BANKING UNION

PROGRESS AND PROSPECTS

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LIST OF ACRONYMS USED IN THIS REPORT

AQR Asset Quality Review
BCBS Basel Committee on Banking Supervision
BIS Bank for International Settlements
BRRD Bank Recovery and Resolution Directive
BTS Binding Technical Standards
CCAR Comprehensive Capital Analysis and Review
CCP Central Counterparty Clearinghouse
CET1 Common Equity Tier 1
COM European Commission
CRD IV Capital Requirements Directive
CRR Capital Requirements Regulation
DG Directorate General
DGS Deposit Guarantee Scheme
DRI Direct Recapitalisation Instrument
EA Euro area
EBA European Banking Authority
ECA European Court of Auditors
ECB European Central Bank
EIOPA European Insurance and Occupational Pensions Authority
ELS Emergency Liquidity Support
EMU Economic and Monetary Union
ESA European Supervisory Authority
ESFS European System of Financial Supervision
ESM European Stability Mechanism
ESMA European Securities and Markets Authority
ESRB European Systemic Risk Board
EU European Union
FDIC Federal Deposit Insurance Corporation
FRBNY Federal Reserve Bank of New York
FSA Financial Services Authority (United Kingdom)
FSB Financial Stability Board
SIFI Systemically Important Financial Institution

IASB	International Accounting Standards Board
FASB	Financial Accounting Standards Board
FSAP	Financial Sector Assessment Programme
ICAAP	Internal Capital Adequacy Assessment Process
IGA	Intergovernmental Agreement
ILAAP	Internal Liquidity Adequacy Assessment Process
GDP	Gross Domestic Produce
IMF	International Monetary Fund
JST	Joint Supervisory Team
LTRO	Long Term Refinancing Operation
MREL	Minimum Requirement Eligible Liabilities
NCA	National Competent Authority
NAMA	National Asset Management Agency (Ireland)
NFL	Net Financial Liability
NRA	National Resolution Authority
OECD	Organisation for Economic Co-operation and Development
OMTs	Outright Monetary Transactions
OTC	Over the counter
RWA	Risk Weighted Assets
SGP	Stability and Growth Pact
SMEs	Small and Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer System
TBTF	Too-big-to-fail
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
UK	United Kingdom
US	United States

PREFACE

This report on 'Banking Union: Progress and Prospects' is an updated version of a book published in October 2014, which was based on a two year project initiated in 2012 in response to the European Council's decision to create a Banking Union.

Work commenced by using the standard Institute methodology of creating a group of experts volunteering their time and expertise to explore the issues, options and implications arising from the EU's ambition to break the doom-loop between the sovereigns and the banking system. The group was co-chaired by Pat Cox, former President of the European Parliament, and Pat McArdle, formerly of the Department of Finance and Ulster Bank and currently Chairman of the Institute's Economists Group. The project team was assisted by Andrew Gilmore from the Institute's in-house research staff.

The project team met on a regular basis, with some members preparing papers for discussion. The difficulty in the formative stages of the project was simply to keep abreast of events as solutions emerged within ECOFIN and the ECB in embryonic form and were then finessed as the debate progressed. Nevertheless, the project proceeded satisfactorily to the point where a major conference was held at the end of 2013 which was addressed by many policy-makers and senior figures, including the Vice-President of the ECB, Vítor Constâncio, and the Governor of the Central Bank, Professor Patrick Honohan. The conference proved of great value in clarifying many of the issues.

In addition, field research was conducted by Pat McArdle and Andrew Gilmore involving consultations with the European Commission, Parliament, Council and other think-tanks, notably Bruegel in Brussels. Of necessity, they also attended many conferences and seminars both in Ireland and elsewhere in the EU. Throughout this period, the advice of the Department of Finance and of the Central Bank was sought on many technical issues and the cooperation of both bodies is gratefully acknowledged.

Due to new responsibilities arising from a special mission to the Ukraine at the request of the President of the European Parliament, Pat Cox had to wind down his engagement in the project. Pat McArdle was then invited to draft the final report, with the assistance of Andrew Gilmore, taking account of the various working papers already presented and updating the research to include new developments.

The Board of the Institute wishes to thank Pat McArdle for the professionalism with which this task was accomplished and for the expertise he brought to bear on a highly complicated policy area. As will be seen, the report is written in a highly accessible style without compromising the technical complexity of the subject matter and for that alone we thank him. Andrew Gilmore conducted extensive research throughout the evolution of the project, contributed a number of chapters and organised meetings and field trips. Both edited the report with skill and great effect. They are due our best thanks.

The same is true of the members of the project group, the authors of the working papers and drafts of chapters, the various Irish and other officials who gave so freely of their time and expertise and, in particular, the many speakers who addressed the Institute on issues central to the Banking Union project.

It will be obvious from perusing the report that it is one of the most ambitious ever undertaken by the Institute, and certainly one of the most important. It could not have been undertaken on the scale achieved without the generous sponsorship of Bank of Ireland, who were at all times throughout the project a considerate and positive supporter of the work in hand. Their understanding of the difficulties encountered along the way went far in helping to manage a timetable that was always subject to change and last minute adjustment. Our best thanks is expressed in the production of this report which, hopefully, meets all of the objectives on which we jointly agreed at the outset.

Any publication depends in the end not only on content and style but on its physical presentation and here we are fortunate in the design team housed within the Institute. Brian Martin and Alba Comenge have already set the highest standards in terms of creativity and aesthetics, which are again in evidence in this publication, which will appear in both hard and soft copy. We salute their professionalism.

In a personal capacity, I owe a great deal of gratitude to the Governor of the Central Bank of Ireland, Professor Patrick Honohan, and to Ann Nolan of the Department of Finance for their unfailing support and advice, always given with good humour ever in the most trying of circumstances.

Within the Institute, two Directors General, Dáithí O'Ceallaigh and Tom Arnold, and the Director of Research, Jill Donoghue, were indispensable members of the management team that guided the project throughout two years of unrelenting work and many difficulties. I thank them most sincerely.

It is obvious that this report is a snapshot in time, the very title captures that reality. It is a record of progress on Banking Union up to late October 2014 and an assessment of its prospects over the medium term. Clearly it is not the final word. There will be more reports, and seminars, and papers. Such is the nature of European integration, a complex process of iterating progress towards a goal that is being constantly refined. Nevertheless, the basic message coming from this report is that more progress has been made than originally anticipated in breaking the doom-loop between the sovereign and the banks. In many respects, Banking Union is the greatest achievement within the EU since the creation of EMU and the earlier establishment of the Single Market. It will, no doubt, lead on eventually to a more developed Fiscal Union and to a more clearly defined Political Union. In short, the agenda ahead will be no less demanding than that described here in assessing the progress and prospects of Europe's new Banking Union.

Brendan Halligan
Chairman, IIEA

FOREWORD

The context which frames the publication of this report is one of change. Within the regulatory landscape there have been significant developments at both national and European level in recent years. Chief amongst these was the decision in 2012 to create a European Banking Union.

This has been a highly significant initiative for the European Union, the Eurozone, the European Central Bank, the national competent authorities including – in the case of Ireland – the Central Bank of Ireland, and the banking sector. Understanding the implications of Banking Union – across the range of stakeholders, and the specific impact on Ireland – forms the basis of this extensive report.

The challenges that the banking sector has faced since 2008 – and the response to these challenges – has changed the sector considerably. The development of a suite of regulatory changes within the EU and Eurozone has been an obvious manifestation of the response to these challenges. European banking union is now a reality, with Ireland as a full member.

The components of banking union include the Single Supervisory Mechanism, the Single Resolution Mechanism, and the harmonisation of national deposit guarantee schemes. Each of these is significant.

The SSM creates a new system of financial supervision comprising the ECB and the national competent authorities of participating EU countries, such as the Central Bank of Ireland. Under the SSM the ECB assumes a direct supervisory role over approximately 130 large and systemic banks within the Eurozone. The institutions which are part of the direct supervisory role of the ECB represent almost 85% of total banking assets in the Eurozone. The ECB will also work closely with the national competent authorities to supervise all other credit institutions in Ireland, under the overall oversight of the ECB.

The SRM consists of a European Resolution Authority and a European Resolution Fund, covering all banks in the European Union and financed by a European bank levy. Finally, the harmonisation of national deposit guarantee schemes sees deposits up to €100,000 per depositor being insured with a repayment to the depositor within seven working days in the event of bank insolvency.

We have been happy to support the development of this report as part of the Institute of International and European Affairs Banking Union Group. I would like to compliment the Institute, the members of the Banking Union Group, and all contributors to the publication for their considerable work on this publication, which I hope will be a valuable resource as the process of Banking Union is embedded across the EU and Eurozone.

Richie Boucher
Group Chief Executive, Bank of Ireland

"Citizens may not realise it yet, but for the financial community it is a game changer as important as the introduction of the euro."

Jyrki Katainen
European Commission Vice-President for Jobs, Growth, Investment and Competitiveness

PART 1.
CRISIS AND RESPONSE

CHAPTER 1. INTRODUCTION AND BACKGROUND TO THE FINANCIAL CRISIS

"The rationale for a Banking Union complementing Monetary Union is straightforward. Europe's Economic and Monetary Union (EMU) was constructed on the basis of two pillars: a monetary pillar with the independent and price-stability oriented European Central Bank (ECB), and a fiscal pillar oriented towards fiscal discipline with a modicum of coordination. It (had) no financial policy component apart from the ban on capital controls and the promotion of a Single Market for financial services, both of which apply to the whole EU, and it (had) no banking component, apart from those arising from the operation of monetary policy and the common banking regulation and common standards on deposit insurance. The ECB itself had few financial stability competences."[1]

Bruegel, June 2012

1.1 INTRODUCTION

Even before the crisis there were reasons to question whether an Economic and Monetary Union (EMU) without a financial services or banking component was sufficient. Academics and bankers had highlighted the inherent contradiction between pan-European banking, on the one hand, and exclusive national responsibility for bank supervision, on the other. There was no mechanism for orderly debt restructuring or for any possibility of exit from the euro area (EA) or, indeed, for common bank supervision and resolution. Banking Union was not part of the grand plan of EMU; rather, it is one element of the response to the financial crisis.

During the crisis, banks failed for a variety of reasons. The first phase of the financial crisis was triggered by the US sub-prime mortgage crisis. This extended into Europe

[1] Jean Pisani-Ferry, André Sapir, Nicolas Véron and Guntram B. Wolff, "What kind of European banking union?" Bruegel, June 2012.

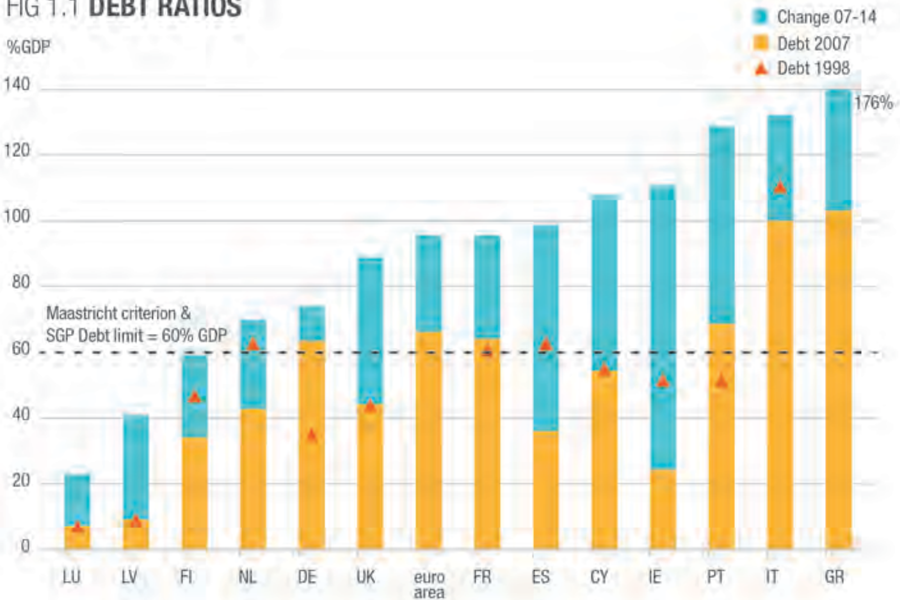
because some EU banks had purchased derivatives linked to US mortgages that became worthless. Virtually overnight, the interbank market dried up, switching the focus to banks like Northern Rock in the UK and to the Irish banks, which had borrowed to excess and/or had funding models that were no longer sustainable. These banks failed even though they held little or no sub-prime linked debt. Aggressive cross-border expansion was also a feature. This was most obvious in the case of the ABN AMRO takeover. In October 2007, a consortium of the Royal Bank of Scotland (RBS)[2], Fortis and Banco Santander acquired ABN AMRO, the second largest bank in the Netherlands, in what was the world's biggest bank takeover until then. ABN AMRO was split in three and Santander quickly sold much of its part to Banca Monte dei Paschi di Siena (BMPS). RBS, Fortis and BMPS subsequently collapsed and/or had to be bailed out by their respective sovereigns.

The second phase of the financial crisis was specific to the euro area and even more virulent. It was triggered by excessive government borrowing and debt in Greece but spread to other countries where the problem was private, not public, debt. The two rapidly intermingled, however, as countries like Ireland first guaranteed vast amounts of private sector debt and then decided to bail out banks regarded as systemic and therefore crucial to their domestic economies. The links between banks and governments were reinforced, as in many cases banks held large quantities of their sovereign's debt[3]. Inadequate and uncooperative bank supervision, a major causative factor of the crisis, continued to bedevil efforts to solve it, and EU policymakers rescued their own national banking systems without taking into consideration the effect of their actions on others.[4] Speculation also played a big part, as the tardy and piecemeal EU response facilitated conditions that were ripe for speculation and which only ended when the ECB promised unlimited intervention.

The crisis revealed weaknesses in the structures of euro area governance and, in particular, the regulation, oversight, and resolution of financial institutions. More than €800 billion in guarantees had to be dedicated to keep the financial sector afloat. While only a tiny part of this sum was activated, the combination of bank bail-outs funded by public money, anaemic growth, and Troika loans to several sovereigns caused euro area public debt to grow from 66% of GDP in 2007 to 92% in 2013.[5] Though Ireland entered the crisis with a debt ratio of only 25%, it recorded the biggest deterioration, leaving it with a ratio of 124%[6] in 2013. The debt legacy

[2] Parent of Ulster Bank.
[3] The reasons for this in the pre-crisis period are not clear. However, once the crisis broke and speculation on the euro mounted, both banks and national governments had a vested mutual interest.
[4] The Irish bank guarantee was an early example of this.
[5] Bank bail-out costs of €607 billion accounted for 5 percentage points of the increase; the rest reflected other factors, notably the cumulative effects of budget deficits.
[6] One third of this reflected bank recapitalisation, the rest accumulated as the large annual budget deficits that emerged once the economy slowed down were painfully and slowly reduced.

from the crisis will be a major constraint on EU fiscal policy in coming decades as the members have solemnly committed to reducing the excess over 60% by one-twentieth per annum.



The financial crisis in the euro area periphery resulted, in large measure, from the failure of regulators and banks to control the untrammelled growth in private credit expansion, which was frequently used for housing purposes and generally funded by banks in the periphery borrowing from banks in the core countries. As often happens, the problems that emerged were not those that were foreseen. This was because there was relatively little focus on bank supervision when the euro was instituted. For a considerable period of time, the crisis was misdiagnosed as one of fiscal profligacy reflecting budgetary laxity in the periphery. This narrative suited core countries that were reluctant to bail-out others. However, this stance gradually changed and there is now widespread recognition that while the rules of the Stability and Growth Pact were flouted for a while by a few countries, including

Germany and France, flagrant fiscal excesses were confined to Greece and, to a much lesser extent, Portugal. Instead, Member States treated the windfall taxes that accompanied the boom as permanent sources of revenue, leaving them with large deficits when the tide inevitably turned.[7]

Part of the problem was insufficient bank regulation, inadequate supervision, and regulatory forbearance. But the euro area in general and the periphery in particular also suffered from weak economic growth, reflecting widespread uncertainty about prospective demand; deleveraging by over-indebted firms, households and banks; contractionary fiscal policies; and fragmentation of financial markets that led to higher borrowing costs for households and individuals in several countries.

The so-called 'no-bail-out clause' of the Treaty on the Functioning of the European Union (TFEU), was quickly set aside as Greece, followed by Ireland, Portugal, Spain and Cyprus, all required external financial assistance from the EU and the International Monetary Fund (IMF). Second, the Stability and Growth Pact which had the objective of avoiding major errors in the design and implementation of fiscal policies, was reformed to strengthen the rules and make them more binding as regards both deficits and debt – the latter had been ignored until that point.[8] In addition, surveillance was extended to cover private sector imbalances – a major omission from the earlier regime. Third, bank supervision was overhauled to ensure more and better quality bank capital and greater co-ordination, albeit still left in the hands of the national authorities for the time being.

Herculean though they were, these efforts were not enough and by mid-2012 EMU was on the verge of collapse, with large countries like Spain and Italy unable to borrow on the sovereign debt markets and speculation on the break-up of the euro rife. Two further measures were announced in quick succession. In June 2012, proposals for a Banking Union, essentially centralised supervision of financial institutions by the ECB,[9] were unveiled. However, the speculation continued and a month later ECB President Draghi promised to "do whatever it takes" to safeguard the euro (via unlimited purchases of Government bonds). Market speculation and turbulence subsided and a virtuous circle of falling bond yields and spreads ensued. In the event, the ECB's promise did not have to be executed.

The Banking Union proposals were fleshed out and agreed over the following 21 months and commenced in November 2014. The proposals were a vision for the

[7] The SGP terms were widely broken from 2009 on. In addition, the major forecasting agencies, the IMF, OECD and European Commission, radically revised their earlier estimates to show that Ireland and other countries had run large underlying structural budget deficits in the run up to the crisis – however, this was with hindsight.
[8] Although the vast bulk of euro area countries started EMU with debt ratios below 60%, many of them, including Germany, recorded increases which saw their debt ratios exceed 60% by 2007.
[9] Common bank resolution was added subsequently.

future – which explains why, on their own, they were insufficient to immediately restore lost confidence in the financial markets. Though they are still incomplete, they are nonetheless a major step forward and have already had a major impact as banks rushed to raise capital in advance of the results of the balance sheet assessment and strict stress tests that preceded Banking Union.

1.2 BACKGROUND

The European Council at Maastricht in December 1991 approved the Treaty on European Union and decided that Europe would have a single currency by the end of the century. The exchange rates of participating Member States were locked on 1 January 1999 with euro notes and coin appearing three years later, in 2002. In the event, however, the EU ended up with an Economic and Monetary Union quite different from the textbook examples – most notably that of the United States. The main differences were to be found in the underdeveloped nature of its fiscal and political union and, though there was little enough focus on it at the time, the absence of a centralised banking supervisory function.[10]

In 1989, the Delors Report[11] had made the case for EMU, arguing that a union with perfect capital mobility would strengthen the EU Single Market, eliminate exchange rate volatility and prevent balance-of-payments crises.

Concerns – mainly from the US – were expressed about the viability of a monetary union that did not meet key criteria for an optimal currency area, such as similar economic cycles, a high degree of labour mobility, and cross-country fiscal burden-sharing via a developed central budget.[12]

In the event, the euro triggered a major convergence of nominal interest rates on the back of significant financial market integration and cross-border capital flows. Market perceptions of risk, whether related to banks, firms, or governments, became increasingly divorced from nationality, if not reality:

> *Exuberant investors fuelled domestic demand booms in deficit economies in search of higher yields. Capital flowed steadily from core euro area countries, especially Germany and France (and the United Kingdom in the case of Ireland), mostly toward deficit countries' sovereigns or banks. The capital*

[10] The IMF Report on Capital Markets, September 1998, was an exception. It stated that "it is unclear how a bank crisis would be handled under the current institutional framework – which is not likely to be sustainable".

[11] Committee for the study of Economic and Monetary Union, Chaired by Jacques Delors, "Report on economic and monetary union in the European Community," presented to the European Commission April 1989.

[12] Some local commentators did note that economic differences between Member States could become a source of concern, including Prof. Philip Lane, "The Real Effects of European Monetary Union", *Journal of Economic Perspectives*, Vol. 20, No. 4, 2006, pp. 47–66 but these were few and far between and a major ESRI Report came to a positive conclusion.

flows financed property booms (especially in Ireland and Spain, but also in Greece), at the expense of tradable sectors. Higher growth and domestic demand helped fuel wage growth in excess of that elsewhere in the euro area and in other trading partners, with the increase in unit labour costs coming primarily in the non-traded sectors. Interest rates no longer served as signals of macroeconomic pressure points, because market discipline had weakened. As sovereign ratings converged, markets adopted procyclical behaviours, and risks were not priced in.[13]

IMF, July 2014

The euro had two significant implications for monetary policy. First, it brought one standard base interest rate for all euro area members. By targeting interest rates that were appropriate for the average euro area inflation rate, as it was obliged to do, the ECB exacerbated the situation in the periphery. In deficit economies, where inflation rates were high, the consequence was low real interest rates that contributed to booming domestic demand, thereby generating and widening current account deficits. This, however, was not a problem as long as these deficits were financed by capital inflows from the centre.

Second, devaluation by an individual Member State was no longer an option when costs got out of line and competitiveness deteriorated.[14] It also gave Irish banks access to extensive – virtually unlimited – interbank market funding in their domestic currency at unusually low interest rates. This plus securitisation of mortgages provided the wherewithal for massive balance sheet expansion which was not curbed by the regulator.

While it was recognised that countries joining the euro area had significant structural differences, the launch of the common currency was expected to result in further real convergence among member countries. The benefits of the Single Market were to be reinforced by growing trade and financial links – making economies more similar and subject to more common shocks over time. In that context, these common shocks would be best addressed through a common monetary policy.

Instead, country-specific shocks persisted and the consequences were compounded by fiscal policies which, in the event, were unable to alleviate them. In some cases, the shocks were the result of poor fiscal policies (in the case of Greece, for example). More

[13] The historical description of the crisis in this report draws on "Adjustment in Euro Area Deficit Countries: Progress, Challenges, and Policies," IMF, July 2014.
[14] The alternative is 'internal devaluation', a painful reduction in local prices and costs as experienced in Ireland and other Programme countries in recent years.

often, they resulted from the build-up of excessive private sector debt. Fiscal policies in Ireland and elsewhere did not mitigate these demand expansions. The windfalls from lower interest and debt payments were not saved and higher revenues generated by unsustainable domestic demand booms were wrongly deemed permanent. In addition, there are political limits to running large fiscal surpluses. However, though the Stability and Growth Pact was notably broken by France and Germany early in the last decade, lack of fiscal discipline was not a major factor behind the external imbalances other than in Greece and, to a much lesser extent, Portugal.[15] When the crisis hit, most countries had insufficient fiscal leeway to enable countercyclical support at national level.

A corrective mechanism against unsustainable national fiscal policies could have come from the capital markets. In fact, the 'no-bail-out' clause in the Maastricht Treaty was intended to ensure that no member ended up assuming another's fiscal commitments. This was meant to prompt financial markets to price default risk in a differentiated way across the euro area. However, general optimism about the region's growth prospects after the euro's inception blunted markets' scrutiny of national fiscal policies which, in any event, were generally in compliance with the formal terms of the Stability and Growth Pact.

Capital flows into the peripheral economies fuelled domestic demand and housing booms. With no exchange rate risk and, it was assumed, no sovereign risk, the revenues found their way into European peripheral bonds – one reason why interest rate spreads narrowed so rapidly. This process was helped along by the pre- financial crisis global 'hunt for yield' and by a 'heads I win, tails you lose' attitude among investors, notably those at German Landesbanks, who benefited from an explicit government subsidy. Peripheral countries' current account balances, which in some cases already posted significant deficits, deteriorated sharply, and Net Financial Liabilities (NFLs) mushroomed. The hoped-for progressive external adjustment through the monetary aggregates did not occur.

Instead, when the crisis broke, there was an abrupt reversal as market perceptions of risk refocused on individual countries and debtor countries experienced large reversals and outflows of capital.

Also labelled the 'vicious circle' and the 'pernicious triangle', the doom-loop referred to the interaction between governments, banks and the economy as each reacted to developments in the other in a vicious downward spiral, spurred by market

[15] This refers to budget deficits only – debt ratios rose in some countries but this was not regarded as a concern and the EMU debt criterion was ignored once the euro was up and running. While Ireland formally respected the terms of the SGP, the property transactions and other taxes associated with the boom were used to increase spending and lower taxes. When the party stopped, the deficit exploded.

FIG 1.2 **THE DOOM-LOOP**

speculation and negative economic comment. In countries like Ireland, the banks were regarded as being of systemic importance and were therefore bailed out by the Government. This increased the national debt, thereby calling the solvency of the state into question. In Greece the doom-loop operated in the opposite direction – an insolvent state brought down the banks. In either case, the end result was the same. In 2010-11 Greece, Ireland and Portugal all had to be bailed out by the EU and the IMF. Spain and Cyprus followed later.

As private capital withdrew from the stressed economies, adverse sovereign-bank-real economy feedback loops exacerbated the crisis. In part, these feedback loops arose because safety nets and backstops remained national and, therefore, limited in size. This provided fertile ground for fears of exits from the monetary union. As a result, the balance of payments of individual countries – which normally should not matter in a monetary union – once again became a critical source of risk. Various interventions by the ECB, Member States and the IMF were needed to stabilise the situation, including official financing and debt restructuring. In practice, outflows of private capital were replaced by inflows initially associated with extensive lender-of-last-resort lending to banks by the ECB and, subsequently, by official 'bail-out' loans from the EU and the IMF. Without this, the crisis would have been infinitely worse as budget and balance-of-payments deficits would have had to be corrected immediately.

All euro area countries that had large external imbalances experienced severe financial stress after the crisis broke. For the EA, the trigger was Greece's fiscal data in the autumn of 2009, which had vastly understated the true budget deficit of the country.

The Irish crisis began much earlier – in 2008 – when the Irish banks lost access to market funding following the US sub-prime crisis. An extensive Government guarantee of banks' liabilities had only a temporary impact as the scale of losses in Irish banks grew and the Member States debated how to tackle the crisis. The Greek crisis and associated speculation further destabilised Ireland's banking system and its Government in 2010, and spread to Portugal in the spring of 2011. The systemic nature of the crisis intensified in the summer of 2011, as market concerns about banks and sovereigns spread to Italy and Spain. A generalised freeze of wholesale funding hit euro area banks, including those from core countries, in the autumn of 2011. In the first half of 2012, adverse sovereign-bank loops intensified financial stress in Spain and Italy, with market concerns about a euro area exit multiplying.

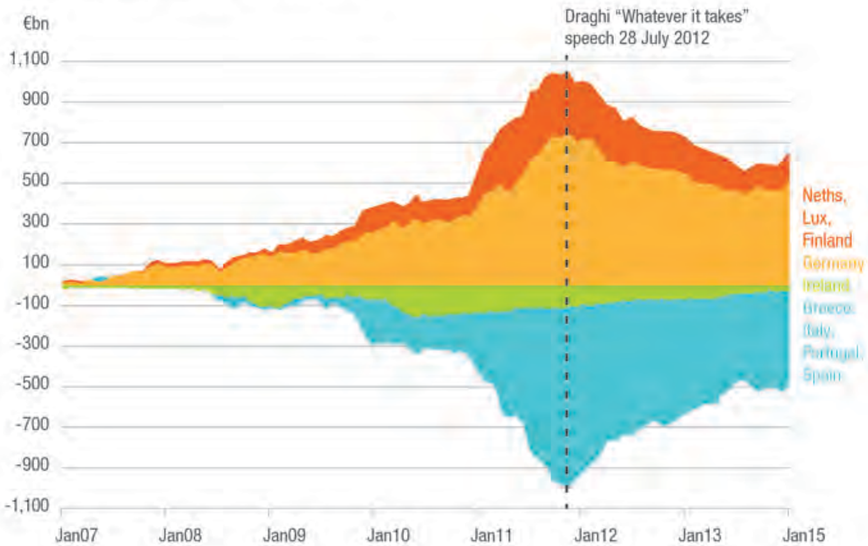
BOX 1.1 **CAPITAL FLOWS**

TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System), is an interbank payment system for the real-time processing of cross-border transfers throughout the EU. It facilitates ECB and other central bank transactions and allows participants to settle payments related to monetary policy operations, money market transactions and other activities. These include trade payments for imports and exports, current transfers, direct investment flows and capital movements. TARGET2 (the second generation of the system) is, thus, the plumbing of the Eurosystem. It is like a water pipe or conduit through which the various payments flow.

In normal circumstances, these various flows net out, leaving TARGET2 balances close to zero – see chart prior to 2007. This happens even when there is large current account deficits as there is usually a roughly equal contra bank flow on capital account.

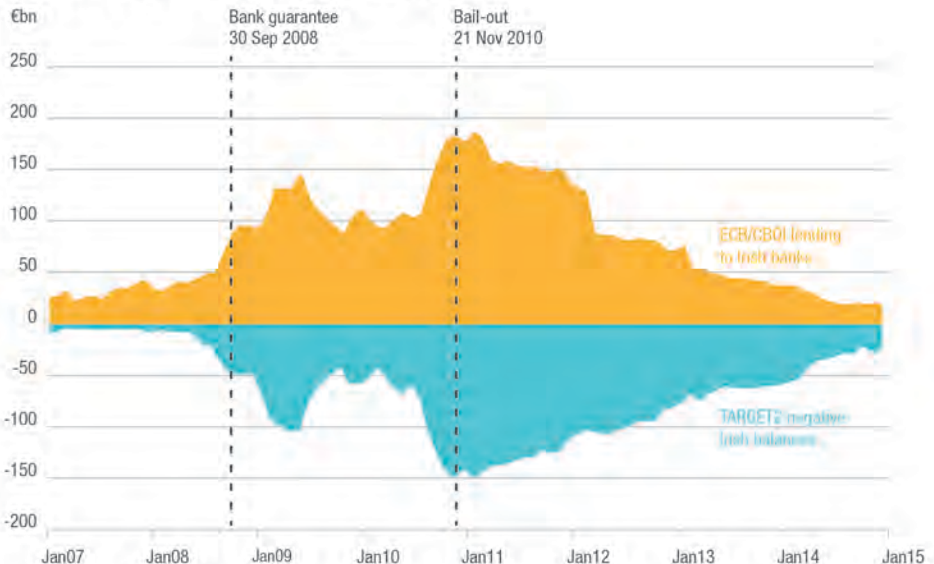
> *In the years prior to the financial crisis, Germany's cross-border payments were virtually balanced. Credit institutions' (short-term) net external position in particular acted as a kind of 'offsetting item' in the balance of payments. As the current account surplus*

FIG 1.3 **TARGET 2 BALANCES**



Source: Euro Crisis Monitor

FIG 1.4 **TARGET 2 BALANCES - IRELAND**



Source: Euro Crisis Monitor, CBOI

and frequent net capital imports in portfolio transactions meant that incoming payments regularly outweighed outgoing payments, most years saw outflows of funds (net capital exports) in banks' short-term credit business. Hence temporary TARGET2 positions were quickly reduced by private capital flows.

This all changed with the financial crisis. While funds tended to continue to flow into German banks from abroad due to non-bank payments and their own operations, after the onset of the crisis they were less willing, and in some cases unable, to lend these funds to foreign institutions on the interbank market. The sharp rise in the Bundesbank's TARGET2 balance since 2007 is essentially due to the tension on the money markets and problems in the banking sector within the euro area.[16]

Instead of placing their surplus funds abroad, German banks parked them on deposit in the ECB giving rise to positive German TARGET2 balances offset by negative balances in the peripheral countries experiencing outflows. From another perspective, TARGET2 balances are the counterpart or mirror image of the ECB's lender-of-last resort operations. Net capital flows out of Ireland could only be financed by the banks borrowing from the ECB and the Central Bank of Ireland. The TARGET2 balances are second order in the sense that they are a consequence of other decisions. If, for example, the ECB had not provided emergency liquidity to Irish banks, TARGET2 flows would have remained in balance but the damage to the banking system would have been enormous with widespread overnight failures.[17]

The TARGET2 data are useful in that they illustrate the history and geographic dimensions of the crisis. Initially, the outflows were mainly from Ireland to Germany, but from 2010 on other peripheral countries came into focus. For most of the time, the destination was Germany and Luxembourg with the Netherlands and Finland entering the picture later on. However, the vast bulk of the outflows, on average 90%, ended up in Germany.

Following the Irish Bank Guarantee in September 2008, capital continued to flow out of Ireland. The position subsequently recovered only to deteriorate

[16] "Deutsche Bundesbank Monthly Report," Deutsche Bundesbank, March 2011.
[17] There was considerable controversy over the explosion in TARGET2 balances with some holding that this represented a second, secret bail-out of the peripheral countries by the ECB – see, for example, "The Euro Crisis: From the Original Sinn to the Ten Commandments", by Pat McArdle, Institute of International and European Affairs, January 2012.

again in the run up to the bail-out and Troika Programme in late 2010. Since then, there has been a steady recovery.

In the EA, by contrast, the deterioration continued until mid-2012 when the scale of the imbalances was roughly €1.1 trillion. This figure has been halved in the meantime, indicative of substantial progress but also highlighting that the current situation remains far from normal. It will only return to normal when German banks have sufficient confidence to once again place their surplus funds with banks in the peripheral countries. Banking Union and the balance sheet tests that preceded it are expected to be a catalyst for this action.

1.3 THE EARLY RESPONSE

When the crisis broke, national regulators defaulted to protecting their national interests (banks) instead of co-operating, thereby adding to the fragmentation already in train as banks withdrew from cross-border lending. Extensive guarantees and bank bail-outs were introduced, frequently boosting sovereign debt to unsustainable levels. It is therefore appropriate that regulatory change should be a key focus of the Banking Union proposals.

One of the early responses was to convene a High-Level Group under the chairmanship of Jacques de Larosière, former Managing Director of the IMF and former Governor of the Banque de France.[18] As the crisis had highlighted significant problems, their mandate was to review the scope for regulatory and supervisory reform. The report was commissioned in November 2008 and produced in February 2009.

The de Larosière Report attributed the crisis to errors of judgement by both private and public sector agents, viz.:

- Macroeconomic policy, where ample liquidity and low interest rates contributed to the accumulation of large global imbalances, the mispricing of risk and large increases in leverage;
- Poor risk management by banks, supervisors and regulators and a lack of transparency, leading to the build-up of a shadow banking system, the malfunctioning of the 'originate-to-distribute' model and extreme complexity which few could understand;

[18] Members of the high-level group included: Jacques de Larosiére (President); Leszek Balcerowicz; Otmar Issing; Rainer Masera; Callum McCarthy; Lars Nyberg; José Perez Fernandez; and Onno Ruding.

- The behaviour of credit rating agencies, where there were failures in the ratings of structured products, e.g. bundled mortgage-backed securities, and major conflicts of interest;
- Corporate governance, where shareholder control of management was weak and remuneration schemes provided the wrong incentives;
- The functioning of financial regulation and accounting rules, which resulted in adverse incentives and pro-cyclical market behaviour, e.g. in banks' bad debt provisioning; and
- Global institutional weakness, resulting in a lack of co-ordination in preventing and then managing the crisis.

Within the EU, it was clear that co-operation and information exchange among national supervisors fell far short of what was necessary. In particular, when cross-border banks failed, supervisory co-operation was found wanting as national supervisors sought to ring fence and protect 'their' banks.

> *"Before the crisis, national authorities had encouraged 'their' banks to grow so that they could become predators rather than prey in what most anticipated would be a wave of cross-border banking consolidation across Europe. This ambition came at the expense of prudence about systemic risk; between 2003 and 2008, the aggregate assets of Europe's banks grew by the equivalent of almost the entire European GDP. The act symbolising this era was the takeover of the Dutch bank ABN AMRO by a consortium of the UK-based Royal Bank of Scotland, the Belgium-based Fortis, and (after a follow-up transaction) Italy's Monte dei Paschi di Siena. All three took on too much risk and debt for their own good in the process. They should have been discouraged from doing so by their respective home-country supervisors, but were not. All three acquiring banks then became costly failures, requiring fiscal bailouts and disrupting of credit flows."*[19]
>
> *Adam Posen & Nicolas Véron, June 2014*

BOX 1.2 **REGULATORY CAPTURE**

"...government agencies are frequently described as being at the mercy of the financial sector, routinely hijacking political, regulatory and supervisory processes,

[19] Adam Posen and Nicolas Véron, "Europe's half a banking union," *Europe's World*, June 2014.

a trend often referred to as 'capture'. But alternatively, governments are portrayed as subverting markets and abusing the financial system to their benefit, mainly to secure better financing conditions and allocate credit to the economy on preferential terms, referred to as 'financial repression'."[20]

Bruegel, July 2014

In fact, the relationship is more complex than either of these labels portrays and there is a complex two-way interaction between banks and governments which varies from country to country.

Structural characteristics of different financial systems in Europe vary quite a bit. For instance, German public saving banks (Sparkassen and Landesbanken) that accounted for one third of all German bank assets were owned and controlled by regional governments, which naturally created a close relationship. In Italy, though state-owned banks have been privatised, many of them remain under the influence or control of foundations ('*fondazioni bancarie*') that maintain close ties with the political system and in some cases are directly appointed by political parties. In Spain, small and medium sized *Cajas* were partly owned by the public and largely under the influence and control of regional officials and Church leaders, thus weakening the hand of the central government in supervising and regulating them and favouring undue forbearance by the central authorities. These links are sometimes reinforced by informal ties, such as the social networks in France generated by the *Grandes écoles* where future civil servants, politicians and bankers train together. These formal and informal ties between the political system and the banking system make banks receptive to political guidance but also allow them to exercise influence over the regulatory process through their political connections.

