13 December 2012. In particular, significant amendments to the EBA Regulation may endanger the whole outcome of the successful intergovernmental negotiation in 2012 and would risk compromising the significant success that the timely implementation of the SSM would represent for the entire EU. Thus, it is important to avoid a significant delay and aim at enactment of both Regulations in March 2013. Moreover there will be an opportunity to review EBA arrangements soon anyway, as its review is planned for 2014 together with that of the other European Supervisory Authorities and the European Systemic Risk Board.

However, in our view the Parliament should seek stronger accountability of the SSM and specifically its Supervisory Board<sup>13</sup>. We believe there is a strong case for granting the European Parliament a right of consent (or veto) over the appointment of the Chair and Vice Chair of the Supervisory Board, as well as of two of the four members appointed by the ECB (as a compromise between the concerns to preserve a degree of discretion for the ECB while enhancing accountability). This would further strengthen the alignment of the SSM with the European public interest.

The CRR and CRD4 have proven more difficult to finalise than was initially anticipated by many observers. Among other issues, we are concerned by the material non-compliance of the CRR with the international Basel III Accord as regards the definition of capital, in particular as it waters down the requirements on banking groups with insurance operations and allows the counting of so-called "silent participations" as common equity (BCBS, 2012). Even at the current late stage of negotiation, it would be worth considering corresponding changes that would apply at least to large internationally active banks, so that the "single rulebook" that the SSM will start applying in 2014 is in line with an international standard-

<sup>12</sup> It also includes the Operational Framework for ESM direct recapitalisation, which will not be a text of legislation.

<sup>13</sup> This agenda is reinforced by the recent frustrating episode of Executive Board appointment at the ECB, see e.g. John O'Donnell and Robin Emmott, "Mersch takes ECB executive board job despite gender row", *Reuters*, 23 November 2012.

setting process that the EU has long endeavoured to promote and strengthen<sup>14</sup>. We also believe that the finalisation of the CRR and CRD4 in the early spring of 2013 is highly desirable.

### **3.2. Step 2: BRR and DGS Directives, operational framework for ESM Direct Recapitalisations**

The adoption of the proposed Bank Recovery and Resolution Directive is an important and logical prior step to the establishment of the SRM. This is because the SRM will have to work at least partly through national special resolution regimes, as we expose in the next subsection. Thus, priority attention should be devoted to the adoption of the BRR Directive as soon as Step 1 is completed.

While the detailed discussion of this complex text exceeds the scope of this note, we believe that it should mark a clear step towards a much greater ability and readiness to impose losses on banks' creditors including senior unsecured ones. Unless the economic environment dramatically improves and reduces credit risk across the board, this appears to be the only way to chart a path towards crisis resolution and the eventual restoration of trust in the European banking system. As the overall stability of the euro area financial system will be strengthened by the introduction of the SSM, the adverse impact on banks' perceived creditworthiness would be partly mitigated. This suggests two changes from the original Directive proposal. First, depositors should be granted clear preference over senior unsecured bondholders in the hierarchy of banking liabilities: the US experience in particular suggests that depositor preference creates a favourable framework for adequate burden-sharing by senior creditors in bank resolutions. Second, the main emphasis should be on mechanisms that enable the imposition of losses on existing senior creditors to be in place immediately upon transposition of the directive, while the current text puts much focus on "*bail-in*" provisions that are delayed until 2018<sup>15</sup>. The empowerment of authorities to impose losses on holders of existing debt should be as robust as possible<sup>16</sup>.

The proposed recast of the DGS Directive should be examined in a joined-up manner with the BRR Directive. Linkages between the two include the question of depositor preference; the possible participation of deposit guarantee funds in bank resolution; and the quantitative calibration of these funds. However, we are sceptical about the practicality and current relevance of the idea, present in both texts' initial versions, of national (deposit and/or resolution) funds lending to each other. Now that Europe has decisively started to create a banking union, any funding for deposit guarantee and crisis resolution that does not come from national funds in their respective territories should be drawn from pooled European funding sources, including possibly the ESM but not permanently limited to it.

As regards the preparation of the operational framework for direct bank recapitalisations by the ESM, we see it as a potentially useful complement to the involvement of the ESM in national assistance programmes as currently in place. In our assessment, the discussion of this framework among euro area Member States has already been useful as a collective learning process, as we understand a lot of technical work is happening under this heading. We would propose however that the operational framework should leave considerable flexibility to possible future interventions by the ESM, both in terms of recapitalisation

---

<sup>14</sup> Especially as our assessment is that, contrary to the perception of many European observers, the United States is on track to implement Basel III in a largely compliant manner in the course of 2013.

<sup>15</sup> See in this context Jim Brunsten and Rebecca Christie, "German Push to Accelerate Bank Bail-Ins Joined by Dutch, Finns", *Bloomberg*, 4 February 2013.

<sup>16</sup> This arguably calls for basing them to the extent possible on tried-and-tested processes such as those administered by the US FDIC.

instruments (which may include voting common equity, hybrid securities such as preferred stock, and various forms of debt) and in terms of the respective modalities and shares of financial intervention by the ESM on the one hand, and national authorities on the other hand. This is because the exact features of future crisis situations may be difficult to predict with accuracy, and in such future situations of emergency, constraints on the ability of the ESM to act may result in a higher collective cost for Europeans.

Much attention has been devoted to the issue of so-called "*legacy assets*". In September 2012, a joint statement of the ministers of finance of Germany, the Netherlands and Finland, released from a meeting near Helsinki, stated that "*the ESM can take direct responsibility of problems that occur under the new supervision [under the SSM from 2014], but legacy assets should be under the responsibility of national authorities*". Taken literally, this wording implies that all assets that were brought on the bank's balance sheet before the cut-off date cannot be kept in the entity in which the ESM would invest, which means the ESM is practically prevented from recapitalising the bank. This stance would render successive European Council Conclusions that refer to ESM direct recapitalisations meaningless.

However, we believe the ESM should be an instrument for risk-sharing, not loss-sharing. In other words, if the ESM recapitalises a bank that until then has been under the exclusive control of national authorities, such direct recapitalisation should be structured as arm's-length transactions in which the ESM does not assume assets at a price that it deems below their economic value. This requires that the ESM have access to adequate financial assessment and evaluation resources as a prerequisite to any recapitalisation, and that any concessional financial intervention in such circumstances should be performed by the Member State itself under the European Commission's state aid control.

### **3.3. Step 3: The Single Resolution Mechanism**

Ideally, the resolution framework for Europe's banking union should involve a centralised and exclusive decision-making authority over all banks covered by the SSM. Achieving a high degree of centralisation is desirable for a number of reasons.

- Bank resolution crucially requires the ability to make high-risk decisions very quickly and under intense pressure. The decisions may in particular include the liquidation of a bank, the assumption of risky assets on a public-sector balance sheet, and mandating the immediate sale of assets or activities to third parties. This requirement, by all experience, implies a high degree of centralisation of authority. In the case of large banks operating across borders within Europe, the current distribution of decision-making power in bank restructuring between the national and supranational level has sometimes led to considerable delays. In some instances (e.g. Fortis and Dexia) the break-up of multinational banks along national borders could not be avoided, harming the single market.
- A system where supervision is centralised but resolution is not may harm the effectiveness and credibility of the supervisor. While the new SSM could in principle force a resolution by withdrawing a banking license, national resolution authorities may refuse to act. This knowledge could lead the ECB to delay the supervisory decision in order to avoid a disorderly scenario. In principle, Article 13(2a) of the SSM Regulation as amended by the Council (Council, 2012) is designed to prevent a deadlock in such circumstances, but how it will function in practice remains to be seen. Through its current liquidity policy the ECB may lend to banks that could be insolvent, but it does not have the institutional responsibility for this assessment. Such liquidity provisioning forms part of monetary policy and the supervisory responsibility is squarely with the national authorities. Once the ECB has supervisory



responsibility, it would breach its mandate by providing liquidity to banks it deems insolvent.

- The incentive structure of a decentralised resolution system cannot be easily aligned with a system that involves burden-sharing among Member States. If resolution remains primarily a responsibility of Member States while the fiscal cost of resolution is already partially mutualised, national resolution authorities will not have the appropriate incentives to minimise the overall public costs of bank resolution.

However, a fully centralised system cannot be reached in Step 3, assuming, as we do, the absence of significant revision of the European Treaties, and the absence of a dramatically more integrated fiscal framework. Under these assumptions, the SRM cannot be strictly parallel to the SSM in its design and establishment, for at least two major reasons.

First, special bank resolution regimes are established in parallel and as an alternative to insolvency regimes<sup>17</sup>. Our assessment is that a European bank insolvency regime is out of reach in Step 3 – even though it should be considered as part of what we called Step 4 in the first section of this note. We fail to identify in the current treaties an adequate and sufficiently robust legal basis for a European insolvency regime. Even assuming a proper such basis, the creation of an effective supranational insolvency regime is bound to require a long time for planning and preparation. For example, the creation of a European insolvency court should not be envisaged in a rushed process. We have not analysed in depth the option of establishing a supranational insolvency regime by a specific, ad hoc treaty (as was done with the ESM) within the timeframe envisaged for the creation of the SRM, but we are sceptical about its feasibility. Even a harmonisation of national bank insolvency regimes would take more time than is available for the creation of the SRM. Our conclusion is that national bank resolution regimes must remain and play a core role in the operation of the SRM.

Second, bank resolution regimes are linked to fiscal or quasi-fiscal resources. Unlike insolvency processes, they can result in the public assumption of significant financial risk and liabilities. Experience suggests that some bank resolution processes eventually result in a financial gain to public authorities, but others result in a financial loss and it is often impossible to predict the eventual financial outcome at the start of the process. An increased willingness to impose losses on bank creditors can help reduce the public cost of future bank resolution, but not to the extent that this cost could be assumed away entirely.

The SRM should be able to draw on ESM resources in future SRM-conducted resolutions. However, the ESM should not necessarily finance all the public cost and/or assume all the public risk of resolution processes in the context of the present crisis and a strong reliance on national funding mechanisms and institutions will remain necessary at least for a transitional period. Because of its size limit and governance, the ESM is not suited as an instrument to provide the kind of fiscal guarantees that may become necessary to address a systemic crisis (Pisani-Ferry and Wolff, 2012). Furthermore, the involvement of national resources may remain necessary at least in some cases, including to mitigate the possibility of moral hazard arising from national economic policy decisions that shape banks' risk while not being part of the European banking policy framework, e.g. housing policy.

One option would be to create an industry-funded European resolution fund together with the establishment of the SRM. However, a European fund would take time to build up and it is unlikely to gather significant financial firepower before a number of years, well beyond the SRM's start of operation. Moreover it could raise issues of moral hazard of its own. The

---

<sup>17</sup> Even though we have not explored this issue in sufficient depth, we understand that this is even more the case in the EU than in the US given the content of the Charter of Fundamental Rights of the EU.

upshot is that the SRM will have to operate in relationship with both national and European counterparties for any public funding of resolution processes.

