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FROM SUPERVISION TO RESOLUTION: NEXT STEPS ON THE ROAD TO EUROPEAN BANKING UNION

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Highligh

- The European Council has outlined the creation of a Single Resolution Mechanism (SRM), complementing the Single Supervisory Mechanism. The thinking on the SRM's legal basis, design and mission is still preliminary and depends on other major initiatives, including the European Stability Mechanism's involvement in 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 the 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.

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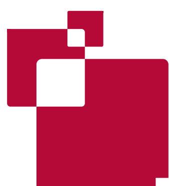

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though a longer and more complex sequence might also happen, and we discuss their possible objectives and content in the next sections.

2.5 Banking structure

The reform of banking structures has been given high political prominence in Europe as well as in the US, where the Dodd-Frank Act of 2010 introduced the 'Volcker Rule' of separation of proprietary trading, though the implementing regulations are still being discussed by federal agencies. At the level of individual EU member states, there have been 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 what stage exactly remains unspecified.

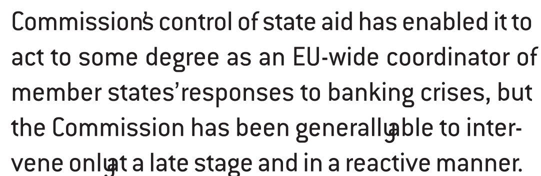
3 POLICY OBJECTIVES AND SEQUENCING

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

The EU bank resolution agenda combines simultaneous short-term and long-term challenges: 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 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.

3.1 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 (eg Caballero et al, 2008). Sadly the same pattern is increasingly recognisable throughout Europe.



Commission's control of state aid has enabled it to act to some degree as an EU-wide coordinator of member states' responses to banking crises, but the Commission 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 policy makers, particularly in the early years of the crisis, to guarantee all bank creditors and avoid imposing losses on any of them or at least to senior unsecured creditors (Goldstein and Véron, 2011). However, European policy makers 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 is called into question. 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[7]. 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[8], to envisage the 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 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 WolfdTJT-.0015 Tc-.0247 3pean else-

moment in this process was the release of the European Council President's report *Towards a Genuine Economic and Monetary Union* of 26 June 2012 (Van Rompuy, 2012a), which envisaged four 'building blocks' of eventual crisis resolution, now commonly referred to as banking union, fiscal union, economic union, and political union (eg Draghi, 2012). The multiple interdependencies among the 'fourfold union' building blocks 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, there is greatest consensus on banking union in terms of definition (Pisani-Ferry *et 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 about how far away they are (Vaisse *et 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 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 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.

3.3 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, implies effectiveness in the early spring 2014; moreover, the ability of the ESM to recapitalise banks directly is delayed until "an effective single supervisory mechanism is established", ie at the same time as the entry into force of Step 1. As for Step 3, the "intention" is to adopt the legislation creating the SRM "during the current [European] parliamentary cycle", ie during the spring of 2014 at the latest. If these intentions are 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.

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, particularly its Directorate-General for Competition (DG COMP), in the assessment of state aid cases[11]. Here again, the Spanish programme, in which the disbursement of ESM funds was made contingent on 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 the systematic ex ante involvement of DG COMP in cases

by the ECB (as a compromise between the concern 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. Among other issues, we are concerned by the material non-compliance of the CRR with the international Basel III Accord on the definition of capital, in particular because the CRR waters down the requirements for 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-setting process that the EU has long endeavoured to promote and strengthen[14]. We also believe that the finalisation of the CRR and CRD4 in the early spring of 2013 is highly desirable.

4.2 Step 2: BRR and DGS Directives, Operational

assessment, the discussion of this framework among euro-area members 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 for possible future intervention by the ESM, both in terms of recapitalisation 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. 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 so-called 'legacy assets'. In September 2012, the finance ministers of Germany, the Netherlands and Finland 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[1]". Taken literally, this implies that assets that were brought onto 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 in practice prevented from recapitalising the bank. This stance would render meaningless successive Council Conclusions that refer to ESM direct recapitalisations.

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 should 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

member states. If resolution remains primarily a member-state responsibility 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 [18]. 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 Policy Contribution. We cannot identify in the current treaties an adequate and sufficiently robust legal basis for a European insolvency regime. Even assuming the existence of such a basis, the creation of an effective supranational insolvency regime is bound to require a long planning and preparation period. For example, the creation of a European insolvency court should not be 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 continue to 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, for example to mitigate the possibility of moral hazard arising from national economic policy decisions that shape banks' risk but are not part of the European banking policy framework, eg housing policy.

One option would be to create an industry-funded European resolution fund alongside the establishment of the SRM. However, a European fund would take time to build up and would be unlikely to gather significant financial firepower for a number of years, well beyond the SRM's start of operations. Moreover such a fund could raise moral hazards of its own. The 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 for 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 the delegation of authority to the home-country resolution authority alone, which would 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 would 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 about 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 for the rapid-action requirement that applies to a resolution authority. The fact that the ESM exists outside 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. First, 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. Second, a new body could 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 over accountability and judicial review.

To fulfil its aim of contributing to the breaking of 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 considering that the ESM currently does not cover those countries remains to be debated[19]. 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 the respective merits and flaws of these options.

Among other operational concerns, the SRM's cen-

play in future resolution processes. This should be on the agenda with the planned review of both of these institutions in 2014, in application of the European legislation that created them.

4.4 Banking structure

In spite of its political prominence, we believe the discussion on regulating banks' structures would 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 and 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.

5. CONCLUSION

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, 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 in which Europe cannot afford to fail.

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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 the 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 as 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 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 [20].

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 [21], 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 to how it would reflect the financial stability objective in its assessment.

The Banking Communication[22] 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 minimise negative sp 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[23] provided further guidance on the pricing of state recapitalisation measures[24].

The Impaired Assets Communication[25] provides guidance on the design and implementation of asset

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