In Europe, these considerations are boosted by the fact that banks are, by far, the most important suppliers of credit to the economy and, frequently, to governments as well. Governments often set up development banks and, of course, most governments like to champion one or more 'national' banks – this was particularly evident during the spate of cross-border expansion that followed the arrival of the euro and in the rows that characterised the reaction when large cross-border banks failed and supervisors fought to safeguard their patches.

[20] Éric Monnet, Stefano Pagliari and Shahin Vallée, "Europe between financial repression and regulatory capture," Bruegel, July 2014.

Governments may, therefore, seek to ensure that the interests of the financial sector are aligned with those of the economy even without pressure from banks. For example, Sir Howard Davies, former Chairman of the UK Financial Services Authority (FSA) commented that, during the pre-crisis period:

> *On the whole, banks [in the UK] did not have to lobby politicians, largely because politicians argued the case for them without obvious inducement.*[21]

Minutes of relevant Bank of England meetings, recently released, reveal that it, like other central banks, was caught unawares by the crisis.

The situation in the US was similar. In 2009, the Federal Reserve Bank of New York (FRBNY) commissioned a report on the supervisory lessons to be learned from the crisis and an assessment of changes it might need to make if the Federal Reserve were designated as the nation's new systemic risk regulator. Following are some extracts from the report:

> *We find that during the run-up to the recent crisis many potential issues were identified but did not ring alarm bells and were not acted upon [...] our review of lessons learned from the crisis reveals a culture that is too risk-averse to respond quickly and flexibly to new challenges. Officers are intensely deferential to their superiors, similar to an army. Knowledge is too often hoarded in silos [...] many within FRBNY say that "we saw issues but did not respond". Action requires officers to take initiative and assume personal responsibility for recommendations that may be controversial. The culture needs to encourage this kind of risk-taking rather than punish it.*[22]

According to this report, which was intended to be confidential but was released to a subsequent bank enquiry, the most daunting obstacle the FRBNY faced in overseeing the US banks was its own culture. The Fed had become too risk-averse and deferential to the banks it supervised. Its examiners feared contradicting bosses, who too often forced their findings into an institutional consensus that watered down much of what they did. While bank risk management was found to be ineffectual and to have been steam-rollered in the pursuit of profit, the supervisors were clearly as much, if not more, to blame. We know from the

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[21] Howard Davies, "Comments on Ross Levine's paper 'The governance of financial regulation: reform lessons from the recent crisis,'" Bank for International Settlements, 2010.
[22] Prof David Beam, "Report on Systemic Risk and Bank Supervision", FRBNY, September 2009.

Honohan Report[23] that the situation in Ireland was similar, if not worse.

[23] Governor Patrick Honohan, "The Irish Banking Crisis 2003-2008: A Report to the Minister for Finance," Central Bank of Ireland, May 2010.

The primary objective of supervision is to evaluate the overall safety and soundness of banks. Supervisory failure was at the heart of the crisis, not just in the euro area but in the US and the UK as well. The response to the crisis, both at the global Basel III level and in the EU, thus focused on remedying regulatory and supervisory deficiencies.[24] Macroprudential supervision in the EU is a relatively new concept which relates to financial stability risks arising from macroeconomic developments such as excessive credit growth or house price inflation, an undue concentration in mortgage lending or widespread exposure to complex and illiquid assets. The de Larosière Report proposed the establishment of a European Systemic Risk Council (ESRC) of central bankers and supervisors. As risks emerge, the ESRC would issue warnings and recommendations. It would have no legal powers of its own, however, and would depend on others to implement its recommendations.

Another significant recommendation was for the establishment of a European System of Financial Supervisors (ESFS) which would build on existing co-operation arrangements. The ESFS would comprise three new supervisory authorities which would have specific responsibility for promoting a more harmonised set of financial rules and a common supervisory culture. Though still largely voluntary in nature, they could set common technical supervisory standards and act as mediators in the event of disputes between national supervisors.

The de Larosière recommendations were all essentially voluntary in nature; bank supervision was to remain the preserve of the national supervisors with no suggestion that it be otherwise. This reflected the *realpolitik* of the day. The ECB and some others had long argued for a greater centralisation of supervision, more from a prudential than a macro-economic perspective, let it be said, but this was stoutly resisted by national supervisors and finance ministers. Successive ECOFIN Councils professed their satisfaction with the existing set up in the early 2000s. By 2009, the inherent defects of this system had become glaringly obvious, but de Larosière did not dare challenge the consensus. Things were to get worse before they would get better.

[24] At the same time, there was a strongly held view in some creditor countries that the crisis was fiscal in nature and could be rectified by tightening the Stability and Growth Pact rules, a view that has only begun to wane in recent times.

CHAPTER 2. THE RESPONSE TO THE CRISIS

"The 2007-08 financial crisis was, to a great extent, the result of a failure of public authorities in the United States and Europe to adequately monitor and address systemic risk. Initial US and European policy responses involved a significant degree of improvisation and learning by doing."[25]

Nicolas Verón, September 2014

"...the dominant prevailing opinion is that the crisis that started in 2007, and turned for the worse after the failure of Lehman Brothers in the autumn of 2008, had a destructive potential similar to that of the Great Depression of 1929-33, and that central bank action was decisive in avoiding this potential to fully manifest itself."[26]

Francesco Papadia, February 2014

2.1 THE GLOBAL RESPONSE

At a global level, the response to the crisis was coordinated by the Group of Twenty (G20). An initiative by the French President, Nicolas Sarkozy, and the UK Prime Minister, Gordon Brown, led to a special meeting of the Group on 15 November 2008 to:

> *Review progress being made to address the current financial crisis, advance a common understanding of its causes, and […] agree on a common set of principles for reform of the regulatory and institutional regimes for the world's financial sectors.*[27]

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[25] Nicolas Véron, "The G20 Reform Agenda after five years," Bruegel, September 2014.
[26] Francesco Papadia "Prophets and loss," *Business Strategy Review*, Volume 25, Issue 1, February 2014.
[27] "The G-20 Summit: What's It All About?", The Brookings Institution, October, 2008.

The G20 decided to strengthen regulation via a more demanding framework for banks' capital, leverage and liquidity, prepared by the Basel Committee on Banking Supervision (BCBS) and known as the Basel III accord. It also recommended additional capital requirements and disclosure obligations for systemically important financial institutions (SIFIs) and banks. In addition, hitherto unregulated activities such as over-the-counter (OTC) derivatives, executive remuneration, credit rating agencies, hedge funds, 'shadow banking' and, more recently, financial benchmarks (following the discovery of fraud in the setting of EURIBOR, LIBOR etc.) were to be subject to controls. Although the G20 has no formal enforcement powers, its influential membership ensured that most of its recommendations were adopted by its members, including the EU which has introduced extensive legislation to implement the G20 principles. Although by no means identical, there is a much greater than hitherto degree of similarity in the rules adopted around the globe.[28]

The G20 also attempted but failed to harmonise global accounting, by calling on the international accounting bodies (the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB)) to "achieve a single set of high-quality, global accounting standards". A further effort, which is still ongoing, seeks to address coordination issues in the resolution of complex cross-border financial institutions, including banks, whose activities are scattered across several jurisdictions. More recently, the G20 has embraced ending too-big-to-fail (TBTF) and the financing of long-term investment as priority objectives.

2.2 THE EU RESPONSE

The approach adopted by the EU was extensive but iterative, and the Banking Union proposals came late in the day. Many argue that this exacerbated the situation, but this reflects the unique nature of the Union, which had design flaws that left it totally unprepared for the crisis. In the event, the EU response has, perforce, had to be more extensive than that in the more developed economic unions such as the UK or the US which also experienced crises but were able to react more quickly.

A long list of measures were adopted prior to Banking Union. These can be organised under three categories: (a) financial assistance, (b) fiscal surveillance and (c) bank regulation and supervision. The measures are described below.

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[28] Notwithstanding this, in December 2014, the Basel Committee on Banking Supervision declared the EU to the "materially non-compliant" with Basel III, *inter alia*, because of laxer capital rules.

FIG 2.1 **CRISIS MANAGEMENT TIMELINE**

May 2010
Greece: first bilateral support programme; Foundation of EFSF: ECB starts buying government bonds of Greece, Portugal and Ireland

Oct 2010
Principle agreement to create a permanent rescue fund (ESM)

Aug 2011
ECB starts buying government bonds of Italy and Spain

Dec 2011
Agreement reached on Fiscal Compact; ECB starts LTROs of commercial banks

Jun 2012
Principle agreement on Banking Union and direct bank recapitalisation by ESM

Sep 2012
ECB starts Outright Monetary Transaction programme (OMT)

Oct 2012
Permanent ESM enters into force

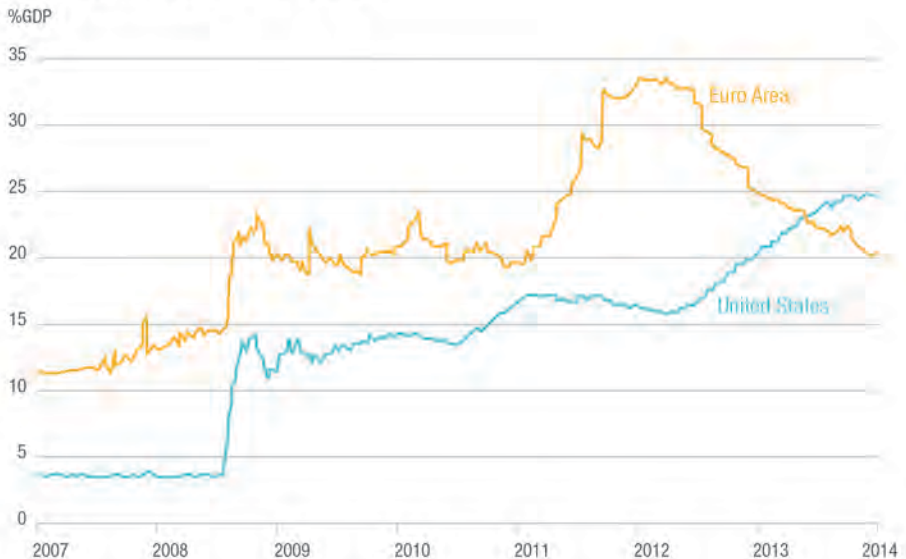
Jan 2013
Fiscal Compact formally enters into force

Aug 2013
Banking Union: important pillars finalised

a. Financial assistance

- The European Financial Stability Facility (EFSF) (temporary and limited to the euro area), was agreed in May 2010, with a nominal capacity of €440 billion and backed by the governments of the euro area. This and similar facilities had to be introduced against the backdrop of a Treaty mandated 'no-bail-out clause'. Since there were no Community mechanisms, the bail-outs were organised under the State aid rules, which were gradually adapted to the new situation;
- The European Financial Stabilisation Mechanism (EFSM) (EU-wide and temporary), also agreed in May 2010, with a capacity of €60 billion and backed by the EU budget;
- The European Stability Mechanism (ESM) (also limited to the euro area, but a permanent institution), signed in February 2012 based on a limited amendment to Article 136 TFEU, and a separate treaty, with a capacity of €500 billion and backed by participating Member States. The ESM obtains its funds by issuing bonds and is obliged by its Treaty to impose strict conditionality on loans to Member States;
- Considerable bi-lateral assistance and IMF loans were also provided. In total close on €500 billion official loans were provided to EU member states – this does not include ECB shorter term liquidity facilities for financial institutions

- The Securities Market Programme (SMP), under which the ECB purchased €200 billion of Member States' debt on the secondary markets. The ECB is not allowed to purchase directly from governments as this would be regarded as monetary financing, which is prohibited by the Treaties;
- Long-Term Refinancing Operations (LTROs) to provide liquidity to banks which could no longer borrow on the markets, in effect, lending of last resort by the ECB. This boosted its balance sheet threefold, though much of it was been repaid as conditions settled.
- In addition, emergency liquidity support (ELS) was made available via the national central banks against collateral with conditions that were repeatedly eased;
- Between 2008 and 2013, EU governments injected €608 billion into 110 banks[29], equivalent to just over 5% of EU GDP. EU states also issued extensive guarantees totaling €835 billion at their peak in 2009.[30] State aid rules were applied and resulted in extensive downsizing and remodeling of banks affected.



[29] Representing about a quarter of the EU banking system by assets.
[30] The figure had fallen to €400 billion by end – 2013. While only €3 billion was actually called upon, the guarantees had generated fees of €38 billion by end 2013 – per report of Joaquín Almunia, Vice President of the Commission responsible for Competition policy, to the European Parliament, 23 September 2014.

FIG 2.3

FINANCIAL SECTOR SUPPORT, 2008-11 (percent of 2011 GDP)	
Belgium	7.0
Ireland	41.2
Germany	12.2
Greece	6.1
Netherlands	14.1
Spain*	19.5
United Kingdom	6.8
United States	5.3

Sources: Fiscal Monitor, Spain FSAP, IMF staff estimates
*Includes use of debt guarantees, asset purchases and capital support from the FROB

b. Fiscal surveillance

- The six-pack, concluded in November 2011, comprising five regulations and a directive, designed to provide for tighter discipline on public finances. These regulations included the 'European Semester' of multilateral economic and budgetary surveillance which reviews Member States' budgets before they are adopted and also introduced the Macroeconomic Imbalance Procedure, an alert system based on a scoreboard of ten indicators covering major sources of macroeconomic imbalances such as private sector debt and balance-of-payments positions that were not monitored previously;
- The two-pack, concluded in May 2013, consisting of two regulations applying only to the euro area, and ensuring closer oversight of the public finances;
- The Euro-Plus Pact, with 23 Member State signatories, intended to promote better economic policy;
- The Fiscal Compact (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)), signed in March 2012, that embedded a new stricter version of the Stability and Growth Pact's (SGP) limits on deficits and debt into primary domestic law. A major innovation was the focus on reducing debt ratios by one twentieth per annum until they reached 60%.

c. Bank regulation and supervision

- Capital Requirements Directive (CRD IV), a package which transposed the new stricter global standards on bank capital (commonly known as the Basel III agreement) into EU law;
- Three new European Supervisory Authorities that replaced the existing

architecture as recommended by the de Larosière report in 2009, namely, the European Banking Authority (EBA) in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt and the European Securities and Markets Authority (ESMA) in Paris;

- The European Systemic Risk Board (ESRB), effectively part of the ECB, charged with 'macroprudential supervision', again as recommended by the de Larosière report;
- Proposals to change the structure of the banking industry revolving around three major reports – Dodd-Frank in the US, Vickers in the UK and Liikanen in the EU. Though the details differ, the essential aim is for a mandatory separation of proprietary and other high-risk trading from more traditional, safer, retail banking in large global systematic banks.[31] These proposals have been adopted to varying degrees in the US and the UK but are still under discussion in the EU.

First, the EU responded with the creation of essential financial backstops. The establishment of the EFSF and, later, the ESM allowed euro area members to grant loans at favourable interest rates and under strict conditionality to countries that had lost market access. The so-called austerity measures and structural reforms that were, in turn, adopted by Greece, Ireland, Portugal and Spain contributed significantly to rebalancing their economies. The measures were both impressive – subsequently putting these countries among the top performers in the 34-member OECD – and painful. By early 2014, Ireland, Portugal and Spain had regained market access and exited their bail-out programmes with proposals to repay debt early emerging shortly afterwards. In December 2014, Ireland repaid €9 billion of IMF debt with more to come in 2015.

Second, the Governing Council of the ECB was innovative in its use of monetary policy, putting in place both standard and non-standard policy measures. The reduction in interest rates to practically zero, the provision of ample liquidity to banks and the Securities Market Programme all played their part.

Third, significant steps were taken to improve economic policy coordination. These measures included the strengthening of the Stability and Growth Pact, the establishment of the European Semester, stronger emphasis on macroeconomic imbalances and the Fiscal Compact Treaty designed to bolster the SGP rules by enshrining them in primary law.

Despite all this, by summer 2012 major Member States such as Spain and Italy were under sustained attack in the markets with the cost of borrowing increasing

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[31] Irish banks were too small to qualify.

and investors reluctant to lend to governments. Interest rates on Spanish and Italian bonds breached the psychologically critical 7% mark for the second time[32] and were approaching levels at which other Member States had been bailed out.

On 27 June 2012, both Spain and Cyprus applied for financial assistance, bringing the total number of EU/IMF programmes to five.[33] A €100 billion emergency loan package for Spanish banks hardly calmed the situation.[34] Matters looked even worse in Greece, which seemed incapable of fulfilling the demands of its creditors. German Economy Minister, Philipp Rösler, broke a taboo by publicly voicing the idea of Greece exiting the euro area – but not even Germany was immune from the effects of the crisis, and Moody's threatened to downgrade its triple-A credit rating because of potential spill-over effects.

After a period of reflection and recriminations, it transpired that Greece did not want to leave the euro and that Germany did not want to see it leave for fear of the knock-on consequences. This set the scene firstly for the Banking Union and secondly for the ECB's extraordinary promise to do whatever it took to safeguard the system.

2.2.1 THE NEED FOR RADICAL ACTION

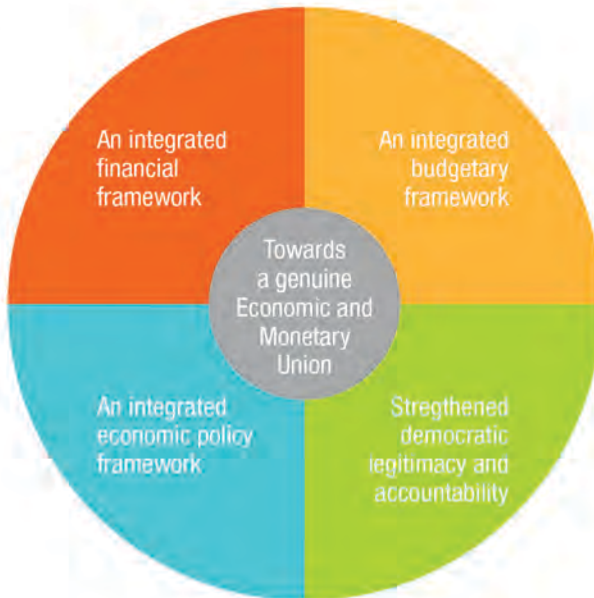
Faced with this situation, the European Council recognised that urgent action was required and tasked the President, Herman Van Rompuy, with preparing a report for their June 2012 meeting.[35] His report, *Towards a Genuine Economic and Monetary Union*, envisaged a "stable and prosperous EMU based on four essential building blocks":

- An integrated financial framework to ensure stability in the euro area and minimise the cost of bank failures to European citizens;
- An integrated budgetary framework to ensure sound fiscal policy-making, encompassing coordination, joint decision-making, greater enforcement and commensurate steps towards common debt issuance and other forms of fiscal solidarity;
- An integrated economic policy framework;
- Ensuring the necessary democratic legitimacy and accountability of decision-making within the EMU, based on the joint exercise of sovereignty for common policies and solidarity.

32 In late 2011/early 2012, the ECB allotted €1 trillion in emergency long term (3-year) liquidity to banks but this had only a temporary effect.
33 Greece, Ireland, Portugal, Spain and Cyprus.
34 In the event, only €41.3 billion of this was drawn down.
35 The Van Rompuy report was prepared in close cooperation with the Presidents of the Commission, the Eurogroup and the European Central Bank and was further developed over the course of the second half of 2012.

2.3 THE BANKING UNION PROPOSALS

FIG 2.4 **TOWARDS A GENUINE EMU**



Whereas the proposals for an integrated financial framework, or Banking Union[36] were novel, many of the other proposals for fiscal union and economic integration were not.[37]

The Van Rompuy Report is notable for its renewed emphasis on the 'E' of EMU. This reflected the dire straits in which the European economy had found itself and the frequently-aired criticisms that the absence of political and economic union had

36 The term 'Banking Union' first appeared around this time

37 Eighth Report of the House of Lords European Union Committee, "'Genuine Economic and Monetary Union' and the implications for the UK," House of Lords, February 2014.

exacerbated the crisis.[38] In the event, these aspects of the Van Rompuy report were quickly discarded – though the European Parliament grasped the opportunity to enhance its role and influence in banking matters.

The proposed Banking Union was to consist of:

- **Integrated supervision** to ensure the effective application of prudential rules, risk control and crisis prevention throughout the EU. The current architecture was to evolve as soon as possible towards a single European banking supervision system with the ultimate authority and powers at the European level;
- A **European resolution scheme** primarily funded by contributions of banks that would oversee the orderly winding-down of non-viable institutions, thereby protecting taxpayers;
- A **European deposit insurance scheme** that would introduce a European dimension to national deposit guarantee schemes for banks overseen by the European supervisor;

The ground-breaking decisions were taken by the Heads of State and Government at the June 2012 Euro Summit:[39]

> *We affirm that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present proposals on the basis of Article 127(6) for a Single Supervisory Mechanism shortly. When an effective Single Supervisory Mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly... The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme.*[40]

According to ECB Vice President, Vítor Constâncio, the idea of launching the Single Supervisory Mechanism (SSM) emerged during the June 2012 European Council meeting and was a consequence of the decision that the ESM could directly recapitalise weak banks, thus taking some fiscal pressure off sovereigns. But if the

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[38] While the US and the UK have fiscal and political unions they also experienced banking crises but were able to respond quickly, notably by bailing out banks and also by more extensive central bank backstops and intervention, e.g. Quantitative Easing, for both governments and banks. Very extensive government guarantees were also a feature.

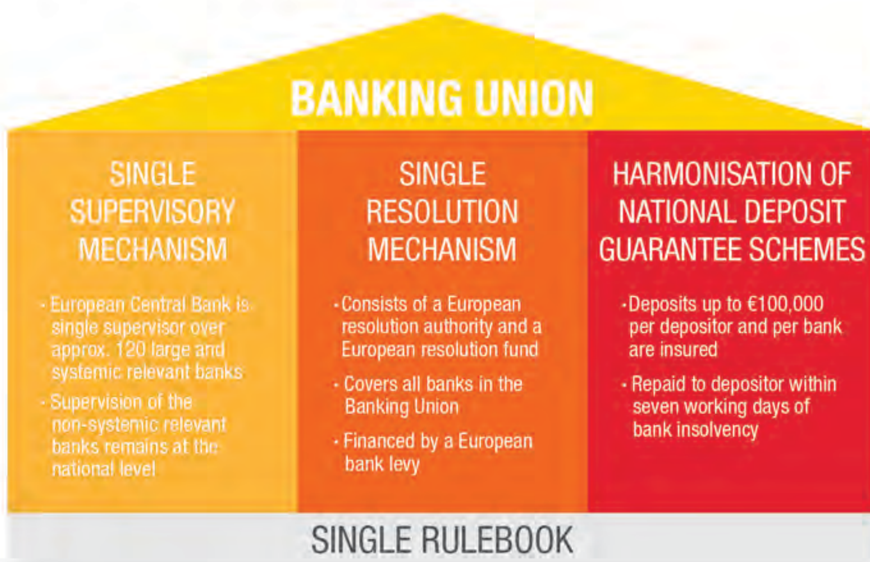
[39] The Euro Summit (also referred to as the Eurozone Summit or Euro Area Summit) is the meeting of the Heads of State or Government of the Member States of the euro area.

[40] The reference to Ireland is unusual and proved controversial as the core Member States subsequently refused to contemplate retrospective liability for bank capital shortfalls incurred under national supervision, i.e. before Banking Union. The statement in question can be found online at: http://www.ecb.europa.eu/ssm/pdf/statement/Euroareasummitstatement2012-06-29EN.pdf

European level were to assume liability for European banks, he reasoned, it also logically had to assume control:

> *[…] hence the need for a European supervisor. It was only later that the concept of a fully-fledged Banking Union emerged, which would contain a Single Resolution Mechanism (SRM) and a possible Deposit Guarantee Scheme, which has meanwhile been postponed.*[41]

FIG 2.5 **THE BANKING UNION**



Banking Union comprises a number of interrelated building blocks, viz.:

- A Single Supervisory Mechanism;
- A Single Resolution Regime;
- A financing regime for bank failure, including a Single Resolution Fund, a fiscal back-stop and a common Deposit Guarantee Scheme (replaced, for the time being, with the harmonisation of national deposit guarantee schemes); and

[41] Vítor Constâncio, "Banking Union and European integration," speech at the OeNB Economics Conference, Vienna, May 2014.

- A Single Rulebook – this predated Banking Union but assumed much greater importance in light of the new proposals.

It will be immediately obvious that the June 2012 Euro Summit referred to only the first element of Banking Union in the diagram above, the Single Supervisory Mechanism. The Single Resolution Mechanism followed later, while the original 'third pillar', a common Deposit Guarantee Scheme, has yet to be elucidated upon. The other more fundamental, non-Banking Union, aspects of the Van Rompuy proposals are even further away, though some of them are included in the work programme of the 2014-2019 European Commission.

As initially formulated in the Van Rompuy report, the objective of Banking Union was to "break the link between banks and sovereigns". Subsequently, this was diluted to weakening the link between them.[42] An early disappointment came in September 2012, when the finance ministers of Finland, Germany and the Netherlands issued a joint statement opposing any direct bank recapitalisation by the ESM to bridge 'legacy' capital gaps, i.e. losses on investments made by banks before Banking Union. The statement reversed what some understood as the agreement at the June 2012 summit that the ESM would retroactively directly recapitalise Spanish and possibly Irish, banks.

This reflected an unwillingness to provide an unlimited central backstop for rescue funding that might be required if national resources were insufficient in the face of major systemic bank failures. It likely also reflected the success of a major ECB initiative that closely followed the Banking Union decision.

The essence of Banking Union lies in the transfer of competence from national supervisors to a stricter and more credible central supervisor – the ECB. It aims to weaken the pernicious link between banks and sovereigns by cleansing bank balance sheets and by increasing the quality and quantity of banks' capital reserves. Should banks fail, the Single Resolution Mechanism gives the final say to the Commission on when to terminate a bank, and a new streamlined resolution process will provide a clearly defined pecking order for the bail-in of bank creditors, along with a supra-national backstop as a last resort. In future, the taxpayer will be a last, rather than a first, resort when banks begin to fail.

[42] "When (direct recapitalisation of banks by the ESM) was first proposed, it was supposed to cut the link between troubled banks and sovereigns. However, it soon became apparent that the remaining building blocks of the Banking Union would most likely achieve this aim without the need for (the ESM) to provide substantial amounts of funds," from "ESM FAQ on the preliminary agreement on the future ESM direct bank recapitalisation instrument," European Stability Mechanism, 10 June 2014.

2.3.1 THE PROMISE TO "DO WHATEVER IT TAKES"

> *"The ECB's Outright Monetary Transactions (OMT) programme announcement was the most important policy measure to address fragmentation."*[43]
>
> *Zsolt Darvas and Guntram B. Wolff, September 2014*

While the stated aim of Banking Union was to break the link between banks and sovereigns, the proposals were all medium-to-long-term. Their announcement in late June 2012 had little impact and a month later both Spanish and Italian yields were at fresh highs. Banking Union was an expression of intent that was welcomed by the markets but it was not key to the dramatic improvement in sentiment and reduction in speculation that followed. This reflected another, even more ground-breaking, event.

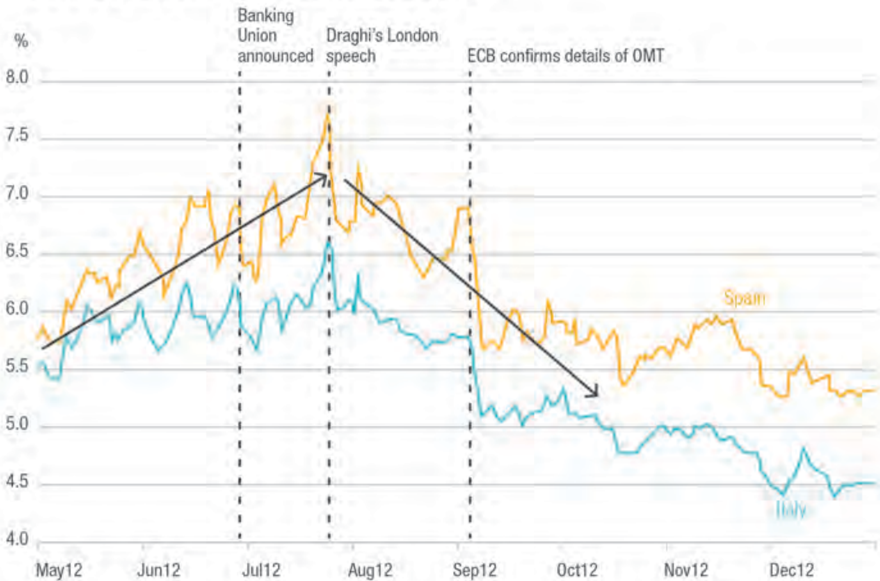


FIG 2.6 **GOVERNMENT BOND YIELDS 2012**

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[43] Zsolt Darvas and Guntram B. Wolff, "So far apart and yet so close: Should the ECB care about inflation differentials?" Bruegel, September 2014.

The single most influential intervention in the crisis came, not from the Council of Ministers, but from the President of the ECB, Mario Draghi. When market speculation becomes entrenched, the only thing that can reverse it is a counter threat from someone with even deeper pockets. The maximum that the EU bail-out funds could muster was €700 billion, long derided as being too little to cope with a run on a major state like Italy or Spain. The only institution with unlimited firepower was the ECB. The ECB could print money but it had hitherto limited its ambition for fear of transgressing its mandate, which explicitly prohibits direct financing of governments. Saving the euro area was not prescribed as an objective when the ECB was established. The ECB President saw, however, that break-up fears were pushing up interest rates in some countries thereby nullifying the impact of cuts in official ECB rates and interfering with the transmission of monetary policy. This was the preserve of the ECB and gave him the justification to act. The context in which he operated was political and it is doubtful if he could or would have intervened in the absence of the acceptance by Chancellor Merkel that no country should exit the euro.

Speaking in London on 26 July 2012, President Draghi added two unscripted sentences to an otherwise routine speech: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro," he said, "And believe me, it will be enough." Though the impromptu intervention was opposed by at least one of his more influential Council members,[44] President Draghi carried the day and successive announcements in August and September rolled out the Outright Monetary Transactions (OMT) programme. Governments benefiting from it would be required to enter a programme to step up their fiscal discipline; in return, the ECB would buy their (short-term) bonds in unlimited quantities thereby placing a ceiling on their interest rates. Markets calmed down, risk spreads began to fall steadily, the lingering crisis abated and a nascent recovery began. In the event, there was no need to execute the plan, testimony to the speculative nature of markets and the state they were in at the height of the crisis. Draghi subsequently described OMT as "probably the most successful monetary policy measure undertaken in recent times".[45]

It should be noted that there is, in all probability, a strong link between Banking Union and OMT.

> *"It is difficult to disentangle the respective effects of Banking Union, OMT, and reassurance against Greek exit on the reversal of market trend and 'positive contagion' that ensued. However, even if the succession in time does not imply causality, there are strong indications that the commitment of political leaders*

[44] Jens Weidmann, head of the German Central Bank, firmly opposed the idea, arguing that it would lead to inflation and lessen pressure on governments to carry out reforms, but he was not supported by the German Chancellor or Minister for Finance.
[45] "Introductory statement to ECB press conference," Frankfurt am Main, 6 June 2013.

on Banking Union was a key factor in the ECB's decision to announce OMT. If such is the case, and even as the OMT announcement clearly had the most direct influence on market participants' perceptions and behaviour, then the decision to embark on Banking Union in late June can be seen as the true turning point of at least this phase of the European crisis."[46]

Nicolas Véron, February 2014

There was also a political dimension as, shortly beforehand, Germany had finally decided keep the euro intact and prevent a Greek exit.

2.4 THE CHALLENGE

In broad terms, EU banks are as well capitalised as US ones, but their shares trade at a discount and funding is both more expensive and harder to source. This, in turn, reflects fears that their balance sheets still contain unpleasant surprises. Banking Union proper was preceded by balance sheet assessments and stress tests designed to, once and for all, remove these doubts. If successful, this will be a major factor in restoring confidence in EU banks but it is likely to be a "necessary" rather than a "sufficient" condition for this to happen.

Banking Union is designed to strengthen the stability and safety of Europe's financial system by limiting the dependency between banks and governments. It seeks to do this by enhancing supervision via stricter standards and an impartial, common, supervisor, by a standard resolution procedure to either terminate or rescue failing banks and by substituting 'bail-in' in place of 'bail-out' – meaning taxpayers will no longer be the first port of call in a crisis.

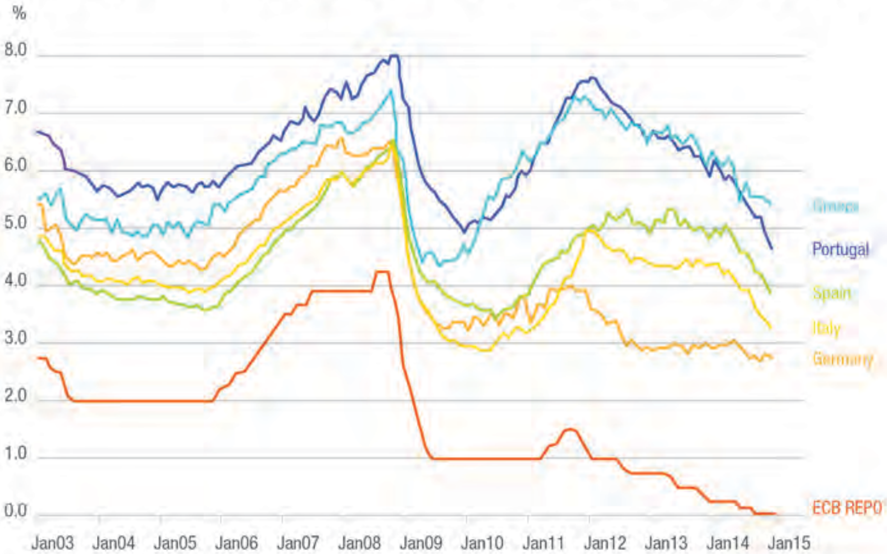
It would be wrong, however, to think that order has been restored with a return to something resembling the *status quo ante*. Far from it. Banking Union has begun but markets remain significantly fragmented. The doom-loop between banks and sovereigns has certainly eased in the sense that both sovereign and bank borrowing costs have fallen sharply. Whether or not it is broken remains unclear. The ultimate test will be the failure of a major bank or banks and the absence of a knock-on effect on government borrowing costs. This may not happen for some considerable time and, indeed, might be avoided altogether if the new regulatory and supervisory requirements are sufficiently comprehensive and rigorous.[47] However, in some

[46] Nicolas Véron, "European Banking Union: Current Outlook and Short-Term Choices," speech at the Banking Union and the Financing of the Portuguese Economy Conference, Lisbon, February 2014.
[47] The 2014 failure of the second largest bank in Portugal with only temporary and limited knock-on effects gives grounds for some optimism in this regard.

countries, the monetary transmission mechanism remains broken with reductions in ECB rates not being passed on to borrowers, especially SMEs. The dispersion in borrowing costs remains elevated, both by reference to pre-crisis levels and to core countries like Germany and France. For example, ECB rates have fallen by more than 4 percentage points since 2008; for Irish small or medium-sized enterprises (SMEs), the reduction has been about half that.

The core countries by contrast, are experiencing interest rates that are abnormally low, reflecting the concentration of risk-averse funds that, in more normal circumstances, would find a home elsewhere. The challenge for Banking Union is to remove these

FIG 2.7 **INTEREST RATES ON SME LOANS** (new business, up to €1mn maturity up to 1 year)



anomalies and restore the Single Market in banking, *inter alia*, by severing or reducing the link between banks and sovereigns.

Cross-border funding was the norm before the crisis, reflecting the high degree of integration in wholesale financial markets. Once EMU began, Irish banks for example could fund, virtually without limit and with no exchange-rate exposure,

in the unsecured interbank market at low rates of interest. Cross-border interbank activity in the euro area rose from little more than a fifth of all interbank lending in 1999 to over a third by 2008. It subsequently fell rapidly in two phases; initially when the financial crisis broke and subsequently when the euro area debt crisis materialised. By 2012 virtually all of the increase associated with the arrival of the euro had been unwound – with only a modest recovery so far. Euro area banking remains fragmented from both a funding and a lending perspective.

The ultimate test of Banking Union will be the extent to which it restores credit spreads to more normal levels, in other words to a situation where borrowers of equal risk but located in different countries face similar borrowing costs. To achieve this, the cost of funding to banks will first have to normalise.

Whilst the general economy has been recovering slowly over recent months and market conditions have remained benign, the European financial system is still facing a range of inter-related and cross-sectoral risks, such as weak economic growth, high levels of private and public debt, and the effects of persistently low interest rates and fragmentation.[48]

ESAs Joint Committee, August 2014

48 ESAs Joint Committee, "Report on Risks and Vulnerabilities in the EU financial system," August 2014.

PART 2.
THE BANKING
UNION

CHAPTER 3. THE SINGLE SUPERVISORY MECHANISM

"The idea of the SSM was born at a moment when the sovereign debt crisis threatened the cohesion of the euro area. Since the political decision to set up the SSM during the June 2012 European Council meeting, we have come a long way in building a strong and independent supranational supervisor. For the first time in the history of the EU, we will have a supervisor with a truly European mandate, and a collective responsibility. The SSM will take an encompassing view of banks' activities throughout the SSM Member States (and beyond) and remove national bias in supervision."[49]

Danièle Nouy, June 2014

3.1 INTRODUCTION

During the crisis, national supervisory authorities demonstrated a marked inability to prevent or limit the build-up of excessive risk in the banking sector. A culture of banking nationalism – or favouritism shown by supervisors towards large domestic banks – not only contributed to the onset of the crisis, but also impeded efforts to coordinate a cross-border crisis response.[50] National supervisors were in some cases cognisant of the imbalances in their respective banking sectors, and of the growing weakness of 'their' banks, but were reluctant to act unilaterally to address these problems – fearing that doing so would lead to a loss of competitiveness for their 'national champions' as well as potentially resulting in heavy costs to the taxpayer.