The core challenge of designing the SRM is how to combine the lingering relevance of national structures as regards insolvency processes and resolution funding with the need for quick and effective decision-making on a system-wide basis. Because resolution decisions are high-risk, the bar must be set high in terms of accountability, which in the SRM's case must prominently involve accountability at the European level. Thus, the SRM should be based neither on a broad committee structure with weak decision making structures preventing quick and effective decision-making, nor on a delegation of authority to the home-country resolution authority alone, which does not provide European-level accountability.

We believe that the SRM can meet the objectives set out by the European Council only if it has at its core a central body with a significant degree of binding decision-making authority. Whether this may work by some direct empowerment of the central body by the relevant Member States' national legislation, or through a form of injunction authority (possibly with some safeguards) over national resolution authorities, remains to be explored.

Predictably, a lot of the early debate on the future SRM has centred on what this central body could be. Proceeding by elimination, we believe it can be neither the ECB nor the ESM.

- The ECB's mandate is defined in the European Treaties and does not include bank resolution. Furthermore, the politically charged nature of bank resolution strikes us as difficult to square with the ECB's independence. We also do not believe that the current political institutions of the EU are compatible with the concentration of powers within the ECB that such a choice would entail. Additional incompatibilities may arise from the fact that the geographical perimeter of the SRM is likely to include some Member States outside of the euro area (see below).
- The ESM's decision-making framework makes it unsuitable to the rapid action requirement that applies to a resolution authority. The fact that the ESM exists outside of the EU treaty framework would raise major questions about judicial review. Furthermore, granting the ESM direct resolution powers would give it conflicting incentives for the use of public money in case of banking and/or sovereign crisis emergencies.

In our current (and tentative) understanding this leaves two practical possibilities, each of which merits further study. In one option, the European Commission would host the central body of the SRM, for which adequate relationships should be defined both with the College of Commissioners (perhaps using as a partial template the existing arrangements for competition policy) and with DG COMP (which could provide expertise and support based on its track record of state aid control). Crucially, a sufficient degree of independence in the resolution task should be ensured. In an alternative option, a new body would be created, on either a temporary or permanent basis. Doing so within the framework of EU institutions raises questions about the treaty basis and the decision-making autonomy that such a new body would have (Meroni jurisprudence). If it were established by a specific treaty as was done with the ESM, the relationship with the existing European institutions is likely to raise even more difficult questions than was the case with the ESM, including in terms of accountability and judicial review.

To fulfil its aim of contributing to breaking the "*doom loop*", the SRM should have immediate authority over all euro area Member States and not only those that have requested an assistance programme. The December 2012 European Council Conclusions

state that its authority should be extended to all non-euro area countries participating in the SSM, but how this is articulated with the fact that the ESM currently does not cover those countries remains to be debated<sup>18</sup>. As for which banks should be subject to the SRM's authority among those headquartered within its geographical perimeter, there are three broad possible options: (a) only those banks with significant cross-border presence or systemic significance at European level; (b) all banks directly supervised by the SSM; or (c) all banks, including smaller ones that escape direct SSM supervision. We have not yet carried out a detailed analysis of these options' respective merits and flaws.

Among other operational concerns, the SRM's central body should be able to recruit specialist staff with the financial restructuring experience needed to steer complex bank resolution processes. It should have the financial flexibility to build up its operations quickly, as its first few years of operation are likely to be uniquely active given the current condition of the European banking system. Over a longer-term basis (Step 4), the same body could also be considered for playing a role in a future European deposit insurance system, not unlike the structure in place in the US where the Federal Deposit Insurance Corporation acts as the bank resolution authority.

The creation of the SRM should also include a consideration of the role that the European Banking Authority and European Systemic Risk Board may play in future resolution processes. This should be on the agenda with the planned review of both these institutions in 2014, in application of the European legislation that created them.

### **3.4. Banking structure**

In spite of its political prominence, we believe the discussion on regulating banks' structures should be best delayed until the features of Europe's single resolution mechanism and banking union have been more precisely shaped. There is no one-size-fits-all response to the challenges posed by banking structures, which should be different in different financial systems. Thus, we feel that the EU as well as individual Member States should refrain from introducing significant new legislation in this area until the completion of Step 3 and the establishment of the SRM.

---

<sup>18</sup> In any case, it appears logical to assume that the SRM will not have authority beyond the geographical scope of the SSM.



## **4. CONCLUSION**

As this note suggests, the work programme outlined in the December 2012 European Council conclusions, even with a limitation to the first three steps, entails a large number of policy questions of considerable complexity. It will be a challenge for European policymakers to explore all these questions in due time and in a reasonable sequence. As the recent experience with systemic banking crisis resolution is limited in most of Europe, it will also be advisable to have an in-depth look at past crisis experiences, in the US but also in Japan and other countries, to better understand the nature and magnitude of the challenges ahead. The legislative steps needed to achieve the timely creation of the Single Resolution Mechanism represent a marathon run in which Europe cannot afford to fail.

## REFERENCES

- Angeloni, Chiara and Guntram Wolff (2012), "Are Banks Affected by their Holdings of Sovereign Debt?" Bruegel Working Paper 2012/7, March, <http://www.bruegel.org/publications/publication-detail/publication/717-are-banks-affected-by-their-holdings-of-government-debt/#.URmRBqWzjsY>.
- Barroso, Jose Manuel (2013), "Speech at the European Parliamentary Week on the European Semester for Economic Policy Coordination", January 30, [http://europa.eu/rapid/press-release\\_SPEECH-13-73\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-13-73_en.htm).
- BCBS (2012), "Basel III regulatory consistency assessment (level 2) Preliminary report: European Union," Basel Committee on Banking Supervision, Bank for International Settlements, October, [http://www.bis.org/bcbs/implementation/l2\\_eu.pdf](http://www.bis.org/bcbs/implementation/l2_eu.pdf).
- Caballero, Ricardo, Takeo Hoshi, and Anil Kashyap (2008), "Zombie Lending and Depressed Restructuring in Japan", *American Economic Review* 98:5, <http://economics.mit.edu/files/3770>.
- Cameron, David (2013), "Speech on the Future of the EU and the UK Relationship with It", London, January, <http://www.number10.gov.uk/news/david-cameron-eu-speech/>.
- Constancio, Vitor (2012), Hearing before the Select Committee on EU Economic and Financial Affairs of the House of Lords, October, <http://www.ecb.europa.eu/press/key/date/2012/html/sp121022.en.html>.
- Constancio, Vitor (2013), "Establishment of the Single Supervisory Mechanism: The First Pillar of the Banking Union", January, <http://www.ecb.europa.eu/press/key/date/2013/html/sp130131.en.html>.
- Council (2012), text agreed by the Council on the Commission "Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions" [SSM Regulation], Brussels, Council of the European Union, December, <http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf>.
- Dewatripont, Mathias, Gregory Nguyen, Peter Praet and Andre Sapir (2010), "The role of state aid control in improving bank resolution in Europe", Bruegel Policy Contribution 2010/04, May, <http://www.bruegel.org/publications/publication-detail/publication/404-the-role-of-state-aid-control-in-improving-bank-resolution-in-europe/#.URrsTqWzjsY>.
- Draghi, Mario (2012), "The monetary policy of the European Central Bank and its transmission in the euro area," Speech at Bocconi University, Milan, November 15, [http://www.ecb.europa.eu/press/key/date/2012/html/sp121115\\_1.en.html](http://www.ecb.europa.eu/press/key/date/2012/html/sp121115_1.en.html).
- ECOFIN (2012), Press Release 17598/12, 3214<sup>th</sup> Council Meeting, Economic and Financial Affairs, 13 December, [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/134287.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/134287.pdf)
- ESRB (2012), "Forbearance, resolution and deposit insurance", First Report of the ESRB Advisory Scientific Committee, European Systemic Risk Board, July, [http://www.esrb.europa.eu/pub/pdf/asc/Reports\\_ASC\\_1207.pdf?a90f992f80753286929f3b44326be397](http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1207.pdf?a90f992f80753286929f3b44326be397).
- European Commission (2012), "Blueprint for a Deep and Genuine Economic and Monetary Union", Brussels, November, [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/11/20121128\\_2\\_en.htm](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/20121128_2_en.htm).

- European Council (2012a), Conclusions of the European Council 28/29 June, EUCO 76/12, [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131388.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf)
- European Council (2012b), Conclusions of the European Council 14 December 2012, EUCO 205/12, [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134353.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf)
- FDIC (2011), "The Orderly Liquidation of Lehman Brothers Holding Inc. under the Dodd-Frank Act", *FDIC Quarterly*, April, <http://www.fdic.gov/regulations/reform/lehman.html>.
- FSB (2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions", Financial Stability Board, October, [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).
- Goldstein, Morris, and Nicolas Véron (2011), "Too Big To Fail: The Transatlantic Debate", Working paper 11-2, January, <http://www.iie.com/publications/interstitial.cfm?ResearchID=1745>.
- Goodhart, Charles (2012), "Funding arrangements and burden sharing in banking resolution", *Vox*, October, <http://www.voxeu.org/article/funding-arrangements-and-burden-sharing-banking-resolution>.
- Goyal, Rishi, Petya Koeva Brooks, Mahmood Pradhan, Thierry Tresselt, Giovanni Dell'Ariccia, Ross Leckow, Ceyla Pazarbasioglu, and IMF Staff team (2013), "A Banking Union for the Euro Area", IMF Staff Discussion Note SDN/13/01, February, <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40317.0>
- Kane, Edward (1987), "Dangers of Capital Forbearance: The Case of the FSLIC and "Zombie" S&Ls", *Contemporary Economic Policy* 5-1:77-83, January, <http://onlinelibrary.wiley.com/doi/10.1111/j.1465-7287.1987.tb00247.x/abstract>.
- Liikanen, Erkki (2012). "Final Report of the High-level Expert Group on reforming the structure of the EU banking sector", European Commission, October, [http://ec.europa.eu/internal\\_market/bank/docs/high-level\\_expert\\_group/report\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf).
- Pisani-Ferry, Jean, André Sapir, Nicolas Véron, and Guntram Wolff (2012), "What Kind of European Banking Union?" Bruegel Policy Contribution 2012/12, June, <http://www.bruegel.org/publications/publication-detail/publication/731-what-kind-of-european-banking-union/>.
- Pisani-Ferry, Jean, and Guntram Wolff (2012), "The Fiscal implications of a Banking Union" Bruegel Policy Brief 2012/2, September, <http://www.bruegel.org/publications/publication-detail/publication/748-the-fiscal-implications-of-a-banking-union/#.URbjTqWzjsY>.
- Posen, Adam, and Nicolas Véron (2009), "A Solution for Europe's Banking Problem", PIIE Policy Brief PB09-13, June, <http://www.piie.com/publications/pb/pb09-13.pdf>.
- Vaisse, Justin, Douglas Elliott, Domenico Lombardi and Thomas Wright (2012), "Brookings Survey on Eurozone Progress", Brookings Institution, December, <http://www.brookings.edu/research/interactives/2012/brookings-eurozone-survey>.
- Van Rompuy (2012a), "Towards a Genuine Economic and Monetary Union" Brussels, 26 June, [http://ec.europa.eu/economy\\_finance/focuson/crisis/documents/131201\\_en.pdf](http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf).
- Van Rompuy (2012b), "Towards a Genuine Economic and Monetary Union" Brussels, 5 December, [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134069.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf).