The consequences of this home-bias are, by now, well documented, and served as

49 Daniele Nouy "Launch of the SSM – what will change in banking supervision and what are the imminent impacts on the banking sector?" speech at the Third FIN-FSA Conference on EU Regulation and Supervision, Helsinki, June 2014.
50 Adam Posen and Nicolas Véron, "Europe's half a banking union", *Europe's World*, June 2014.

a vivid demonstration that a single currency area also requires a centralised and unbiased authority for financial supervision. Compared to national supervision, a well-functioning common supervisor would, theoretically, operate without being unduly influenced by the desire to protect national interests, and with the benefit of a macroscopic view of the European banking sector, allowing for comprehensive information-gathering, as well as cross-border comparison and co-operation. Thus, it is hoped, a common supervisor will enable Europe to prevent the sort of systemic risks to the banking system which may previously have been unidentified, underestimated, or simply unaddressed by the national competent authorities (NCAs). The SSM was therefore the first step in cutting the Gordian knot that ties banks to their sovereigns, and a necessary pre-requisite for a harmonised system for winding down troubled banks.

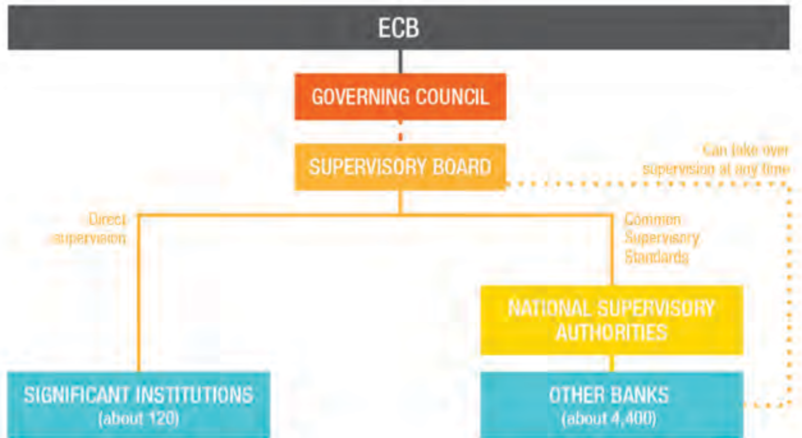
Its position in the overall sequencing, though, was as much a matter of *realpolitik* as logistics.[51] First, addressing the failures in supervision which led to and exacerbated the crisis was considered a pre-requisite for the newly-established European Stability Mechanism to directly recapitalise troubled banks – it would simply not have been politically acceptable to share the cost of bank resolution across the euro area while still maintaining national supervision. Second, through article 127(6) of the Treaty of the Functioning of the European Union (TFEU), which allows the conferral of "specific tasks upon the European Central Bank" concerning policies relating to the prudential supervision of credit institutions, the Commission found a convenient means of allocating supervisory duties to an existing institution, without the need for protracted Treaty change negotiations. Thus, the financial crisis, and the failures in national supervision which preceded it, provided European leaders with the political capital needed to push ahead with the supervisory mechanism as the first element of the Banking Union.

The proposal for the Single Supervisory Mechanism (SSM) Regulation was adopted in the remarkably short time frame of seven months and enabled the ECB to become the Single Supervisor for banks in participating Member States from 4 November 2014.

[51] Eilis Ferran and Valia Babis, "The European Single Supervisory Mechanism," University of Cambridge Faculty of Law, March 2013.

3.2 STRUCTURE AND GOVERNANCE OF THE SSM

FIG 3.1 **STRUCTURE OF THE SINGLE SUPERVISORY MECHANISM**



3.2.1 STRUCTURE

Broadly, the Supervisory Mechanism consists of:

- A Supervisory Board[52], consisting of a Chair, Vice Chair, four representatives from the ECB and one representative from each participating national supervisory authority. The board drafts decisions by simple majority, with each board member having one vote;
- A Steering Committee, drawn from the Supervisory Board's members, which guides the board's decisions;
- A mediation panel, which ensures the separation of supervision and monetary policy and will resolve, if requested, any differences of view between the governing council and the supervisory board. The panel consists of one member per participating Member State. The Vice Chair of the supervisory board will chair proceedings;
- An administrative board of review, tasked with carrying out internal administrative review of the decisions taken by the ECB in exercising SSM powers. The panel consists of five individuals with relevant expertise and 'of high repute.'[53]

52 As of November 2015, the six appointed members of the Supervisory Board are: Danièle Nouy, Chair; Sabine Lautenschläger, Vice-Chair; Ignazio Angeloni, ECB representative; Luc Coene, ECB representative; Julie Dickson, ECB representative; and Sirkka Hämäläinen, ECB

53 European Central Bank, "SSM Quarterly Review," August 2014. As of November 2015, the Administrative Board of Review consists of Chairman, Jean-Paul Redouin; Vice-Chair Concetta Brescia Morra; and regular members F. Javier Arístegui Yáñez, André Camilleri and Edgar Meister.

As shown below, the SSM's internal architecture consists of four directorates general (DGs). Two of these DGs (Microprudential Supervision I and II) have responsibility for the everyday supervision of significant institutions, while the third deals with the supervisory oversight of less significant institutions and, most importantly, is tasked with identifying risky banks and recommending that they be taken under the direct supervision of DGs I and II. DGIV is essentially the policy lynchpin of the new SSM, tasked with conducting system-wide analysis and overseeing the consistent application of supervisory standards across the euro area.

FIG 3.2 **INTERNAL ARCHITECTURE OF THE SINGLE SUPERVISORY MECHANISM**

SINGLE SUPERVISORY MECHANISM			
DIRECT SUPERVISION (SIGNIFICANT INSTITUTIONS)		INDIRECT SUPERVISION (LESS SIGNIFICANT INSTITUTIONS)	HORIZONTAL SUPERVISION & SPECIALISED EXPERTISE
Micro-prudential Supervision I	Micro-prudential Supervision II	Micro-prudential Supervision III	Micro-prudential Supervision IV
Supervision of significant institutions	Supervision of significant institutions	Supervisory Oversight & NCA Relations Institutional & Sectoral Oversight Analysis & Methodological Support	Authorisation Centralised on-site Inspections Crisis Management Enforcement & Sanctions Methodology & Standards Development Planning & Coordination of Supervisory Examination Programme Supervisory Policies Supervisory Quality Assurance Risk Analysis Internal Models

Source: European Central Bank

3.2.2 GOVERNANCE

In practice, the Supervisory Board is the sole decision-making body of the SSM. The legal situation, however, is somewhat more complex, as the establishment of such an authority within the existing governance structure of the ECB was greatly complicated by Article 129(1) of the TFEU, which establishes the Governing Council of the ECB as the supreme decision-making authority in the institution. From a legal perspective, then, the Governing Council is simply delegating certain tasks or decision-making powers to the Supervisory Board, and is entitled to reject its recommendations, as it would any internal committee. Maintaining a strict separation between the new supervisory duties and the ECB's existing monetary policy role, while also respecting the ECB's Treaty-enshrined governance structure, therefore, required some creative thinking. In order to ensure the separation of the supervisory work stream, an operational workaround was established, known as the 'non-objection procedure', whereby the decisions of the Supervisory Board would be deemed adopted if the Governing Council does not object within 10 days (or two days in times of crisis). In the event that the Governing Council fundamentally disagrees with a decision by the Supervisory Board, the SSM Regulation stipulates that the mediation panel must be convened to resolve the dispute.

3.3 SCOPE OF THE SSM

The legal jurisdiction of the SSM extends to about 4,900[54] banks in the euro area Member States and participating non-euro area Member States. In practice though, these duties will be divided up among the ECB and the national supervisors, leaving a substantial part of the supervisory tasks at national level.[55] Furthermore, the limitations of Article 127(6) only allow for the ECB to take supervision of credit institutions (which are defined as undertakings whose business it is to receive deposits and issue credits on its own account). The Article explicitly prohibits the ECB from assuming supervisory responsibilities over insurance undertakings, creating the sub-optimal situation in which the insurance wing of a significant credit institution would continue to be supervised at the national level. Investment firms too will continue to be supervised at national level – as will hedge funds, an industry which has seen explosive growth since 2008. Worldwide, the hedge fund industry's coffers expanded to €1.8 trillion in 2013.[56]

54 A figure of 6000+ banks was in general usage during the creation of the Banking Union. The disparity between the theoretical and actual number arises as a consequence of different interpretations of credit institutions in many Member States. By way of example, in some countries lending on one's own account (without deposit taking) requires authorisation as a credit institution. However, the definition of a credit institution has been significantly tightened up in CRD IV. It is now necessary for the institution in question to both take deposits and lend on own account. The number of "real" credit institutions is therefore significantly less in practice – circa 4,900 based on the ECB's current estimates.

55 Stijn Verhelst, "The Single Supervisory Mechanism: A Sound First Step in Europe's Banking Union?" Egmont Institute, March 2013.

56 "Hedge funds enjoy post-crisis popularity with 'safe' image," Reuters, September 2013.

The SSM will be directly responsible for the supervision of only 123 of the euro area's 'significant institutions', or an estimated 85% of its total assets. A bank falls into the category of 'significant' when it meets one of the following six conditions:[57]

- The value of its assets exceeds €30 billion;[58]
- The value of its assets exceeds both €5 billion and 20% of the GDP of the Member State in which it is located;
- The bank is considered by its national competent authority, with the agreement of the ECB following a comprehensive assessment, to be of significant importance to its domestic economy;
- The bank is deemed by the ECB to have systemically significant cross-border activities;
- The bank is one of the three most significant financial institutions in a Member State;
- The bank previously requested or received public financial assistance from the ESM/EFSF.

These definitions are necessarily quite broad, but they may have some unintended consequences for the future shape of the banking industry in Europe. For example, while one would expect an institution of Deutsche Bank's size and systemic importance to find itself among the 123 significant institutions, its Maltese subsidiary would not, strictly speaking, be considered systemically important. Nonetheless, as one of the largest banks in Malta, it will find itself subject to European supervision and may pay supervisory fees both to the financial regulator of Malta and to the ECB. Large banking groups may therefore be inclined to reconsider their business profiles in smaller countries. Moving towards branches, rather than subsidiaries, would seem a logical step for groups with a presence in small countries who might wish to limit their exposure to intrusive supervision under the new regime – while also avoiding the necessity of holding capital and liquidity locally.

The remaining so-called 'less significant institutions' will be subject to a 'common supervisory culture', including supervisory standards derived from the Single Rulebook, and can be brought under the ECB's direct supervision at any time, if deemed necessary. In practice, though, this right will only be exercised in the most extreme of circumstances. The ECB taking control of one of the less significant institutions would send a clear message to the markets that that institution was in difficulties, undermine the institution's market credibility, and more than likely exacerbate its problems.

[57] It should also be noted that a bank can, under the Regulation, cease to be 'significant'. This can happen if the institution fails to meet any of the criteria for significance for three consecutive years; if three years have elapsed since the bank returned any financial assistance it may have previously received; or if three years have passed since the bank requested and was denied financial assistance.

[58] This kept smaller banks under local supervision and was seen as a concession to the powerful German local-bank lobby; virtually all of the Landesbanks have assets below €30 billion

3.4 ECB SUPERVISION: EVOLUTION, NOT REVOLUTION

3.4.1 SUPERVISION IN PRACTICE

In practical terms, the SSM is responsible, firstly, for the application of the Single Rulebook, a set of regulatory standards based on the Capital Requirements Regulation (CRR), and the Capital Requirements Directive IV (CRD IV), Europe's version of the Basel III accords.[59] The ECB's supervisory powers extend to:

- **Investigation:** The ECB is entitled to request information and requires regular reporting from supervised institutions. NCAs remain the point of entry for the ECB's information requirements and it is their responsibility to check the integrity and quality of the data.
- **Inspection:** The ECB also has the power to launch on-site inspections (OSI). Though OSIs have long been a standard part of the supervisory toolkit at national level, the new regime will see teams led by the ECB and with the participation of representatives from the NCAs.
- **Infringement:** The ECB has the exclusive competence to open infringement proceedings against and impose administrative penalties on significant[60] supervised entities.
- **Authorisation:** This is one of the SSM's most important functions. The ECB has the power to grant and withdraw authorisations for banks wishing to operate in a participating Member State.

Much of the day-to-day work of bank supervision is carried out by Joint Supervisory Teams (JSTs). Each JST is assigned to a particular significant institution and managed by a coordinator from the ECB, but there remains a strong emphasis on the involvement of the NCAs, whose supervisors work alongside supervisors from the ECB.

The ECB itself claims that the new regime will not be heavy-handed, and that it does not intend to reinvent the wheel with the SSM, but to build on already-established supervisory best practices.[61] The deep involvement of the NCAs and their representatives in all aspects of the day-to-day supervisory process, in the short term

[59] The Single Rulebook is part of the underlying framework of banking regulation and is applicable to all 28 Member States. Though it is sometimes referred to as the 'foundation' of the Banking Union, in reality it predates the concept and, while it was designed for the purpose of harmonising banking supervision, the term 'single' is something of a misnomer, as there are multiple discrepancies, or 'local specificities' in the rules, depending on the jurisdiction in which it is applied. Nonetheless, it is a basic building block of the SSM and will be complemented by a Supervisory Handbook, drawn up by the ECB and applied to all banks under its remit.

[60] NCAs retain the exclusive competence to open infringement proceedings against and impose administrative penalties on less significant supervised entities.

[61] European Central Bank, "Guide to Banking Supervision," September 2014.

at least, strongly supports this assertion. Once this 'honeymoon' period is over and the ECB's capacity and experience increases, however, banks should expect the new supervisor to gradually impose its own culture of financial supervision.

3.4.2 THE CONTINUED ROLE OF NATIONAL SUPERVISORS

"The SSM does not, however, mean less work for us, but rather more work, inasmuch as the procedures of the SSM require a further expansion of our bank supervisory staff as well as a reorganisation of their function." [62]

Governor Patrick Honohan, January 2015

It is by now clear that the NCAs continue to play a significant part in supervision of the financial sector. Indeed, the initial structure of the ECB's direct supervision relies heavily on the involvement of the competent authorities in Member States. For now, at least, the representatives of the NCAs in the JSTs are many of the very same staff who had been supervising the same institutions prior to the launch of the SSM.[63] Furthermore, areas such as consumer protection and money laundering fall outside the remit of the ECB and will remain the purview of the NCAs for the foreseeable future.

On initial assessment, this may seem a contradiction of one of the stated aims of the SSM, leaving the mechanism open to accusations that it is centralised 'only in name'. There are, however, compelling reasons behind the deep involvement of the NCAs – not least is the familiar mantra of 'geography matters'. The experience of national supervisors with local internal models, used by banks for the purpose of quantifying the risks they face, is a vitally important advantage which has allowed the European supervisor to hit the ground running. Additionally, the uniform supervisory handbook that the ECB will apply to all institutions in the euro area can do little about regional specificities beyond the financial sector – it is worth noting that neither company law nor tax law is harmonised in the EU (to name just two examples). A deep knowledge of the incentives and motivations that drive companies in a particular territory, therefore, can be an invaluable commodity.

Language barriers too should not be underestimated. English may be the *lingua franca* of the ECB, but no such linguistic requirements have heretofore been placed upon private companies in the EU. Documents from an institution in France or

62 Governor Patrick Honohan, "Introductory statement at Oireachtas Banking Inquiry," Central Bank of Ireland, January 2015.
63 Elke Koenig, "The Role of National Supervisors in Banking Union," speech at the Institute of International and European Affairs, Dublin, April 2014.

Italy will invariably be written in the language of that country. Even in Germany, only one bank – Deutschebank – uses English as its working language. The situation, naturally, will evolve over time, as the ECB builds expertise and capacity, but the involvement of the NCAs is vitally important during the early years of its operation when the SSM's performance will continue to be under close scrutiny.

The involvement of the NCAs should not be mistaken, however, for a continuance of business as usual in banking supervision – nor feed any belief that supervisors will once again act only in the interests of their own national banking system. Supervisory activities and decisions will be led by ECB staff and the supervisory culture will be dictated from Frankfurt. Involving the NCAs to this level is both necessary and astute. Tall though the ECB's tower may be, it would struggle to see the farthest flung corners of the Union without the benefit of local proxies.

3.4.3 ACCOUNTABILITY

In what was a foreshadowing of the difficulties ahead for the other pillars of the Banking Union, the final agreement on the SSM was delayed by six months, while the European Parliament wrangled with the ECB over its democratic accountability. The final agreement[64] allowed for a level of accountability and access to information that is unprecedented in the history of the ECB:

- The Parliament has access to a "meaningful and comprehensive" record of the Supervisory Board's meetings;
- The Parliament has a joint role, with the Council, in the appointment of the Chair and Vice-Chair of the Supervisory Board. It also has a joint role in initiating dismissal proceedings against the Chair and Vice-Chair;
- If the Governing Council of the ECB objects to a draft decision by the Supervisory Board, the President of the ECB must inform the President of the Parliament, or the President of the relevant Parliamentary Committee, of the reasons for the objection on a confidential basis;
- The ECB is required to provide the Parliament with written or oral answers to questions relating to supervisory matters. If confidentiality is required, these questions may be answered in the course of private meetings with the Parliament;
- The ECB must "cooperate sincerely" with any European Parliament investigation into its supervisory decisions;

[64] European Union, "Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism," *Official Journal of the European Union*, November 2013.

- The ECB must report to Parliament regularly regarding its supervisory activities.

To understand why these demands on the ECB's accountability caused such difficulty, the design of the organisation itself must first be understood.

A high degree of operational independence is a critical feature of the ECB's definition under Article 130 of the TFEU. The purpose of that independence is no less than to "shield the ECB from political pressure in order for it to pursue the objectives attributed to its tasks". From the moment of its creation, the institution has enjoyed strict limits on its reporting requirements and general accountability. In its monetary policy role that level of independence from political influences has meant that the ECB has been less paralysed than other actors at the European level during the crisis, and, as witnessed in the institution of its OMT programme, has been capable of acting swiftly to restore market confidence. [65] Indeed, its capacity and willingness to act has been noted by many analysts as the reason that the ECB has emerged from the crisis with its reputation unscathed.

Nonetheless, it must be pointed out that monetary policy and banking supervision are two very different paradigms, and the levels of independence the ECB requires in pursuit of the former are not necessarily appropriate to the latter. Monetary policy usually involves the use of a few macro instruments (interest rates, for example) to achieve price stability – a measurable objective involving a relatively predictable trade-off between inflation and unemployment[66]. Banking supervision, on the other hand, has a wider number of objectives: financial stability, investor and depositor protection, consumer protection and tackling financial crime, to name but a few. Unlike monetary policy, banking supervision requires a greater level of transparency, and a more equal balance between the independence and accountability of the bank supervisor.

3.5 MONETARY POLICY AND SUPERVISION

Though ECB Vice President Vítor Constâncio has described it as a "false risk",[67] it is widely felt in Europe that combining monetary policy and supervision creates unavoidable conflicts of interest, in particular the possibility that monetary policy might be used as an instrument by the ECB for it to attain its supervisory goals. The central thesis of this debate is that a central bank may be led to be more dovish on monetary policy than the inflation objective warrants in order to safeguard certain

[65] Nicolas Véron, "The Challenges of Europe's Fourfold Union," Bruegel, June 2013.
[66] Kern Alexander, "Proposals for a European Banking Union must be redesigned to provide a more accountable and effective institutional framework," London School of Economics, September 2013.
[67] Vítor Constâncio, "Establishing the Single Supervisory Mechanism," speech at the BAFT-IFSA 2013 Europe Bank-to-Bank Forum, January 2013.

banks it supervises, or even in order to conceal supervisory failures; conversely, it might be tempted by supervisory forbearance to prevent a crisis happening that could result in price instability.

Thus, the SSM regulation provides for a far-reaching separation of monetary policy and supervision, with a clear division of labour between the two work streams. Even the measures outlined in the regulation, however, cannot ensure a true separation of the two objectives. Under the proposal, NCAs will still play a significant, albeit, subordinate role in supervising significant banks and an even greater role where the numerous smaller banks are concerned. It is worth noting that, in some Member States, the national Central Bank is responsible for both monetary policy and supervision and the division of labour is rarely as strict as in the ECB. Since the Governing Council and the Supervisory Board are both made up of representatives from the national supervisors of the Member States, the question arises of whether it is even possible to separate monetary policy and supervision on the European level. The idea of a 'Chinese wall' between the two may only exist at a basic administrative level.

There is, however, no universal consensus on the issue, and, as noted, several European countries continue to house monetary policy and supervision under the same roof[68]. In the absence of a definitive solution, the proposed arrangement is an adequate solution, though perhaps not one that will last indefinitely. If nothing else, the visible separation of the two responsibilities should be a boon in terms of perception, allowing the ECB to carry out its dual role without its credibility or impartiality being called into question.

3.6 CONCLUSION

The launch of the first pillar of Banking Union in November 2014 was a vitally important step towards a genuine Economic and Monetary Union, and pan-European bank supervision is now a reality. The SSM's governance structure is fully operational, its directorates general fully staffed and the initially controversial non-objection procedure,[69] has thus far functioned as expected. Though the idiosyncratic governance design was an exercise in creativity under legal constraint, and the incomplete denationalisation of its governance and operational structure is less than ideal, these shortcomings should not be overstated: the successful first year of the SSM's existence has shown that a complex organisational structure does not necessarily imply that the mechanism is fatally flawed. On the contrary, the SSM

68 Whereas before the crisis, Ireland had a hybrid situation, the two functions now sit within the Central Bank of Ireland.
69 European Central Bank, "SSM Quarterly Review," August 2014.

and the common supervisory culture it will impose on the European banking sector, which will over time become stricter than those applied by national supervisors, will eventually prove an effective instrument and should be inherently superior to the fragmented model of the past.

The completion of the Comprehensive Assessments, discussed later in this report, allowed the ECB to commence its supervisory duties with a relatively clean slate and greatly diminish the need for costly bank resolution in the near future.

It would be wrong, however, to assume that the euro area's future stability could be addressed by simply transferring supervisory responsibility to the ECB. It scarcely needs stating that the identification of risk is just one part of the solution and improved supervision cannot, alone, negate the possibility of future crises. In a complete, steady-state Banking Union, the Supervisory Board will, upon identification of a serious risk, have the capacity to refer a troubled financial institution to the Resolution Mechanism, which would then oversee its restructuring or winding-down. Without such an authority, the SSM's options would be limited to notifying the competent national authorities of its concerns, and bank resolution and restructuring would remain the responsibility of the Member State. In essence, banks would be European in life, but national in death – a situation that would not be sustainable.

CHAPTER 4. THE SINGLE RESOLUTION MECHANISM

"One of James Joyce's most famous literary characters, Stephen Dedalus, once observed that errors were the portal of discovery. Having failed to prevent the crisis in the first place, policy-makers and supervisors alike are at last rightly being called on to learn the right lessons […] The onus is now on policy-makers and supervisors to develop a bank resolution and restructuring process."[70]

Sabine Lautenschläger, July 2013

4.1 INTRODUCTION

There is a compelling logic to have both bank supervision and bank resolution conducted at supranational level in Europe. The previous chapter of this report concluded by noting that pan-European supervision without pan-European resolution would lead to an unsustainable situation in which Member States could ultimately find themselves bearing the cost of a failure in supervision by the single supervisor. Equally, differences of view regarding the necessity for – and approach to – bank resolution among Member States would be inevitable.

'Resolution' implies the restructuring of a bank by a competent authority, to ensure the continuity of its critical functions, preservation of financial stability and the restoration to viability of all or part of its business, with the remaining unsalvageable parts of the institution put into normal insolvency proceedings. The resolution of small banks is a relatively uncomplicated process that has been taking place across the EU for years, but the financial crisis witnessed a number of larger banks with extensive cross-border activities experience severe difficulties, in some cases leading to resolution proceedings. Without a harmonised set of rules, central oversight, or

[70] Sabine Lautenschläger, "From Supervision to Resolution: A German Perspective," speech at the Institute of International and European Affairs, Dublin, June 2013.

effective communication between Member States, the process of winding down these significant institutions was invariably disorderly, and often resulted in tremendous expense for the taxpayer. The example of Cyprus in 2013 further highlighted the need for dedicated resolution regimes as part of the financial regulatory toolkit – regimes which would allow for swift and decisive action, backed by EU-level funding arrangements, to avoid a situation in which bank resolution conducted at national level would have a disproportionate impact on the local economy. Such a regime would also curb uncertainty and prevent bank runs and contagion in other Member States. It is therefore necessary to set out a framework that allows for the in-depth restructuring of banks whilst avoiding the very significant risks and costs that their disorderly liquidation under national insolvency laws can give rise to.

Building on the established SSM, the EU has agreed a Single Resolution Mechanism (SRM) to deal with failing banks – a remarkable achievement considering the fragmented nature of Europe's existing bank resolution regimes and the sometimes chaotic nature of bank resolution during the crisis. The SRM is designed to govern the orderly resolution of banks in participating Member States and to establish the uniform application of a single set of rules to restore the orderly functioning of the EU's banking markets and weaken the 'doom-loop' between banks and sovereigns.

This chapter will describe and assess the European Union's plans for a Single Resolution Mechanism for European banks, as well as its accompanying Resolution Fund. However, before discussing the SRM, it is necessary to discuss the Bank Recovery and Resolution Directive – an essential precursor to the resolution mechanism – which first seeks to harmonise the diverse frameworks for bank resolution at Member State level.

4.2 THE BANK RECOVERY AND RESOLUTION DIRECTIVE

4.2.1 HARMONISING NATIONAL SCHEMES

The Bank Resolution and Recovery Directive (BRRD) is the first step in addressing the issue of disparate bank resolution regimes in Europe and will come into full effect on 1 January 2016.[71] The BRRD will apply to all 28 Member States, with the aim of harmonising technical standards among the diverse national schemes that exist and enshrining the writing down/conversion of capital instruments and the bail-in of eligible liabilities, in lieu of bail-out by the taxpayer. The Directive aims to ensure that an unsound credit institution can be resolved speedily and with minimal risk to

[71] Though, as will be noted in Chapter 7, Member States have the option of unilaterally bringing forward the start date of the bail-in and MREL rules. The transposition process has not been without complications, however, with Czech Republic, Luxembourg, the Netherlands, Poland, Romania and Sweden all referred to the Court of Justice on 22 October 2015, for failing to properly transpose the legislation.

financial stability. Under its terms:

- Each institution will have to prepare a recovery plan that sets out the measures it will take in various scenarios in which it may be at risk;
- Resolution authorities will have powers to require an organisation to take steps to restore financial soundness or to reorganise its business;
- Banks will submit resolution plans, or 'living wills', to the national competent authorities, setting out options to resolve them in different scenarios;
- Supervisors will have powers to intervene early if the financial situation or solvency of a bank is deteriorating;
- Supervisors may appoint a temporary administrator with all the powers given to management by the company's constitutional documents and by national law.

If a bank is failing, the relevant resolution authority[72] has four main instruments in its toolkit, including:

- The sale of part or all of the business;
- Establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity pending a future return of the business back to the private sector when market conditions improve);
- Asset separation (the transfer of impaired assets to an asset management vehicle such as NAMA in Ireland);
- Bail-in of eligible liabilities (e.g. senior bondholders). Bail-in is in addition to the requirement to write down or convert capital instruments (shareholders and junior bondholders). In 2015, under BRRD there will be a requirement to write down or convert capital instruments, but bail-in will not become mandatory until the start of 2016. It should be noted that under EU State aid rules, the principle of burden-sharing is confined to shareholders and subordinated debt, therefore the introduction of bail-in represents a considerable broadening of this principle.

There will also be additional loss absorbency capacity from Resolution Funds financed by contributions from the banking sector. There is a requirement by 31 December 2024 that such resolution funds should reach a target level of at least 1% of the amount of covered deposits of all the institutions authorised in a Member State. There is also a facility whereby a fund in an affected Member State can make a request to borrow from its counterparts in other Member States.

[72] This may be the National Competent Authority, or the Single Resolution Mechanism. The criteria for resolution under the latter authority is discussed later in this chapter.

4.2.2 THE NEED FOR CENTRAL OVERSIGHT

The BRRD relies on a network of national resolution authorities (NRAs) and resolution funds, operating under a harmonised set of standards, to resolve banks. While this is a major step forward in minimising the disparities between national schemes, it is not, on its own, sufficient. Under the BRRD, Member States will retain a great deal of discretion and the precise degree of burden sharing in a resolution scenario will depend on the specificities of each case, including the amount of losses that need to be covered, and the broader economic conditions. The directive stipulates that a minimum of 8% of liabilities must be bailed-in, beyond which NRAs may exempt further liabilities from bail-in, based on imprecisely-defined arguments such as "to avoid value destruction". Member States also have discretion as to whether they set up resolution funds or instead have the levy proceeds flow into the general budget (from which it might not be available in times of crisis). This was introduced in particular to facilitate the UK.

The combination of the potential bail-in of creditors and the discretion granted to Member States to operate this on a case-by-case basis is not ideal. Though the BRRD will provide established principles about the concept of bail-in and ensure equality for creditors across Member States, these flexibilities and national discretions, left to stand alone, could create further asymmetry in the market, and lead to a situation in which bank resolution could continue to have inconsistent effects, depending on the jurisdiction in which the bank is resolved. In addition, experience has shown that any form of coordination of national resolution authorities and national resolution funds is difficult, allowing for the likelihood of separate and potentially inconsistent decisions by Member States regarding the resolution of cross-border groups, which could have implications for the overall cost of resolution.

A central authority is therefore vital to coordinate proceedings and to balance the need for swift decision-making while protecting both national and EU-wide interests.

4.3 THE SINGLE RESOLUTION MECHANISM

The Single Resolution Mechanism (SRM) Regulation[73] is designed to provide just such an authority – at least for a subset of the EU 28 – and would level the playing field for banks in the Single Market. Unlike the SSM, though, which had an explicit legal basis under Article 127(6) TFEU, the Treaty makes no specific allowance for bank resolution, which led to serious disagreements between Member States and European Institutions regarding its shape and operation. The Commission's 10 July 2013 proposal called for the regulation to be established under Article 114 of the

[73] European Commission, "2013/0253 (COD) Regulation of the European Parliament and of the council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No. 1093/2010 of the European Parliament and of the Council," July 2013

TFEU, governing the Single Market, under what some observers considered to be the tenuous[74] rationale of preserving Single Market integrity by ensuring the uniformity of bank resolution. While the legal foundation remained largely intact during the negotiation process, there were nonetheless some notable changes in the final agreement.

After months of what were, at times, acrimonious negotiations, an agreement was reached between the European Parliament and the Council in March 2014. The compromise solution is rather unwieldy, being carefully designed to circumscribe the manifold legal and political concerns arising from the creation of a central resolution authority. Nonetheless, the Council and Parliament believe they have reached a compromise which will allow for even a major cross-border group to be resolved in the course of a single weekend. Though the final agreement is more complicated than the Commission's July 2013 proposal, it is nonetheless a considerable improvement on the hotly disputed compromise texts which were proposed in the interim, in that the role of the Council is circumscribed and the resolution process more streamlined.

The scope of the SRM will extend to all banks in the euro area and Member States that elect to opt in to the system. In practice, however, the structure reflects the division of tasks under the SSM – meaning that it will mostly be responsible for the resolution of entities directly supervised by the ECB (significant banks) and cross- border groups. NRAs will still be involved in both the drawing-up and executing of resolution plans – and will have the option of relinquishing responsibilities entirely to the SRM, a potentially attractive option for smaller countries with limited resources and expertise.

Though the Regulation does not officially come into effect until 1 January 2016, the SRM is de facto in operation as of early 2015 (though it will not have any implementation powers during this 12 month period). Its focus for 2015 will likely be on coordinating the implementation of the BRRD, lending technical assistance in drawing up recovery plans for credit institutions and, most pressingly, setting up and staffing the mechanism itself.

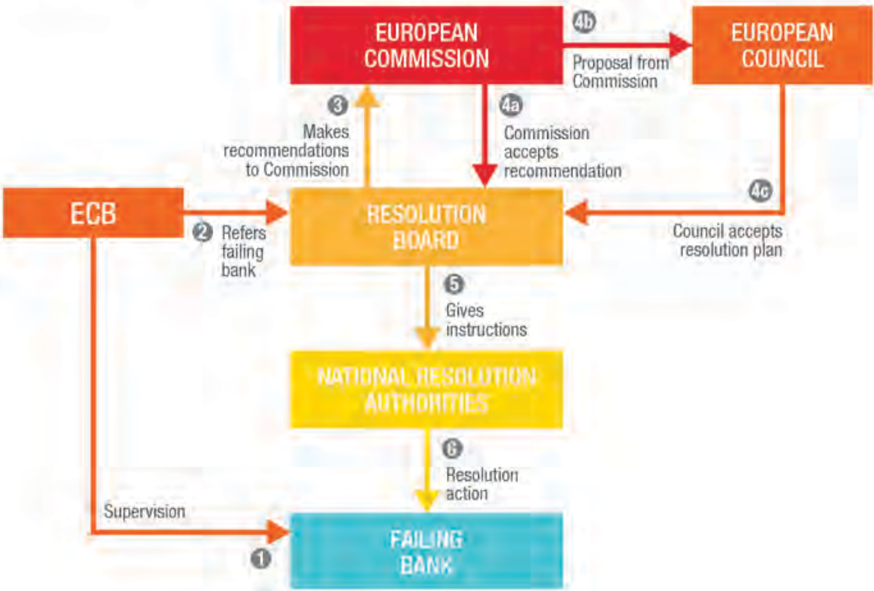
4.4 GOVERNANCE AND OPERATION

4.4.1 STRUCTURE AND DECISION-MAKING

The legal and political constraints mentioned previously are most noticeable in the SRM's governance structure, shown in Figure 4.1.

[74] "Controversial second pillar of banking union looks insufficient to hold up Eurozone roof in a crisis," Open Europe Flash Analysis, Open Europe, July 2013.

FIG 4.1 **SRM GOVERNANCE STRUCTURE**



The mechanism will consist of a Brussels-based Resolution Board, comprising a Chair, Vice-Chair and four further full-time members, as well as representatives from the National Resolution Authorities of participating Member States. The ECB and Commission, who were originally proposed to be voting members of the board (much to the chagrin of certain Member States, who feared that their NRAs would be outvoted by representatives of the Institutions) have retained the right to attend meetings, but only as observers[75]. A representative of the European Banking Authority will be invited to deliberations on cross-border resolutions and there is a presumption that the EBA will attend when matters within its purview are discussed.

Due to the constraints of the Meroni doctrine of EU law, which addresses the institutional power balance and prohibits the delegation of discretionary powers from an EU Institution, the Board has the status of an agency, acting under the aegis of the European Commission, and may only make non-binding recommendations. The power of implementation resides with the Commission or, when the public interest

[75] In its assessment of the SRM in November 2013, the ECB explicitly indicated its preference to have observer status, in order to avoid any potential conflicts of interest.

is at stake, the Council on a proposal from the Commission[76], a vestigial element of the proposal, whose seemingly innocuous nature belies the fierce debate which preceded it. Indeed, the Council's general approach of 19 December 2013 had attempted to take this power of implementation entirely out of the Commission's hands[77] and allow Member States to collectively have the final say in all resolution cases – an outcome that would have been the antithesis of the independent and unbiased resolution procedure the SRM was designed for. It was only the European Parliament's refusal to ratify the Council's general approach that resulted in a compromise greatly restricting the grounds on which the Council could become involved.

In the final agreement, a bank will be placed in resolution only if the ECB and/or the Board determines that the following three conditions are met: (i) the institution is failing or about to fail; (ii) there is no private sector alternative; and (iii) that resolution of the institution in question is in the public interest.

Once the Board communicates a resolution plan to the Commission, there are now two possible decision-making scenarios:

Scenario 1
The Commission has no objection on the grounds of either public interest or material modification of the amount of the Fund provided for in the resolution scheme:

> In this scenario, within 24 hours of communication, the Commission may either:
> a. endorse the resolution scheme; or
> b. object to it on grounds other than those specified above.

Scenario 2
The Commission specifically objects on the grounds of public interest, or on the grounds of a material modification of the amount of the Fund provided for in the resolution scheme:

> In this scenario, the Commission, within 12 hours of the original communication from the Board, must propose to the Council to either:
> a. object to the resolution scheme on the grounds that it does not fulfil the public interest criterion; or

---

[76] The principle of institutional balance set out in the Treaties, and solidified by the Meroni case-law, dictates that each institution has to act in accordance with the powers conferred on it by the Treaties and prohibits any encroachment by one institution on the powers conferred on another. Since the Board is an agent whose duties are delegated by the Commission, the Council cannot directly intervene in its work, nor may it intervene in the Commission's final decision – it may only do so on proposal from the Commission.
[77] This too would have occurred "on a proposal from the Commission", in order to satisfy the Meroni case-law.

b. approve or object to a material modification of the amount of the Fund provided for in the resolution scheme.

In the case of 2 (a) or 2 (b) the Council's decision must take place within a further 12 hour window. If the Council objects to the resolution scheme, the entity is wound up in accordance with the applicable national law.

4.4.2 THE BOARD: PLENARY AND EXECUTIVE FORMATIONS

The Resolution Board will have two formations. First, a plenary formation, consisting of the five permanent members, plus the representatives of all the participating National Resolution Authorities (NRAs).

The Board will also have an executive formation, responsible for most decisions relating to bank resolution. The executive formation will be structured as follows. Made up of the five permanent members, the executive formation will also consist of nominees from the NRAs of the relevant Member States (i.e. one from the bank's 'home' country, and one from each of the bank's 'host' countries, where applicable), as well as non-voting observers from the ECB, Commission and, by invitation, the EBA and others.

Though the 10 July 2013 proposal had specified that all resolution decisions would be taken by the executive session of the Board, the final text stipulates that in certain key scenarios competence will be transferred to the plenary session which is composed of the representatives of the Member States' NRAs, who would, in most cases, vote by simple majority[78] – a situation which, it could be argued, runs contrary to the Board's founding principles of independence and neutrality.

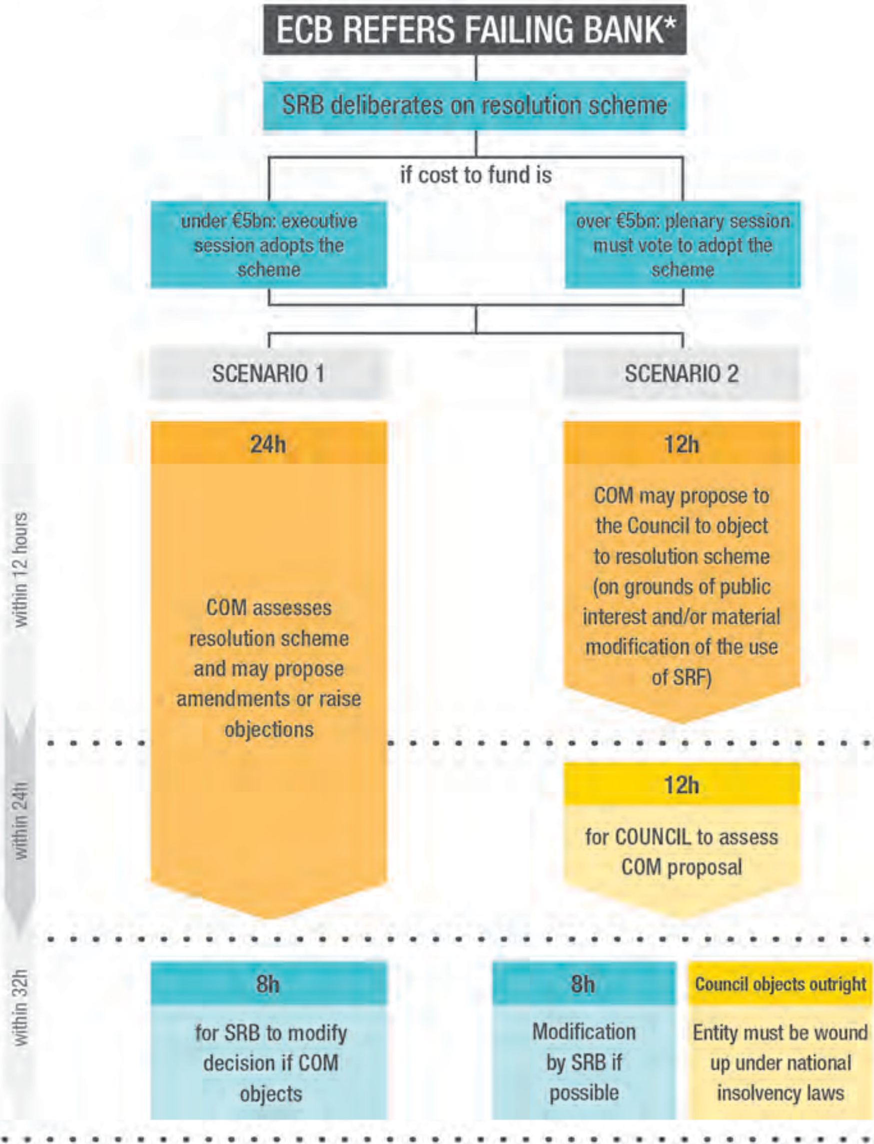
Competence will rest with the plenary session where the support of the fund is required above a threshold of €5bn. However this only arises if any one member of the plenary objects to the executive's decision. In this case they may convene a meeting within three hours of the executive submitting a draft resolution scheme. If the plenary doesn't react within three hours, the Executive's decision enters into force.

4.4.3 DECISION MAKING PROCESS IN FULL

The full decision-making process in the SRM is shown in Figure 4.2.

[78] The phrase 'simple majority' belies a rather more complicated procedure. For decisions relating to the use of the paid-in financial means in the fund, that simple majority must represent at least 30% of contributions to the fund. Further complicating proceedings, decisions relating to resolution schemes which require borrowing between compartments, use of mutualised funds, or any decisions involving the use of financial means exceeding that presently available in the fund must be taken by a majority of 2/3 representing at least 50% of contributions until 2024, while the fund is still building up, and at least 30% of contributions after 2024.

FIG 4.2 **DECISION-MAKING PROCESS IN THE SRM**



* The Board may also refer a failing bank if the ECB fails to do so within 3 days of being notified that the bank must be wound up.

The procedure detailed above is admittedly more convoluted than what might be considered optimal. The Commission and Parliament, however, have done their best to mitigate the risk of delays, and the express deadlines in place at each step are designed to ensure that an institution can be resolved between the closing of business on a Friday and re-opening on a Monday morning. Of course, the potential for delays and the possibility of a politicisation of the resolution process cannot be entirely disregarded in the final structure. In truth, though, it may only be during the first test of its abilities that we shall be able to gauge the efficiency of the Single Resolution Mechanism.

It is nonetheless worth comparing the final resolution procedure to the Commission's July 2013 proposal, shown in figure 4.3 which seemed a rather more apt solution to the problem of swift bank resolution.

FIG 4.3 **ORIGINAL SRM DECISION-MAKING HIERARCHY**

4.5 THE SINGLE RESOLUTION FUND

4.5.1 THE FUND

The Single Resolution Fund (SRF), a €55bn pool designed to facilitate bank resolution, was created to eventually replace the national funds established under the BRRD,[79] described in the first part of this chapter. Contributions paid by the banks[80] into the BRRD fund will be transferred to the SRF from 2016 and will allow for any funds already raised under the BRRD to be transferred directly to the central level.[81]

The SRF quickly became one of the more contentious issues of the Banking Union proposals and the sometimes difficult negotiations greatly changed the structure and legal basis of the Fund. Due to political opposition in some Member States to the idea of mutualisation, the SRF will not be a single pool as originally proposed – at least not in the beginning. Instead there will be an eight-year transition period, during which the participating Member States will transfer funds raised at national level into corresponding national compartments, the designated size of which will be equal to the total of the contributions payable on each territory[82]. These national compartments will then be progressively mutualised, reaching 60% mutualisation by the second year of operation and increasing incrementally for every subsequent year. The SRF is then expected to reach its target level of at least 1% of the amount of covered deposits of all institutions in all of the participating Member States within a period of eight years, starting from 1 January 2016.

In order to address domestic constitutional concerns raised by Germany, the Council agreed, over vociferous opposition from the European Parliament who accused Ministers of attempting to circumvent the ordinary legislative process,[83] that the mutualisation and certain aspects of the use of the Resolution Fund would

79 The national funds will remain in place for investment firm contributions under the BRRD.

80 The Commission released its draft methodology for calculating the banks' contributions to the Resolution Fund on 21 October 2014. The delegated act sets out in detail: (i) The fixed part of the contribution, which is based on the institution's liabilities (excluding own funds and guaranteed deposits), as the starting point for determining the contribution; so the larger the bank, the higher the fixed part of the contribution. (ii) How the basic contribution is adjusted in accordance with the risk posed by each institution. The proposal includes a number of risk indicators against which the risk level of each institution will be assessed.

81 Existing funds at national-level will be transferred by 31 January 2016. Yearly payments in every other case must be made by June of each year.

82 This figure will be calculated by the national authorities and communicated to the Board. The contribution of each institution either to the resolution financing arrangement under BRRD or to the SRF will be based on a flat rate in accordance with Article 103(2) of the BRRD and Article 66 (1) of the SRM adjusted by specific risk factors as set out in Article 103(7) of the BRRD.

83 Martin Schulz, "Letter from Martin Schulz, President of the European Parliament, to Jose Manuel Barroso, President of the European Commission," European Parliament, January 2014.

be moved out of the SRM Regulation and into an Intergovernmental Agreement (IGA)[84], which was signed on 20 May 2014.

The division of tasks between the agreed Regulation and the IGA is shown in Figure 4.4 below.

FIG 4.4

COVERED BY THE SRM REGULATION	COVERED BY THE INTERGOVERNMENTAL AGREEMENT
Establishment of the SRM and the Board	
Establishment of the Fund	
Governance and decision-making (including use of the Fund)	
Principles in determination of national bank levies	
Bail-in rules	
	Rules explicitly setting bail-in provision applicable to the use of the Fund
	Compensation clause for non-participating MS in case of non contractual liability involving SRM
	Mutualisation of national compartments
	Transfer of contributions raised at national level of the SRF
	Review of implementation after 10 years

4.5.2 USE OF THE FUND

During any resolution case which requires the use of the SRF, the Resolution Board and the Commission will authorise a resolution plan detailing the amount of the Fund required after the bail-in process has been exhausted. After the bail-in process ends, the Board will first draw funds from the SRF compartments of the relevant home and host countries, before drawing on any available mutualised funds from other compartments, if necessary. Only when all other options are exhausted would recourse be made to national budgets or a future community backstop for the SRM, which would facilitate borrowings by the SRF, and for which the banking sector would ultimately be liable for repayment by means of *ex-post* levies in participating Member States.

[84] The agreement does, however, contain a 'sunset clause' stipulating that the text must, after an assessment of its implementation, be incorporated into the Treaties no later than 10 years after its start date.

The process, including the mutualisation split, is shown in Figure 4.5.

FIG 4.5

<table>
<tr><th>Year</th><th>Step 1</th><th>Step 2</th><th>Step 3</th></tr>
<tr><td></td><td>Use of available funds in the relevant national compartments</td><td>Use of the available paid-in funds in all compartments making up the SRF, including the same percentage of remaining funds in the national compartment</td><td>If steps 1 and 2 are insufficient, the following options are available:</td></tr>
<tr><td>1</td><td>100%</td><td>40%</td><td rowspan="9">1. Use of remaining funds in the home/host national compartments
2. Extraordinary ex-post levy on banking sector of affected Member State(s)
3. Possibility for lending between national compartments during transition period or borrowing from the markets
4. Bridge financing from national sources or the ESM in line with the agreed procedures
5. Community Backstop</td></tr>
<tr><td>2</td><td>60%</td><td>60%</td></tr>
<tr><td>3</td><td>40%</td><td>66.7%</td></tr>
<tr><td>4</td><td>33.3%</td><td>73.4%</td></tr>
<tr><td>5</td><td>25.6%</td><td>80.1%</td></tr>
<tr><td>6</td><td>19%</td><td>86.8%</td></tr>
<tr><td>7</td><td>12.3%</td><td>93.5%</td></tr>
<tr><td>8</td><td>5.6%</td><td>100%</td></tr>
<tr><td>9</td><td>0%</td><td>100%</td></tr>
</table>

As an example, a case involving use of the fund in Year 2 of the transition period, (entailing a 60% / 60% mutualisation split, as described in the table above) would work as follows:

- The fund will first use 60% of the available funds in the relevant home/host compartments.
- If the amount required exceeds 60% of the available funds in the home/host compartments, the next step will be to make use of 60% of the available funds in all national compartments, including 60% of the *remaining funds* in the home/host compartments.
- If 60% of the available funds in all SRF compartments is not sufficient to cover the cost of a resolution action, all remaining funds in the home/host compartments will next be used.
- If the above is insufficient, NRAs would be required to raise extraordinary *ex-post* contributions from institutions authorised in the territories affected by the resolution case.

- If all of the above is insufficient, pending authorisation of a designated community backstop for the SRF (scheduled to be *in situ* by the end of the mutualisation period in 2024), bridge financing from national-level sources in accordance with State aid rules (see State aid section below), borrowing from the markets, or the ESM would be the final recourse.

4.5.3 STATE AID AND THE USE OF THE SINGLE RESOLUTION FUND

As implied by the financing arrangements described above, the expense of winding down a large banking group implies that the possibility of State aid cannot be fully excluded. However, the SRM cannot, in the current Treaty framework, compel the use of public money in the resolution process.

In order to address these legal concerns, the resolution process carefully compartmentalises the use of private funding and taxpayer money. The resolution plans drawn up by the banks and the National Resolution Authorities should foresee the possible need for State aid in resolution cases, and this requirement will be taken into consideration by the SRB when deliberating on the case. If State aid is required, it will, in essence, be 'pre-agreed' before the resolution process begins. Upon approval of the resolution plan, the affected Member State will submit its formal request to the European Commission's Directorate General for Competition to be given assistance in applying the State aid rules, and the State aid process will then occur separately, but in parallel, with the Single Resolution Mechanism. Administering the State aid rules is a competence of DG Competition, and, in a sense, the process is simply incorporating and formalising a procedure that has been taking place throughout the crisis. Though this compartmentalisation of the private and public financing elasticates the Treaty almost to breaking point, the Resolution Mechanism itself will technically not rely on the injection of public money in any form, thus bypassing a key legal concern.

4.5.4 IS THE RESOLUTION FUND SUFFICIENT?

It is essential to note that the Fund cannot be considered a backstop or bail-out fund. Indeed, the Regulation explicitly states that it may not be used to directly absorb the losses of the institution under resolution, nor to directly recapitalise it. Its primary uses will be to purchase assets or liabilities from the institution under resolution, or to make loans to the institution, its subsidiaries or a bridge institution. It is also abundantly clear from the built-in safeguards governing its application that the minimisation of its use was a priority for the negotiators. It is therefore more appropriate to consider the Fund as a facilitator of the resolution process, which ensures that resolution proceeds in an orderly and stable manner, while minimising the need for public money.

Nonetheless, the layers of safeguards protecting its use, coupled with its relatively small target level of €55 billion, have given rise to concerns that the Fund will be insufficient to break the link between banks and sovereigns. It has even been argued that that link may be reinforced, particularly during the mutualisation phase up to 2024. However, these concerns are likely to be overstated.

It is true, of course, that the need for public money cannot be ruled out in every instance. In the worst case scenario, for example, in which the EU encountered a further systemic crisis in which several significant institutions were to fail in a relatively short period of time, and in which the effectiveness of bail-in may be hampered due to the inter-relatedness of creditors in the affected institutions, national financing could conceivably come back into play. And, of course, in such a situation it would be extremely difficult for a supervisor to make an impartial assessment of an institution's resolvability. Such circumstances, however, are once-in-a-century occurrences, and in normal times the new resolution regime under the SRM and BRRD should be sufficient to cover the resolution costs of most significant institutions – and to protect Member States against the type of crippling bank resolution scenarios witnessed during the recent crisis. In his press conference announcing the SRM proposal, then Commissioner for Internal Market and Services, Michel Barnier, argued that only one bank resolution case prior to Cyprus – that of Anglo Irish – would have needed some degree of public money had the SRM and BRRD been in place before the crisis struck.[85]

In order to further mitigate this risk, Europe has agreed to put in place by 2016 a system by which bridge financing would be available, as a last resort, from the European Stability Mechanism. The next logical step must be for EU leaders to make progress on a designated backstop for the SRF – though the Intergovernmental Agreement on the SRF called for such a community fund to be established by 2024, no work schedule has emerged to date. The issue is far from forgotten, however, and the June 2015 Report of the Five Presidents *Completing Europe's Economic and Monetary Union*, called for swift action on completion of this backstop, suggesting a credit line from the European Stability Mechanism as one possible course of action.

4.6 CONCLUSION

The SRM is not without its issues and idiosyncrasies. The structure is less optimal than might have been hoped; the decision-making is more complicated than the original proposal; and the Fund is smaller than many analysts had anticipated.

85 Commissioner Michel Barnier, "Single Resolution Mechanism Press Conference," European Commission, July 2013.

However, just as was the case with the Single Supervisory Mechanism, these issues are far from fatal[86] .

Indeed, from a political perspective, the approval of the new resolution framework outlined under the BRRD and SRM represents an enormous achievement and should be considered an important foundation for the future sustainability of Europe's banking sector. It is particularly encouraging that bank resolution will, henceforth, be based on a deep bail-in of creditors, rather than a bail-out by taxpayers. It scarcely needs stating that the effects of the latter can be unpredictable and can extend far beyond the borders of the Member State affected.

Much like the SSM, credibility and market confidence will be the key to the SRM's success. Much will depend upon how the Board navigates its first eight years, during which the Fund will not be fully mutualised, and no dedicated SRM backstop will be in place. More still will depend upon its handling of the first crucial test of its abilities in winding down an institution. If and when such a situation arises, it is sure to prove politically and logistically challenging, and the Board will doubtless be subject to intense scrutiny. As noted earlier in this report, though, such a situation might be avoided altogether if the new regulatory and supervisory requirements are sufficiently comprehensive and rigorous. It is clear that important lessons have been learned from the crisis and, with the BRRD and SRM, Europe's financial sector is entering a new era – one in which the need for public money in bank resolution is, at the very least, likely to be far more limited.

[86] Eilis Ferran, "European Banking Union: Imperfect, but it can work," University of Cambridge Faculty of Law, April 2014.

CHAPTER 5. THE COMMON DEPOSIT GUARANTEE SCHEME

"As a case in point, the European deposit guarantee scheme cannot be established upon the existing legal basis. It would require common accountability and European control rights – things which are not permitted under European law as it stands. This is why we have shelved the common deposit guarantee scheme for now and are instead concentrating on harmonising national funds. I think it is wise for us to take our time here." [87]

Andreas Dombret, October 2014

5.1 INTRODUCTION

When the Banking Union was first conceived in 2012, a common Deposit Guarantee Scheme (DGS) was seen as a fundamental 'third pillar' of the plan, alongside the Single Supervisory Mechanism and Single Resolution Mechanism, discussed in the previous chapters.

The 2012 Communication from the Commission, *A Roadmap Towards a Banking Union,*[88] stated that shifting supervision and crisis management of banks to the supranational level was only one part of the process of restoring confidence in the euro area, and must be combined "with other steps, such as a common system for deposit protection." Deposit insurance in the EU is currently fragmented along national borders, and the harmonisation of these national schemes has been on the legislative agenda in Europe for nearly two decades, beginning with the Directive on Deposit Guarantee Schemes in 1994, which itself was heavily amended after the onset of the financial crisis. The collapse of Lehman, and the knock-on effects felt in EU Member States, ultimately led to the implementation of a harmonised insurance

[87] Dr. Andreas Dombret, "The more the merrier? Harmonisation and transparency in banking supervision," speech at the joint workshop of the Deutsche Bundesbank and the Research Task Force of the Basel Committee on Banking Supervision, October 2014.
[88] European Commission, "A Roadmap towards a Banking Union, Communication from the Commission to the European Parliament and the Council," European Commission, September 2012.

level of €100,000 per depositor and a proposal for a radical overhaul of national systems in 2010,[89] which was finally agreed in the form of the recast Directive on Deposit Guarantees on 15 April 2014.

In the interim, however, the idea of a common deposit insurance scheme with a shared fund quietly slipped from the legislative agenda, amid shrinking post-crisis political ambition and opposition from some Member States, for whom mutualisation remains a politically sensitive subject. The June 2015 Report of the Five Presidents explicitly states that the current system remains vulnerable and that moves towards a common, fiscally neutral deposit insurance scheme must be taken in due course. Nonetheless, the report acknowledges that this will be a lengthy endeavor, and recommends only 'concrete steps in that direction' in the short-term. Without a proposal, or even the prospect of a proposal in the near-term, then, the common DGS is therefore the least certain element of the Banking Union and will only be discussed in broad terms in this chapter.

5.2 WHAT IS A DEPOSIT GUARANTEE AND WHY IS IT NECESSARY?

Deposit insurance provides protection to bank customers, thereby seeking to resolve the issue of bank runs and preventing the 'self-fulfilling prophecy' of a bank failure. This issue is inherent to the fractional reserve banking system, where only a small amount of the deposits are actually kept in cash or short term liquid assets; most of a bank's assets are tied up in long term commitments, such as loans or mortgages. The rationale behind deposit guarantees assumes that retail customers will not rush to withdraw their savings if they are certain that their deposits are safe even when the bank fails. If such an event occurs and banks cannot meet their obligations, a fund will reimburse the deposits up to a certain limit, while a closely associated resolution authority will close the bank and wind it down in order to retrieve the most from the remaining assets of the bank.

In Cyprus in March 2013, the EU was given a vivid example of the need for, at the very least, a harmonised system of deposit protection. When the Cypriot bank insolvency issues finally reached crisis-point in March 2013 – exacerbated by the Eurogroup's vacillations on whether or not small depositors would be bailed in – panic gripped depositors, and Cypriot customers queued at the ATMs of Cyprus Popular Bank (CPB) to withdraw their savings. The malaise quickly spread to other financial institutions and resulted in the authorities declaring a suspension of convertibility by setting a daily withdrawal limit of €400 per account – later reduced further to only €100 per day. Faced with the threat of deposit flight, the

89 European Commission, "Proposal for a Directive EU of the European Parliament and of the Council [recast], COM(2010)368 final," European Commission 2010.

banks would otherwise have run out of liquid assets and would have had to shut their doors.

Furthermore, the uneven response to the financial crisis in Europe led to uncoordinated increases in deposit coverage across the Union – in some cases leading to depositors transferring money to credit institutions in countries in which deposits were guaranteed at a higher level. For example, when Ireland declared in 2008 that the deposits in Irish banks were backed by the Irish State to the full amount, banks in the UK began to lose depositors to branches of Irish banks. This prompted the Financial Services Authority (FSA) to raise the UK insured deposit limit from £35,000 to £50,000. These uncoordinated actions exacerbated the asymmetry in Europe's financial markets, and drained liquidity from credit institutions in a time of extreme stress. Even in times of stability, disparities between deposit insurance in Member States can lead to deposits migrating to territories with the highest deposit protection. Left unharmonised, these disparities can lead to competitive distortions in the internal market. It was therefore deemed necessary to ensure a harmonised level of deposit protection, regardless of where the deposits are located in the Union.

5.3 THE PRESENT: DIRECTIVE ON DEPOSIT GUARANTEES (RECAST)

Agreed alongside the SRM at the final plenary session before the European Parliament elections in April 2014, the recast Directive on Deposit Guarantees is, much like the BRRD discussed in Chapter 4, based on the principle of minimum harmonisation, and in keeping with the principle of subsidiarity set out in Article 5 TFEU.

The Directive harmonises the minimum level of protection for deposits at €100,000[90] and also encompasses the harmonisation of the funding mechanisms of DGSs, the introduction of risk-based contributions and the harmonisation of the scope of products and depositors covered. It is hoped that depositors will benefit from significantly improved access to DGSs, thanks to a broadened and clarified scope of coverage, faster repayment periods, improved information and robust funding requirements. This will improve consumer confidence in financial stability throughout the internal market.

90 It should be noted that the Directive retains the principle of a harmonised limit per depositor rather than per deposit. The Directive therefore takes into account deposits made by depositors who are not mentioned as holders of an account or who are not the sole holders of an account. The €100,000 limit will be applied to each identifiable depositor.

5.3.1 SCOPE

The recast Directive adopted by the EU applies to all 28 Member States and will ensure that each territory either establishes a DGS or harmonises the various existing protection schemes in Member States in accordance with the Directive. In principle, the Directive requires every credit institution established in a territory to join a DGS, to which they will contribute payments on an ex ante basis.

Member States must ensure that small deposits below a harmonised threshold of €100,000[91] are protected, though there are temporary exceptions to this threshold where local specificities demand it.[92] Shares in Irish or UK building societies (apart from those of a capital nature) will also be treated as deposits and protected up to the same threshold.

In addition to the simple protection of small deposits, the following types of deposits are protected above €100,000 for at least three months and no longer than 12 months after the amount has been credited or from the moment when such deposits become legally transferable:

- Deposits resulting from real estate transactions relating to private residential properties;
- Deposits that serve social purposes laid down in national law and are linked to particular life events of a depositor such as marriage, divorce, retirement, dismissal, redundancy, invalidity or death; and
- Deposits that serve purposes laid down in national law and are based on the payment of insurance benefits or compensation for criminal injuries or wrongful conviction.

5.3.2 FUNDING

The Directive stipulates that each DGS fund should reach a target level of at least 0.8% of covered deposits of its members within ten years of the Directive entering into force (though payments already made to existing schemes designed for the purpose of covering costs related to systemic risk can be drawn upon at the discretion of each Member State). As a new element of the recast Directive (clearly influenced

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[91] Excluded are: deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering; deposits by pension and retirement funds; deposits by public authorities; deposits by insurance and reinsurance undertakings.

[92] The Directive's fixed coverage level of €100,000 has put some Member States in the situation of having to lower their coverage level, creating risks of undermining depositor confidence. The Directive acknowledges that while harmonisation is essential in order to secure the level playing field and financial stability in the internal market, risks of undermining depositor confidence should be taken into account. Therefore, Member States will be able to apply a higher coverage level if they provided for a coverage level that was higher than the harmonised level before the application of the Directive.

by the experiences of the crisis), contributions to DGSs will be based not only on the amount of covered deposits, but by the degree of risk incurred by the respective member, allowing the risk profiles of individual credit institutions to be reflected. These risk-weighted contributions are designed to mitigate the moral hazard issue that is considered to be inherent to deposit insurance schemes. It is frequently argued that explicit guarantees can lead banks to take excessive risks and can systemically weaken market discipline.[93] Well-targeted premiums should alleviate this danger to a certain extent – especially when coupled with similarly risk-weighted fees being levied under the Single Resolution Fund.

The precise weighting of the contributions is, at time of writing, unknown, but it will be determined by each individual DGS, according to guidelines issued by the EBA, and should lead to a fairer calculation of per-institution contributions while providing a further incentive for institutions to operate under a less risky business model.

5.3.3 USE OF FUNDS

The paid-in financial means of the DGS will primarily be used to pay back depositors in the event of a bank failing, with the amount to be determined by the resolution authority. However, where national law allows, it will also be possible for the funds to go beyond a pure reimbursement function and for the available financial means to be used in order to prevent the failure of a credit institution, thereby avoiding any extra costs associated with reimbursing depositors as well as staving off any unpredictable systemic effects that might be associated with winding up the institution in question. This would add a further layer of security to Europe's crisis response system and could have substantial benefits, but it is also to be strictly regulated, compliant with State aid rules, and limited to just a handful of circumstances.[94]

93 Ata Can Bertay, Asli Demirgüç-Kunt and Harry Huizinga, "Is the financial safety net a barrier to cross-border banking?" The World Bank, January 2012; Kam Hon Chu, "Deposit Insurance and Banking Stability," Cato Journal, Vol. 31, No. 1, November 2011. The latter also finds in his analysis of 56 countries between 1996 and 2007 that countries with lower coverage levels of deposit insurance exhibit less systemic and non-systemic crises – only one out of the 22 low coverage countries as opposed to nine in the high coverage countries.

94 The specific circumstances provided for are: (a) where the resolution authority has not taken any resolution action; (b) where the DGS has appropriate systems and procedures in place for selecting and implementing alternative measures and monitoring affiliated risks; (c) where the costs of these measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS; (d) where the use of alternative measures by the DGS is linked to conditions imposed on the credit institution that is being supported, involving at least more stringent risk monitoring and greater verification rights for the DGS; (e) where the use of alternative measures by the DGS is linked to commitments by the credit institution being supported with a view to securing access to covered deposits; (f) where the ability of the affiliated credit institutions to pay the extraordinary contributions in accordance with the Directive is confirmed in the assessment of the competent authority.

5.3.4 PAYOUTS

In a consumer-friendly change to the Directive, DGSs must now ensure that the repayable amount is available within seven working days of the approval of reimbursement. However, during the transitional period up to 2023, there is broad discretion afforded to Member States in this respect:

a. 20 working days until 31 December 2018;
b. 15 working days from 1 January 2019 until 31 December 2020;
c. 10 working days from 1 January 2021 until 31 December 2023.

5.3.5 ASSESSMENT

The formalisation and legal anchoring of deposit protection sends a strong signal to depositors, and the customer-oriented content of the Directive is a positive change in the aftermath of the financial crisis. That bank resolutions may still require more than the bail-in of equity and debt-holders, as discussed in the previous chapter, of course remains a possibility (however slim). It is therefore essential that small deposits are protected. Harmonisation of protection should also improve the competitiveness of the banking sector, allowing customers to focus on aspects other than deposit safety when choosing a retail bank.

The biggest issue with the fragmented system in Europe is that in times of financial stress or a systemic crisis, the schemes could prove to be inadequate and the explicit or implicit sovereign guarantee of deposits could put even more stress on the fiscal authority. Therefore, a credible common financial backstop would ensure the integrity of deposit insurance in any Member State.

5.4 THE FUTURE: A COMMON DEPOSIT GUARANTEE?

The common DGS has drifted in and out of the European policy debate over the past two years, most recently as part of the Report of the Five Presidents, but with no clear consensus emerging on either its necessity or its feasibility. The current harmonisation Directive, however, contains hints that it has been constructed with a similar goal in mind to that of the BRRD, which served as a precursor to the central authority of the SRM - specific allowances are made for the voluntary cross-border merging of schemes, as well as for inter state lending. The legal dimension may prove difficult but, as detailed in Chapter 4 of this report, the Commission has already found significant leeway in Article 114 TFEU, and has been no stranger to feats of legal gymnastics[95] in the creation of the Banking Union as a whole.

[95] Eilis Ferran, “European Banking Union: Imperfect, but it can work,” University of Cambridge Faculty of Law, April 2014.

5.4.1 WHAT MIGHT A COMMON DEPOSIT GUARANTEE LOOK LIKE?

Though resolution and deposit protection are separate functions, they are often combined in practice and such a system could form a long-term goal for the European Union. In the United States the Dodd-Frank Act assigns resolution powers for large banks to the Federal Deposit Insurance Corporation (FDIC), while in Japan the Deposit Insurance Corporation (DIC) also possesses resolution power. Indeed, combining resolution and deposit insurance would seem a logical progression as it allows for the type of swift decision-making which was regrettably lacking in Europe during the crisis. The US system, in particular, could serve as a model for any future European solution. Much like in Europe under the SSM, supervision in the US is divided between state level and federal level, with the FDIC entitled to bring banks under direct supervision if it deems them to be undercapitalised. The combined deposit insurance and resolution system in the US is of proven effectiveness, with most banks being wound-up in the space of 48 hours.

Taking inspiration from the FDIC model, Dirk Schoenmaker and Daniel Gros have proposed the creation of a dual deposit and resolution system for Europe.[96] The authors' proposed European Deposit Insurance and Resolution Authority (EDIRA) would be accompanied by a joint Deposit Insurance and Resolution Fund, which would be fed through risk-based deposit insurance premiums, with a target amount of €90 billion (a figure which translates to 1.5% of covered deposits in the EU – slightly less than the likely 1.8% of the combined funds which will be available through the newly agreed resolution and deposit insurance frameworks) and the European Stability Mechanism acting as a fiscal backstop for all participating Member States.

The legal and technical obstacles to such an authority can quite conceivably be overcome – perhaps via another elastication of Article 114, or via an Intergovernmental Agreement – but the political landscape is rather more problematic. This is particularly true in the short-term, while disparities between schemes still exist and funds are asymmetrically dispersed between Member States. To merge these disparate schemes under these conditions would, in effect, constitute an instant transfer union. Even when the schemes have converged, the creation of a common DGS would still imply a significant political leap. While the Single Resolution Fund has proven that mutualisation is not necessarily inadmissible (albeit with the caveat of an eight year transition period), it is also true that this agreement was reached under the extraordinary circumstances of the crisis, and was driven by enormous political and public pressure. As Europe enters the post-crisis era, no such climate of political imperative exists for the common DGS.

[96] Dirk Schoenmaker and Daniel Gros "European Deposit Insurance and Resolution in the Banking Union," *Journal of Common Market Studies, Vol 52, No 3, pp. 529-546, December 2013.*

Coverage would also present significant problems. It was largely domestic political concerns in a number of Member States that necessitated the two-tiered coverage system of the SSM (and, by consequence, the SRM), which divides Europe's banking sector into 'significant' and 'less significant' institutions. There is little reason to believe that the common DGS would not suffer a similar fate – indeed the Report of the Five Presidents specifically notes that the coverage of any future European deposit insurance scheme should 'coincide with that of the Single Supervisory Mechanism' The rationale for such a decision is clear: a DGS which covers only systemically important cross-border European banks, mimicking the scope of the Single Supervisor, would put less stress on any central deposit insurance fund, provide a more politically palatable solution to the question of burden-sharing and allow for even more control over systemically important banks. However, while this approach may have been adequate for supervision, the selective-coverage approach to deposit insurance has the potential to create the very competitive distortions that the existing Directive hopes to eradicate. Depositors might opt to keep their savings in the systemically important institutions, which would naturally be perceived as safer because they would be backed by an EU-wide fund. Banks in non-participating Member States could find themselves at a competitive disadvantage for the same reason. If a common fund in Europe is established for deposit insurance, therefore, all banks in the EU 28 would have to be allowed to opt-in, in order to maintain a level playing field. This option, however, would likely require a fully independent authority with an explicit legal basis. This, of course, is only achievable through Treaty change and with unanimity among the Member States.

Nonetheless, the continued harmonisation of national schemes is positive movement, and will be a necessary precursor to any future reforms, whatever form they might take. This is likely to continue to be the main vector of the EU's approach to the issue of deposit insurance for the time being.

CHAPTER 6. THE CHANGING ROLE OF THE EUROPEAN BANKING AUTHORITY

"Experience of the financial crisis has exposed important failures in financial supervision, both in particular cases and in relation to the financial system as a whole. Current supervisory arrangements proved incapable of preventing, managing and resolving the crisis. Nationally-based supervisory models have lagged behind the integrated and interconnected reality of today's European financial markets, in which many financial firms operate across borders. The crisis exposed serious failings in the cooperation, coordination, consistency and trust between national supervisors." [97]

European Commission, May 2009

6.1 INTRODUCTION TO THE EBA AND THE EUROPEAN SUPERVISORY AUTHORITIES

In light of the failures in financial supervision exposed by the financial crisis, the Commission in 2008 requested a group of high level experts, chaired by Jacques de Larosière[98], to make proposals to strengthen European supervisory arrangements.

This led to agreement on the institution of a new European System of Financial Supervision (ESFS) in September 2010. The EBA is one of three European Supervisory Authorities (ESAs) which began operation in January 2011 as part of the initial regulatory response to the crisis. It has a limited but increasingly significant role in the new European supervisory architecture.

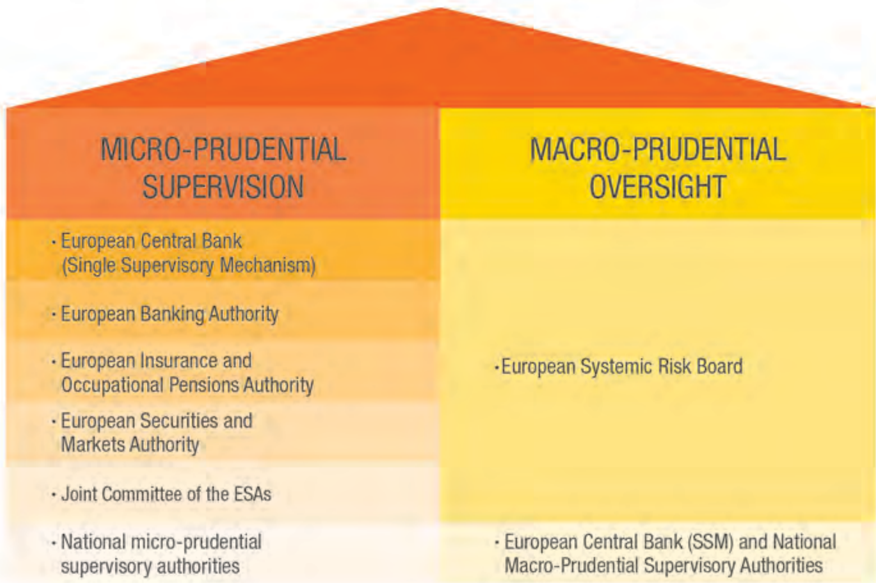
The European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the National Competent Authorities (NCAs) provide for

97 European Commission, "European financial supervision; Communication from the Commission," May 2009.
98 Former Governor of the Banque de France and former MD of the IMF.

micropudential supervision, the area of greatest failure and biggest prospective change.[99] The NSAs and the European Systemic Risk Board (ESRB) are responsible for macroprudential supervision, a new approach aimed at preventing future bubbles. Together, these ESFS entities formed the European supervisory architecture prior to the transfer of responsibility for bank supervision from the NCAs to the ECB in November 2014.