- Véron, Nicolas (2012), "Challenges of Europe's Fourfold Union", Testimony to the US Senate Committee on Foreign relations, August, [http://www.foreign.senate.gov/imo/media/doc/Veron\\_Testimony.pdf](http://www.foreign.senate.gov/imo/media/doc/Veron_Testimony.pdf).
- Wolff, Guntram (2011), "The Euro Area's Macroeconomic Balancing Act", Bruegel Policy Contribution 2011/05, May, <http://www.bruegel.org/publications/publication-detail/publication/555-the-euro-areas-macroeconomic-balancing-act/#.URm-aWzjsY>.
- Wolff, Guntram (2012), "A budget for Europe's monetary union", Bruegel Policy Contribution 2012/22, December, <http://www.bruegel.org/publications/publication-detail/publication/762-a-budget-for-europes-monetary-union/#.URmRVaWzjsY>.

## APPENDIX: RULES FOR STATE AID TO THE FINANCIAL SECTOR

Since the start of the financial crisis, EU Member States have provided significant support to financial institutions. Most of this support qualifies as state aid as defined in Art. 107 of the Treaty on the Functioning of the European Union and therefore has required approval of the European Commission.

As of the collapse of Lehman Brothers, the Commission has issued several Communications to guide EU Member States in their support of the financial sector and to coordinate their action providing Member States first with more precise guidance on specific instruments such public guarantees, recapitalisations and impaired asset relief, and then on bank restructuring (see below). The European Commission has invoked four main principles to guide its state aid policy during the financial crisis:

- the granting of state aid has been subject to a principle of remuneration that reduces the cost for the taxpayer;
- the Commission has requested that banks draw up restructuring plans with a view to returning to viability. Where the prospects of a return to viability were not credible, the Commission has asked for the orderly resolution of the bank;
- the Commission has requested that the aid be minimised and the burden of the rescue be as much as possible fairly shared between the government and the bank and its main stakeholders, thereby reducing the risk of moral hazard;
- the Commission has sought solutions that minimised the distortions of competition between banks and across Member States with the overall objective of preserving the single market.

Based on this framework, the Commission has already taken more than 60 decisions on bank restructuring and resolution, both in the context of programmes and outside of a programme context.<sup>19</sup>

### ***Summary of the European Commission's state aid rules for the crisis***

The Commission's "*crisis communications*" are rooted in its rescue and restructuring (R&R) guidelines<sup>20</sup>, introduced in 2004 and applied to all sectors. However, the R&R guidelines proved in some aspects to be inadequate for the financial sector, as they were not designed to take into account a systemic crisis and a persistent threat to financial stability. As mentioned above, the European Commission therefore introduced a temporary set of guidelines for State aid granted to financial institutions, consisting of six Communications based on Art. 107(3)(b) which it published from 2008 onwards.

The first three Communications provided precise guidance for specific aid instruments, recalled some of the basic principles outlined in the R&R guidelines and set out the Commission's general approach on how it would reflect the financial stability objective in its assessment.

---

<sup>19</sup> European Commission memo: State aid: recapitalisation of Spanish banks – the Commission's role under EU State aid control, 28 November 20.

<sup>20</sup> Communication from the Commission - Community guidelines on State aid for rescuing and restructuring firms in difficulty, Official Journal C 244, 1.10.2004, pp. 2-17.

The "*Banking Communication*<sup>21</sup>" reiterates general criteria for the design of State aid measures which "*have to be well-targeted, proportionate and designed in such a way as to minimize negative spill-over effects on competitors, other sectors or Member States*", as well as provisions for guarantees on liabilities, recapitalisation and controlled winding-up. Moreover, the Communication introduced a distinction between fundamentally sound financial institutions and other financial institutions characterised by endogenous problems. The distinction was relevant as fundamentally sound institutions granted State aid were required to submit a viability plan, while institutions with endogenous problems needed to present a – comparatively further reaching - restructuring plan.

The "*Recapitalisation Communication*<sup>22</sup>" provided further guidance on the pricing of State recapitalisation measures<sup>23</sup>.

The "*Impaired Assets Communication*<sup>24</sup>" provides guidance on the design and implementation of asset relief measures<sup>25</sup>.

The fourth Communication ("*Restructuring Communication*<sup>26</sup>") complements the criteria already established in the first three Communications. It sets out the essential requirements that a restructuring or viability plan has to display in order to be approved. In particular, restructuring plans need to demonstrate how a bank can restore its long-term viability without further State support, entail adequate burden-sharing of the restructuring cost between itself, its stakeholders and the State, and include appropriate measures to limit the distortions. This was the only Communication with an expiry date, set at the end of 2010.

The fifth Communication ("*Exit Communication*<sup>27</sup>") extended the application of the fourth one until the end of 2011 and updated the conditions for guarantees to incentivise exit from state support. In particular, it established that both fundamentally sound and distressed bank benefiting from a state support measure have to submit a restructuring plan.

The sixth Communication ("*Prolongation Communication*<sup>28</sup>") extended the crisis rules beyond the end of 2011, and takes into account the sovereign crisis – it clarifies that if a bank's difficulties are solely due to the exposure to sovereign debt (and no excessive risks had been taken), the required depth of restructuring will be proportionate.

---

<sup>21</sup> Communication from the Commission - The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8.

<sup>22</sup> Communication from the Commission - The recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition. Adopted on 5 December 2008, OJ C 10, 15.1.2009, p. 2-10.

<sup>23</sup> The Communication makes reference to the methodology proposed by the Recommendations of the Governing Council of the ECB of 20 November 2008

<sup>24</sup> Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.3.2009, p. 1.

<sup>25</sup> Principles to design asset relief measures contained in the Communication are: (i) ex ante transparency and disclosure requirements; (ii) burden-sharing of the costs related to impaired assets between the State, shareholders and creditors; (iii) aligning incentives for banks to participate in asset relief with public policy objectives; (iv) eligibility, valuation and management of impaired assets criteria; (v) the relationship between asset relief, other types of state support and bank restructuring.

<sup>26</sup> Communication from the Commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ. C 195, 19.8.2009, p. 9.

<sup>27</sup> Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis, OJ C 329, 7.12.2010, p. 7.

<sup>28</sup> Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis, OJ C 356, 6.12.2011, p. 7.



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **On the Design of a Single Resolution Mechanism**

**Thorsten BECK, Daniel GROS, Dirk SCHOENMAKER**

## **NOTE**

### **Abstract**

A single supervision mechanism requires a Single Resolution Mechanism (SRM), i.e. supervision and resolution should be at the same level. We argue that the SRM i) should be responsible only for the banks under the direct supervision of the ECB; ii) should be an independent institution with its own funding and staff; iii) powers should dovetail those of the ECB so that the SRM can take over when the ECB has come to its limits; iv) procedures and powers need to be specified in a Regulation; and v) bank resolution and deposit insurance are best bundled within one institution.

Even more important for the future of the banking system in Europe than the institutional design of the SRM will be the willingness to actually let banks fail or at least bail in creditors before public funds are used to prop up institutions which cannot survive on their own. The present practice of an almost unlimited bail out of all bank creditors maintains overcapacity and an excessive leverage in the European banking system. It risks leading to a similar situation as in Japan where the so-called 'zombie' banks held back the recovery for a very long time.

## **CONTENTS**

<b>LIST OF ABBREVIATIONS</b>	<b>31</b>
<b>EXECUTIVE SUMMARY</b>	<b>32</b>
<b>1. INTRODUCTION</b>	<b>33</b>
<b>2. TRANQUIL VERSUS TURBULENT TIMES</b>	<b>35</b>
<b>3. REVIEW OF THE LITERATURE</b>	<b>37</b>
<b>4. THE SINGLE RESOLUTION MECHANISM</b>	<b>39</b>
<b>5. CONCLUSION</b>	<b>41</b>
<b>REFERENCES</b>	<b>42</b>



## LIST OF ABBREVIATIONS

<b>BaFin</b>	Bundesanstalt fuer Finanzdienstleistungen
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>ELA</b>	Emergency Liquidity Assistance
<b>FDIC</b>	(US) Federal Deposit Insurance Corporation
<b>FSA</b>	Financial Supervisory Authority
<b>GC</b>	Governing Council
<b>NCB</b>	National Central Bank
<b>SB</b>	Supervisory Board
<b>SRM</b>	Single Resolution Mechanism
<b>SSM</b>	Single Supervisory Mechanism

## EXECUTIVE SUMMARY

Resolving small banks is easy and is being done in most Member States without great fanfare. However, resolving large and/or internationally active banks seems so difficult that these banks are almost always bailed out. In the few instances where large internationally active banks have gone into insolvency the process of disentangling the claims of hundreds of thousands of creditors has usually taken years of endless litigation. There is thus an urgent need to create a mechanism (the Single Resolution Mechanism, SRM) by which even large, internationally active banks can be resolved.

Which banks should be subject to the SRM? It seems appropriate to start with the banks which will be directly under the supervision of the ECB. For these banks which will be under the Single Supervisory Mechanism (SSM), a European institution - i.e. the ECB - will be responsible for trying to prevent bank insolvencies. If this fails, and insolvency becomes inevitable, it is only proper that a European institution picks up the tab. The responsibility of the SRM in terms of banks should thus mirror that of the SSM.

The SRM cannot work on the basis of national bank resolution rules. The way the SRM could resolve a bank needs to be specified in a Resolution Regulation to ensure uniform conditions for all the banks supervised by the ECB. The powers of the SRM need to be specified in such a way that it can intervene immediately once the supervisor, i.e. the ECB, has signalled the need to intervene.

We also argue that it would be best to put deposit 'insurance'<sup>1</sup> and resolution authority under one roof (as in the US). When a bank fails deposit insurance and resolution face anyway a common pool problem: there might simply not be enough assets left for both of them.

Even the best designed SRM will be useless if the authorities are too afraid of the systemic consequences of large failure to let any banks ever go under. At present very little bail-in takes place and no single bank is allowed to fail because of the fear to cause another '*Lehman*'. However, if this policy continues the excessive leverage in the European banking system will not be reduced and Europe could find itself in a similar situation as Japan where the so-called '*zombie*' banks held back the recovery for a very long time.

---

<sup>1</sup> Deposit 'insurance' is covered in the EU by the Deposit Guarantee Schemes Directive, 94/19/EEC as amended.

## 1. INTRODUCTION

Preparatory work on the 'Single Supervisory Mechanism' (SSM) is proceeding and concrete plans have already been drawn up with much of the basic legal questions already settled. A logical consequence of the creation of the SSM is the need for a single resolution mechanism (SRM) because national authorities cannot be expected to provide national tax payers' money to support an institution which has been supervised by the ECB.

Any resolution mechanism must be seen in the context of the supervisory mechanisms that accompany banks in difficulties. The nature of the tools available to the supervisor determines to a large extent in what shape banks arrive at the resolution authority.