The ESAs titles are somewhat misleading as, for the most part, supervision in the period 2010 to 2014 was still the prerogative of the National Competent Authorities and in future it will be shared between the ECB and the NCAs. Instead, the ESAs aim is to create a Single EU Rulebook. They do this by developing draft technical

FIG 6.1 **THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION**



99 These authorities replaced three earlier committees, viz. the Committee of European Banking Supervisors (CEBS) the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) which were established on 1 January 2004.

standards, which become law following adoption by the Commission[100]. The ESAs may also issue guidance and recommendations to national supervisors and firms and also have consumer protection functions. ESMA now regulates credit rating agencies, while the EBA, whose evolving role in light of the Banking Union is the focus of this chapter, is responsible for, among other things, bank stress tests at the EU level, and promoting harmonised banking legislation across the EU.

6.2 WHAT THE EBA DOES

6.2.1 THE SINGLE RULEBOOK

The primary task of the EBA is to contribute to the creation of the Single Rulebook. The Single Rulebook aims at providing a set of harmonised prudential rules for financial institutions throughout the EU, helping to create a level playing field and protecting depositors, investors and consumers.

The EBA plays an important role in the preparatory phase of the legislative process and its regulatory workload and deadlines are both determined by and predefined in the legislation. It drafts the technical standards which provide detailed guidance and rules to complement the main financial services legislation. The sheer volume of technical standards adopted by the EBA in its short history is impressive.

The EBA also promotes convergence of supervisory practices to ensure a harmonised application of the prudential rules by issuing guidance and recommendations to national supervisors. However, it does not regulate banks directly and has limited powers to compel them to provide information to it.[101] Rather, it has a role in developing and contributing to the consistent application of the rules by the NSAs – but this is largely at the instigation of the NSAs rather than the EBA *per se*.

6.2.2 STRESS TESTING

The EBA is also mandated to assess risks and vulnerabilities in the EU banking sector through, in particular, regular risk assessment reports and pan-European stress tests – this includes banks in countries who will participate in Banking Union as well as those who will not. The EBA should ensure that a consistent methodology is

applied at national level to such tests and may address recommendations to National

[100] The ESA's are not Treaty bodies, thus their technical standards must be officially adopted by the Commission before they can become law.
[101] This was a major factor in the 2011 stress tests debacle.

Competent Authorities to correct any issues identified in the stress test.

The failed 2011 stress tests are a major blot on the EBA's escutcheon and while it had a similar role in the 2014 stress tests, much of the work was done by the ECB, which was given a new role and enhanced powers in the context of Banking Union. For example, the ECB was mandated to carry out a Comprehensive Balance Sheet Assessment prior to assuming its direct supervisory role, which included a thorough Asset Quality Review (AQR), which is arguably more important than the stress tests, in that it exposes current balance sheet weaknesses, whereas the stress tests attempt to simulate future adverse events. The ECB's replacement of the euro area NCAs as the Competent Authority meant that the tests were more rigorous and consistent than heretofore for the euro area significant institutions it dealt with.[102] For its part, the EBA continued to co-ordinate events at the EU-28 level, interacting with the competent authorities, i.e. the ECB and the national authorities.

6.2.3 OTHER TASKS

The EBA's other tasks include:

- Investigating alleged incorrect or insufficient application of EU law by national authorities. Where the EBA believes that an NCA is failing to apply EU law, it can investigate and may issue a recommendation, followed by a formal opinion from the Commission (if the recommendation is not acted upon). If the NCA does not comply with the Commission's formal opinion, the EBA may then take decisions binding on firms or market participants to ensure they are complying with EU law;
- Taking decisions directed at individual competent authorities or financial institutions in emergency situations. If a crisis is declared, the EBA is mandated to provide EU-wide co-ordination and it may make decisions that are binding on national supervisors and on firms;
- Mediating to resolve disagreements between competent authorities in cross-border situations. The EBA can, if invited to do so, mediate in certain situations where National Competent Authorities disagree, if necessary resolving disputes by making a decision that is binding on both parties to ensure compliance with EU law;

[102] Lithuanian banks were also tested as Lithuania became the 19th euro member on 1 January 2015.

- Ensuring that EU supervisory colleges[103] function efficiently and that consistent approaches and practices are followed. The EBA conducts peer reviews to improve the consistency of supervision across the EU;
- Acting as an advisory body to the European Parliament, the Council and the Commission; and
- Taking a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market.

6.2.4 PERFORMANCE OF ITS TASKS

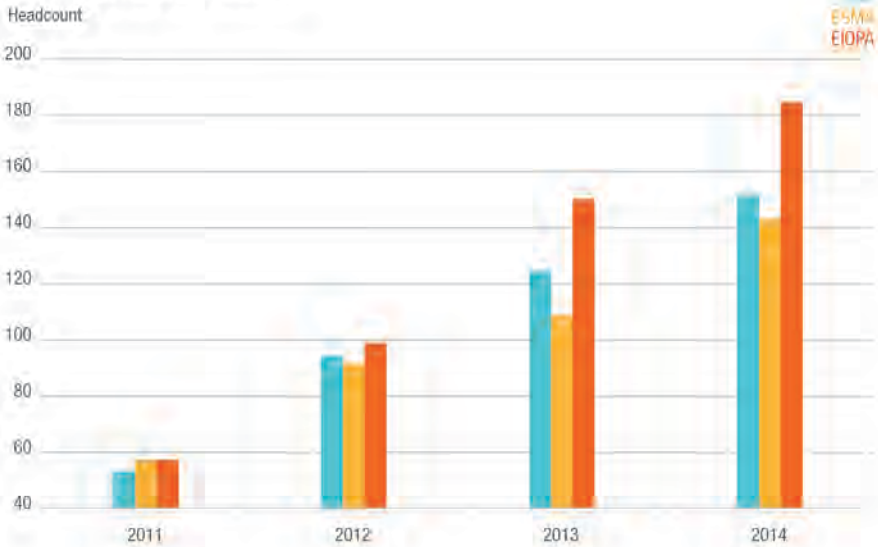
To perform these tasks, the EBA produces Binding Technical Standards (BTS), guidelines, recommendations, opinions and reports. The BTS are legal acts which specify particular aspects of an EU Directive or Regulation and aim at ensuring consistent harmonisation. The EBA develops draft BTSs which are formally endorsed and adopted by the European Commission. Unlike guidelines or recommendations, the BTSs, once adopted, are legally binding and directly applicable in all Member States. However, the EBA's powers are circumscribed in that it can only produce BTSs where mandated by law to do so and is reliant on others to adopt them.

The Board of Supervisors is the principal decision-making organ of EBA and consists of the head of the NCA in each of the 28 Member States. According to the legislation, the members of the Board of Supervisors should act independently and objectively in the sole interest of the Union. The Court of Auditors, however, found that the members of the Board of Supervisors mainly represented their national interests, which is contrary to the objective in the legislation. Moreover, the permanent EBA Chairman has no vote when the Board takes a decision which undermines his authority. Commission representatives participate as non-voting members at the Boards of Supervisors and as observers in the meetings of the Management Boards. The EBA is 60% financed from the NCAs and 40% from the EU budget. In 2013 it had an annual budget of €26 million and it is largely dependent on staff from the NCAs (national experts or short-term assistance on specific tasks) as well as contract staff. Its resources are limited, with just 124 staff in 2013 – a small number when compared, for example, with the ECB's plan to recruit 1,000 bank supervisors (see Figure 6.2).

[103] Supervisory Colleges are permanent coordination structures that bring together regulatory authorities involved in the supervision of a particular banking group. In practice, colleges are a mechanism for the exchange of information between home and host authorities, for the planning and performance of key supervisory tasks in a coordinated manner or jointly, including all aspects of ongoing supervision, and also for the preparation for and the handling of emergency situations. One of the fundamental tasks for supervisory authorities as members of colleges is reaching joint decisions on the risk-based capital adequacy of cross-border groups.

Nothing that the EBA does can impinge on the fiscal responsibilities of EU Member States. This reflects its status as a non-Treaty body and is a major constraint on its activities.

FIG 6.2 **ESAs HEADCOUNT**



6.2.5 THE OVERALL PICTURE

The EBA was established in the midst of a severe banking crisis that prompted a slew of legislation – something which dramatically increased its work burden and its founding statutes had to be modified to take account of the new SSM.

The general view is that the EBA, and the ESAs in general, are doing a good job, albeit under circumstances of little autonomy, a limited mandate and inadequate resources. The EBA, in particular, was heavily criticised for the failure of the 2011 bank stress tests – somewhat unfairly, as the responsibility for this failure lay elsewhere (see section 6.3).

In its July 2014 Special Report on the EBA, the European Court of Auditors (ECA) concluded that:

> *The Commission's reform of banking sector legislation and the creation of the EBA and their activities in setting up the new regulation and supervision system of the banking sector established in 2011 were important first steps in response to the financial crisis. However, shortcomings were identified in the functioning of the new arrangements, in respect of cross-border banking supervision, the assessment of the resilience of EU banks and promotion of consumer protection in the market for financial products or services in EU*[104].

BOX 6.1 **HOW HAS THE EBA PERFORMED?**

A number of reports have been published in recent years on the EBA's performance of its tasks. Three are synthesised below.

EUROPEAN PARLIAMENT REVIEW OF THE ESAS

A review of the ESAs by the European Parliament[105] confirmed that the EBA has made significant progress, despite being set up in the midst of a prolonged and severe crisis. From an operational perspective, it was successfully established and is a well-functioning organisation despite very material demands and limited resources.

However, a key conclusion was that, while the EBA had contributed efficiently to the continuing work on the Single Rulebook, it had not been able to ensure consistent supervision across the EU or to play a comprehensive role in identifying, tracking, policing, and enforcing divergent applications of EU law by the national supervisors. While it could have done more, its role is limited and it has limited decision-making powers.

105 Fabrice Demarigny, Jonathan McMahon and Nicolas Robert, "Review of the New European System of Financial Supervision (ESFS) Part 1: The Work of the European Supervisory Authorities (EBA, EIOPA and ESMA) – The ESFS' Micro-Prudential Pillar," European Parliament, October 2013.

104 European Court of Auditors, "European banking supervision taking shape — EBA and its changing context," July 2014.

EUROPEAN COURT OF AUDITORS SPECIAL REPORT

The European Court of Auditors (ECA) concluded that the EBA lacks the authority to make or enforce decisions on supervisory convergence and to resolve disputes between NSAs. Although it has made significant efforts to resolve disputes between NSAs, it has limited legal powers in mediation. Likewise, the ECA found that EBA had a limited legal mandate and staff to conduct the 2011 stress tests. Overall, EBA's resources during its start-up phase were insufficient to allow it to fulfil its mandate.

It is difficult for a regulator to ascertain the resilience of a bank if its headquarters are not under its supervision so national supervisors communicate with each other in so-called 'colleges of supervisors'.

The audit said those colleges were too often used to discuss procedures instead of focusing on risks to the stability of the banking sector.

The ECA found that its role in mediation was limited due to legal constraints. It can provide binding mediation only in restricted cases where there is a specific legislative provision and only if it is requested to do so by the NSAs in dispute. However, the ECA found that NSAs preferred to resolve disputes bilaterally and that none had requested binding mediation from the EBA.

The ECA concluded that, in general, EBA's contribution to supervisory convergence through the colleges was relatively limited and information sharing had been sub-optimal.

THE International Monetary Fund's FINANCIAL SECTOR ASSESSMENT PROGRAM

In March 2013, the International Monetary Fund (IMF) concluded that the European Supervisory Authorities were performing a critical role for the Single Market.[106] The EBA had significant achievements in its first two years of existence, but the pace and prioritisation of its activities had been dictated by the crisis. Despite its limited resources and cumbersome governance structure, the EBA had made significant progress in the area of rule making, but it needed

106 International Monetary Fund, "European Union: Financial System Stability Assessment," *IMF Country Report No. 13/75,* March 2013.

additional resources and independence. It played a crucial role in securing bank recapitalisation, but despite a high level of transparency, the June 2011 stress tests failed to signal some subsequent bank failures. The recapitalisation exercise in June 2012 was more effective, and led to substantial infusions of capital into EU banks.

The IMF suggested that the EBA should be more assertive in cross-border colleges of supervisors and crisis management groups. Importantly, it should ensure that national authorities undertake careful and consistent analysis of the underlying quality of bank assets, to ensure the credibility of its stress tests – this was done via the Asset Quality Review. As most large EU banks have activities inside and outside the Single Supervisory Mechanism perimeter, the EBA should be assertive in the colleges in ensuring that practices do not diverge across the two areas.

Providing voting rights to the Chairs of the ESAs, moving to a full time board or delegating more decisions to the management board should be considered.[107]

Data transparency was a significant handicap to effective supervision and market discipline. Lack of direct, easy access to institution-specific data created inefficiencies and posed reputational risks, and should be replaced by a mechanism allowing joint but still direct and straightforward access.

The IMF's priority recommendations were to:

- Modify governance to limit national bias – by end-2013;
- Improve access to data – immediately;
- Increase resources – immediately;
- Strengthen Supervisory Colleges and crisis management groups by enhancing the role of EBA and EIOPA – immediately.

[107] In the event, this opportunity was not availed of – see later.

6.3 THE EBA AND THE 2011 STRESS TESTS

In 2011 the EBA oversaw a controversial stress testing of 91 banks in 21 EU countries. The objective was to assess the resilience of the EU banking system and the solvency of individual institutions. Banks were assessed against a benchmark defined

by reference to a Core Tier 1 capital target ratio, set at 5% of risk-weighted assets (RWA). The stress test led to detailed disclosure of banks' data for the first time.

The stress test itself was a bottom-up exercise. The European Commission and the ECB, respectively, designed the baseline scenario and the adverse scenario. The banks applied the scenarios and calculated the results themselves. The NCAs had direct contact with the banks and did the first quality check of the banks' results. The role of the EBA was to provide the methodological framework and to coordinate the work of the NCAs as well as to perform consistency checks on the banks' data.

The EBA review of the data was carried out by ten seconded national experts and five EBA staff. The ECA found that the large scale of the exercise (91 banks[108]), the short timeline (4 months), the EBA's limited mandate and legal scope (it did not set the scenarios, it did not perform the calculations and it did not have direct access to query the banks), made it difficult to check the banks' data. All these factors affected the overall reliability of the stress test results which quickly lost credibility when some banks that had been given a clean bill of health began to fail. The tests did not include an assessment of the quality of the banks' assets or of the underlying collateral – a major lacuna that was rectified in the 2014 stress tests.

Moreover, in 2011 there was no EU resolution mechanism or financial backstop to support banks in need of capital. Ad hoc national solutions for injecting capital into banks were therefore necessary for those banks that could not raise capital on the financial markets, thus placing pressure on national governments' budgets at a time when they were stretched already. This situation contrasted with that in the United States, where financial backstops were put in place before the stress tests were conducted.

The subsequent actions of the EBA on bank capital and systemic risk were much more positive but are less well-known. It asked the banks to reach a capital ratio of 9% by end-June 2012 and to build up capital buffers to address market concerns over sovereign exposures.[109] This led to an increase in banks' capital of more than €200 billion. As a result, the average Common Equity Tier 1 (CET1) ratio of major EU banks by end 2013 was 11.7%, higher than that of the largest American banks. The EC has estimated that, between 2008 and 2014, overall bank capital increased by €560 billion, using primarily private but also public capital.

108 Results for 90 were published as one bank objected to publication.

109 In practice, this represented a severe acceleration of the initial 2019 deadline, decided under Basel III. This was extended in July 2013 with the publication of recommendations on the preservation of capital during the transition to the CRD/CRR capital requirements.

BOX 6.2 **THE 2011 STRESS TESTS AND SUBSEQUENT EVENTS**

January 2011	EBA announced the 2011 stress test.
15 July 2011	EBA published the results of the stress tests of 90 banks. Eight banks (five Spanish, two Greek and one Austrian) fell below the capital threshold of 5%. The total capital shortfall was €2.5 billion.
10 October 2011	Belgium, France and Luxembourg agreed to restructure Dexia and to grant it a financing guarantee of up to €90 billion. Dexia was assessed in the stress test as one of the safer banks in Europe (ranked 13 out of 91).
May 2012	Bankia, the largest holder of real estate assets in Spain, was nationalised and requested a bail-out of €19 billion. In the stress test (adverse scenario) Bankia's Core Tier 1 ratio would fall to 5.4 % by the end of 2012, still above the minimum threshold of 5%.
September 2012	A stress test by the Spanish authorities of 14 banking groups, comprising 90% of the Spanish banking system, estimated that under the adverse scenario, total capital needs were €60 billion. In July 2012 the Eurogroup had approved an envelope of financial assistance for Spain of up to €100 billion including a safety margin. However, in the event, only €31.3 billion was drawn down.
Beginning of 2013	Beginning of 2013: SNS Bank was nationalised by the Dutch government. It had incurred heavy losses in its real estate holdings. In the 2011 stress tests, the Tier 1 capital ratio of SNS bank was 8.4%, well above the required minimum of 5%, and would fall to 7% at the end of 2012.

End of 2013	The two biggest banks in Slovenia — Nova Ljubljanska banka (NLB) and Nova Kreditna Banka Maribor (NKBM) were subjected to an Asset Quality Review and stress test. Compared to the assessment made in the 2011 EBA exercise where no capital shortfall was identified, the 2013 exercise led the Slovenian government to recapitalise NLB by €1.5 billion and NKBM by €0.9 billion.

6.4 THE EBA AND THE BANKING UNION

6.4.1 INS AND OUTS

Given that it was already *in situ* and well-versed in the functioning of the European banking sector, the EBA would have been the logical choice to assume responsibility for banking supervision. Without an explicit legal basis, however, conferring these powers on it would have required a Treaty amendment. Instead, as described in Chapter 3, European leaders chose the more politically attractive option of availing of an existing Treaty provision to confer supervisory tasks on the ECB. This was, of course, in spite of the fact that the ECB had no experience of supervision, was structured for a completely different task (namely monetary policy) and, as noted earlier, had a degree of independence and a lack of accountability that was unsuitable to the task, and required adaptation. In addition, the ECB was a euro area body whereas Banking Union was originally aimed at all 28 Member States.

The fact that not all EU Member States' banks will be supervised by the ECB immediately caused a major political headache, as non-euro states can keep their national supervisors unless they choose to pool this responsibility with the euro area countries. Some, notably the UK and Sweden, have indicated that they will not do so. By contrast, all EU supervisors are part of the EBA which has an EU-wide mandate. There was a fear that a bloc of countries sharing a currency as well as bank supervision and resolution regimes would gravitate towards similar policy goals, and this created the prospect that the euro area bloc would suddenly gain preponderant influence in the EBA voting structure. The euro area would, in effect, have had the power to dictate the rules for the entire EU28.

In the event, the EBA legislation was amended to cater for these concerns. In December 2012, EU Finance Ministers agreed that – once the SSM came into operation in November 2014 – decision-making in the EBA would require a double majority.[110] In other words, decisions, whether taken by simple majority or by qualified majority, would henceforth require a simple majority of both Member States participating in the SSM, and of Member States not participating in the SSM, i.e. the non-participants have a blocking vote. These complicated voting arrangements are subject to review if the number of non-participating Member States falls below five – otherwise, a small number of 'outs' would be able to block progress. From a Community point of view, this double weighting is a retrograde step. There is also great uncertainty as to what would happen if the number of 'outs' drops below five and whether a change of the double majority voting procedures would be needed. Either way, it is unlikely to make the EBA's task easier.

6.4.2 THE EBA AND THE ECB

From a purely theoretical point of view, Banking Union and the enhanced role of the ECB, should have no impact on the EBA – it would continue to interact with NCAs as they, in turn, would continue to participate in the organisation's internal Board of Supervisors. NCA staff continue to form the various sub-committees and working groups developing the Technical Standards.

In practice, however, the ECB's key supervisory role makes it likely that its influence will increase– as has already happened in the case of the bank stress tests – at the expense of the EBA, making the EBA's task of securing (voluntary) agreement between the ECB and the remaining 'outs', such as the UK and Sweden, more difficult.

The ECB technically has the power to enter into bilateral agreements with the outs on supervisory matters – without the involvement of the EBA. This could further restrict the EBA's role and damage perceptions of the agency's efficacy. The European Court of Auditors Report described in Box 6.1, for example, noted that the EBA's role in the college of supervisors could be called into question as a result of this. The ECB's willingness to actually use these powers, though, remains to be seen – doing so would, naturally, undermine the EBA, whose position at the 'fault-line' of Banking Union, and as a neutral mediator between ins and outs, may be beneficial in future negotiations. If all 28 Member States were to join the new supervisory regime then, of course, this point would be moot, but this seems unlikely when one considers

[110] As of now, decisions on binding EBA powers are taken by simple majority; one member, one vote (binding powers include decisions on the application of EU law, action in emergency situations and settlement of disagreements between national authorities). On the other hand, decisions on guidelines and recommendations and on draft technical standards and budgetary matters are taken by qualified majority. The supervisors of the 19 euro area Member States – if they all vote together – have a simple majority but do not have a qualified majority.

the fundamental disagreement of the UK, in particular, to the transfer of sovereign powers over its financial system.

Furthermore, while the EBA is responsible for initiating and coordinating EU-wide stress tests, it is the responsibility of the competent authorities, including the ECB, to conduct them. However, there is ambiguity regarding who has overall responsibility for them. In practice the ECB will be in a strong position as it will have responsibility for the bulk of the Member States.

6.4.3 THE SINGLE SUPERVISORY HANDBOOK

The creation of the Banking Union resulted in the EBA getting one new function: the revised Regulation on the EBA mandates it to develop a Single Supervisory Handbook to complement the EU's Single Rulebook and ensure consistency in bank supervision across the 28 countries in the Single Market. The ECB has since decided, however, to develop in parallel its own handbook for SSM participants meaning that there will be two handbooks: one for the 'ins' and one for the 'outs', which runs against the grain of a Single Market and the EBA's mandate. Moreover, it is not clear what each handbook will cover, and any differences between them would inevitably increase the wedge between 'ins' and 'outs', further complicating the EBA's tasks.

6.5 THE EUROPEAN COMMISSION'S REVIEW OF THE ESAS

The founding Regulations require the Commission to carry out regular reviews[111] of the ESAs and the first such report was published in August 2014.[112] It is, in many ways, a holding exercise, noting that Banking Union did not call into question the existence and necessity of the current arrangements but that an assessment of the interactions between the ESFS and the Banking Union would be premature at this stage.[113] With rare exceptions, the more radical proposals to remedy deficiencies were postponed for further study – see Box 6.3.

[111] The actual requirement per Article 81 was: "By 2 January 2014 and every 3 years thereafter, the Commission shall publish a general report on the experience acquired as a result of the operation of the Authority and the procedures laid down in this Regulation".

[112] European Commission, "Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision," August 2014.

[113] In its "Roadmap towards a Banking Union, COM (2012) 510 final," of September 2012, the Commission had said that the effective impact and implications of the Single Supervisory Mechanism on the operational functioning of the EBA would be further examined in the review.

BOX 6.3 **THE EUROPEAN COMMISSION REVIEW OF THE ESAS**

While the Commission concluded that the ESAs had overall performed well during their first three years of operations, it identified areas for improvement in both the short and the longer terms. In the short term, the ESAs should give a higher profile to issues related to consumer/investor protection, and strengthen the focus on supervisory convergence, amongst other things by making better use of peer reviews. For the longer term, the somewhat tentative conclusion is that there "could be a need to further consider possible improvements which would imply changes to the legislative framework for the ESAs". Areas for consideration include:

- The governance of the ESAs, in particular to further improve the capacity of the Board of Supervisors to take decisions in the interest of the EU as a whole;
- A revision of the existing funding arrangements so that the ESAs could fulfil their broad range of tasks, taking into account EU and national budgetary constraints;
- Merging the three ESAs into a single location;
- Assigning them new tasks, e.g. oversight of shadow banking.

Of the 150 draft technical standards submitted to the Commission (58 by the EBA), during the period under review in the Commission's report, 45 were approved with only three returned for further amendment. This work on the development of the Single Rulebook had, thus, contributed significantly towards enhanced regulatory harmonisation and coherence while allowing the EU to equip itself with a significant amount of high-quality rules within a relatively short timeframe.

The founding Regulations entitle the ESAs to address recommendations to national authorities when a national authority appears to be in breach of Union law and, following a pre-defined procedure and as a last resort, to directly address decisions to financial institutions to ensure respect of directly applicable EU law. The Commission found that the ESAs had assessed a number of alleged breaches, in particular the geographic ring-fencing of intragroup capital flows which contributed to fragmentation, but did not take action. The Commission said that this failure to act was partly explained by the reluctance of the Board of Supervisors to agree to address any

recommendations to national authorities or to addressing individual decisions to financial institutions. In other words, the NSAs were unwilling to chastise themselves when questions of possible breaches of law arose.

The Commission also cited the dissuasive effect of the relevant powers as well as the lack of clarity of the founding Regulations as to the scope of and triggers for binding mediation.[114] Consequently, it proposed that, as a first step, the ESAs should consider increasing the focus on supervisory convergence, in particular through increased use of peer review and appropriate follow-up. In a second stage, it undertook to explore options to review the triggers for and scope of binding mediation powers. Similarly, it will examine further whether the ESAs could have direct access to data, where necessary, for the performance of their tasks.

The ESAs' consumer protection role has perforce been subordinated to more urgent regulatory matters. This prompted the Commission to recommend that they should give a higher profile to consumer/investor protection issues and make full use of available powers. The ESAs should also ensure, to the extent possible, the involvement of national authorities competent in the field of consumer protection where these are not represented on the Boards of Supervisors[115] though it was silent on how this is to be achieved.

In a second stage, the Commission will examine further whether the ESAs' Regulations should be converted into a self-standing empowerment – Article 9(5) of the founding regulation allows the EBA to temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the EU financial system but not on its own initiative.

The Management Boards of the ESAs were considered to work satisfactorily but things could be improved by amending their composition and mandate to confer more permanent and executive functions on them; by enhancing their role in the preparation of legislation[116] and by giving them more time for stakeholder consultation. In addition, the authority of the Chairs could

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[114] The Commission does not expand on this but presumably it refers to anticipatory actions by NSAs which seems unlikely.

[115] In several countries, responsibility for consumer protection lies with agencies other than the main banking supervisor, i.e. they are not represented on the EBA Board.

[116] For example, by allowing them to chair standing committees and working groups and draft important documents.

be reinforced through greater delegation of specific tasks in accordance with Article 41(1) of the ESA Regulations,[117] for example by enabling them to directly request relevant information from national supervisors.[118]

While there is no mention of giving the Chair a vote on Board decisions or on how to prevent the NCAs looking after their own vested interests, there is a somewhat elliptical reference to the effect that, in the longer term, the Commission will "explore options on how to improve the governance of the ESAs to ensure that decisions are taken in the interest of the EU as a whole".

Funding has been a major bugbear for the ESAs given that they were set up in a time of fiscal retrenchment at both national and EU levels. While their budgets have been significantly increased since their inception, the ESAs and most stakeholders consider the current funding arrangements as not commensurate to their tasks and responsibilities. Given EU and national budgetary constraints, the Commission considers that a revision of the existing funding model should therefore be envisaged, ideally by abolishing EU and national contributions in favour of fees and levies (as suggested by the ESAs).

While the overall structure of the ESAs appears appropriate, the Commission will further assess, in the medium to long term, the need for additional structural changes, including a single seat[119] and extending direct supervision powers to integrated market infrastructures such as CCPs.[120] The Commission will also reflect on whether there is a need to expand the current mandates of the ESAs to new fields such as International Financial Reporting Standards (IFRS) enforcement, a stronger oversight role on internal model validation particularly in the area of insurance, and shadow banking.

The more significant proposals are invariably longer term and subject to further study. The short term suggestions seem reasonable but will only be implemented if the Boards of Supervisors agree.

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117 This article allows the Board of Supervisors to establish internal committees or panels for specific tasks and to delegate certain clearly defined tasks and decisions to internal committees or panels, to the Management Board or to the Chair.

118 While the founding Regulations confer the right on the ESA to request competent authorities to provide them with all the necessary information for the fulfilment of their tasks, the ESAs have experienced difficulties in obtaining information in practice due to resistance of the members at the Board of Supervisors to agree on relevant demands and the legal conditions attached to the use of such powers.

119 At present, the ESAs are split between Frankfurt, Paris and London.

120 Central Counterparty Clearinghouses (CCPs) clear and settle market transactions and benefit both parties in a transaction because they bear most of the credit risk.

6.6 THE GAPS THAT CONSTRAIN THE EBA

In September 2013, Andrea Enria, Chairperson of the EBA, listed some of the gaps and provisions that run contrary to the concept of a Single Rulebook.[121] These include:

- Both banks and national supervisors had pursued an increasing matching of assets and liabilities in their respective domestic countries, thus leading to fragmentation and serious impairment of the functioning of the Single Market;
- According to the SSM regulation, national law will remain relevant for those matters governed by EU Directives or where the ECB has no relevant powers and instructs national authorities to act in accordance with national law;
- The Capital Requirements Directive and even the Capital Requirements Regulation still leave room for national discretion – more than 140 provisions include elements of flexibility for national authorities.

While significant progress has been made since then, some major challenges remain.

> *So far, we have issued 90 technical standards, and another 50 are in the pipeline, to be finalised by end 2015. The progress in harmonisation is truly impressive: EU banks of all types and sizes are now facing truly uniform definitions of key supervisory aggregates, for instance a common definition of non-performing loans and forbearance, common definitions of capital and of high quality liquid assets and a single framework for supervisory reporting – to mention but a few. Of course, the transition to the new system is far from being completed. I would like to draw your attention to two areas, where the legislation has left room for national discretions and options: the definition of capital and the framework for recovery and resolution.*[122]
>
> *Andrea Enria, January 2015*

A number of national discretions and options were inserted into the new legislation. According to Mr. Enria, these still hamper the comparability of capital ratios across EU banks. While most of these discretions are linked to the pace of phasing-in of the new Basel capital requirements and will gradually fade away, some will be in place for up to ten years and some do not have a clear expiration date at all. They involve deductions from common equity – for example, goodwill, deferred tax assets,

121 Andrea Enria, "The new role of the EBA in the Banking Union," speech at the ESE Conference, Frankfurt, September 2013.
122 Andrea Enria, "Challenges for the future of EU banking," speech at the Spanish Banking Association, Madrid, January 2015.

prudential filters on AFS[123] gains and losses – and other technical details such as the calculation of Basel I floors.

These technical issues can have a sizeable, and frequently unnoticed, impact on capital levels and their comparability. For instance, during the 2011/12 recapitalisation exercise, the EBA noticed two different approaches being used by national authorities to calculate the so-called 'Basel I floors', which set a base amount of capital needed by banks. These reflected different interpretations of the legislation and of the Basel standards. But they had a major impact – when EBA compared the results at the aggregate level, the difference was a staggering €45 billion.

As a number of these national discretions are in the remit of competent authorities, the ECB is now in a position to iron them out. But others are at the discretion of the Member States. The EBA has tried to minimise the impact of such differences, for instance by providing very detailed disclosure of the capital components and publishing, for the first time, the results of the 2014 stress test also with reference to the fully loaded Basel III capital ratios, which are much less affected by national discretions. Still, in Mr. Enria's view, there is a need for a stronger commitment to truly common rules.

The second area, the framework for recovery and resolution, is even more complex and important. National authorities at the peak of the crisis decided to ring-fence and focus on national, rather than Europe-wide, banking sector restructuring – in part, because they were aware that most Member States did not have resolution regimes which could be relied upon to look after the interests of depositors and other stakeholders and in part because they wanted support from domestic taxpayers to stay in their own economies rather than bail out others.

The BRRD aims to rectify this and each resolution authority now has similar legal powers, which are effective throughout the EU, and an obligation to use these powers in consultation with the authorities of all affected Member States, taking into account the interests of depositors and financial stability in those jurisdictions. But the BRRD too leaves a number of areas for national discretion, which may still have an adverse impact on cross-border resolution. For instance, it does not make it mandatory to reach a joint decision on the resolution plans for cross-border groups. Therefore, resolution authorities can still decide to follow a non-co-ordinated approach. The same applies to measures to ensure resolvability and the setting of the minimum required eligible liabilities i.e. the type and amount of liabilities that can be promptly written down or converted into equity in case of a crisis. There is a risk that this flexibility may be used to engineer a degree of 'home bias' in recovery and resolution decisions, thus leading to resolution procedures that move along national borders,

123 Available for sale (AFS) is an accounting term used to classify financial assets.

and, in turn, continued ring-fencing and fragmentation. While the Single Resolution Board (SRB) and the Single Supervisory Mechanism (SSM), may well aim to prevent this happening in participating states, this may not apply to non-participants. This raises the risk of barriers remaining within the Single Market, dividing 'ins' from 'outs' and crystallising a two tier system.

In order to prevent institutions financing themselves exclusively with instruments exempted from bail-in, the BRRD requires them to maintain a minimum amount of own funds and other instruments that can be written down or converted into equity in resolution – the minimum requirement for own funds and eligible liabilities (MREL). But the MREL requirement is set on a case-by-case basis and so, again, needs to be implemented in a way which does not further fragment the Single Market.

6.7 CONCLUSION

Given its voting structure and limited powers and resources, the EBA has achieved more than might have been expected in its short history. Its impact is most obvious on the Single Rulebook where it has issued a remarkable number of technical standards in very quick order. The result has been a steady stream of new technical standards which, bit by bit, are building up the Single Rulebook – but the book has some unfinished chapters.

The EBA potentially has some binding powers. In a European Council-declared crisis, for example, the EBA is mandated to provide EU-wide coordination and it may then make decisions that are binding on national supervisors and on firms. However, these powers exist only at the discretion of other players and have thus far remained unused. Indeed, one would have thought that if an emergency were ever to be declared, the recent crisis – the most severe since the Great Depression – would have provided an opportunity. This happened at a time when many feel that the spirit, if not the letter, of Community laws was widely broken, notably in the area of market fragmentation. It, thus, seems unlikely that the EBA's binding powers will become operative in the absence of legal change, which is not contemplated at present.

The EBA will continue to play a leading role in technical and regulatory standard-setting for the foreseeable future, but this function can be expected to diminish over time as the standards equalise.

In the future, the EBA's voting structure will be even more complicated and its tasks more difficult. It remains an open question as to how the new voting procedures will work in practice. The role given to the 'outs', which is now enshrined in legislation,

is a blocking one. It is possible to imagine progress within the SSM nexus but, here, the ECB rather than the EBA will likely be the driving force. Once the number of 'outs' falls below five, however, the situation is unclear. One could then imagine that divergences between the SSM block and the rest might increase.

EBA supervisory activities, on the other hand, which have had little impact so far, may have even less significance under Banking Union as they were designed for an EU28, not for a Union with an emerging mega-supervisor. If a bank operates only within the SSM countries, it will fall under the responsibility of the ECB and the NCAs. The number of colleges will fall, although most large SSM banks will have presences elsewhere, either in the remaining non-SSM EU countries or further afield. The EBA's role will, therefore, continue, albeit in attenuated form as the ECB's influence grows.

The EBA's achievements in minimising systemic risk are considerable, though its reputation remains tarnished by the 2011 stress tests. It will continue to interact with the NCAs but the ECB will be a Supervisory Authority which will represent the combined position of 19 euro members plus opt-ins. The EBA's role will be to ensure that the stress tests are consistent between the 'ins' and the 'outs' – a difficult task. In the past, it dealt with 28 Member States; in future, it will intermediate with a few 'jumbo' elephants if the SSM states vote en bloc.

The European Commission Review described in Box 6.3 noted that, despite the fact that the founding Regulations confer the right on the ESAs to request competent authorities to provide them with all the necessary information for the fulfilment of their tasks, they have experienced difficulties in obtaining this in practice due to resistance of their Boards of Supervisors to agree to this and the legal/secrecy conditions attached to the use of such powers. Some stakeholders, as well as the study undertaken by the European Parliament, described in Box 6.1, suggested exploring the merits of giving a stronger role to the ESA Chairs by enabling them to directly request relevant information from national supervisors. The Commission has long-fingered this by agreeing to examine it in the longer term.

There is also ambiguity regarding who has overall responsibility for stress tests, something the Commission Review, described in Box 6.3 of this chapter, did not address.

The one new task given to the EBA - the development of a new Single Supervisory Handbook to complement the Single Rulebook - has been complicated by the ECB's decision to develop its own handbook. None of the recommendations of the IMF's Financial Sector Assessment Programme, described in Box 6.1, have been

implemented and the European Parliament's criticisms regarding its lack of powers and other impediments have effectively been ignored, at least for the time being. In general, there is a need for more resources, greater powers and a change in voting arrangements to lessen the influence of the NCAs. Absent these, the EBA's influence is likely to wane in favour of the new Single Supervisor, the ECB, which is likely to become increasingly influential in areas such as the stress tests, the Single Rulebook, the Single Supervisory Handbook and the convergence of supervisory practices both within the SSM and, probably also, bilaterally with the non-participants.

The suggestions in the Commission's Review have the potential to improve the situation by stabilising and augmenting financial resources and by improving governance and voting but these are uncertain and are unlikely to be realised in advance of the next scheduled review of the ESAs in 2017. On the whole, the Commission's review was disappointing in that it brought little prospect of immediate alleviation of the disadvantages under which the EBA labours. Moreover, it postponed its promise to examine the effective impact and implications of the Single Supervisory Mechanism on the operational functioning of the EBA.

In the meantime, the EBA will have to struggle on. In the short term, it is increasingly likely to focus on consumer protection matters – where it has a mandate, but which it has neglected in light of other priorities. The gist of the Commission's other, more fundamental, suggestions is clear: there will be a focus on the extension of the current mandate to new fields such as International Financial Reporting Standards (IFRS) enforcement and a stronger oversight role on internal model validation and shadow banking.