With the wide powers to be granted to the ECB, at least for the banks it supervises directly, until the minute before resolution it makes sense to have these same banks being taken care of by a single EU level institution (not just a 'mechanism') once resolution becomes unavoidable.

When a supervised bank is diagnosed by the SSM as having serious problems that it cannot solve on its own, the SRM will have to take important decisions very quickly. The first decision is whether the bank should be let go into un-orderly resolution<sup>2</sup>, which could imply a bank run and asset grabbing by national supervisors, or resolved in orderly manner. An orderly resolution requires a clearly defined process, claim ranking and mechanisms that can include bridge banks, merger and acquisition, purchase and assumption and nationalisation.

If the decision is to go for resolution the key questions will be whether some creditors will have to accept a haircut and how much financial support will be needed to stabilise the bank after the intervention of the SRM. The financial support could be public (i.e. tax payer money) or (preferably) come from an industry financed fund. Taking these decisions requires a dedicated staff and immediate access to potentially large financial resources.

The SRM should thus be a separate institution with its own funding, staff and legal personality. We will not discuss the funding here. There is general agreement that a resolution fund should be financed in the first instance by levies from the industry, but will need a fiscal back up in case a system wide crisis develops. That back up for the SRM will probably have to be the European Stability Mechanism (ESM).

An intervention by the ESM will become inevitable only if the losses are very large and the institution is no longer viable on its own. But in this case deposit insurance might have to kick in as well. If this is the case, a conflict of interest between the SRM and national deposit guarantee schemes could emerge. When a bank fails, if capital and other loss-absorbing liabilities are insufficient, deposit guarantee and resolution schemes face a common pool problem: If the resolution authority does nothing, the bank might fail in a disorderly manner implying large losses for the (national) deposit guarantee funds. But these losses might be avoided if the (European) resolution authority generously recapitalises the bank. To avoid these potential conflicts of interest, one should bundle the deposit guarantee and resolution authority (see Schoenmaker and Gros (2012) and Gros and Schoenmaker (2012) for a solution to the transition problem).<sup>3</sup>

At present policy making in Europe is dominated by a 'post-Lehman' abhorrence of bank insolvency. The US decision to let Lehman Brothers go into insolvency is usually taken as

<sup>2</sup> Resolution can be insolvency or can be restructuring.

<sup>3</sup> See also the overview provided on the following link: <http://www.roubini.com/briefings/175500.php>.

an example to avoid, because this decision was taken unilaterally and thus without taking into account the potential global effects (although few foresaw their size). Hence the concern in Europe has been to avoid a repetition of the Lehman experience.

This has led now to a situation where effectively no bank (except mini banks) is allowed to fail anymore. If this policy continues the SRM will never be used – or rather it might be misused by propping up any bank that has difficulties.

It remains to be seen whether this is temporary. But for the time being, all authorities, especially in Europe, are overemphasising the perceived benefits of bailout (over resolution). AIG, where the US government made a profit on the bailout is held up as the example that a bailout can be better even for the public purse.<sup>4</sup> It is likely (In the view of the authors) that in Europe for a long time the approach will remain to go for bailouts.

---

<sup>4</sup> The precise reasons why the failure of Lehman turned out to have such negative consequences do not matter at this point. What matters is that many policy makers have drawn the conclusion that no large bank should be allowed to fail.

## 2. TRANQUIL VERSUS TURBULENT TIMES

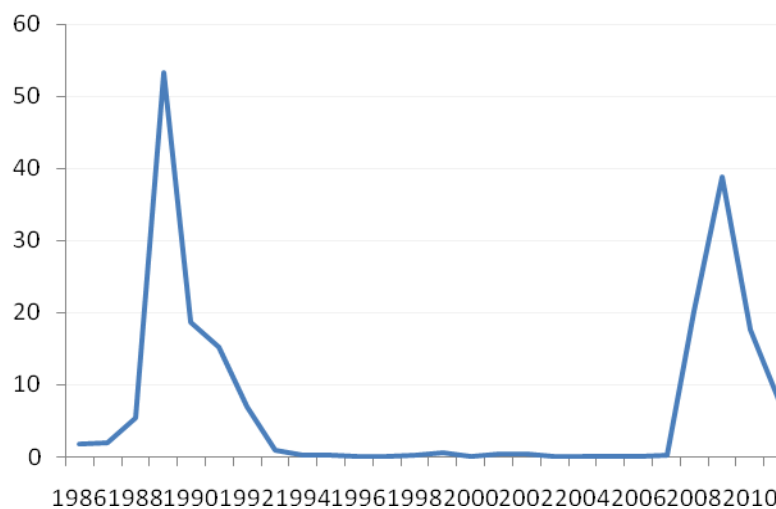
The objective and priorities of a bank resolution fund are in principle always the same: provide funding on a least cost basis for the public purse and only if needed to safeguard systemic stability. In reality, however, the *modus operandi* of a bank resolution fund will be totally different depending on whether the banking system is in a systemic crisis or not.

During a widespread crisis (such as now) it is usually assumed that the spill-over effects from not saving any individual bank are assumed to be very large and negative. Under these circumstances the authorities will be extremely reluctant to let any bank fail or to bail in new classes of investors. This might be called the 'post-Lehman' syndrome, which is dominant today.

This tendency to avoid bail-ins and bank failures might be justified during turbulent times, i.e. when the entire banking system is weak, but not necessarily if the system is stable while only one individual bank has a problem. In this case the spill-over effects from a bank failure are more limited. Closing down a single bank might even benefit the rest of the industry, especially if the reason for failure was aggressive risk pricing and thus undermining other banks' margins.<sup>5</sup> But this is a point of view that is rarely taken into account in practice. Moreover, bank failures are rare during tranquil times, but then bunch together when a crisis erupts.

This implies that the workload of a resolution authority will vary enormously over time. It is often said that the life of a soldier is characterised by long periods of boredom, punctuated by short periods of intense terror. This is likely to be the case for the SRM as well. Figure 1 below illustrates this for the case of the US (which is the only country for which one has a long time series with consistent data).

**Figure 1: Financial crisis are rare, but costly: FDIC estimated losses in USD bn**



**Source:** Own elaboration on the basis of Federal Deposit Insurance Corporation (FDIC) data.

It is apparent that over the 25 years considered in this picture there were only two periods during which the Federal Deposit Insurance Cooperation (FDIC) had to sustain substantial losses, the so-called savings and loans crisis of the late 1980s and the global financial

<sup>5</sup> This absence of state aid considerations is remarkable (and indeed DGCOMP is at present the only institution enforcing some bail-in).

crisis. During both crisis episodes a large number of banks (usually small ones though) were allowed to fail and the FDIC had to step in to make sure depositors were protected. In most cases the FDIC has been very strict in bailing-in shareholders and the creditors of the failed banks, imposing sometimes large haircuts even on senior bond holders if this was necessary to minimise the use of public funds.

It is also clear that during major system wide crisis episodes the accumulated funds can run out. This has happened only every generation, but in these cases the FDIC needed a credit line from the US Treasury to finance pay-outs.

It is not surprising that a major crisis is followed by a longer period of few bank failures: the crisis itself *'purges'* the system of the weaker banks and the heightened awareness of the risk of a crisis on the side of regulators, supervisors and investors leads to more prudent behaviour of the banks themselves. This explains why for about 15 years (between 1992 and 2007) the US system did not experience any important bank failures which required the intervention of public money.

One key question for Europe is whether the SRM will be as strict as the FDIC and *'purge'* the system of unviable institutions. If this is not done there is a real danger that the European banking system will remain unstable for a long time as leverage is not reduced and excess capacity persists, reducing profitability of all banks (which in turns weakens their capacity to build up their capital).

Given the long time periods during which bank failures are rare and do not threaten systemic stability one has to judge burden sharing not only on the basis of the problem on how to distribute losses when they arise, but one should also take into account the fees paid during the long tranquil times. Even *ex post*, the gains and losses from establishing the SRM should thus not be judged on the basis of what bank from what country first has recourse to it; but also on the basis of the fees paid by all other banks during the (hopefully long) periods of tranquillity. This requires of course that the SRM levies risk adjusted fees for the service it provides.

### 3. REVIEW OF THE LITERATURE

The literature on the financial safety net has pointed to the importance of a comprehensive and incentive-compatible system that comprises supervision, bank resolution and deposit insurance. A credible bank resolution regime that imposes losses on equity and junior debt-holders in a manner that minimises disruptions to the rest of the financial system and the real economy, provides important incentives against taking too aggressive risks in normal times (Beck, 2011). A supervisory discipline vis-à-vis banks is only credible if complemented with the credible possibility that a bank can be resolved.

A supervisor with the power of withdrawing a license will not be able to use this power unless she can be sure that the failing bank can be resolved in a manner that minimises disruptions. The experience of Lehman Brothers has reinforced this expectation, where the uncoordinated entry of the institution in bankruptcy proceedings – possibly also because of the absence of a specialised bank resolution regime - triggered widespread panic on global financial markets. The absence of a coordinated bank resolution regime and thus credible threat of closing down large banks, in turn, provides incentives for banks to take more aggressive risks, not taking into account the external costs that their failure imposes on the rest of the financial system and the real economy. These externalities are even larger for internationally active banks, where national regulators do not take into account the costs imposed by bank failure on other economies outside the regulator's perimeter (Beck at al., 2013).

The European Union has long suffered from the mis-match of banks' geographic footprint within the Single European Market in banking and the regulatory perimeter limited to national supervision. Compared to the EU at large or the global financial system, the euro area faces additional challenges, as the recent crisis has shown the close linkages between monetary and financial stability (Allen et al. 2011). The close link between governments and banks through government bond holdings by banks, while banks at the same time might have to rely on governments for support in crises, is exacerbated in a currency union, where certain policy tools are no longer available to national policymakers. Another problem is that of regulatory and political capture, where regulators get too close to the regulated entities and/or are influenced by politicians in the regulatory process, be they national or local government authorities (see, e.g., Garicano, 2012). This is exacerbated by the tragedy of commons, whereby national authorities are interested in sharing the burden of bank failure with other members of the currency union (Westermann, 2012; Wyplosz, 2012).<sup>6</sup>

Recognising the geographic mismatch between banks' activities and regulatory perimeter, the European authorities have decided for the establishment of a Single Supervisory Mechanism, to be housed at the ECB, while the establishment of a European-level resolution and deposit guarantee system was postponed. Several authors have criticised the sequential introduction of supervision and bank resolution, which might lead to less, rather than more, stability, as conflicts between the ECB and the national resolution authorities are bound to arise (Schoenmaker, 2012; Wyplosz, 2012). Without resolution powers, the ECB – as *de facto* lender of last resort in the euro area - will find itself forced to inject more and more liquidity and keep the zombie banks alive. By the same token, the EBC may also be criticised for being excessively severe and putting national funds at risk when it would push for resolution actions at the national level (Angeloni et al., 2013). In addition, leaving resolution powers on the national level will reinforce the tragedy of

---

<sup>6</sup> See Beck (2012b).

commons problems, as individual countries will try to delay recognition of losses or try to communalise them. Also, conflicts between different resolution authorities in the case of cross-border banks are to be expected, as could be seen in the case of Fortis.

There are thus strong arguments to establish a single bank resolution authority on the European level to match the single supervisory mechanism. While the current situation might not be an appropriate one to distribute responsibilities across several institutions, there is a strong case to un-bundle responsibility for bank resolution from supervisory responsibilities at the ECB (Schoenmaker, 2013). Although it is tempting to place the new resolution authority at the ECB, the functions of supervision and resolution should remain separate (Advisory Scientific Committee, ESRB, 2012). Separating these responsibilities would avoid possible conflict of interests. As supervisors have responsibility for the licensing and ongoing supervision of banks, they may be slow to recognise and admit to problems at these banks. Supervisors may fear that inducing liquidation before a bank becomes insolvent could, in some cases, cause panic in the market. A separate resolution authority, on the other hand, can judge the situation with a fresh pair of eyes and take appropriate action with much needed detachment. This is in parallel to the private banking sector, where the responsibility of doubtful loans is transferred from the *'regular'* loan officer to a special department for distressed loans with specialised skills.

One important question is on how to fund the resolution regime. Beck and Laeven (2008) show that the combination of deposit guarantee and bank resolution can be useful in terms of reducing banks' risk-taking while at the same time dampen the moral hazard risks of deposit guarantee.

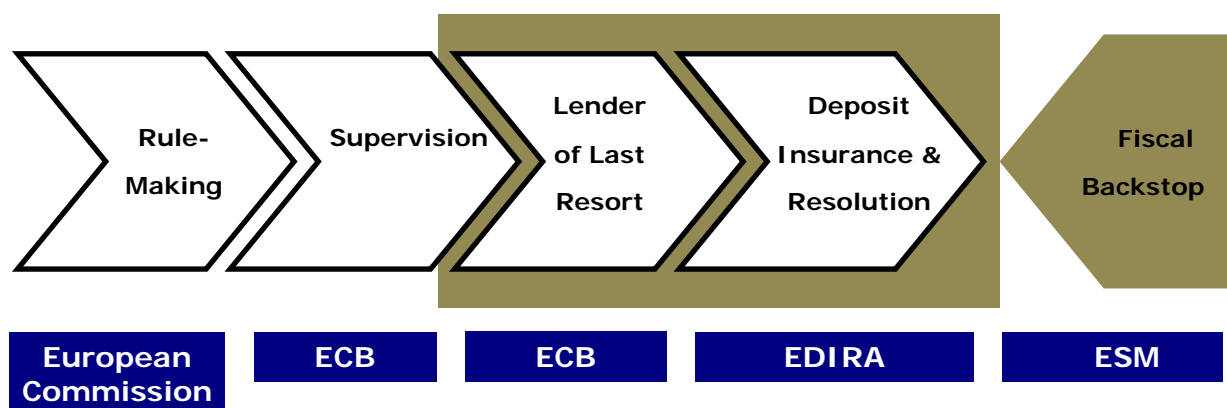
The Commission is planning to come forward with proposals for a separate authority (which would need also funding) to deal with bank resolution. Such a separate authority could also counter the moral-hazard risk mentioned above, i.e. the risk that the ECB is reluctant to intervene in a bank to which it has high exposure as lender of last resort.



## 4. THE SINGLE RESOLUTION MECHANISM

The Single Resolution Mechanism is part of a wider framework for the European Banking Union. Figure 1 shows the decision making stages and the corresponding bodies in this new nascent European governance framework. The European Commission remains the rule-maker and the European Central Bank (ECB) becomes the supervisor and lender of last resort for the European banking system. If this level fails to solve problems, the next step is resolution (i.e. a single resolution mechanism). Schoenmaker and Gros (2012) argue for the establishment of an independent European Deposit Insurance and Resolution Authority (EDIRA) which should take care of this stage. The final stage in the governance framework is the fiscal backstop. The European Stability Mechanism (ESM) was created to provide the fiscal backstop for member countries, but could also act as fiscal backstop to the banking systems of member countries in financial distress. The arrow for the fiscal backstop is thus backward in Figure 1. Given the need for a fiscal backstop, the new SRM (in our view in the form of an EDIRA) has to operate in close cooperation with the ESM. It is nevertheless important to guard the independence of the resolution authority, as the ministries of finance govern the ESM.

**Figure 1: European institutions for financial supervision and resolution in a Banking Union**



**Source:** Schoenmaker (2013).

**Note:** The framework illustrates the five stages from rule-making to fiscal backstop. The bottom line shows the entity responsible for each function.

The design of the Single Resolution Mechanism (SRM) should follow the design of the Single Supervision Mechanism to ensure consistency within this framework. First, the tasks of the SRM should be assigned to a new, independent resolution authority (the EDIRA in our view), established by a Regulation in accordance with Article 114 Treaty on the Functioning of the European Union (TFEU). EDIRA's powers should dovetail with the powers of the ECB to ensure consistency. The moment the ECB uses its supervisory power to withdraw the licence of a bank or request a resolution, the resolution powers of the EDIRA should start.

Second, all banks under the supervisory remit of the ECB should fall under the remit of EDIRA. The ECB can then hand over any problem bank to the EDIRA, if and when needed. We label these banks (under the watch of the ECB and EDIRA) 'European banks'. The perimeter of the SRM should thus closely mirror that of the SSM.

Third, EDIRA should have appropriate funding available. We do not discuss funding options in detail here. Schoenmaker and Gros (2012) argue that a new European Deposit Insurance and Resolution Fund (administered by EDIRA) should be fed through regular risk-based fees paid by the covered 'European banks'. This Fund would have access to the ESM as

fiscal backstop, if and when needed during system wide crisis and should operate independently from national funds, if any remain. As national funds have a national mandate, legally they may not be in a position to release resources for banks that do not fall under the national mandate. In others words, the French resolution (deposit guarantee) fund can not contribute to the rescue of an Italian bank (at least as long as non cross-border lending is provided for, as e.g. proposed in the DGS amendment). We would thus argue that there is a need for a funding source for the SRM which is independent of national resolution entities.

Fourth, a new Resolution Regulation should specify the resolution regime applicable to 'European banks'. So the first step would be a generic (but targeted to European banks) resolution regime.

The Advisory Scientific Committee of the ESRB has laid out the principles to be followed in a clear way (see ASC 2012). It remains to be seen whether it is necessary to establish common insolvency rules. However, at least when property rights are concerned (of shareholders and debt holders) the rules should be enforceable in all participating jurisdictions. The European and national rules need to be fully aligned for that purpose.

Finally, there are some transition issues. Some 'European banks' may need to be resolved (partly wound down and/or recapitalised) before they enter the new European supervisory system to avoid unlimited contingencies. Countries then would have to deal with any legacy problems of weak banks. For this, countries could apply for support from the ESM – if needed. Yet, legacy assets should be separated as much as possible from the insurance for future events for which the SRM should build up funding over time. Only well-capitalised banks should enter the new SSM and the future EDIRA.

## 5. CONCLUSION

Creating a Single Resolution Mechanism which deserves this name will be extremely challenging because a failure of any large bank might be dangerous for financial stability and an orderly resolution often requires substantial financial support from the public sector. Resolution powers and responsibilities thus cannot be divorced from its fiscal consequences.

How much public support is required to prevent a disorderly failure depends to a large extent on the bail-in regime. It is thus difficult to determine in advance burden sharing rules or even the size of the financing needed for any European resolution without knowing what the bail-in regime will be. For example, many banks in Europe finance a substantial part of their operations with so-called subordinated bonds and similar instruments. The treatment of these bonds has varied widely across countries. In the most recent case in the Netherlands, the holders of subordinated bonds of the bank SNS received nothing. By contrast, in Spain the holders of subordinated bonds (and even of preference shares) preserved a substantial part of their investment.

The financing needs of the SRM thus depend to a large extent on the bail-in regime that will govern the resolution of those banks directly supervised by the ECB. This regime will have to be determined by a Regulation which still has to be drafted. The principles for resolution contained in the Commission proposals of June 2012 covering national resolution mechanism should be followed. But this proposed directive alone is not enough. A separate regulation covering the 'European banks' (those supervised directly by the ECB) will be needed.

The best resolution mechanism will not work properly if the competent authorities continue to follow the principle that no bank should ever be allowed to fail, and that most creditors (including senior unsecured and large depositors) should always be guaranteed full payment. If this practice continues, investors will not price the risk of banks properly. The actual practice in resolution followed today is thus more important than the bail-in regime formally enshrined in legislation.

## REFERENCES

- Angeloni Ignazio, Aviram Levy and Carlo Cottarelli (2013) 'Cross-Border Deposits and Monetary Aggregates in the Transition to EMU' IMF Working Papers 91/114, International Monetary Fund.
- Advisory Scientific Committee (2012) 'Forbearance, resolution and deposit insurance', European Systemic Risk Board, Reports of the ASC July.
- Allen, F, T Beck, E Carletti, P Lane, D Schoenmaker and W Wagner (2011), 'Cross-border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies', CEPR, London.
- Beck, Thorsten (ed.) (2012a), 'Banking Union for Europe – Risks and Challenges', VoxEU eBook, <http://www.voxeu.org/content/banking-union-europe-risks-and-challenges>.
- Beck, Thorsten (2012b), 'Why the rush? Short-term crisis resolution and long-term bank stability', VoxEU, 16 October; <http://www.voxeu.com/article/why-rush-short-term-crisis-resolution-and-long-term-bank-stability>.
- Beck, T. and L. Laeven (2008), 'Resolution of Failed Banks by Deposit Insurers: Cross-country Evidence', in Asli Demirguc-Kunt, Ed Kane and Luc Laeven: *Deposit Insurance around the World, Issues of Design and Implementation*, Cambridge, MA: MIT Press.
- Beck, T, R Todorov and W Wagner (2013), 'Supervising Cross-Border Banks: Theory, Evidence and Policy', *Economic Policy*, forthcoming.
- Council of the European Union (2012), Report 15663/12, 6 November 2012, <http://register.consilium.europa.eu/pdf/en/12/st15/st15663.en12.pdf>.
- European Commission (2012a), Memo: Commission proposes a package for banking supervision in the Eurozone – frequently asked questions, 12 September 2012, [http://europa.eu/rapid/press-release\\_MEMO-12-662\\_en.htm](http://europa.eu/rapid/press-release_MEMO-12-662_en.htm).
- European Commission (2012b), Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. 12 September 2012, COM(2012) 511 final, December. [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-511\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf).
- Garicano, Luis (2012), 'Five Lessons from the Spanish Cajas Debacle for a New Euro Wide Supervisor', in Beck (2012a).
- Goodhart, C. and D. Schoenmaker (2009), 'Fiscal Burden Sharing in Cross-Border Banking Crises', *International Journal of Central Banking* 5, pp. 141-165.
- Gros, D. (2012), 'The single European market in banking in decline – ECB to the rescue?', in Beck (2012a), <http://voxeu.org/article/single-european-market-banking-decline-ecb-rescue>.
- Gros, D. and D. Schoenmaker (2012), European deposit insurance: financing the transition. *CEPS Commentary and Duisenberg School of Finance Policy Brief* No. 18.
- Schoenmaker, Dirk (2013) 'Governance of International Banking: The Financial Trilemma', Oxford University Press, New York.
- Schoenmaker, D. and D. Gros (2012), 'A European Deposit Insurance and Resolution Fund: An Update', *Duisenberg School of Finance Policy Paper* No. 26, and *CEPS Policy Brief* No. 283.