The EBA was an obvious candidate to become the single banking supervisor. In the event, political considerations dictated that the job went to the ECB instead. The really big question is whether the ECB's supervision mandate, which that institution was reluctant to accept, could ever be transferred to the EBA. On the whole, this seems unlikely barring a major challenge to the ECB's supervisory competence and, say, an adverse ruling by the European Court of Justice. Such a change would, of course, require a Treaty amendment, something that many countries would not lightly wish to undertake.

A fundamental review of the role of the EBA is required but this is unlikely until Banking Union has settled down and the second review of the ESAs is conducted in 2017.[124]

[124] The first Commission Review of the ESAs effectively postpones radical action until Banking Union is up and running.

PART 3. GETTING THERE

CHAPTER 7.
THE TRANSITION TO BANKING UNION

"The core of the financial system continues to strengthen, with overall improvements in bank capital and liquidity, including in the euro area in advance of the results of the comprehensive assessment."[125]

Financial Stability Board, September 2014

7.1 INTRODUCTION

Whereas the focus for policymakers was initially on the structure and components of Banking Union, the attention subsequently shifted to the actions to be taken during the period preceding Banking Union proper. Indeed, it seems likely that some, if not most, of the more important actions on bank balance sheets took place in advance of Banking Union, reflecting the desire of the ECB to commence operations with a clean slate. To this end, the banks within its remit were subjected to a comprehensive set of balance sheet assessments and stress tests. The ECB and the EBA ensured that the tests were tougher than previous tests in 2010 and 2011. For their part, the banks reacted by significantly bolstering both the quantity and quality of capital, a process that continues.

This is in stark contrast to the outcome of earlier stress tests. In 2011, the EBA was in the process of being established and had neither the resources nor the legal powers to demand, query and check the data supplied by the national supervisors. Banks in several countries collapsed or had to be rescued shortly after they were deemed to have passed the stress tests and the damage done to the EBA's reputation was considerable[126] - see Box 6.3 in Chapter 6. While the EBA remains responsible for overall stress testing, the ECB has been inserted as a 'competent authority' between the EBA and individual national supervisors of the systemically important banks that it supervises.

[125] Financial Stability Board, "Press release from the Meeting of the Financial Stability Board," September 2014
[126] Similarly, Irish banks failed en masse shortly after the stress tests conducted by the EBA's predecessor, CEBS in 2010

Compared to the EBA, the ECB has much greater legal powers and resources. It determined that the tests would be conducted and the results announced before it took formal responsibility for the SSM in November 2014. This ensured that banks' balance sheets were cleaned of legacy issues before the ECB took on responsibility for supervision. This, of course, chimed with the insistence by core Member States that responsibility for legacy issues lies both with the Member States involved and with their national supervisors. Banks that failed the tests have up to nine months to repair their balance sheets and make good any capital shortfalls.

If the stress tests were designed to ensure that the banks are fit for purpose, the revised State aid rules govern what happens in the transitional period to January 2016 when the full bail-in rules come into effect. In a key, but little publicised, move in July 2013, the EU adapted its temporary State aid rules for public support of financial institutions during the crisis. The new rules define the conditions under which Member States can support banks with funding guarantees, recapitalisations or asset relief in the interregnum period before the full BRRD rules come into force or, when they do not apply, after BRRD is in force.[127] The main change was a strengthening of 'burden-sharing': banks are now required to work out a plan for their restructuring or orderly winding down before they can receive recapitalisations or asset protection measures – in the past, this frequently occurred after the aid was granted.

Moreover, the burden-sharing requirements have been strengthened: if banks have capital shortfalls, their shareholders and junior creditors are required to contribute as a first resort, before public funding is entertained. Senior creditors are not required to contribute under the State aid rules now in force but they will be once the BRRD bail-in rules commence in 2016. Critically, Commission approval is required before State aid is granted – this is designed to level the playing field between more and less affluent Member States. Exceptions to the State aid rules, however, are still possible where financial stability is at risk.

The BRRD, described in Chapter 4, became effective on 1 January 2015 except for the bail-in and MREL provisions which will come into force no later than 1 January 2016. Thus, while the write-down and conversion of capital instruments under BRRD is compulsory in a resolution scenario from 1 January 2015, Member States have the option not to bail-in eligible senior debt holders until the start of 2016. It is expected that most Member States will avail of this option.[128]

127 For example, in circumstances of a precautionary recapitalisation outside of resolution.
128 The UK is applying the full BRRD rules from 1 January 2015 and Germany is considering doing so.

7.2 THE TRANSITION TO BANKING UNION: 2014 TO 2016

The planned sequence during the transition to Banking Union is as follows:

- Asset quality reviews (AQRs), completed in July 2014 and followed by stress tests with one announcement of results on 26 October 2014.
- Where a bank fails the AQR/stress test, it has six to nine months to raise the necessary capital. Consequently, it is likely to be mid-2015 before it will be known for certain whether public funds are required for recapitalisation purposes.
- As a general rule,[129] when a Member State decides to remedy a capital shortfall in a bank by means of a public recapitalisation, this will automatically trigger the write-down and conversion of capital instruments under the BRRD. There is no exception to burden sharing under BRRD, unlike the State aid rules.
- Once the institution has written down or converted its capital instruments as required by the BRRD, and there is still a capital shortfall, the State aid rules require further subordinated debt write-downs. A Member State can, however, make a case to the Commission for exemption.
- The BRRD provides for precautionary recapitalisation which does not automatically trigger resolution. The Commission have indicated that in the context of the ECB's comprehensive assessment, this would only apply where a bank failed the adverse stress scenario. However in such a situation, State aid rules would apply, which would mean burden-sharing unless the Commission could be persuaded otherwise for financial stability reasons.
- Under the terms of BRRD, all Member States will begin to levy banks and investment firms from 1 January 2015, to reach a target level of 1% of covered deposits of the institutions authorised in their territory by 31 January 2024.[130]
- For Banking Union Member States, the SRM takes over from 1 January 2016[131] and therefore the Single Resolution Fund (SRF) replaces national resolution funds for banks from this date. The target level for the SRF is at least 1% of covered deposits of all the institutions authorised in the participating Member States within eight years which will also be the transitional period for full mutualisation.
- During this transition period, the SRF will be divided into national compartments into which contributions from banks of the participating

129 Limited exceptions on financial stability grounds may be allowed.

130 1% represents around €70 billion for the EU and €55 billion for the euro area.

131 BRRD will continue to apply to investment firms that are not part of the consolidated supervision of a parent undertaking by the ECB.

Member States will be paid. This is designed to accommodate the transition to mutualisation, 60% of which will have occurred by the end of year 2 with the balance occurring on a linear basis between then and the end of the eight-year period.

- In relation to the Deposit Guarantee Schemes (DGS), the existing nationally-based arrangements have been enhanced through faster pay-out, better information and credible *ex ante* funding arrangements, as described in Chapter 5. This maintains the existing level of protection of €100,000 per person per institution. For the moment, there are no proposals to bring a centralised scheme into place.

BOX 7.1 **BANK RESOLUTION AND THE BRRD**

As described in Chapter 4 of this report, the BRRD delivers a comprehensive bail-in tool that ensures that shareholders and creditors (senior as well as junior), plus large uninsured deposits, bear the cost of bank failure, minimising the burden on taxpayers – in other words, 'bail-in' instead of 'bail-out'.

Effective resolution also addresses moral hazard issues, as one of its key functions is to enhance discipline and avoid contagion and runs on other banks.

The BRRD provides uniform rules for the whole EU Single Market and the SRM sets out how the rules apply in Member States participating in Banking Union.

The BRRD will allow authorities to put banks into an orderly resolution in which their critical functions would be preserved by, for example, a sale to a third party or the creation of a bridge bank, while the non-critical parts of the failed institution would be put into a bad bank or wound down.

In cases where it would be in the public interest to restore an institution to financial viability, the BRRD also allows authorities to write down and convert some of the bank's liabilities (bail-in), and, through this process and subsequent restructuring, enables the bank to continue in business, albeit as a deeply restructured institution. Such a restructuring process would include dilution of shareholders, changes to management, haircutting of creditors and other structural changes so as to ensure that the surviving entity is viable.

7.3 BACKSTOPS

The ECB was explicit about the need for public backstops in the transitional period and during the eight-year mutualisation period of the SRF. Where banks were shown to have a capital deficiency, their plans to rectify this should first draw on private sources of funding, including retained earnings, reduced bonus payments, new issuance of common equity, suitably strong contingent capital and sales of selected assets at market prices or reductions of Risk Weighted Assets associated with restructuring plans agreed with the European Commission. However, according to the ECB:

> *If private sources of capital are insufficient or not readily available, public backstops might need to be drawn upon, in compliance with national policies and European rules, with the overriding goal of financial stability.*[132]

The European Council in November 2013 set out the position regarding public backstops/official assistance should this be required during the transitional period before the full BRRD rules apply. The Council said that if private funding is insufficient, Member States should organise recapitalisations, including through the provision of public backstops. They noted that EU State aid rules will apply if public funds are called for, i.e. junior bondholders will be bailed in by having their bonds converted into equity and shareholders will suffer from the dilution of their shareholding. The Council further stated that if national backstops are not sufficient, euro area/EU funds would be made available in one of two ways:

a. The ESM could lend to a Member State, as already happened in Spain, and after appropriate bail-in of junior bondholders, these funds could be passed on to the banks. A major issue with this is that it would raise the gross debt ratio and might, therefore, be unacceptable in countries where debt burdens are already elevated.
b. The ESM could be used to directly recapitalise banks, following the establishment of the SSM, i.e. after November 2014. ESM decisions on bank recapitalisations, however, require unanimity and strong opposition from Germany and other core countries delayed the start of this mechanism and, in particular, raised serious question marks over the possibility of using it to retrospectively recapitalise troubled banks as had been promised in the June 2012 statement by the Heads of State and Government.

All resolution operations must adhere to EU State aid rules which, pending the full application of the BRRD in 2016, envisage bail-in of shareholders and junior bondholders. However, there is an escape or 'safeguard' clause that allows for exceptions

132 European Central Bank, "Note on the Comprehensive Assessments," October 2013.

to the burden sharing rules in cases where this "would endanger financial stability or lead to disproportionate results". Since debt which is eligible for bail-in is frequently held by other financial institutions, this led to arguments that the safeguard clause might be readily invoked when banks failed the stress tests, thereby defaulting, once again, to 'bail-out' rather than 'bail-in'.[133] However, in July 2014, the EU Council reiterated that any capital shortfalls should first be addressed by private means and that public recapitalisation should be the exception rather than the norm.[134]

The ESM direct recapitalisation instrument (DRI) was finally agreed on 8 December 2014 (see Box 7.2). Announcing the decision, Klaus Regling, ESM Managing Director, said:

> *The ESM is ready to use the direct recapitalisation instrument, should the need arise. The results of the recent asset quality review and stress tests confirm that the use of the new instrument seems unlikely. Nevertheless, the fact that the ESM can provide a rescue of last resort for systemic and viable banks is reassuring for markets and safeguards financial stability in the euro area.*[135]

The ESM Board reiterated that the potential retroactive application of the instrument would be decided on a case-by-case basis and by mutual agreement. Retrospective recapitalisation is, thus, unlikely barring new and unforeseen circumstances.

BOX 7.2 **THE ESM'S DIRECT RECAPITALISATION INSTRUMENT**

The euro area Heads of State or Government agreed in June 2012 that "it is imperative to break the vicious circle between banks and sovereigns", and that when a Single Supervisory Mechanism (SSM) was in place and operational, the ESM could recapitalise banks directly.

On 10 June 2014 the euro area Member States reached a preliminary agreement on the ESM Direct Recapitalisation Instrument (DRI). This then

133 For example: "Should 'precautionary recapitalisations' make taxpayers nervous?" *Finance Watch Policy Brief,* October 2014.
134 Council of the European Union, "Terms of Reference: Applicable rules on addressing capital shortfalls and burden sharing in the context of the Asset Quality Reviews and Stress Tests," July 2014.
135 European Stability Mechanism, "ESM direct bank recapitalisation instrument adopted," December 2014.

required a decision by mutual agreement of the ESM Board of Governors, that is, the Finance Ministers of the euro area Member States. The aim was to have this process completed by November 2014, thereby allowing the DRI to come into effect once the SSM became operational.

In the event, the DRI became operational on 8 December 2014 when the ESM Board agreed to apply it to euro area financial institutions.

This allows the ESM to directly recapitalise a systemic and viable euro area bank as a last resort. The ESM can do this only if private investors have already been bailed in, in accordance with the BRRD.[136] The national resolution funds or, from 2016 onwards, the Single Resolution Fund must also contribute. In addition, the requesting Member State must be unable to provide financial assistance to the beneficiary bank without very serious effects on its own fiscal sustainability or if the provision of such assistance would endanger[137] its access to the markets. Finally, the ESM financial assistance must be deemed indispensable to safeguard the financial stability of the euro area as a whole or of its Member States.

In order to preserve the ESM's creditworthiness, the total amount of ESM resources available for direct recapitalisation is limited to €60 billion.[138] The ESM would generally acquire common shares in the beneficiary bank with a view to selling them on and recovering its capital in due course.

136 For a transitional period until 31 December 2015, a bail-in equal to 8% of total liabilities, including own funds of the bank in question, will be applied. From 1 January 2016, the obligatory private sector contribution will be as defined in the BRRD, viz. (i) a bail-in of at least 8% of total liabilities including own funds; (ii) a contribution by the resolution funds of up to 5% of the total liabilities; and (iii) a write-down or conversion in full of all unsecured, non-preferred liabilities other than insured deposits.

137 In principle, the Member State concerned should contribute to the rescue but the ESM Board has the power to suspend this if necessary.

138 The ESM has a maximum lending capacity of €500 billion. So far, it has disbursed €41.3 billion to Spain in the context of an assistance programme for the Spanish banks (indirect bank recapitalisation). Furthermore the ESM has committed €9 billion to Cyprus of which €457 billion has been disbursed, leaving about €450 billion available, including the €60 billion earmarked for the DRI.

7.4 ECB COMPREHENSIVE ASSESSMENT OF EURO AREA BANKS

In October 2013, the ECB announced that it would undertake a comprehensive assessment of some 120 banks accounting for 85% of the euro area's total banking

assets, beginning at the end of November 2013 and continuing in 2014 with the results being announced in October 2014. The list included banks in every euro area Member State and also subsidiaries of banks from countries outside the euro area.[139]

The assessment had two main pillars:

1. An asset quality review (AQR); and
2. A stress test with baseline and adverse scenarios.

While stress tests had been held before, this was the first time that banks' balance sheets were subjected to combined asset quality reviews, risk assessments and stress tests. The tests were, therefore, more demanding than previous stress tests.

The goal of the comprehensive assessment was three-fold:

a. To foster transparency of banks' balance sheets;
b. To repair balance sheets, where needed, by identifying and implementing necessary corrective measures; and
c. To consequently foster confidence in the banks, thereby unlocking a needed revival of credit to the euro area economy and a reduction in fragmentation.

The stress test part of the assessment was carried out in close cooperation with the EBA which was responsible for overseeing an EU-wide (all 28 Member States) set of stress tests.[140]

7.4.1 ASSET QUALITY REVIEW

The AQR verified the accuracy of the data supplied by the banks and reviewed asset and collateral values, along with the related provisions (with the collaboration of external audit firms). Bank exposures were then classified as standard or non-performing, based on the level of risk, with the ECB imposing quality control on the results of the review. It examined the state of banks' balance sheets as of 31 December 2013 including assessment of data quality, asset valuations, non-performing loans, collateral valuation and provisions. It was risk-based and concentrated on those elements of individual banks' balance sheets that were believed to be most relevant. Both the banking book and the trading book were reviewed, as were on-balance sheet and off-balance sheet exposures as well as loans to sovereigns. The broad objective was

139 The Irish institutions listed were AIB, Bank of Ireland, Ulster Bank, Merrill Lynch International Bank Ltd. and Permanent TSB plc.

140 The tests were conducted by the competent authorities; in principle the national supervisors' participation was much the same as before, but with the ECB supplanting the national supervisors for the banks within its remit.

to assess the quality of bank assets, the first time that this was done on a consistent pan-European basis.

The AQR covered €3.7 trillion of risk-weighted assets (RWA), representing 58% of the total RWA of the banks in the scope of the exercise. The examination involved the review of approximately 135,000 credit files. In total, more than 6,000 supervisors, external auditing staff, consultants and independent specialist appraisers were assigned to the AQR.

The AQR was completed in July 2014, and the ECB then incorporated the results into the stress tests (the 'join-up' in ECB parlance), meaning the process was a cumulative one, unlike previously when only stress tests were conducted.

7.4.2 STRESS TESTS

A stress test is an analysis of banks' capacity to absorb losses, evaluating their resilience in different hypothetical scenarios. The exercise indicates how much capital might be needed were risks to materialise, and it helps highlight areas where supervisory action might be necessary. The common methodology and underlying assumptions for the stress tests were published by the EBA on 29 April 2014. EU bank lenders were tested by reference to their ability to withstand a global debt markets sell-off, a rise in funding costs, a new recession and steep falls in property and equity prices. The systemic risks tested included:

a. An increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies;
b. A further deterioration of credit quality in countries with feeble demand;
c. A stalling of policy reforms jeopardising confidence in the sustainability of the public finances; and
d. A failure by banks to repair their balance sheets causing cost of funds to rise.

The position of banks was evaluated in two scenarios: a baseline scenario, taking as its starting point the European Commission's economic forecasts, and an adverse scenario, approved by the European Systemic Risk Board, the European Union's macroprudential surveillance body headquartered at the ECB. The stress test horizon was three years (2014-2016), a year longer than previously, and it was based on the banks' consolidated balance sheets at the end of 2013.

Minimum thresholds were set that banks had to meet in respect of core capital, based on the Basel III Accord definitions Common Equity Tier 1 (CET1).[141] These thresholds were 8% for the asset quality review exercise and for the stress test baseline scenario, and 5.5% for the adverse scenario. Banks falling below these thresholds got two weeks after the October 2014 results announcement to submit capital-raising plans to cover the shortfalls identified. They were given six months to cover shortfalls identified in the asset quality review and in the baseline scenario of the stress tests, and nine months to cover shortfalls estimated under the more extreme adverse stress scenario.

7.5 THE INITIAL RESPONSE

For a long time, sentiment towards the Banking Union proposals, and in particular the stress tests, was extremely negative. There was a general view that equity strengthening and re-orientation of funding would be difficult, if not impossible, to achieve. The main fears were:

- The dilution of shareholders would be a deterrent to the acquisition of shares in banks regarded as weak or shown by the stress tests to need recapitalisation;
- Investors in subordinated debt would demand increased risk premia given the danger that they would be written down or have their loans converted into equity;
- While bail-in of senior bondholders is optional until the start of 2016,[142] there was a fear that Member States could decide to do so earlier, leading to an expectation of higher returns to lenders to banks to compensate for this new risk;
- In any event, it was feared that, over the course of the transition period to the full implementation of BRRD/SRM, markets would price in the expectation of the introduction of bail-in of senior debt from 2016.

In practice, none of these fears materialised. Instead, banks dramatically increased their capital-raising, with the cost of funding falling rather than rising and bank share prices increasing. In spite of a rise in bad loans, banks saw their borrowing costs fall sharply. Furthermore, the search for yield by investors meant that demand was keen in the peripheral countries, whereas the opposite had been feared.

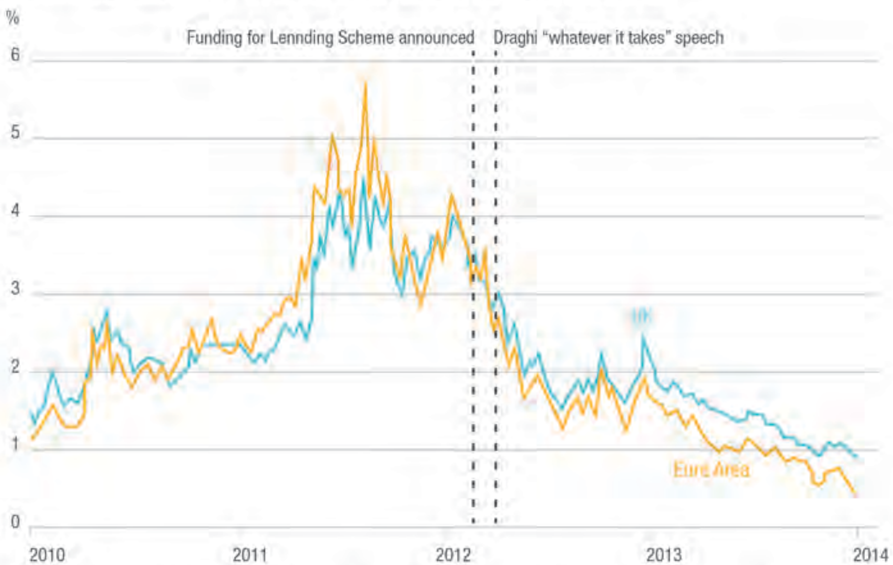
Against this favourable background, intra-country divergences persist. The marginal cost of funding to major banks in the euro area peaked at 4% to 5% in 2011, but

141 This was stricter than the 2011 EBA tests but less demanding than the 10.5% hurdle that Irish banks were subjected to in the 2011 Prudential Capital Assessment Review (PCAR).
142 Or 2015 if Member States decide to advance the BRRD start date.

then fell to around half a percent. In Ireland, by contrast, the marginal cost of funding peaked at more than 20%. In practice this was not applicable because the markets were effectively closed – and the cost has since fallen to about 1.5%. In other words, the cost of funds in Ireland is still one percentage point higher than that prevailing elsewhere. In early September 2014, Goldman Sachs surveyed 125 large institutional investors in the EU, US and Asia on the likely outcome of the AQR/stress tests. Consensus expectations were:

1. On average, nine banks would fail the test, resulting in €38 billion (median) to €51 billion (average) in fresh capital requirements.
2. Expectations of an extreme outcome (>€100 billion in capital requirements) fell sharply to 8% from 18% in their previous survey in October 2013.
3. Italian, German and Greek banks were perceived to be most at risk.
4. Overall, the AQR/stress tests were expected to be credible (89% of surveyed investors).

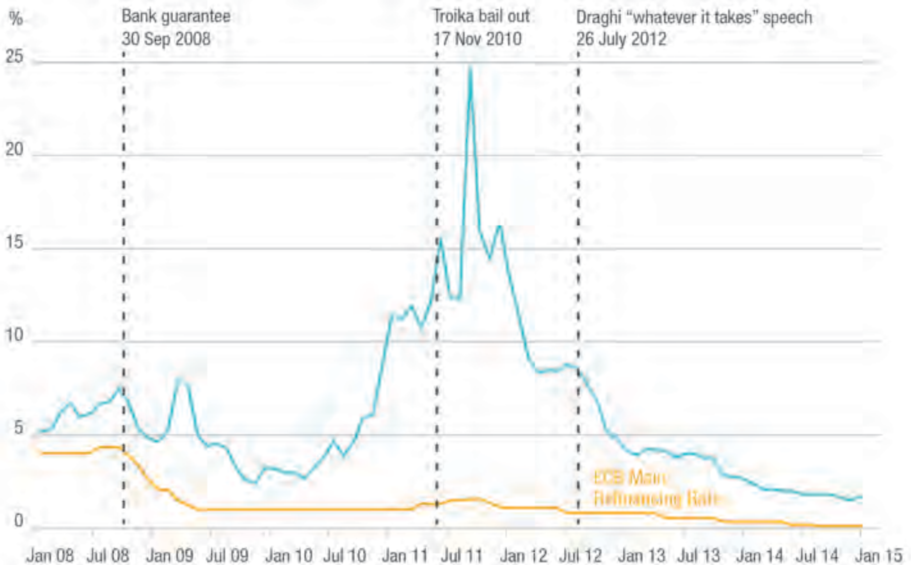
FIG 7.1 **ESTIMATE OF BANKS' MARGINAL FUNDING COSTS***



*Based on 3-month interbank rate and average 5-year CDS premia on the 4 largest banks | Source: Thomson Reuters Datastream / Fathom Consulting

FIG 7.2 **IRISH BANKS MARGINAL FUNDING COSTS**

(BASED ON 3-MONTH INTERBANK RATE + BOI 5-YEAR CDS PREMIUM)



7.6 THE OUTCOME OF THE COMPREHENSIVE BALANCE SHEET ASSESSMENT

In the event, the outcome of the stress tests was even smoother than expected. The overall results, as announced by the EBA, are set out in Box 7.3.

BOX 7.3 THE EBA 2014 EU-WIDE STRESS TEST RESULTS[143]

The 2014 EU-wide stress tests included 123 banking groups across the EU and Norway with a total of €28 trillion of assets covering more than 70% of total EU banking assets. It was co-ordinated by the European Banking Authority

143 European Central Bank, "ECB Risk Assessment," December 2014.

(EBA) and was carried out in cooperation with the European Systemic Risk Board (ESRB), the European Commission, the ECB and National Competent Authorities (NCAs). The EBA developed the common methodology and ensured a consistent and comprehensive disclosure of results. The ESRB and the European Commission provided the underlying macroeconomic scenarios. Competent national authorities and the ECB were responsible for the quality assurance of banks' results. They were also responsible for deciding on follow-up supervisory actions.

The impact of the stress test was assessed by reference to the transitional CRR/CRD IV Core Equity Tier 1 (CET1) capital ratio for which 5.5% and 8% hurdle rates were defined for the adverse and the baseline scenarios, respectively. Whilst the definition of capital varied somewhat depending on national transitional rules, the EBA ensured that all jurisdictions applied the same rules for unrealised gains/losses on sovereign exposures and provided fully implemented capital ratios under CRR/CRD IV.

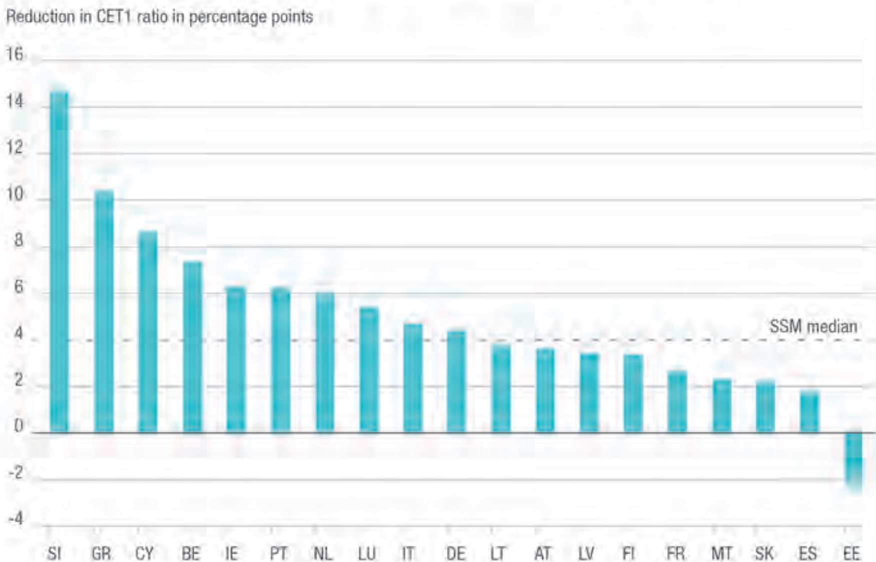
The weighted average CET1 capital ratio as of end 2013 was 11.5%. After a reduction of 40 basis points due to the Asset Quality Review (AQR), primarily in Single Supervisory Mechanism countries, the starting capital ratio for the stress test was 11.1% CET1 capital. In the adverse scenario, the projected aggregate CET1 ratio fell by 260 basis points to 8.5%. (7.6% on a fully-implemented CRR/CRD IV basis). The main drivers of this were credit losses (-440 basis points) and an increase in total risk exposures (RWAs) (-110 basis points). This more than offset the positive effect of operating profits before impairments (+320 basis points).

24 participating banks fell below the defined thresholds leading to an aggregate maximum capital shortfall of €24.6 billion. The additional capital raised in 2014, i.e. after the tests commenced, by banks with a shortfall, reduced the capital needs for those banks to €9.5 billion and the number of banks with a shortfall to 14.

The ECB was the competent authority for the 130 euro area banks examined. Together with the national supervisors, it reviewed 119,000 borrowers and valued 170,000 items of collateral. Supervisors also built 765 models to challenge banks' estimates of their provisions. The results were similar to those in the wider EU exercise:

- The balance sheets of 25 institutions, one quarter of the sample, were found wanting; the ECB concluded that between them they needed an extra €25 billion to be able to withstand a difficult economic surprise.
- The AQR part of the exercise identified an additional €136 billion of non-performing exposures and found that lenders and their supervisors had overvalued assets by €48 billion (only €11 billion of this was in banks with a capital shortfall). The ECB blamed poor valuation of commercial loans, including shipping loans, for a substantial part (28%) of the adjustments.
- The combination of the AQR and the stress tests resulted in a €263 billion or 4 percentage points reduction in the CET1 ratio, from 12.4% to 8.3%. This was almost twice that in the 2011 stress tests (2.1% pts) and was comparable to the Spanish tests (3.9% pts) and, while not strictly comparable, was above the 2013 US CCAR (2.9% pts). Some €25 billion of the total €263 billion was in banks that failed the tests. The distribution of the impact across countries is shown in Fig 7.3. Ten countries including Ireland and Germany recorded above-average declines.
- A standard definition of non-performing loans was used and the AQR

FIG 7.3 **COMPREHENSIVE ASSESSMENT MEDIAN PROJECTED ADVERSE SCENARIO REDUCTION IN CAPITAL RATIO BY COUNTRY OF PARTICIPATING BANK**



found that banks and national regulators had been too lenient in deciding which loans should be classified as bad, identifying an extra €136 billion in non-performing exposures.

- On top of the banks that fell below the 5.5% minimum CET1 ratio required under the "adverse" scenarios in the stress tests, there were a number of banks which were uncomfortably close. Some 16 banks had CET1 ratios from 5.5% to 7%, of which seven were in Germany.
- The exercise represented a huge advance in transparency with 12,000 data points provided on a comparable basis in the published results.

The big headlines presented by the EBA and the ECB were quite misleading, however: of the 25 banks that were reported as having failed the tests, only eight really failed and the overall capital shortfall was only €4 billion. This reflected the way in which the results were presented - see Fig 7.3. The €25 billion shortfall was based on the end-2013 balance sheet situation and did not allow for capital raised in 2014 or other actions taken after the tests commenced. Between January and September 2014, the 25 banks that failed boosted their net capital by an additional €18.6 billion, reducing the number of failures to 13 and the shortfall to €9.5 billion.

This, however, was not the end of the story as seven banks subsequently issued statements explaining that remedial action taken since the beginning of 2014 and approved by the national regulators had further alleviated the situation. In the end, eight banks failed, with a cumulative capital shortfall of €4.2 billion. Two of them were Italian (€2.9 billion), one Austrian (€0.9 billion), one Cypriot (€0.2 billion), one Irish (€0.1 billion), two Slovenian (€60 million) and one Greek (€17 million).

FIG 7.4

Bank	Country	Starting CET1 ratio Dec-13	CET1 ratio post adverse stress scenario Dec-16	Capital shortfall (€ bn)	Net capital raised 2014 (€ bn)	Shortfall post capital raised (€ bn)	Other agreed measures (€ bn)	Residual capital required (€ bn)
Eurobank	Greece	10.6%	-6.4%	4.6	2.9	1.8	1.7	0.017
Monte dei Paschi di Siena	Italy	10.2%	-0.1%	4.3	2.1	2.1	0.0	2.110
National Bank of Greece	Greece	10.7%	-0.4%	3.4	2.5	0.9	0.9	0.000
Banca Carige	Italy	5.2%	-2.4%	1.8	1.0	0.8	0.8	0.810
Cooperative Central Bank	Cyprus	-3.7%	-8.0%	1.2	1.5	0.0	0.0	0.000

Bank	Country	Starting CET1 ratio Dec-13	CET1 ratio post adverse stress scenario Dec-16	Capital shortfall (€ bn)	Net capital raised 2014 (€ bn)	Shortfall post capital raised (€ bn)	Other agreed measures (€ bn)	Residual capital required (€ bn)
Banco Comercial Português	Portugal	12.2%	3.0%	1.1	0.0	1.1	1.1	0.000
Bank of Cyprus	Cyprus	10.4%	1.5%	0.9	1.0	0.0	0.0	0.000
Oesterreichischer Volksbanken-Verbund	Austria	11.5%	2.1%	0.9	0.0	0.9	0.0	0.860
Permanent tsb	Ireland	13.1%	1.0%	0.9	0.0	0.9	0.7	0.125
Veneto Banca	Italy	7.3%	2.7%	0.7	0.7	0.0	0.0	0.000
Banco Popolare	Italy	10.1%	4.7%	0.7	1.8	0.0	0.0	0.000
Banco Popolare di Milano	Italy	7.3%	4.0%	0.7	0.5	0.2	0.9	0.000
Banca Popolare di Vicenza	Italy	9.4%	3.2%	0.7	0.5	0.2	0.3	0.000
Piraeus Bank	Greece	13.7%	4.4%	0.7	1.0	0.0	0.0	0.000
Credito Valtellinese	Italy	8.8%	3.5%	0.4	0.4	0.0	0.0	0.000
Dexia	Belgium	16.4%	5.0%	0.3	0.0	0.3	1.8	0.000
Banca Popolare di Sondrio	Italy	8.2%	4.2%	0.3	0.3	0.0	0.0	0.000
Hellenic Bank	Cyprus	7.6%	-0.5%	0.3	0.1	0.2	n/a	0.180
Münchener Hypothekenbank	Germany	6.9%	2.9%	0.2	0.4	0.0	0.0	0.000
AXA Bank Europe	Belgium	15.2%	3.4%	0.2	0.2	0.0	0.0	0.000
Caisse de Refinancement de l'Habitat	France	5.7%	5.5%	0.1	0.3	0.0	0.0	0.000
Banca Popolare dell'Emilia Romagna	Italy	9.2%	5.2%	0.1	0.8	0.0	0.0	0.000
Nova Ljubljanska banka	Slovenia	16.1%	5.0%	0.0	0.0	0.0	0.0	0.030
Liberbank	Spain	8.7%	5.6%	0.0	0.6	0.0	0.0	0.000
Nova Kreditna Banka Maribor	Slovenia	19.6%	4.4%	0.0	0.0	0.0	0.0	0.030
Total		**10%**	**2.1%**	**24.6**	**18.6**	**9.5**	**8.3**	**4.162**
No failures				25		13		8

Why did the tests go so well? In contrast with the earlier experience, the banks took the exercise seriously and raised very substantial amounts of capital both in advance and during the tests.[144] The total capital raised between July 2013 and August 2014 was €203 billion – see Fig. 7.5 – enough to offset more than three-quarters of the €263 billion capital reduction imposed by the combined tests. More generally, banks' capital and reserves have increased dramatically since 2008.

FIG 7.5

CAPITAL RAISED DURING COMPREHENSIVE ASSESSMENTS	
Total	€ 203 BN
Of which:	
Gross Equity issuances	€ 60 BN
CoCos issuances	€ 32 BN
Internal capital generation	€ 44 BN
Asset sales and other measures	€ 67 BN

7.7 CONCLUSION

"Has enough at last been done to fix the European banking system? And will this on its own be enough to ward off the threat of deflation that is hanging over the Eurozone? The answer to the first question is "probably yes". But the answer to the second is 'certainly no'. The ECB has taken a necessary, but far from a sufficient, step to fix the low-growth, low-inflation condition that has become the norm in the European economy."[145]

Gavyn Davies, October 2014

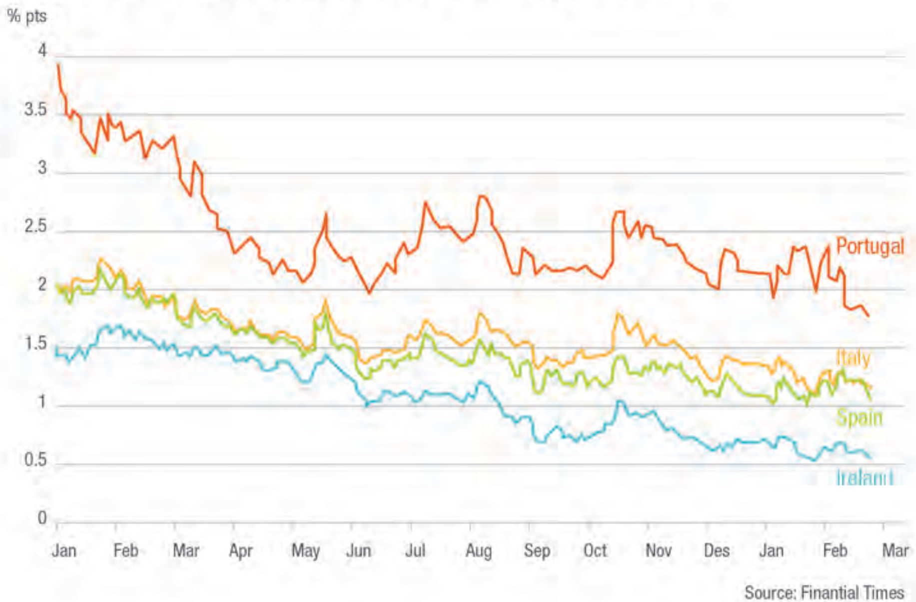
EU banks entered the crisis woefully undercapitalised and were forced, *inter alia*, by the stress tests, to dramatically increase capital in the most unfavourable of circumstances. Understandably, the fear was that one or more of them would have to be resolved during the transition from bail-out to bail-in; the presumption was that bail-out would be the norm and the fear was this might occur in a cash-strapped state, putting renewed pressure on the public finances and re-igniting market tensions. In the event, the stress tests managed to avoid this scenario altogether.