- Westermann, Frank (2012), 'Two types of capital flight: Will a common deposit insurance help to stabilise the TARGET2 imbalances?' In Beck (2012a)
- Wyplosz, Charles (2012), 'Banking Union as Crisis Management Tool', in Beck (2012a).

# NOTES



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Single Resolution Mechanism**

**Sylvester C. W. EIJFFINGER**

## **NOTE**

### **Abstract**

The introduction of a Single Resolution Mechanism would be a major step forward in the formation of a fully fledged banking union. The success of this mechanism will depend, to a large extent, on its implementation. It is important that the entity responsible for resolution has a broad set of tools available and that it can use these when needed. This means that any potential conflict of interest should be avoided as well as political interference. For this reason we propose a separate entity responsible for the resolution mechanism. Simultaneously we argue that common insolvency rules are necessary, that the Single Resolution Mechanism should take precedence over national legislation and that resolution plans are drafted on the level of the holding. These aspects are necessary to ensure that national interests do not disrupt the notion of a European Single Resolution Mechanism. For this reason we also argue that Single Point of Entry resolution strategies are preferred over Multiple Point of Entry resolution strategies.



**CONTENTS**

**INTRODUCTION** **47**

**1. A NEW ENTITY** **48**

**2. COMMON INSOLVENCY RULES** **50**

**3. CONNECTION WITH NATIONAL RESOLUTION MECHANISMS** **52**

**4. RESOLUTION STRATEGY** **53**

    4.1. Single Point of Entry Strategy (SPE) 53

    4.2. Multiple Point of Entry Strategy (MPE) 55

**5. CONCLUSION** **57**

**REFERENCES** **58**

## INTRODUCTION

The European Council<sup>1</sup> has recently agreed on and the European Commission<sup>2</sup> has announced additional steps in the direction of a more integrated, balanced Economic and Monetary Union. One important aspect with respect to ensuring financial stability will be the introduction of a Single Resolution Mechanism.<sup>3</sup> Since global financial stability, cross-border banking and preserving a national resolution authority (sometimes referred to as **financial trilemma**) are hard to combine, resolution *'is not well defined at a cross-border level'*.<sup>4</sup> The trilemma is even more pressing when banks have a larger international exposure and when they are operating in a monetary union. When banks will be supervised under the umbrella of a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) is therefore the appropriate next step. Such a mechanism ensures that when a bank fails under a SSM, the failure can be resolved in an appropriate manner. This is underlined by a review of major cross-border bank failures, which revealed that national resolution powers are often inadequate, leading to costly, inefficient and sometimes ineffective national interventions.<sup>5</sup> So the adoption of a SRM could prove to be a major step forward in this respect.

However, with respect to the implementation a number of questions remain. In this note three aspects in particular are discussed. First of all, there is the question whether this resolution mechanism should be linked to existing entities or whether a new entity should be created. Second, there is the question whether the SRM should be of a generic nature or whether common insolvency rules are necessary. Finally, we consider the connection between the SRM and national resolution mechanisms.<sup>6</sup> After discussing these three questions we focus on the broader strategy a supranational Resolution Authority should take. We argue that a **Single Point of Entry resolution strategy** is to be preferred over a Multiple Point of Entry resolution approach.

Throughout this note we always have **Systemically Important Financial Institutions (SIFIs)** in mind. These are typically large and complex banks engaging in cross-border activities. These international banks are so large and interconnected that a failure severely harms other banks and the real economy. Smaller and domestic banks are not the subject of this note. It is our view that at present a SRM which covers all banks is hardly feasible. Since cross-border banks pose the largest threat for financial stability in case of bankruptcy, the regulation of these banks at a supranational level should take precedence.

---

<sup>1</sup> See European Council, EUCO 205/12, 14 December 2012;

[http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134353.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf).

<sup>2</sup> See Commission Communication, 'A blueprint for a deep and genuine economic and monetary union', COM(2012) 777 final/2, Brussels, 30 November 2012; [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/11/pdf/blueprint\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf).

<sup>3</sup> See EUCO 205/12, paragraph 8 and 11 and COM(2012) 777 final/2, Section 3.1.3 A Single Resolution Mechanism.

<sup>4</sup> See Claessens, S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR: *'The theory highlights the importance of what they call financial trilemma - the conflict between three objectives - preserving national autonomy, fostering cross-border banking, and maintaining global financial stability.'*

<sup>5</sup> Claessens, S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

<sup>6</sup> See Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM/2012/280; <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0280:EN:NOT>.

## 1. A NEW INDEPENDENT ENTITY

One of the key questions in the design of the SRM is whether the SRM task should be linked to an existing or newly created entity. When designing a properly working resolution mechanism, it is necessary to ensure that all involved authorities are able to cooperate and will cooperate. Ensuring cooperation can only be done by having clarity on what is being supervised, what are the procedures, who supervises, who is responsible for resolution and what are the risks.<sup>7</sup> There are three reasons why a separate entity should deal with the SRM task: i) speed; ii) independence; and iii) clarity and transparency.

When dealing with a bank at risk, time is of the essence. Procedures should be swift because delays may undercut efforts to preserve assets and increase the likelihood of systemic consequences.<sup>8</sup> In practice this can be achieved by having clear procedures, resolutions plans and 'Living Wills'.<sup>9</sup> These resolution plans provide the blueprint of a resolution and specify possible SRM authority action. To work in practice it is important that national interests cannot contaminate the resolution process. National authorities nearly always place a priority on national objectives.<sup>10</sup> This leads to the notion of independence.

It has been noted that resolution in practice often led national authorities to consider objectives other than those strictly related to financial stability (which should come first) such as minimising the cost borne by national taxpayers, safeguarding the domestic system while disregarding the broader market and being soft towards national champions. Having a truly **independent entity** is for these reasons important. National supervisors are always under pressure from national political capture so the final responsibility should be taken by an entity at the European level. An entity at the European level should be less prone to particular national interests.

A system where deposit guarantee schemes and resolution remains national, while the supervision moves to the European level under the auspices of the European Central Bank is not viable. Such a system is not incentive-compatible. National authorities would be willing to bet on support by the ECB hoping the institution would survive.<sup>11</sup> The ECB may find itself trapped. It would see the problems and call for action but it might have only limited supervisory powers (while resolution was to be done on national level).<sup>12</sup>

This leads to the conclusion that ultimately, the decision on remedial actions and resolution should be taken on a European level and independently. Independence also implies that the SRM task should be decoupled from other supervisory responsibilities.<sup>13</sup> Supervisors have responsibilities other than resolution such as licensing and day-to-day supervision. A separate Resolution Authority allows for judging the situation from a fresh and detached perspective. This separation is similar to the principle of separation employed in the

<sup>7</sup> Schoemaker, D. (2012), Banking Supervision and resolution: The European Dimension. DSF Policy Paper, no. 19.

<sup>8</sup> Claessens, S., R. Herring and D. Schoemaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

<sup>9</sup> Avgouleas, E., Goodhart, C. and D. Schoemaker (2012), Bank resolution plans as a catalyst for global financial reform. Journal of Financial Stability.

<sup>10</sup> Herring, R. (2007), Conflicts between Home and Host Country prudential Supervisors, in D. Evanoff, J. Raymond LaBrosse and G. Kauffman (eds), International Financial Instability: Global Banking & National Regulation, Singapore: World Scientific, 201-220.

<sup>11</sup> Schoemaker, D. and D. Gros (2012) A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

<sup>12</sup> Schoemaker, D. and D. Gros (2012) A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

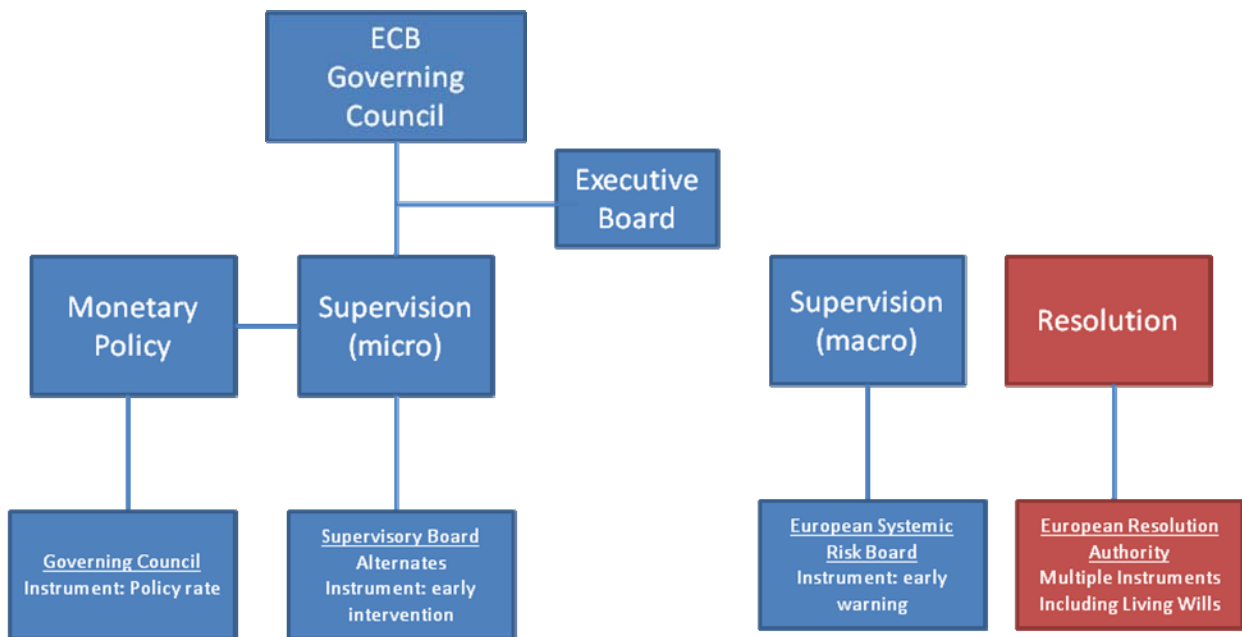
<sup>13</sup> Advisory Scientific Committee (2012), Forbearance, Resolution and Deposit Insurance, Reports of the Advisory Scientific Committee No. 1, Frankfurt.

banking sector where the responsibility for doubtful loans is shifted from a loan officer to a designated credits department.<sup>14</sup>

The status of the Resolution Authority should remain independent of the ECB. Moreover independence of the ECB itself provides the best chance of sufficient detachment. A resolution authority as separate entity should help make the SRM also more transparent. The Resolution Authority has only one responsibility and this responsibility is not muddled by adding it to another entity.

In figure 1, the recommended institutional setup is displayed.

**Figure 1: Future distribution of tasks – An overview**



**Source:** Author's elaboration; this figure is an update of an earlier overview.<sup>15</sup> The parts in red indicate the Resolution Authority.

Figure 1 stresses the independence of the Resolution Authority, here referred to as the *European Resolution Authority*, but in practice there will be some contact and even cooperation among the different supervisors and the Resolution Authority- be it only for information sharing. This connection is in practice unavoidable and even desirable. However, just as the supervisory tasks by the ECB should be independent from political interference,<sup>16</sup> so should the SRM be, i.e. able to function independently (within a clearly defined legal framework). *Ex post*, the Resolution Authority should be accountable to the Committee for Economic and Monetary Affairs of the European Parliament – comparable to monetary policy and economic supervision.

<sup>14</sup> Schoenmaker, D. and D. Gros (2012), A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

<sup>15</sup> Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.

<sup>16</sup> Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.

## 2. COMMON INSOLVENCY RULES

Another issue to be discussed is whether the framework for the SRM should be generic or whether it would be necessary to establish common insolvency rules. A substantial body of research has identified the goals that good resolution procedures should meet.<sup>17</sup> One of these goals is particularly important for the discussion of insolvency rules: A good resolution procedure should lead to **predictable results**. Negative surprises cause uncertainty in financial markets, especially when induced by unexpected behaviour of regulators because they cast doubt over the rules of the game.<sup>18</sup>

Insolvency rules should be implemented at the European level. In part because providing leeway at the national level allows for regulatory arbitrage. On top of that, resolution on national level may cause conflicts of interests due to asymmetries between countries.<sup>19</sup> National authorities may differ in the amount of resources they have (human and financial resources). Some national authorities may even have insufficient resources to resolve a major cross-border bank failure. Also there will be differences in accounting (e.g. for tax purposes), legal and institutional infrastructures. The success of a resolution procedure should not depend on such differences in the accounting and of judicial procedures from one country to another within the euro area. Finally, different national resolution frameworks may induce a differential impact of similar resolution procedures.

These problems suggest that there is a lot to be gained by setting out clear common insolvency rules. Such an approach allows the Resolution Authority to prepare well and avoid disorderly insolvencies or improvised bailouts.

Most importantly, common insolvency rules allow for a good resolution plan because it starts from a clear premise: an insolvent institution where there is not doubt on what insolvency constitutes. Such a resolution plan is seen to be an essential tool to systemic stability.<sup>20</sup>

A resolution plan is a set of procedures which are followed during a resolution. The bank provides practical details such as persons involved in case of bank resolution (attorneys, administrators, etc.). At the same time it lists requirements for the financial institutions which are covered by the Resolution Authority. Such a plan should be updated annually. Detailed descriptions of such plans have already been proposed.<sup>21</sup>

The benefits of resolution plans are that these reduce moral hazard by making it clear that a cross-country bank can be resolved in such a way that losses are borne by or posed on the stakeholders of the bank while avoiding a systemic impact. It is important that the resolution plans are formulated for the cross-border bank as a whole and not only for the separate parts.

Common insolvency rules may be difficult to achieve, but a first major step should involve a harmonisation of current insolvency rules for those banks which fall under SSM and SRM.

---

<sup>17</sup> Hart, O. (2002), Different Approaches to Bankruptcy. Harvard Institute of Economic Research Discussion Paper No. 1903.

<sup>18</sup> Claessens, S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

<sup>19</sup> Herring, R. (2007) Conflicts of interest between Home and Host Country Prudential Supervisors, in D. Evanoff, J. LaBrosse and G. Kaufmann (eds.), International Financial Stability: Global Banking & National Regulation, World Scientific Publishing, Singapore, 201-20.

<sup>20</sup> Claessens, S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

<sup>21</sup> Claessens, S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

In the best case, these insolvency rules should gradually become a common insolvency framework for all banks agreed upon by all Member States. Otherwise, the national legislators could adapt the national insolvency rules for the smaller banks which do not fall under the Single Resolution Framework. These national insolvency rules could then at a steady pace move towards the common insolvency rules.

### **3. CONNECTION WITH NATIONAL RESOLUTION MECHANISMS**

A third issue which needs to be answered is how a SRM should be linked to already proposed national resolution mechanisms which of course should be harmonised as soon as possible. To be effective operationally, the SRM needs to take priority. This means that when a SIFI under the SSM fails, the European Resolution Authority has the ability to intervene and start the necessary resolution procedures. The national resolution mechanisms are then not applicable to banks falling under the European Mechanism. This separation of Resolution Authority (a Single Resolution Authority for cross-border banks and national authorities for national banks) helps avoiding conflicts of interest.

It is important that a clear, thoughtful and well defined legal framework is set up for this.<sup>22</sup> As mentioned above, in practice a Single Resolution Authority will likely be responsible for the largest banks (SIFIs) only. This distinction is motivated by practical concerns. To minimise regulatory arbitrage among the banks which do not fall under the SRM, we suggest that national rulemakers aim at harmonising national legislation and the guidelines of the SRM. In this view the establishment of a SRM is just another step towards a full-fledged banking union.

---

<sup>22</sup> Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.



## 4. RESOLUTION STRATEGY

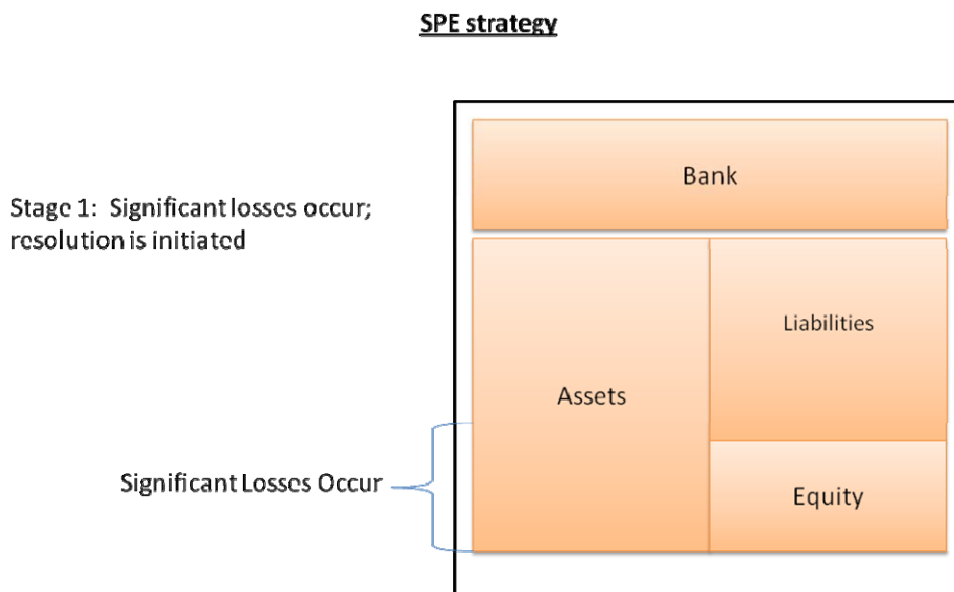
When thinking about a resolution strategy, it is useful to consider two different strategies. On the one hand we could have a Single Point of Entry resolution strategy (SPE) and on the other hand a Multiple Point of Entry resolution strategy (MPE).<sup>23</sup>

We broadly distinguish two phases in every resolution. The first phase is the stabilisation phase which is initiated quickly. The second phase is the restructuring phase which can take months if not years. The fundamental difference between both resolution strategies is the first phase.

### 4.1. Single Point of Entry Resolution Strategy (SPE)

Figure 2 shows the different stages of the stabilisation phase. Under a SPE resolution strategy, the resolution focuses on the entire SIFI.<sup>24</sup> After losses have occurred, the resolution is initiated. The assets are then valued and the resolution authority executes a resolution plan. In our set-up, an intervention such as a bail-in or mandatory debt-to-equity swap happens on the group level only. Losses in subsidiaries can be covered but only through the holding company (by means of a downstream of new capital).

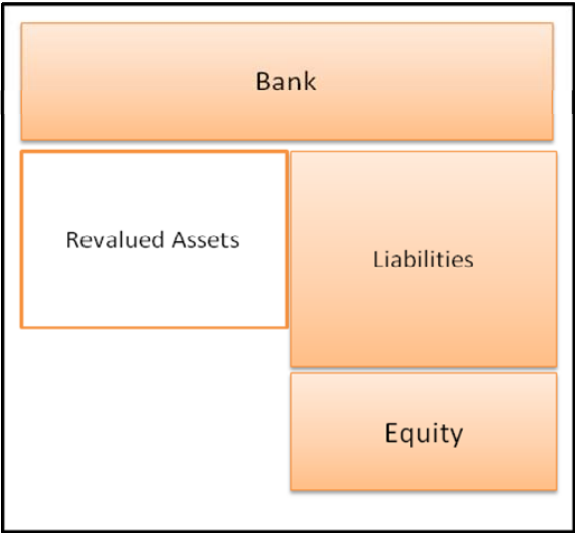
**Figure 2: Single Point of Entry Resolution**



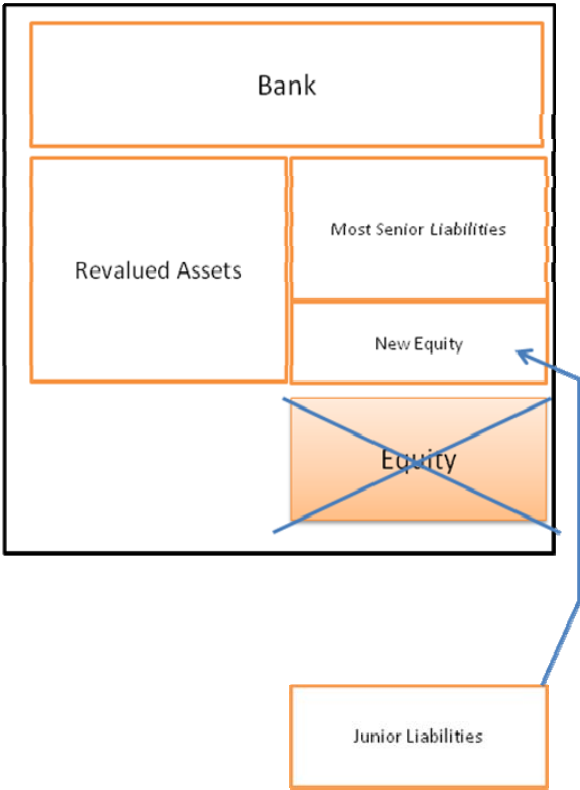
<sup>23</sup> The description of these corner strategies is based on an internal paper on resolution strategies developed by De Nederlandsche Bank.

<sup>24</sup> See for comparison FSB, Recovery and Resolution Planning: Making the Key Attributes Requirements Operational, Consultative Document, November 2012: "This proposed guidance sets out the key elements that may be included in resolution strategies and plans. It draws on two stylised approaches to resolution: a 'single point of entry' approach by which group resolution takes place primarily through action by the home authority mainly at the level of the parent or holding company; and a 'multiple point of entry' approach whereby resolution actions are taken by multiple authorities along national, regional or functional lines. The guidance is not intended to be prescriptive as to one approach or the other. Resolution authorities will need to adapt the strategies and plans to fit individual G-SIFIs and, in practice, some combination of approaches is likely."