However, the system was tested even before the stress test results were announced when Banco Espírito Santo, S.A. (BES), Portugal's second biggest bank, was resolved in near text-book fashion with the State rescuing the good part with a loan of nearly €5 billion and shareholders and junior bondholders bailed-in in accordance with the revised State aid rules. Moreover, the operation was carried out over a weekend in early August 2014, with only a temporary hiccup in Portuguese bond yields – see Box 7.4 for a case study of Banco Espirito Santo at the end of this chapter.

In the event, only eight banks failed the stress tests with a capital shortfall of €4.2 billion and there was no need to resort to public backstops. Some held that this was because the tests were too lenient, ignoring, for example, the possibility of deflation for an extended period. However, the ECB's job is to ensure that this does not happen and Vice-President Constâncio, defended the exclusion on the basis that deflation would not occur; the test parameters were, in any event, established long before deflation fears surfaced. Others took the view that it was not realistic to plan for catastrophic scenarios.

Some critics maintained that the calculations vastly underestimated the true capital shortfall. Economists at Switzerland's Center for Risk Management at Lausanne, for example, put the shortfall for just 37 banks at €450 billion – the biggest offenders

[145] Gavyn Davies, "Stress tests alone will not bring the Eurozone back to health," *The Financial Times,* October 2014.



were France (€189 billion), Germany (€102 billion) and Italy (€76 billion).[146] They used a method that mimics how the market value of equity actually behaves under stress while ignoring risk weights altogether. The two approaches are not easily reconciled. However, the reaction of Gavyn Davies,[147] quoted above, is typical of the general favourable response to the comprehensive assessment.

Perhaps more importantly, the deluge of data from the EBA and the ECB revealed how the banks would have fared if a more rigorous yardstick of capital, known as fully-loaded Basel III, had been used. The Basel III rules are being phased-in and will become fully applicable towards the end of the decade. In that case, a few significant German banks would have failed the test as well. They included HSH Nordbank, a Northern German Landesbank that provides wholesale services to local savings banks (Sparkassen), and DZ Bank and WGZ Bank, two wholesale institutions that serve

146 Ireland was much further down the list, at €3.1 billion.
147 Former Goldman Sachs Partner and Chief Economist, now Chairman of Fulcrum Asset Management and columnist with the Financial Times.

Germany's system of local cooperative banks (Volksbanken and Raiffeisenbanken).[148] Moreover, the insurance subsidiaries of diversified banking groups are treated more leniently in the EU than recommended by Basel, with the result that even the 'fully-loaded' disclosures are based on a laxer standard than Basel III, a sensitive point for several large French banks. Allied to the fact that Italian banks fared worst in the announced results, this would point to potential issues in three large states – France, Germany and Italy. Clearly, a lot has been done but there is more to do.

BOX 7.4 **CASE STUDY: THE RESOLUTION OF BANCO ESPÍRITO SANTO**

Banco Espírito Santo, S.A. (BES) had total assets of about €90 billion, equivalent to 50% of Portuguese GDP, a presence in four continents and 25 countries and almost 10,000 employees. Its roots went back to 1884 when the Espírito Santo dynasty was established.[149] Unlike other banks, it did not get into serious difficulties during the early crisis. Rather, it came unstuck because the complex interests of the extended Espírito Santo family came to haunt it.

The Espírito Santo holding company was Espírito Santo International (ESI), a Luxembourg company originally established as a family refuge following the revolution in 1974 which nationalised the Portuguese banking system and banned the Espírito Santo family from doing business in Portugal. ESI controlled the Espírito Santo Financial Group (ESFG), which, in turn, owned one quarter of BES. In 1991, the Espírito Santo family regained control of BES with the help of Crédit Agricole; together, they held 51% of the equity.

However, by 2011 the crisis that had forced Portugal into a bailout was weighing heavily on ESI. With Portuguese companies locked out of the capital markets, it had become increasingly difficult for the group to service

[149] The family may have had humble origins – it is said that their name, which translates as Holy Ghost originates from a surname traditionally given to babies left at churches by destitute mothers.

[148] In Ireland, both AIB and Bank of Ireland would also have failed, mainly because of the treatment of government preference shares and deferred tax assets. The Irish banks include in their regulatory capital significant amounts of instruments that will be excluded from the calculation of CET1 after the transitional period, including deferred tax assets and preference shares. These instruments are likely to be gradually replaced via retained earnings and other measures before the Basel III rules come fully into force.

its debt. BES began to develop substitutes for the debt and capital that it could no longer raise in the market. As the financial crisis deepened, the group was forced to borrow more and more. By mid-2013, Espírito Santo Liquidez, a BES-owned fund which was marketed to its retail clients, had grown to become the largest fund in Portugal, holding €1.7 billion of debt – consisting almost entirely of short-term commercial paper issued by various ESI companies. In August 2013, the Portuguese stock exchange banned groups from putting more than a fifth of their own securities into a fund.

BES's share price began to fall in May 2014, when details of "material irregularities" at its ultimate parent company, ESI, began to emerge. As some group companies struggled to roll over their debt, other entities within the Group, including ESFG – BES's immediate parent – stepped in to fill the gap. ESFG told the market on 3 July 2014 that its exposure to other group entities had nearly doubled in just six months to €2.4 billion "to support the reimbursement of commercial paper", i.e. to refinance maturing debt. This, in turn, was financed by more than €1 billion from the Group's banking arm, BES.

There were also problems in Angola. BES operations in the former Portuguese colony had grown dramatically and its subsidiary there relied on its parent for funding: its loan-to-deposit ratio hit 220% in 2013. Bad loans soared, prompting the Angolan Government to give a €6 billion temporary guarantee, subsequently withdrawn.

Meanwhile, BES like other banks, needed to boost its capital in the run up to the stress tests. It raised €1 billion in a rights issue in June, 2014 lifting its CET1 ratio from 8% to 9.6% but diluting the existing share owners with the prospectus casting light on the complicated inter-group financing. Concerns grew and in June 2014, the Bank of Portugal forced Ricardo Espírito Santo Salgado, the great-grandson of the bank's founder and executive chairman since 1991, to announce that he would resign at an extraordinary meeting on 31 July which would elect a new board.

On 11 July 2014, the Bank of Portugal reassured markets that, based on information reported by BES and its external auditor (KPMG), BES had a sufficient capital buffer to accommodate possible negative impacts arising from its exposure to ESI.

On 18 July, Angola's central bank announced that BES Angola would need a capital increase to deal with bad loans. Around the same time, the Bank of Portugal accelerated matters, ordering the immediate appointment of a new outside chief executive and other board members.

On 30 July 2014, BES posted a first-half net loss of €3.6 billion on foot of what it described as “extraordinary events” that boosted impairment and contingency costs to €4.25 billion. The contingencies included a provision of €1.2 billion for its exposure to the distressed Espírito Santo group as well as the writing off of irrecoverable interest on loans granted by its Angolan unit. This halved BES's CET1 capital ratio from 10% to 5%, leaving it well below the required regulatory minimum of 7%.

According to the Bank of Portugal, the exposure to the non-financial arm of ESI was as anticipated but the external auditor had identified decisions taken but not reported by the old management that had increased BES's liabilities by €1.5 billion, contrary to the Portuguese regulator's instructions.

As a result, the Bank of Portugal:

- Instructed the BES board to submit a recapitalisation plan;
- Suspended the voting rights of the Espírito Santo Financial Group;
- Suspended, with immediate effect, the members of the management bodies responsible for audit, compliance and risk;
- Appointed a supervisory committee composed of senior officials of PWC, until the shareholders could replace the members of the Audit Committee;
- Ordered the on-going forensic audit to assess individual responsibilities, including those of the former CEO, former CFO and other members of the Executive Board, including with respect to criminal acts. BES President, Ricardo Salgado was subsequently made a formal suspect in a money-laundering investigation.

Even at this late stage, the Bank of Portugal remained optimistic that the required capital could be sourced from the market. However, potential investors retreated, access to liquidity from the Eurosystem was withdrawn because the bank was technically insolvent, its share price collapsed and

depositor confidence evaporated. This led to its shares being suspended on the afternoon of Friday, 1 August 2014.[150] The Bank of Portugal, in turn, determined that that the stability of the Portuguese financial system was endangered and that urgent intervention was necessary to protect its depositors and customers and ensure financial stability. This paved the way for the resolution of BES over the weekend.

The resolution measure chosen was to transfer most of BES's business to a bridge bank, Novo Banco, specifically set up for this purpose. This was designed to swiftly ensure: (i) the protection of deposits and customers; (ii) continuity of the financial services provided by BES; and (iii) the maintenance of stability and confidence in the Portuguese financial system.

FIG 7.8

PORTUGAL: CAPITALISATION OF NOVO BANCO, AUGUST 2014	
(Millions of euros)	
Initial capital of Novo Banco (as of 4 August 2014)	4,900
Treasury loan to the Resolution Fund using Bank Solvency	
Support Facility resources	3,900
Syndicated bank loan to the Resolution Fund	635
Resolution Funds own funds	365

All of the 'good' assets of BES, together with its employees, share capital and senior debt, were transferred to Novo Banco. The share capital of Novo Banco, €4.9 billion, was mainly funded by loans from the unused part of Portugal's EU/IMF bail-out facility (€6.4 billion), i.e. from the Government, and fully underwritten by the Portuguese Resolution Fund which has to pay interest of 2.95% annually, increasing over time.[151] Some €3.9 billion of the funds leftover from the bail-out were used to bolster the Portuguese Resolution Fund, which was set up in 2012. The balance came in the form of loans from other Portuguese banks and the accumulated funds in the Resolution

150 It was subsequently reported that the Portuguese Central Bank provided €3.5 billion of emergency liquidity assistance (ELA) on the day the shares were suspended, as BES suffered large deposit withdrawals, which could no longer be financed by borrowing from the ECB. The risk on ELA is carried by the government, not the Central Bank or the ECB.

151 State funds were lent with a minimum maturity of three months and a maximum of two years, i.e. the Government expected a quick sale or a refinancing by others.

Fund. When the Resolution Fund sells Novo Banco, the proceeds will be used to reimburse the loan from the State; any shortfall is to be made good by the Resolution Fund and the banking sector. The taxpayer was, therefore, spared, any additional burden from the rescue. However, the IMF have pointed out that if the eventual sale proceeds of Novo Banco are insufficient to reimburse the €3.9 billion senior loan received from the Portuguese Government, banks face: (a) (partial) non-repayment of their subordinated loan (€635 million) to the Fund and/or (b) exceptional contributions to the Fund to supplement its resources. In the IMF's view, the financing arrangement risks placing a considerable burden on a highly concentrated and still unprofitable banking system and has suggested that the two-year repayment period be extended. Instead the Portuguese authorities moved to accelerate the disposal, prompting the interim management to resign.

A six-person Management Board and a three-person Audit Commission were also appointed to the remaining 'bad bank' part of BES but, as it was left with few staff and no activity, the expectation was that its licence would eventually be withdrawn, which would result in an insolvency declaration that in turn would lead to judicial liquidation proceedings. As shareholders (€3.7 billion), junior bond holders (€0.9 billion) and claims by related parties were left in BES, they were, in principle, wiped out with their ultimate losses depending on the recovery, if any, in time from the inter-group and Angolan exposures.

On Monday 4 August 2014, The European Commission issued a statement that found the resolution plan of BES, including the creation of a bridge bank, to be in line with EU State aid rules. It noted that the full contribution of shareholders and of subordinated debt holders to the losses of BES was ensured in accordance with the burden-sharing rules set out in the Commission's 2013 Banking Communication.[152] However, in order to limit distortions of competition, new business by the bridge bank will be limited and a prudent pricing policy implemented.

The BES case also highlighted the extent of cross-holdings by banks in other banks. Crédit Agricole, its second biggest shareholder, subsequently took a €708 million hit to its 2014 second-quarter net profit, which fell

[152] European Commission, "Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis," 10 July 2013.

97.5% to €17 million.
Neither did the Bank of Portugal escape attrition. In September 2014, Deputy Governor, Pedro Duarte Neves, Head of Prudential Supervision, was replaced after eight years on the job, two years before he was due to leave.

Novo Banco was not part of the ECB's comprehensive assessment, however, it subsequently said that it had a CET1 ratio of 9.2%, above the 8% minimum required by the ECB in the stress test base scenario.[153]

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[153] Novo Banco, "Institutional Presentation: A leading Portuguese franchise with an International footprint," December 2014.

PART 4.
PROSPECTS

CHAPTER 8. ASSESSMENT OF BANKING UNION

8.1 INTRODUCTION

> *"In the absence of fiscal union, this banking union remains incomplete, with the SRM an awkward hybrid and no central deposit insurance. It does not fully 'break the vicious circle between banks and sovereigns' as initially promised. Even so, it is arguably the most significant policy development in Europe since the creation of the euro."* [154].
>
> *Sylvia Merler and*
> *Nicolas Véron*

Banking Union commenced on schedule in November 2014 and is significantly more robust than most critics feared. The nineteen euro area countries are participating, two non-euro states have applied to join and others are considering their options. This leaves a number of 'outs', notably the UK and Sweden, which could pose problems for the EBA, which is charged with harmonising banking rules across the 28 Member States. Nonetheless, Banking Union is a supervisory game changer that will improve the quality of bank balance sheets dramatically, strengthen their supervision, and establish rules that will protect the taxpayer in the event of bank failures. It is, however, unlikely that it will avoid all future bank crises and is not designed to do so. After all, the UK and the US experienced banking crises even though they had fully fledged banking, monetary and fiscal unions in place.

The first decade of the euro area saw EU banks engage in extensive cross-border activity. In principle, this should have deepened credit market integration and helped smooth economic shocks across countries through diversification. But the way banks integrated, which was short-term and debt-based, in fact produced little genuine risk-sharing. When the shock came, debtor nations faced a 'sudden stop' and an unanticipated reversal of financial flows. Even those banks that had integrated through acquisitions and take-overs, and so should in principle have been insulated from a fragmenting financial system, sometimes found themselves faced with supervisory

[154] Memo to the Commissioner for Financial Services, by Silvia Merler and Nicolas Véron. Bruegel, Sep 2014.

ring-fencing that disrupted their funding efforts by preventing them from funding in one country and lending in another. Moreover, the cost of backstopping banks fell largely on national authorities, contributing to the infamous bank-sovereign doom-loops.

The first attempt at Banking Union is unlikely to be definitive. The EU has a long history of incremental progress. In the case of Banking Union, the first step has been a big one, but the journey may take a decade or two to complete. The pace of progress has nonetheless been remarkable. Banking Union was put in place in little more than three years. Economic and Monetary Union, by contrast, took a decade from the Maastricht Treaty to the arrival of euro notes and coin.[155] The debate is now focused on the remaining gaps and discretions left to national supervisors and the degree to which Banking Union is less than perfect. The greater the imperfections and the greater the discretion left at national level, the more incomplete the Union and the greater the potential for persistent fragmentation in the short term and further bank crises in the long term.

8.2 WOULD A BANKING UNION HAVE PREVENTED THE CRISIS?

The IMF concluded that although Banking Union would not have halted the sovereign debt crisis, it could have had positive effects for depositors, banks and supervisors, and could at least have mitigated the intensity of the last crisis:

> *"Arguably, it would not have halted the sovereign debt crisis in some countries. But a well-functioning Banking Union could have substantially weakened, if not broken, the adverse sovereign-bank-growth spirals, maintained depositor confidence, and attenuated the liquidity and funding freezes that followed. A strong Banking Union would also have limited the concentrated exposures of banks to certain risks. For example, euro-area-wide supervisors would arguably not have allowed size, structure and concentration risks to grow as they did in countries such as Spain, Ireland, or Cyprus, or for general banking weaknesses to have accumulated in some other places. That said as the United States and other recent experiences suggest, supervision would have had to strive to be of a high standard. Merely reorganising supervisory structures would not of itself have addressed the build-up of systemic risk or the too-big-to-fail problem"*[156]

This seems plausible given the nature and intensity of the crisis and the relative laxity of regulation that facilitated it. While it is inevitable that crises will recur, it

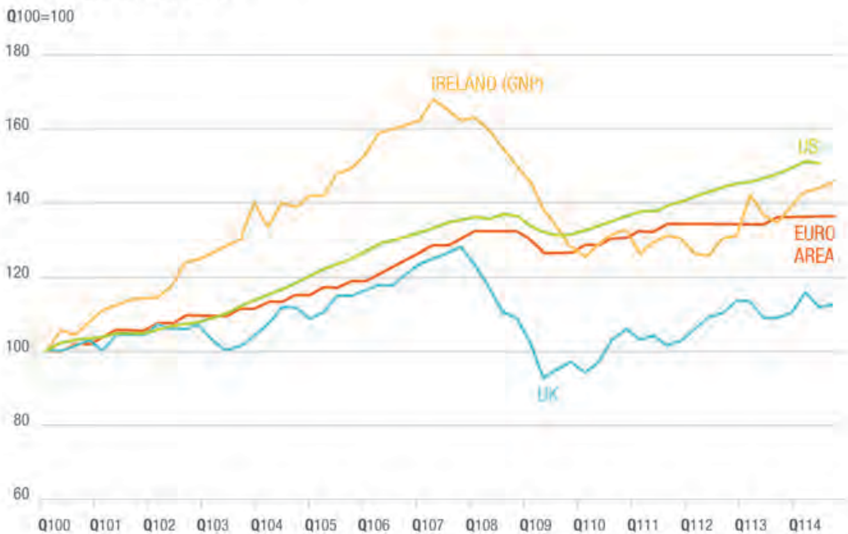
155 And even longer since it was first proposed in the Werner Report in 1970
156 A Banking Union for the Euro Area, IMF Staff Discussion Note, March 2013.

is unlikely that this will happen for some time and highly likely that the drivers of the next crisis will be different. It can be asserted with confidence, however, that the intensity and systemic nature of future crises will be less if even some of the lessons from the current crisis are learned. Banking Union might not have prevented the recent crisis but it should leave the euro area better placed to withstand future crises.

8.3 THE ECONOMIC CONTEXT

Banking Union is not the answer to all the economic problems that beset the euro area. ECB President Mario Draghi has identified three further challenges – monetary policy, structural reforms and financing of SMEs – all requiring attention:

> *"The crisis will only be over when full confidence returns in the real economy and in particular in the capacity and willingness of firms to take risks, to invest, and to create jobs. This depends on a variety of factors, including our monetary policy but also, and even most importantly, the implementation of structural reforms, upholding the credibility of the fiscal framework, and the strengthening of euro area governance."* [157]

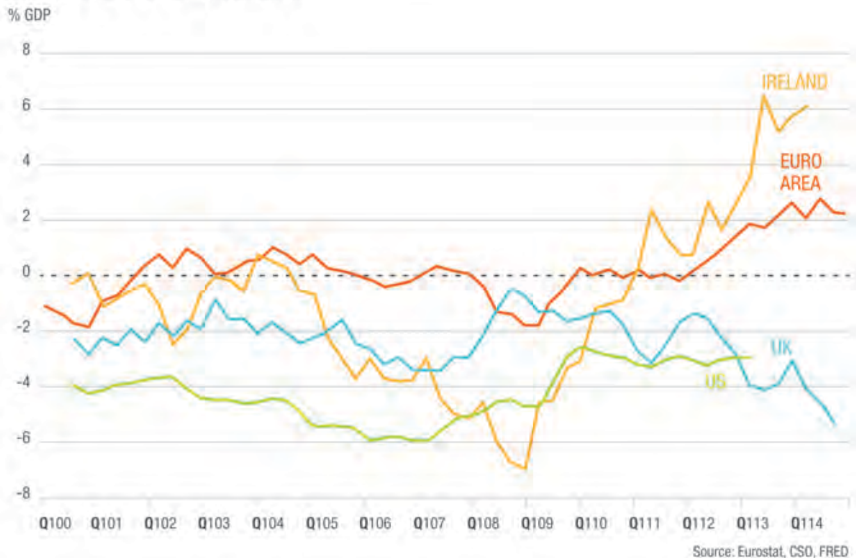


157 Introductory remarks at the EP's Economic and Monetary Affairs Committee, speech by Mario Draghi, President of the ECB. September 2014.

While growth has resumed, the crisis has left some very significant scars. The US has made the most progress, even if its recovery is the weakest on record and US GDP per capita is still well below its previous trajectory. In other countries the gap is much greater, with GDP per capita in Ireland and the UK, for example, growing at slower rates and still well below previous peaks.[158] Unemployment remains elevated and youth unemployment is a particular problem in many countries. In general, external competitiveness, as reflected in the balance of payments, has improved but government debt levels everywhere remain high – reducing them to the 60% target mandated by the Stability and Growth Pact will be a major challenge that will limit fiscal policy options for decades to come, and private sector debt ratios are particularly high in Ireland and a few other countries.

Economic activity in the euro area is weaker than elsewhere and slowed further in 2014 with inflation rates heading towards zero – far away from the ECB target of below, but close to, 2%. In response, the ECB announced yet another range of emergency policy measures, including negative interest rates and purchases of assets directly from banks and others, so called Quantitative Easing (QE). These however are not the concerns of Banking Union per se, whose objective is to restore confidence in banks, thereby enabling them to fund in the interbank market and to resume lending at rates that, adjusted for the risk of the borrower, are more uniform across the euro area.

FIG 8.2 **BALANCE OF PAYMENTS**



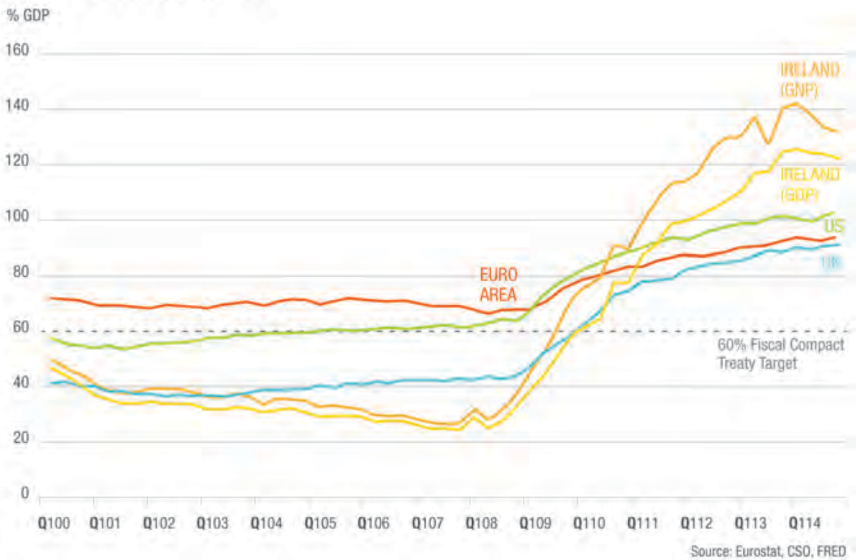
158 That said, it is clear that Ireland's previous growth trajectory was not sustainable and, in fact, Irish GNP, measured in Purchasing Power Parities (PPPs) compares favourably with the rest when measured from the start of EMU in 1999.

8.4 BANKING UNION SHOULD NOT BE CONFUSED WITH EMU

The report Towards a Genuine Economic and Monetary Union issued by the Presidents of the European Council, the Commission, the ECB and the Eurogroup in 2012 suggested that the euro area be equipped with powers for common decision-making on national budgets and be given a fiscal capacity of its own. When a recession emerges in one or more countries, funds could be available from this countercyclical euro area budget to stimulate growth, e.g. by investments in infrastructure and research and development[159]. While the fiscal and political ideas advanced by Council President Van Rompuy were tentative, they were quickly disassociated from the Banking Union project by the Finance Ministers in Ecofin[160].

Nevertheless, Banking Union is still criticised because it falls short of the popular concept of EMU. In highly developed unions such as the US and the UK, there are full political, budgetary, monetary and banking unions. In some cases, these took centuries to evolve. The euro area, by contrast, is a very recent development with a developed monetary union and embryonic fiscal and political unions. Until now, it did not have a Banking Union. The proposals for a Banking Union should, therefore, be seen as part of the jigsaw, rather than an attempt to complete it in one fell swoop.

FIG 8.3 **GROSS DEBT RATIOS**



159 The current EU budget represents around 1% of European GDP and is spent mainly on agriculture. According to some economists, a budget of 2% of euro area GDP would be sufficient to support a significant capacity to fund asymmetric shocks.

160 However, they have not gone away entirely and progress on Fiscal Union, for example, is part of the Programme of the new Commission President.

Jens Weidmann, President of the Bundesbank, clearly outlined the German position on a genuine EMU, identifying two possible scenarios; a genuine Fiscal Union or individual responsibility for repaying public debt:

> *"One way to (proceed) would be a genuine Fiscal Union. If common debt were matched by common control, incentives could be aligned. But this would require a quantum leap in terms of ceding sovereignty to the European level, a leap neither the electorates nor the governments of the Member States seem willing to take. If a true Fiscal Union that requires extensive changes to the European Treaties is not on the cards, then we need to take the second avenue. That implies taking concrete steps towards restoring a balance of individual control and individual responsibility within the existing Maastricht framework. Individual responsibility requires that sovereigns, banks and investors bear the consequences of their decisions. This means that it is primarily up to the respective government and its citizens to come up with the revenue needed to repay public debt"*[161].

There is a reluctance in Germany, in particular, to bail-out and take financial responsibility for the mistakes of others, be they prospective or retrospective. This also explains the desire to make bank stakeholders responsible for bank losses with national and, above all, supra-national backstops very much a last resort.

The IMF, too, stopped short of calling for Fiscal and Political Union, though it did emphasise the necessity for Banking Union to be accompanied by certain fiscal backstops in order to mitigate the effects of future crises. It identified four elements:

> *"The ultimate scope and shape of further fiscal integration will remain a matter of social and political preferences. But to make a future crisis less severe, four elements seem essential: (i) better oversight of national fiscal policies and enforcement of fiscal rules to build buffers and ensure common concerns are addressed; (ii) subject to strong oversight and enforcement of fiscal discipline, some system of temporary transfers or joint provision of common public goods or services to increase fiscal risk sharing; (iii) credible pan-euro area backstops for the banking sector; and, (iv) some common borrowing to finance greater risk sharing and stronger backstops and provide a common – albeit limited in size – safe asset"*[162].

Arguably, most, if not all, of these have been provided by the measures taken to date to combat the crisis, albeit, in more limited form than some would wish.

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161 Speech at the German-British Chamber of Industry & Commerce Annual Dinner, by Jens Weidmann, July 2014.

162 Toward a Fiscal Union for the Euro Area, by Céline Allard, Petya Koeva Brooks, John C. Bluedorn, Fabian Bornhorst, Katharine Christopherson, Franziska Ohnsorge, Tigran Poghosyan, and an IMF Staff Team, IMF September 2013.

Back in 2012, Nicolas Véron of Bruegel, an influential commentator on Banking Union, was emphatic about the need to complement the proposals with progress on the other elements of EMU. His views were typical of those expressed at the time, arguing that because there are strong interdependencies between banking, political and fiscal union, the Banking Union could not be achieved without prior progress on the other two.

These comments must be seen in the context of the time – when the confidence of the markets was a good deal more fragile than it is today and the EU response less clear-cut. In the meantime, a single supervisory authority, and a resolution authority with a (limited) common backstop has been put in place and the ECB's Comprehensive Balance Sheet Assessment was a new and important development. However, consideration of a European Deposit Guarantee Scheme has been deferred and there has been little or no progress on political union. These developments prompted Véron to use the term 'half a Banking Union' to describe what has been achieved.

> *"With supervision now meaningfully integrated within the ECB, centralised resolution on the right path even though not yet there, and common deposit insurance sadly off-limits, it is fair to label the current legislative arrangements a "half a Banking Union". It is much more than a small step on the journey towards eliminating the vicious circle between banks and sovereigns, but it's still incomplete.…Our view is that…this is sufficient progress to be meaningful and of a stabilising nature. As we argued in 2009, to end the European banking crisis required the strict testing of bank solvency by a European-level authority using a unified and transparent standard. The half a Banking Union meets these criteria"*[163].

This is a significant change of tone and a vote of confidence that Banking Union will end the banking crisis.

There are parallels between Banking Union as proposed and currency unions such as the 'one-for-one' no margins link between the Irish pound and Sterling prior to the break in the link on 30 March 1979. Maintenance of the link was viable as long as the weaker currency authorities took responsibility for and ensured that a volume of external reserves sufficient to guarantee the confidence of the markets was maintained. Similarly with Banking Union – the German model is sustainable as long as individual responsibility is maintained and debt is curbed and reduced to levels that avoid another wholesale loss of market confidence. This would be the situation if, for example, Denmark which is not part of the euro, were to join Banking Union.

163 Europe's half a banking union, by Adam Posen & Nicolas Veron. Europe's World, June 2014.

It would not have access to common bail-out funds and would have to compensate by maintaining an adequate supply of foreign currency reserves.

The net point is that Banking Union with limited common fiscal backstops is viable without the more ambitious proposals that typically form part of a Fiscal Union, which should be decided on its own merits; Banking Union should not be viewed as a backdoor entry to Fiscal Union.

8.5 THE OBJECTIVES OF BANKING UNION

Instead, Banking Union should be assessed by reference to both its declared objectives. The short-term objective is to break or 'weaken', in the current parlance, the link between banks and sovereigns, i.e. the vicious cycle between financial and fiscal instability, while the long-term goal seeks to preserve the Single Market in financial services by ensuring consistent, competitively neutral, high quality, financial supervision across the EU at least cost to the taxpayer.

According to the Basel Core Principles for Effective Supervision,[164] a number of preconditions are necessary for a viable long-term Banking Union. These include:

a. The implementation of coherent and sustainable macroeconomic policies;
b. A clear framework for financial stability policy;
c. An effective crisis management and resolution framework to deal with bank failures and minimise disruptions;
d. An adequate safety net to deal with confidence crises while minimising distortions;
e. A well-developed public infrastructure; and
f. Effective market discipline.

Clearly, most of these preconditions will only be met when all the Banking Union arrangements are in place, for example the Bank Recovery and Resolution Directive (BRRD) rules regarding bail-in. The area of most debate revolves around the adequacy of the safety net and whether the resolution framework is sufficient.

Critics of Banking Union contend that the Resolution Fund will be too small, at just €55 billion after eight years and/or that the €60 billion available from the ESM's Direct Recapitalisation Instrument, is not enough to deal with a major crisis in a Member State of the size of Italy, for example, noting also that European banks required €608 billion in recapitalisations and bailouts between 2008 and 2013 [146165]. This criticism fails, however, to take account of the following:

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164 Core Principles for Effective Banking supervision, Basel Committee on Banking Supervision, September 2012.

165 Guarantees and commitments were much higher, for example Germany committed €500 billion in 2008 and Ireland introduced an unlimited guarantee for bank liabilities totalling €375 billion, also in 2008.

- The new Macroeconomic Imbalances Surveillance Procedures which are designed to prevent imbalances building up in the first place, thereby averting potential crises;
- Basle III and the subsequent Capital Requirements Directive and Capital Requirements Regulation which have dramatically increased the quantity and quality of bank capital – the EC has estimated that banks@ capital has increased by roughly half a billion;
- Single Supervisory Mechanism and Single Resolution Mechanism which are designed to improve the supervision and, in extremis, the resolution of failing banks;
- The BRRD bail-in provisions which will require (i) a bail-in of at least 8% of a bank's total liabilities including own funds, (ii) a contribution by the resolution funds of up to 5% of the total liabilities, and (iii) a write-down or conversion in full of all unsecured, non-preferred liabilities including eligible deposits[166], shareholders and bondholders prior to recourse to national or supranational backstops;
- Common resolution funds of €55 billion, funded by the banks, with a possibility of top-up by borrowing from the markets;
- National backstops which, as yet, have not been clearly outlined;
- Direct recapitalisation from the ESM as a last resort - €60 billion has been earmarked for this;
- The ECB's OMT Programme which promises unlimited intervention in the bond markets of stressed Member States and which, ultimately, ended the last crisis.

As evidenced by the above, a lot has been done and, as noted in Chapter 4, the Commission has stated that, had the new arrangements been in place, only one failing bank would have had to resort to State aid between 2008 and 2010. The recent crisis was a "once in a century" type event; it follows that a future crisis would have to be even more severe before resolution funds or common backstops would be called upon.

There is also the point made by the IMF, namely that a Banking Union should aim to resolve individual banks or groups of banks and not necessarily seek to provide for all eventualities. The UK and the US had well-established banking unions but both governments were forced to come to the assistance of the banks in an ad hoc manner. It is likely that a parallel situation will pertain in Europe. Though the amount of ESM funds earmarked for direct bank recapitalisation – €60 billion – is modest, the total resources of the fund are of the order of €500 billion, 5% of the area's GDP, which can be lent to governments, if necessary. If another 'once in a century' crisis

166 Insured deposits are excluded.

were to materialise and were the new rules put in place by Banking Union to prove insufficient, the authorities would then have to decide between either letting one or more banks fail in an uncontrolled manner, or once again resorting to public resources. The latter may, at times, remain the lesser of evils; in the midst of a crisis, there may be little or no alternative but to resort to the public purse as a last resort[167].

In broad terms, at least, it seems that the design of Banking Union meets both the short and the long-term objectives that were set for it.

8.6 EU – SPECIFIC ISSUES

The unique nature of the EU means that the challenges faced in realising a project of this scale are vastly more complex than those faced by a unitary state with sole power of decision in relation to banking, fiscal and monetary matters. As described in Chapters 3 and 4, the Banking Union was shoehorned into an existing Treaty and Institutional framework that had not foreseen – and made little allowance for - the need for systems of bank supervision and resolution. The absence of enabling articles in the Treaties and the unwillingness on the part of Member States to amend them forced the use of existing provisions which stretched the regulatory envelope to the limit. As a result, supervision and resolution have been entrusted to institutions which were not designed for the task and whose efficacy in their new roles remains to be proven. Banking Union, ultimately, is a project born into and shaped by constraint.

8.6.1 SUPERVISION

For example, as described in Chapter 3 of this report, decisions on bank supervision must be ratified by the ECB Governing Council,[168] a Board that was set up for an entirely different purpose, viz. monetary policy. Though the non-objection procedure described in Chapter 3 has, thus far, proceeded without difficulty, such smooth operation cannot be guaranteed in every instance in the future. Furthermore, in the litigious arena of bank supervision and resolution, legal challenges to the SSM's decisions cannot be excluded from the realm of possibility. To copper-fasten the situation, a Treaty amendment setting up a new supervisory body outside the ECB may be required at some later stage.

Designing an effective supervisory mechanism for the euro area also entailed other complications. The ECB will be formally accountable for supervision but will have to rely on competencies and resources at the national level. This is not just because of resource constraints in the near term, but also differences in legal, accounting

167 What if the Next Financial Crisis Hits the Banking Union, Egmont Policy Brief, September 2013.
168 Albeit via the 'non-objection' procedure.

and tax frameworks, as well as differing local language, business and supervisory cultures, and local knowledge and relationships that are important to assess bank activities. In such an environment, the ECB will have to delegate, but also monitor, supervisory operations to contain reputational risks. As the experience of Spain and others has demonstrated, small banks with correlated risks can represent a major fiscal risk for a sovereign and ultimately a systemic risk for the euro area. Though the ECB has the ability to take over responsibility for directly supervising any bank when it wishes, it will depend on the local supervisors to a significant extent for advance warning of trouble.

Moreover, the ECB's criteria for distinguishing between groups it considers integrated (such as Rabobank or Erste Bank) and those scattered across independent local entities (such as the German Sparkassen or Austrian Raiffeisen cooperatives) are based on legal form and ownership[169]. German savings banks rely on an elaborate system of mutual oversight and contingent guarantees, which suggests that they might be consolidated as one single entity for the purpose of systemic risk analysis. In other words, the ECB's separation of euro area banks into 'significant' and 'less significant' relies on objective criteria, but the practical relevance of these criteria may well be tested over time'[170].

In the future, the interaction between the centre and the national authorities and the division of powers between them will be key. While the ECB has devoted much attention to this issue, it remains to be seen how things will work out in the long-term. The experience with the 2014 Comprehensive Balance Sheet Assessment would suggest that, so far, the ECB has had the whip hand. The challenge will be to see if it can maintain it in the face of any future rear-guard action by the national supervisors.

Finally, opinion in some countries, notably Germany, is that housing monetary policy and supervision under the same roof gives rise to unacceptable conflicts of interest[171] when monetary policy decisions impact the soundness of important

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169 Germany, Austria and Italy together have almost four-fifths of the smaller banks, and Germany has the lion's share (1,697 out of the 3,532 'less significant supervised entities' are in Germany).

170 A more Machiavellian perspective would hold that Germany insisted the triggers be set at levels that ensured that their politically sensitive savings banks would be supervised locally instead of centrally by the ECB. German savings banks (Sparkassen), cooperative banks (Volksbanken) and the public-sector Landesbanken represent about half of the German banking system. The Sparkassen in particular have considerable political influence given the presence of elected officials on their boards. Hence Wolfgang Schäuble's ECOFIN comment that "it would be very difficult to get an approval by the German Parliament if you would leave the supervision for all the German banks to European banking supervision" as reported by the Financial Times on 4 December, 2012.

171 Speaking in the Bundestag on 25 September 2014, German Finance Minister Schäuble said that the decision to put the responsibility for monetary policy and banking supervision in one institution would not be "without problems" and that in this context the ECB's ABS purchase program would be "somewhat unfortunate".

banks. A revision of ECB objectives through Treaty changes may in time be warranted to provide clarity with respect to the interaction between the ECB's monetary mandate in the Monetary Union and its supervisory mandate in the Banking Union.

8.6.2 RESOLUTION

The situation regarding the Resolution Board is not dissimilar to the Supervisory Board of the SSM. Due to legal constraints regarding the delegation of powers from an EU Institution, decisions to resolve a bank will be referred to the Commission for ratification, with exceptional recourse to the Council of Ministers. Numerous commentators have questioned whether effective and timely decision-making is possible given the complexity and number of parties involved and the requirement that a failing bank should be resolved over a weekend[172]. Fear of legal challenge prompted the German authorities to insist that certain aspects of the Resolution Fund be set up by means of a separate Intergovernmental Agreement, much to the chagrin of the European Parliament, which considered this an attempt to circumnavigate the ordinary legislative process. Here, too, the arrangements have the look of unfinished business about them.

In addition, shortcomings remain in the underlying resolution framework laid out in the BRRD - the most important of these is the fact that different countries could still adopt a differentiated treatment of banks in cases of crisis. The BRRD allows for deviation from the 'no bail-out without bail-in' rules under certain conditions in times of systemic crisis. In these circumstances, Member States may still inject public funds as 'precautionary recapitalisations'. This creates a danger that Member States with solid public finances could continue to bail-out banks to protect 'national champions', while Member States with precarious public finances might have no option but to bail-in creditors. The safeguard against this is that the State aid rules will apply when public money is involved but it remains to be seen how effective this deterrent will be.

Furthermore, assessments by the Bank of International Settlements (BIS) and the EBA have found significant variation in banks' risk-weighted assets that are not explained by underlying differences in the riskiness of banks' portfolios. Excessive variation in risk-weighted assets undermines confidence in the risk-based capital framework as a measure of bank safety.

> *"The Committee is well aware of these concerns, and we are taking steps to reduce the variation arising from differences in how banks measure risk. At*

172 Banco Espírito Santo, S.A. of Portugal was resolved over a weekend in early August 2014 but it did not have major cross-border ramifications.

the same time, we know that variation in risk-weighted assets can arise from differences in the rules and implementation standards set by national regulators, and so we are also focusing on these areas" [173].

When the EBA compared two different approaches being used by national authorities to calculate the so-called 'Basel I floors' in 2011/12, the difference at the aggregate EU level was a shocking €45 billion. Clearly, there is more work to be done to make the concept of the Single Rule Book effective and this is a priority for the EBA.

Then there is the question of the 'ins' and the 'outs'. Ideally, both the SSM and the SRM should include all banks licensed in the EU but this is unlikely as the UK and Sweden have announced that they will opt out. This in turn means that the resolution of cross-border banks with operations in and out of Banking Union remains uncertain, with no clear rules in place[174].

8.6.3 BURDEN-SHARING

Finally, political considerations also dictated that common fiscal backstops should be limited both in size and scope as some member countries were unwilling to commit funds to bail-out what they saw as the irresponsibility of others. This resulted, for instance, in the deferral of the proposed common bank Deposit Guarantee Scheme and fund.

The no bail-out clause in Article 125 of the Treaty prohibits the EU, euro area or Member States from assuming liabilities of another state or of its public bodies. However, voluntary loans to other Member States (as in the EU Directive on bank resolution), or multiple guarantees (as under the ESM) would not appear to be in contradiction with the current Treaty. Treaty change would, however, likely be required if a future euro area Deposit Guarantee Scheme were to involve joint and several liabilities. According to ECB Vice President Vítor Constâncio, this part is less urgent but could yet be introduced at a later date:

"What was achieved in December 2013, when the co-legislators agreed on the Deposit Guarantee Scheme Directive (DGSD) was only a little part of what in the end will be necessary. Doubts on this ability, due to concerns on the fiscal health of the sovereign, could for instance easily reinforce the possibility of local bank runs. From a central bank perspective, the establishment of a common deposit insurance scheme is of less urgency than the other components of

173 Opening speech by Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of Sveriges Riksbank, at the 18th International Conference of Banking Supervisors, Tianjin, China. September 2014.
174 BRRD rules apply but they only provide a starting point.

a Banking Union. Still, it is an important element that that should be pursued later, as it will be important to fend off bank runs on cross-border banks, thereby enhancing trust in the European banking sector."[175]

8.7 FINAL ASSESSMENT

Writing in the Financial Times in May 2013, German Finance Minister Wolfgang Schäuble provides a good sense of both the achievements and the inadequacies of Banking Union, using the metaphor of the 'timber-frame' Banking Union versus the 'steel-frame':

> *"A Banking Union of sorts can thus be had without revising the treaties, including a single supervisor; harmonised rules on capital requirements, resolution and deposit guarantees; a resolution mechanism based on effective co-ordination between national authorities; and effective fiscal backstops, also including the European Stability Mechanism as last resort. This would be a timber-framed, not a steel-framed, banking union. But it would serve its purpose and buy time for the creation of a legal base for our long-term goal: a truly European and supranational Banking Union, with strong, central authorities, and potentially covering the entire Single Market."*[176]
>
> *Wolfgang Schäuble*

Minister Schäuble's article also introduces a sense of time. Banking Union is not a steady state; rather it is the start of a process that should continue in the future. Inevitably, this means that the starting Banking Union will be less than perfect. The qualified nature of the initial Banking Union assessment is captured in the following quotation from Sebastian Dullien of the European Council on Foreign Relations (ECFR):

> *"Banking Union, along with related legislation such as that setting out higher capital requirements for banks through the capital requirements directive (CRD IV), will make the euro area banking system much more stable. The union will also make supervision much more uniform and coherent. Moreover, it will limit the toxic link between Member States' banking systems and their sovereign debts. It will make a banking crisis less likely and restrict bail-outs by the Member States by prescribing that private creditors have to be bailed in before public*

175 Banking Union and European integration, speech by Vítor Constâncio, Vice-President of the ECB, at the OeNB Economics Conference, Vienna. ECB, May 2014.
176 Banking union must be built on firm foundations, by Wolfgang Schäuble. The Financial Times, 12 May 2013.

funds can be used for a bank rescue."[177]

Critical to this assessment is the notion that Banking Union will 'limit' rather than break the toxic link between sovereigns and banks. This, in turn, is because there is a limit to the bail-out funds available from the ESM, the ultimate backstop.

The more idealistic critics of Banking Union tend to frame their argument in one of several ways. Some contrast the recent experience with the likely response to an equivalent financial crisis in pre-euro times. Then, those countries faced with severe financial pressure would simply have devalued. The costs would have been borne partly by households in the devaluing nations (import prices would now be higher), partly by industry in the revaluing nations (their products would now be less competitive) and partly by creditors in the revaluing nations (assets held by them in the devaluing nations would now be worth less).

In other words, the costs would have been shared between the weak and the strong, the debtors and the creditors. The fixed exchange rate nature of the euro meant that devaluation was not an option. The euro's design created a collective action problem because the 'strong' were able to impose most or nearly all of the costs of adjustment on the 'weak'[178]. This is true but it ignores other important aspects of EMU and the euro, which facilitated catch-ups and booms in several countries, bringing substantial economic gains, many of which persist. The rules of the game were meant to avoid bail-outs but were altered significantly by the establishment of the ESM. In the end, all the troubled Member States, including Greece, were bailed out via loans, not transfers, and all, to date, have chosen to remain in the euro. In the absence of transfers from the centre, the consequence is that the periphery has had to bear the costs of adjustment.

Other critics focus on the highly developed and integrated models in the UK and the US and wonder why the euro area cannot respond similarly. These models, however, are based on full economic and political union which is not the case in the euro area and, moreover, is unlikely to be the case for the foreseeable future. Their advantage is that virtually unlimited funds are available from the centre, although we should note in passing that these funds are not pre-committed. Rather, the US and UK authorities responded to systemic crises as necessary. After all, the recent financial crisis was the first systemic crisis in the US since the 1930s and most people thought it would never happen. It is the authority and flexibility to respond that gives the US and the UK their advantage. This, however, is not and will not be the case in the EU without full Political Union. That said, it is worth noting that

177 Testing the willingness for further reforms, by Sebastian Dullien. Banking Union Discussion in Brussels, 7 July 2014.
178 The euro and the three musketeers, by Stephen King. HSBC, September 2014.

the euro crisis was in the end defused by the prospect of unlimited intervention by the ECB which severed the perceived tie between fiscal capacity and the funding of domestic banks.

Others still focus on the limited common fiscal backstop that is available. The key quote in this regard is not the Summit conclusions of June 2012 that launched Banking Union but rather, the subsequent clarification by the Finance Ministers of Germany, the Netherlands and Finland, who specified the conditions for Direct Recapitalisation:

> *"Regarding longer term issues, we discussed basic principles for enabling direct ESM bank recapitalisation, which can only take place once the Single Supervisory Mechanism is established and its effectiveness has been determined. Principles that should be incorporated in (the) design of the instrument for direct recapitalisation include: 1) direct recapitalisation decisions need to be taken by a regular decision of the ESM to be accompanied with a MoU; 2) the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities; 3) the recapitalisation should always occur using estimated real economic values; 4) direct bank recapitalisation by the ESM should take place based on an approach that adheres to the basic order of first using private capital, then national public capital and only as a last resort the ESM."* [179]

This 'clarification' caused much angst in Ireland as it appeared to run counter to an admittedly nuanced sentence in the June 2012 Council conclusions:

> *"When an effective Single Supervisory Mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly…The Euro group will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme"*[180].

First, it clarified that direct recapitalisation, as opposed to indirect recapitalisation via the ESM lending to a Government to finance a bank bailout as happened in Spain, would only be possible after the SSM was up and running, i.e. after 4 November 2014. In practice, this was no more than a literal reading of the Summit statement.

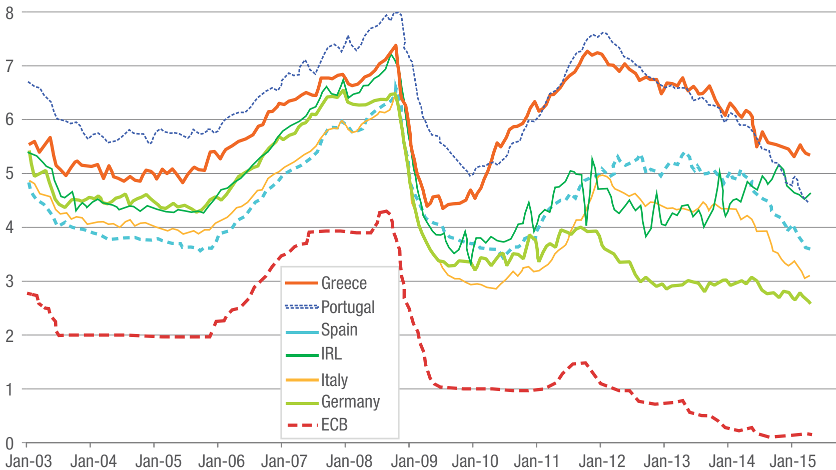
The particular sentence on Ireland mentioned above followed hard on the heels

179 Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, Helsinki, 25 September 2012.
180 Euro Area Summit Statement, 29 June 2012.

of the Banking Union commitment in the June 2012 statement; hence, the expectation that it opened up the possibility of retrospective recapitalisation of the Irish banks which had been indirectly bailed-out earlier. In reality, however, this sentence is open to different interpretations and the Irish Finance Minister, Michael Noonan, has since indicated that selling the State's interest in the nationalised banks to the ESM is no longer the preferred option. While the ESM would, as outlined above, value the banks at estimated real economic values (as NAMA did when it took over the Irish banks' property assets) instead of distressed book value, the judgement is that a better return for the taxpayer might now be achieved by selling to the market instead. Of course, this only applies to the viable banks in State ownership. There was never any hope of recovering the capital injections into the wound-up Irish banks: decisions by the Member States on 10 June 2014 and 8 December 2014 made the ESM Direct Recapitalisation Instrument operational but the retrospective recapitalisation element remains in limbo, requiring, as it does, a unanimous agreement which is unlikely to be forthcoming.

FIG 8.4 **INTEREST RATES ON SME LOANS**

(new business, up to €1mn maturity up to 1 year)



Some €60 billion of the remaining €450 billion funds in the ESM has been earmarked for direct recapitalisation which will, in any event, be subject to strict conditionality. Clearly, €60 billion is a relatively small sum given that the euro area

committed €668 billion to its banks and the Irish bail-out alone cost €64 billion in gross terms. However, as noted above, this criticism fails to take a number of factors into account. First, a clean-up of bank balance sheets and a tough central supervisor should reduce the odds on a repeat of the recent systemic crisis. At least, any future crises should be of a lesser magnitude and intensity. Second, in the event, the amount of public funds injected into the banks was about 5% of euro area GDP and the Commission have calculated that, were the new bail-in arrangements in place, only one bank would have required public capital between 2008 and 2010. It follows, therefore, that we could have a repeat crisis of a broadly similar magnitude with little or no call on the taxpayer. Third, a common €60 billion backstop from the ESM is available and can be quickly activated, if necessary. However, this takes no account of funds that might be available from the national governments or of the fact that a further €400 billion could be made available from the ESM either indirectly via national governments or directly by raising the €60 billion sub-ceiling. Viewed from this perspective, the size of the central backstop is roughly equivalent to another 5% of GDP.

The euro area is, therefore, capable of dealing with a systemic crisis of roughly twice the size of the last one. This is probably as much as can be expected given the current institutional set up. It would not be sufficient to bail-out major countries like Italy or France. For that, the unlimited resources of the ECB would be required and would, most likely, be available as, indeed, was promised by President Draghi in July 2012 and confirmed subsequently with the OMT announcement. Given that Banking Union has started with a clean bill of health, there should be time to address outstanding issues which, for the most part, relate to euro area specific factors, including legal constraints, outlined earlier.

The stress and other tests that preceded the commencement of the SSM, once perceived as a major challenge, proved to be credible in market terms. While fragmentation is by no means eliminated, the early results are positive in that the cost of SME borrowing is both declining and converging on German levels. Indeed, these trends predated the release of the stress test results as the data in Fig 8.1 testify. Nonetheless, the early judgement is positive, although differences still exist, not least those occasioned by differences in funding costs, as mentioned in Chapter 7.

CHAPTER 9.
CONCLUSIONS

"Despite its predominantly economic content, the European Union is an eminently political construct. Even readers primarily interested in economics would hardly understand the euro if they ignored its political dimension"[181]

Padoa Schioppa

• BANKING UNION IS A GAME CHANGER THAT WAS PUT TOGETHER IN RECORD TIME

The banking crisis was not unique to EMU; both the UK and the US had banking crises as did Iceland, Denmark and a range of other non-euro area countries. EMU did however affect the response to the crisis in member states given the absence of pan-euro area mechanisms to deal with failing banks, and the supervisory fragmentation that this gave rise to, a defect that is ultimately being rectified with the creation of a Banking Union.

After the crisis broke, it became de rigueur to bemoan the lack of a banking union; however beforehand its absence was barely noticed with only a few isolated voices calling for it.

Banking Union aims to combat one of the most pernicious causes of the crisis, viz., the global failure of bank regulation and the inability to provide for the orderly resolution of banks should supervision again fail[182]. The chosen mechanisms are (a) the transfer of responsibility for bank supervision from the national supervisors to the ECB, (b) the institution of a vast array of new rules and regulations designed to improve both the quality and quantity of banks' capital, (c) the establishment of a single central resolution mechanism to deal with failing banks and a single resolution fund financed by levies on the banks to support them where necessary, (d) a radical change in the rules that will see bail-in of shareholders, junior and senior bondholders as well as unguaranteed deposits before the possibility of drawing on resolution funds arises and (e) by putting in place a common, backstop as a last resort by earmarking €60 billion of ESF funds that can be used to directly recapitalise failing banks that are deemed systemic and, therefore, worth saving.

181 The euro and its central bank, Tommaso Padoa Schioppa, ECB Executive Board member, 2004.
182 The other main response was fiscal, as reflected in the ESM, the reformed Stability and Growth Pact and enhanced surveillance procedures.

The first pillar of Banking Union, the Single Supervisory Mechanism, was launched on schedule in November 2014, nineteen euro area members participate, two more Eastern European countries have applied to join[183], and of the 28 EU member states it looks like less than half a dozen will remain outside in the long-term. This is a much better result than could have been expected when the project was launched in 2012 and the euro appeared to be on the verge of imminent breakup. The UK and Sweden will not participate, however, thereby introducing the risk of a fracture in the single regulatory handbook between the "ins" and the "outs" and complicating the work of the European Banking Authority (EBA) which has an EU-wide mandate to produce a Single Rulebook.

The urgency of the situation was reflected in the political response; Banking Union was completed in a fraction of the time it took to establish EMU. Together with the fiscal safety nets that have been put in place, it represents the most significant achievement since EMU commenced in 1999 and is a continuation of the evolutionary approach envisaged by Robert Schuman in 1950.[184]

• BANKING UNION DOES NOT REQUIRE A FULL FISCAL OR POLITICAL UNION

Banking Union is designed to be a supervisory game changer, not as a definitive step towards the establishment of an economic union. Initially, there was a deal of confusion on this latter point which stemmed, in part, from the ambitious, holistic plans outlined in the Report of the Presidents that preceded the decision to create the Banking Union. This extended to greater Fiscal Union, and even some thoughts of Political Union, as an antidote to the most virulent stage of the crisis.

Though Banking Union does not require either full fiscal or full political union, it does nonetheless require a modicum of each. Barry Eichengreen, a long-standing critic of EMU, expressed it concisely at a Conference in Dublin Castle in January 2015, saying:

> *"Europe needs just enough fiscal union to make Banking Union work and just enough political union to make fiscal union work."*[185]

Eichengreen recognises the reality that centralising banking supervision is only feasible if there is political will to cede the rights of the national supervisors to a central authority. Bank resolution, in turn, requires a common fiscal backstop, not

183 Bulgaria (June 2014) and Romania (July 2014) have submitted official requests to join.

184 "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity." Robert Schumann, 9 May 1950.

185 Barry Eichengreen, University of California, Berkeley, at IMF Conference on Ireland—Lessons from Its Recovery from the Bank-Sovereign Loop, Dublin Castle, 19 January, 2015.

necessarily a full-blown fiscal union. The ESM's Direct Recapitalisation Instrument, which will serve as the common backstop of last resort, does not involve fiscal transfers; rather the €60 billion of earmarked ESM funds would be used to acquire stakes in banks and would be fully recouped subsequently. Care has, thus, been taken to avoid fiscal transfers from one country to another. The same caution is evident in the arrangements governing the build-up and use of the private sector resolution funds; these are governed by an inter-governmental agreement, as it was feared that use of the Treaty could be challenged. Banking Union thus represents continued incremental progress towards fiscal union but does not require more than this to be a success.

• BANKING UNION PLAYED A CRITICAL PART IN RESOLVING THE CRISIS

In mid-2012, the euro area was in enormous difficulty and the issues were so big that Banking Union, on its own, could not solve them. The financial crisis was only resolved when three factors came into play, more or less simultaneously, viz., (i) the political decision that the euro would not be allowed to fracture with Greece exiting, (ii) the decision on Banking Union and (iii) the pledge by the ECB to "do whatever it takes" in the contest of its Outright Monetary Transactions (OMT) Programme. The complexity of the situation and the critical role played by Banking Union is captured in the following quotation:

> *"It is difficult to disentangle the respective effects of Banking Union, OMT, and reassurance against Greek exit on the reversal of market trend and 'positive contagion' that ensued. However, even if the succession in time does not imply causality, there are strong indications that the commitment of political leaders on Banking Union was a key factor in the ECB's decision to announce OMT. If such is the case, and even as the OMT announcement clearly had the most direct influence on market participants' perceptions and behaviour, then the decision to embark on Banking Union in late June (2012) can be seen as the true turning point of at least this phase of the European crisis."*[186]
>
> *Nicolas Véron*

Pragmatism was also a factor. According to ECB Vice President, Vítor Constâncio, the idea of launching the Single Supervisory Mechanism (SSM) was a consequence of the proposal that the European Stability Mechanism (ESM) could directly recapitalise weak banks, thus taking fiscal pressure off sovereigns. The reasoning was

186 European Banking Union: Current Outlook and Short-Term Choices, speech by Nicolas Véron, at the conference Banking Union and the Financing of the Portuguese Economy. Lisbon, February 2014.

that if the European level were to assume liability for European banks, it also logically had to assume control. It was only later that the concept of a fully-fledged Banking Union emerged, which would contain a Single Resolution Mechanism (SRM) and a possible Deposit Guarantee Scheme, subsequently postponed. The addition of the SRM was necessary; otherwise bank supervision would be centralised but bank resolution, i.e. the treatment of a failing bank, would remain national, which would give rise to impossible conflicts; for example, the ECB could declare a bank to be insolvent but it would then be up to the national authorities to effect the rescue from its own resources.

• BANKING UNION HAS ALREADY OVERCOME SOME MAJOR HURDLES

Some already think that the bank-sovereign doom loop has been broken[187] but we will only truly know that Banking Union is a success when it is put to the ultimate test – a failure of one or more banks without any knock-on impact on the borrowing costs of the sovereign(s) involved. To some extent, this has already occurred in that Portugal's second biggest bank, Banco Espírito Santo, failed and was resolved under the new bail-in rules over a week-end in early August 2014 with little or no impact on the creditworthiness of the sovereign. That experience was an important test of the new resolution rules, albeit that they were applied before the new regime came into full effect.

The comprehensive balance sheet assessment and stress tests were another major hurdle that had to be overcome before Banking Union proper could commence. Earlier stress tests in 2010 and 2011 had damaged credibility when banks that were deemed to have passed subsequently failed and/or had to be rescued soon afterwards. The ECB thus determined that banks' balance sheets would be rigorously tested before it took on responsibility for supervising them. Banks responded by raising more than €200 billion in capital and, in the event, only a few failed, mainly in Italy. Not all banks were tested, however, and there are residual concerns about the health of some smaller banks in the major countries. In addition, further improvements in bank capital ratios will be required as the fully-loaded Basle III rules come progressively into force by 2019. The positive outcome to the 2014 stress tests was critical to the successful start of Banking Union.

187 See, for example, the title of the recent IMF conference referred to earlier in this chapter: 'IMF Conference on Ireland - Lessons from Its Recovery from the Bank-Sovereign Loop' held at Dublin Castle, on 19 January, 2015.

• BANKING UNION IS A NECESSARY BUT NOT A COMPLETE SOLUTION TO THE FINANCIAL CRISIS

Apart from the general aim of improving the quality of bank supervision, thereby preventing future crises, Banking Union has two more immediate objectives, viz., (i) to break the vicious link or "doom loop" between banks and sovereigns whereby the weakness of one magnified the weakness of the other, and (ii) to reduce financial fragmentation which is reflected in greatly differing costs of borrowing across the euro area. The burden of these tasks was alleviated by the ECB's OMT Programme announcement. In effect, this took care of the first objective, at least for the time being, as it was followed by a virtuous circle as cost of borrowing by both governments and banks fell in tandem in the peripheral states, nowhere more so than in Ireland.

The second objective proved to be more intractable as SMEs in the periphery continued to face interest rates on new borrowing that were elevated by reference to those of sister companies of equivalent risk in the core countries. While such spreads remain elevated, the trend is positive, an indication the successful start of Banking Union is having a positive impact.

It is clear, none the less, that more needs to be done. The ECB has already recognised this by agreeing to implement quantitative easing (QE), i.e. printing money to boost economic activity. While that increases the supply of money it is of limited help if the problem is one of lack of demand, as increasingly appears to be the case. Governments, therefore, need to do more to stimulate activity but those which have the necessary fiscal scope are reluctant to use it[188].

• BANKING UNION WILL MITIGATE FUTURE BANKING CRISES

Critics of Banking Union focus on the perceived inadequacy of the common backstop, lamenting the fact that its small size rules out dealing with a systemic banking crisis in a large Member State. In other words, they feel that the modicum of fiscal union represented by the backstop is not enough but such a view fails to give due credit to the significant achievements that have been recorded and which are listed in Chapter 8.

The financial crisis was a "once in a century" type event. Enhanced fiscal governance, stricter supervision of banks and greater and better quality capital should mean that future crises will be of a lesser magnitude. However, if these were to fail and an equally devastating banking crisis to recur, it would not require the use of public

188 The Investment Plan of the new President of the EC is a step in this direction, albeit one that is likely to have a modest impact. It is designed to unlock public and private investments in the real economy of at least €315 billion over the three years 2015-2017.

funds. The Commission have calculated that, had the new arrangements been in place, only one failing bank would have had to resort to State aid between 2008 and 2010. It follows that a future crisis would have to be even more severe before public funds would be called upon.

The ESM's €60 billion Direct Recapitalisation Instrument (DRI), allied to national fiscal backstops, has been put in place in case of necessity. While the €60 billion is modest, less than one per cent of GDP, the total funds in the ESM are greater, of the order of 5% of GDP, and could be used to bail out banks indirectly. Even this, however, might not be sufficient were a big country like Italy to come under fire, as looked possible in mid-2012. Here, it should be recalled that the OMT Programme was designed for such an eventuality and it can be concluded that the Banking Union arrangements are sufficient to deal with all but the most extreme of crises and that mechanisms are in place to cater for more extreme eventualities.

• BANKING UNION WILL AFFECT COMPETITION AND BANK STRUCTURES

It is sometimes stated that the US and the EU took very different approaches to the crisis, with the EU saving most of its banks while numerous US bank failures were recorded but such a view underplays the fact that most failing US bank were very small – with the notable exception, of course, of Lehman Brothers. Banks in the Programme countries have, however, been heavily restructured and downsized under the EU State aid rules. Some, like Anglo Irish, INBS, Northern Rock and WestLB bank, were wound up. More generally, financial fragmentation saw banks retreat behind national borders, sometimes of their own volition but more often because they were encouraged by their supervisors to do so.

The result was a substantial downsizing of the banking sector. Bank staff numbers fell by 10% on average with double-digit falls being recorded in Belgium, Denmark, Estonia, Spain, Finland, UK, Greece, Ireland[189], Italy, Lithuania, Latvia, Netherlands and Romania. The number of EU banks fell from 9,500 to 7,500.

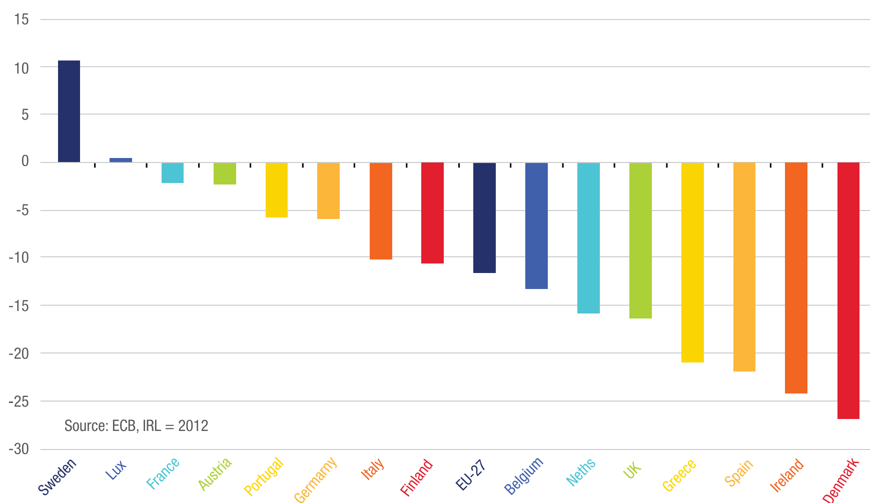
Cross-border banking activity took a big hit and is only slowly recovering. It is probably fair to say that as of now neither the banks nor their supervisors contemplate mergers and acquisitions. Instead, the focus is on recapitalising and on restoring profitability. Nevertheless, it is likely that this will change in time. While official pronouncements are sparse, there is general acceptance that Banking Union should be a catalyst for change not least because some of the opacity that has restricted bank comparability has been removed. Strict common supervision should, in time, cause

189 The number of jobs lost in Ireland exceeded 10,000.

banks to shed their fear of venturing abroad. Continued differentials in lending rates should prompt banks with lower cost of funding to seek opportunities elsewhere, most likely in the peripheral countries. How this will materialise is unclear. Local knowledge, customs and varying legal structures will continue to be important, militating against 'suitcase banking' on a large scale. There is a view in official circles that Europe remains overbanked[190] and that we can, in time, look forward to further consolidation.

> *"In fact, there is scope for further consolidation without reinforcing the so-called 'too-big-to-fail' problem and for reaping the benefits of efficiency-driven consolidation. The present weak profitability in the banking sector and the existence of over-capacity in certain areas of the European market suggest that some efficiency gains could be achieved"*[191]
>
> *Vítor Constâncio*

FIG 9.1 **BANK EMPLOYEES** **% change 2007-2013**



190 Is Europe Overbanked? Report by the ESRB Advisory Scientific Committee, June 2014.
191 Banking Union and European integration, speech by Vítor Constâncio, Vice-President of the ECB, at the OeNB Economics Conference, Vienna. ECB, May 2014.

• THE IMPACT ON IRELAND SHOULD BE LIMITED

The crisis has seen the Irish banking system undergo one of the most radical transformations imaginable, moving from one extreme to the other in terms of competition and size:

1. From 14 mortgage providers in 2006 to just 8 in 2015, with only two pillar banks;
2. From returns on equity of up to 15% to double-digit losses annually from 2009 to 2013;
3. From massive credit expansion to credit contraction and downsizing;
4. From loan to deposit ratios of up to 200% to half that percentage.

All the banks had to be rescued by the state and, Bank of Ireland apart, the remaining Irish headquartered banks are still predominantly state owned. Their foreign operations were sold off as part of the required downsizing. Their models were completely overhauled to deal with non-performing loans and to refocus on sectors other than real estate and construction. At the same time, they have major challenges in dealing with loss-making tracker mortgages and an SME sector, much of which is struggling with bad legacy property investments.

Ultimately, the test of the Banking Union is often said to be the extent to which it restores normality to banking transactions in the next few years. 'Normality', however, is hard to define: certainly a return to the situation that prevailed before 2008 seems unlikely. Then, the Irish Government could borrow at German sovereign rates – this set a benchmark for the banks - and Irish banks could borrow freely in the unsecured interbank market at abnormally low interest rates. In future, credit spreads for both governments and banks will likely be higher, reflecting local risk. Perhaps the more accurate desideratum is that borrowers of equivalent risk should face the same cost of credit, irrespective of their country of residence. While the successful start to Banking Union should result in further convergence, we remain some way from this goal.

This has negative connotations for banks in peripheral countries like Ireland where credit spreads are likely to be higher for longer. Banks at the centre should be able to fund more cheaply and lending opportunities should be greater in the periphery. The natural consequence is that they should begin to seek opportunities abroad as conditions normalise facilitating the consolidation process envisaged above.

Domestic control and management of the major banks, once a sacred policy cow, has had to be adapted with much of their former assets already in foreign ownership, more on the sales bloc and the Government's shareholdings likely to be sold to the highest bidder. In this context, it is likely that any future challenges posed by Banking

Union will be modest by comparison with the recent traumatic experience.
On the one hand, the Stability and Growth Pact and the Fiscal Compact should prevent any Irish government from pursuing the type of fiscal policies that characterised the pre-crisis period and exposed the Exchequer to a devastating collapse in income. That much seems certain. On the other hand, the Single Supervisory Mechanism should prevent banks from over-lending for speculative purposes and so incurring losses that destroy their solvency or put at risk that of the sovereign.

In short, barring unforeseen events and serious external shocks, Banking Union should provide for a period of relative stability in the banking sector which might endure into the medium-term. The fact that it is possible to speculate in these terms, and to do so with credibility, is an index of how much has been achieved by the very creation of a Banking Union.

• BANKING UNION IS STILL NOT COMPLETE

> *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."*[192]
>
> *Robert Schuman*

From the outset Schuman recognised that building Europe would be a gradual process and so, six decades later, it has proven to be and in this context Banking Union is best viewed as part of a process which will continue in the future.

Clearly, much remains to be done. First, there are the gaps and imperfections that arise when trying to reconcile the differing interests and systems of 28 countries. While EU banks now have common definitions of capital, non-performing loans and forbearance, as well as a common framework for supervisory reporting, differences remain which hamper the comparability of capital ratios. While most of these discretions are linked to the pace of phasing-in of the new Basle capital requirements and will gradually fade away, some will be in place for up to ten years, and some do not have a clear expiration date at all[193].

Secondly, the framework for recovery and resolution, is too complex. The BRRD leaves a number of areas for national discretion, which may still have an adverse impact on cross-border resolution. For instance, it does not make it mandatory to

192 The Schuman Declaration by French foreign minister Robert Schuman on 9 May 1950 proposed the creation of a European Coal and Steel Community, whereby France, West Germany, Italy, the Netherlands, Belgium and Luxembourg would pool coal and steel production.
193 They involve deductions from common equity – e.g., goodwill, deferred tax assets, prudential filters on AFS (available for sale) gains and losses – and other technical details such as the calculation of Basel 1 floors.

reach a joint decision on the resolution plans for cross-border groups and resolution authorities can thus still decide to follow a non-coordinated approach. While the revised State Aid rules are designed to ensure a level playing field, there is a risk that such flexibility may be used to engineer a degree of "home bias" in recovery and resolution decisions, thus leading to resolution procedures that are not truly uniform.

Thirdly, there are the wider issues relating to the Treaty. Banking Union was shoe-horned into the Treaty and it is conceivable that some of its elements may well be challenged before the European Court of Justice. The ECB was by no means an ideal candidate for the Single Supervisor and some of the artefacts designed to circumvent this may be challenged or may prove to be wanting. The construction of the Resolution Mechanism was even more complicated and, in the end, its financial mechanism was concluded by means of an Intergovernmental Agreement outside the Treaty. There is, however, agreement in principle to revisit the issue which will probably involve an amendment of the Treaty framework. It is not even certain that the ECB should be the Single Supervisor in the long run as the EBA seems better suited to this role in lieu of the more minor role it currently plays.

Fourth, advances will be necessary in other areas. The Single Market in financial services, in particular, has yet to be completed, while the Banking Union is but the start of a process. Moreover, the common deposit insurance scheme, which is the third pillar of the Banking Union still has to be agreed, even if it is not strictly necessary in the short term.

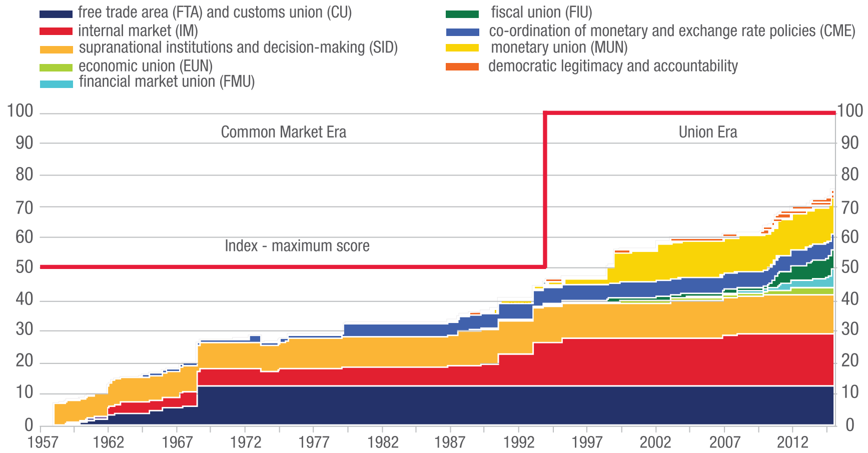
Finally, capital markets are arguably not integrated enough to provide deep and evenly distributed funding across the European economy as a stable complement, if not an alternative, to bank funding on which Europe relies to a much greater extent than elsewhere – this is a priority item on the agenda of the new Commission.

The ECB has recently calculated an Index of Regional Institutional Integration.[194]

As they see it, the job is about three-quarters done. The introduction of the single currency in 1999-2002 was a major event, which caused the overall index to jump from 48/100 to 58/100. The response to the recent crisis has been responsible for a further jump to 76/100. Clearly, there is more to do. According to the ECB, the main areas where further progress is needed include the economic and fiscal spheres, as well as the necessary political adjustments to ensure appropriate legitimacy for such integration. While the monetary union is judged to be almost complete, EMU scores about 70/100, economic union is down around the 20 mark.

194 Occasional Paper 160, The four unions "PIE" on the Monetary Union "CHERRY": a new index of European Institutional Integration, ECB, February 2015.

FIG 9.2 **EUROPEAN INDEX OF REGIONAL INSTITUTIONAL INTEGRATION (EURII)**



CLOSING THOUGHTS

The path to Banking Union has been surprisingly fast at times and tortuous at others. It is the way Europe progresses, and as was foreseen by Monnet. He understood that great change was only undertaken as a response to crisis. As a result of the responses to the financial crisis, those concrete achievements that Schuman foretold have reached a point that would not have thought possible (or indeed necessary) a few short years ago.

That so much has been accomplished in a relatively short period bodes well for the future of that *de facto* solidarity he regarded as the very foundation of the new Europe. It also highlights the primary role to be played by national governments in determining the pace and the direction to be followed for they remain the masters of the Treaty, particularly where economic and political union is concerned. Despite many understandable misgivings on the part of observers, the most concrete achievement of the Member States over the past decade has proven to be a functioning, if incomplete, Banking Union.

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