Stage 2: Assets are revalued.



Stage 3: Old equity is written off, apply a bail-in until sufficient recapitalization (most junior first). Bailed-in creditors become the new owners of the bank.



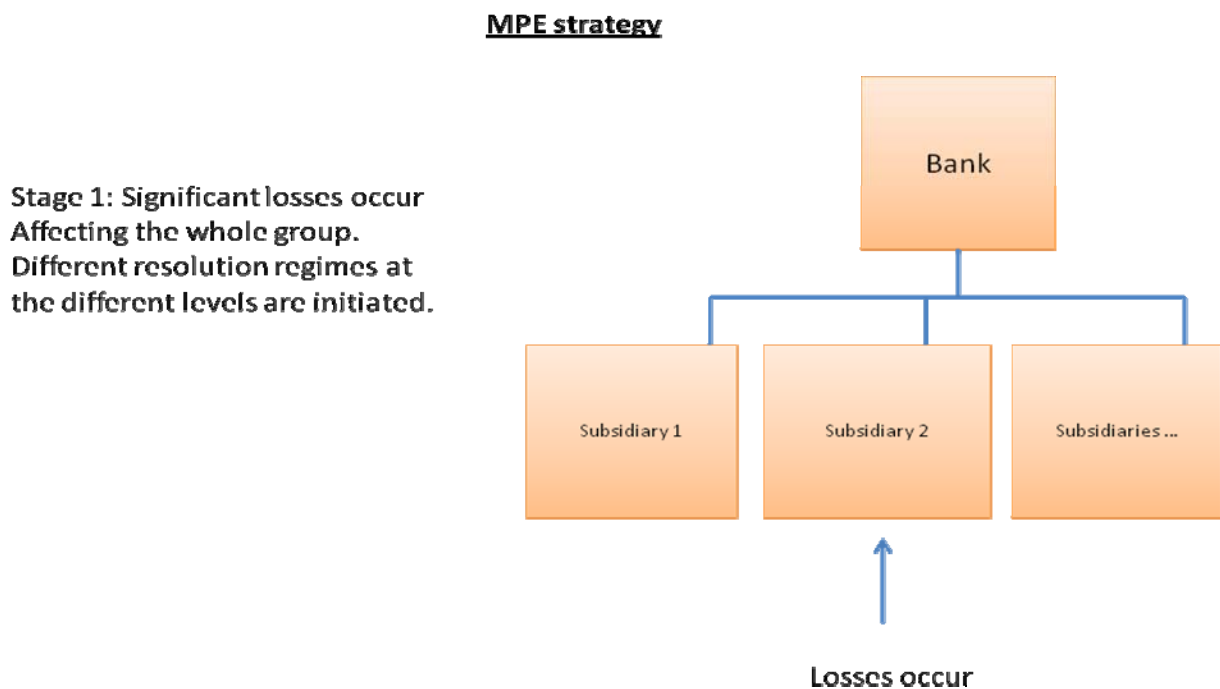
Source: De Nederlandsche Bank (2013), internal document (reproduced and adapted with DNB permission).

## 4.2. Multiple Point of Entry Resolution Strategy (MPE)

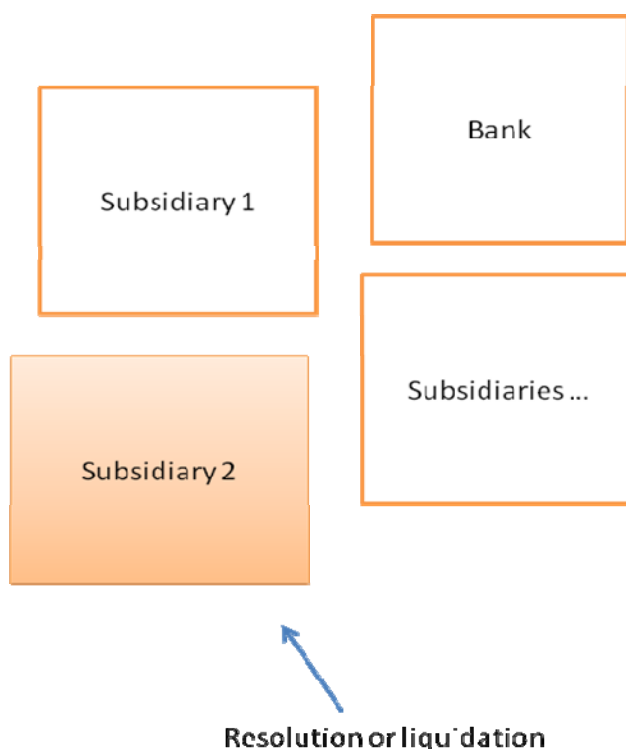
Compare the SPE resolution approach with a MPE strategy where a cross-border bank is resolved on multiple levels: the holding company and the subsidiaries. The resolution effectively ends the existence of the 'cross-border' bank and multiple national resolution authorities take resolution actions. Within the MPE framework, resolution authorities typically act along national, regional or functional lines.

The stabilisation phase emphasises a stabilisation of the bank and the continuity of its critical activities. In the restructuring phase the financial institution is restructured, a reorganisation may take place and management replaced. This strategy is presented in figure 3.

**Figure 3: Multiple Point of Entry Resolution**



**Stage 2: All subsidiaries are separated from the group and put under the responsibility of local Resolution Authorities.**



**Source:** De Nederlandsche Bank (2013), internal document (reproduced and adapted with DNB permission).

### 4.3. Assessment of the two strategies

Both strategies are at the opposite ends of the spectrum and many resolution interventions may lie in between. In the context of the SRM we recommend that any resolution intervention should be close to a SPE resolution strategy and resolution plans should take this *ex ante* into account. The use of a MPE resolution strategy while having a supranational Resolution Authority seems hardly beneficial. In practice a MPE resolution strategy leads to a split along national lines or at least to segments which are more relevant for some countries. This may tempt national governments to put pressure on the national resolution authority to favour their part. Also, when a country (government, voters or media) have the impression that the resolution strategy is more harmful domestically than to other countries, the risk rises that the country will push for a national solution. Similarly a country may have the impression that it could have done better on its own. As an example, the resolution of the Fortis/ABN AMRO group proved to be difficult for these reasons.

This concern is related to the financial trilemma mentioned earlier. In times of distress it is harder for an individual country to internalise the broader impact on global financial stability. A SRM which is meant to deal with complex cross-border banks should be protected from national agendas. A strategy which avoids increased national intrusion is to be preferred.

If the resolution plans by the SRM are all conceived from a SPE resolution perspective then the incentive for national governments to push for particular outcome is weakened. After all, after the resolution there are no pieces to be picked up or national champions to be preserved. The cross-border bank, albeit in a new form, may remain intact.<sup>25</sup> We therefore have a strong preference for a SPE resolution strategy.

<sup>25</sup> Claessens, S., R. Herring and D. Schoemaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR.

## 5. CONCLUSION

In this note we discussed issues related to the implementation of the SRM. Specifically the questions of form, legal nature and relation between SRM and national resolution mechanisms. Finally, we focused on the broader strategy a supranational Resolution Authority should take.

The discussion leads to five recommendations:

i) **Single Independent Entity:** First, it is recommended that a new separate, independent European entity for the SRM should be created, the European Resolution Authority. This separate entity has one clear task, the resolution of cross-border banks/SIFIs.

ii) **Common rules for all countries:** Second, we argued that to have any probability of success, the SRM should include common insolvency rules. Common insolvency rules could preclude regulatory arbitrage and avoid hazardous legislative asymmetries between countries.

iii) **Resolution Plans for SIFIs:** In the same section we emphasised that resolution plans should be drafted for the totality of the SIFI and not for the separate parts.

iv) **Priority over national authorities:** Then we argued that the European Resolution Authority should have priority over national supervisors and resolution authorities. If this is not the case then this leaves the door open for conflicts of interest. Moreover, a clear delineation of tasks is necessary for properly drafted living wills and resolution plans.

v) **Single Point of Entry resolution:** Finally, we concluded that a Single Point of Entry resolution mechanism is more suitable than a Multiple Point of Entry resolution strategy for a supranational Resolution Authority.

The rationale behind these five recommendations is the same. The problem with national resolution approaches for complex SIFIs is that national governments tend to take a national perspective and do not take the international (European) dimension into account. To be effective in solving this problem, the SRM needs to deal with national interests and avoid national interference. A single independent entity (i), accompanied by common rules applicable in all countries (ii), with resolution plans drafted for SIFIs in their entirety (iii), with priority over national authorities, and (iv) with a Single Point of Entry resolution, is the best set-up to ensure that the SRM can be successful.

## REFERENCES

- Advisory Scientific Committee (2012), *Forbearance, Resolution and Deposit Insurance*, Reports of the Advisory Scientific Committee No.1, Frankfurt.
- Avgouleas, E., Goodhart, C. and D. Schoenmaker (2012), *Bank resolution plans as a catalyst for global financial reform*. Journal of Financial Stability.
- Claessens, S., R. Herring and D. Schoenmaker (2010), *A safer world financial system: Improving the resolution of Systemic Institutions*, 12<sup>th</sup> Geneva Report on the World Economy, London: CEPR; <http://personal.vu.nl/d.schoenmaker/Geneva12.pdf>.
- De Nederlandsche Bank (2013) *Internal document on resolution strategies*. Amsterdam.
- Eijffinger, S. (2012), *Monetary Policy and Banking Supervision*. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.
- FSB, Recovery and Resolution Planning: Making the Key Attributes Requirements Operational, Consultative Document, November 2012.
- Hart, O. (2002), *Different Approaches to Bankruptcy*. Harvard Institute of Economic Research Discussion Paper No. 1903.
- Herring, R. (2007), *Conflicts between Home and Host Country prudential Supervisors*, in D. Evanoff, J. Raymond LaBrosse and G. Kauffman (eds), *International Financial Instability: Global Banking & National Regulation*, Singapore: World Scientific, 201-220.
- Schoenmaker, D. and D. Gros (2012), *A European Deposit Insurance and Resolution Fund – An update*. DSF Policy Paper, no. 26.
- Schoenmaker, D. (2012), *Banking Supervision and resolution: The European Dimension*. DSF Policy Paper, no. 19; <http://www.dsf.nl/assets/cms/File/Research/DSF%20Policy%20Paper%20No%2019%20Banking%20Supervision%20and%20Resolution%20-%20The%20European%20Dimension%20Jan%202012.pdf>.





DIRECTORATE-GENERAL FOR INTERNAL POLICIES

## POLICY DEPARTMENT ECONOMIC AND SCIENTIFIC POLICY **A**

### Role

Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

### Policy Areas

- Economic and Monetary Affairs
- Employment and Social Affairs
- Environment, Public Health and Food Safety
- Industry, Research and Energy
- Internal Market and Consumer Protection

### Documents

Visit the European Parliament website: <http://www.europarl.europa.eu/studies>

PHOTO CREDIT: iStock International Inc.



ISBN 978-92-823-4251-0  
doi:10.2861/15568