Progress on the second pillar of the Banking Union: The Single Resolution Mechanism

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The EU is currently discussing draft legislation on the creation of a Single Resolution Mechanism, which along with the proposed creation of a new Single Supervisory Mechanism, would constitute the two main pillars of the Banking Union. Negotiations are progressing slowly and given political considerations, we expect further changes to be introduced prior to the Directive's final approval.

The existence of a Single Resolution Mechanism for banking crises would ensure the absence of any competitive distortion in this area within the single market. Its main objective would be to ensure efficient resolution, under the Single Supervisory Mechanism, of a bank that was facing serious difficulties, with minimal cost to taxpayers and the real economy. Although the EU decision process tends to be slow and complicated, it seems that over the next year, the mechanism should be operational.

Introduction

The European Commission (EC) proposed on July 10th a Single Resolution Mechanism (SRM) for banking crises as part of the so-called Banking Union (BU), that resulted in draft regulation, COM (2013) 520. The proposal will undergo the usual co-decision making procedure, which entails approval by the Council of the European Union (EU) and by the European Parliament. Ideally, this should be completed prior to the European Parliamentary elections, scheduled for mid-2014.

The SRM, which has been configured as something more than a network of national resolution authorities, like the FROB (Fund for Orderly Bank Restructuring) in Spain, is a necessary complement to the Single Supervisory Mechanism (SSM). The latter was still pending final approval as of early September 2013. The two mechanisms will apply to banks in the Euro-Area, as well as banks in other EU countries that voluntarily join them[2].

The two pillars, SRM and SSM, would constitute the BU, as shown in Exhibit 1. There has been talk of a common deposit guarantee fund, but this subject has not become a pillar in its own right in the EU. Nevertheless, as shown in the exhibit and discussed later herein, it is in someway contemplated given its implicit link to the SRM.

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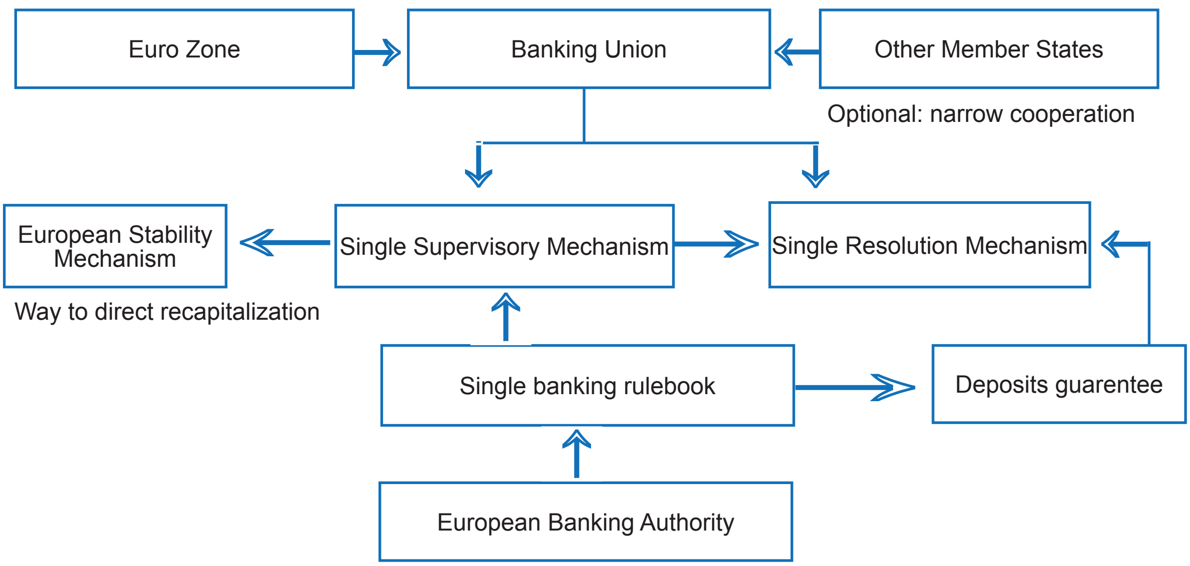
[2] Estimated total of some 6,000 banks.

Exhibit 1

The European Banking Union



Source: Afi.

The BU seeks to break the negative feedback loop been sovereign and banking risks in the monetary union and to eliminate fragmentation and the resulting distortions due to differing financing conditions of economic agents depending on their country of origin. Logically, such conditions are worse for the weakest countries, such as Spain.

The legal basis used by the EC to implement the SRM is Article 114 of the Treaty on the functioning of the European Union (TFEU), the objective of which is to harmonize the laws of EU countries with a view to the functioning of the single market. This prevents the need to reform the Treaty, in line with the requests by countries such as Germany, but also has some limitations.

Relationship with resolution directive

The SRM is based on the Bank Recovery and Resolution Directive, COM (2012)280, which is currently under negotiation in the co-decision making procedure between the Parliament and Council of the European Union, and it would apply throughout the EU. The directive would create a single rulebook on bank resolution to ensure against any competitive distortions in banking in the single market[3].

The directive acquired particular significance during the crisis in Cyprus in relation to guaranteed deposits (up to 100,000 euros) in the resolution of banking crises, leading to negotiations in the EU Council whose results are reflected in the

[3] It could be argued that non-participation in the centralized resolution mechanisms could be a competitive disadvantage, but the decision would be a voluntary choice for countries.

SRM proposal. mainly in Articles 15 and 24.3, as detailed below:

1) Precedence of liabilities (descending order) for purposes of internal recapitalization:

- Ordinary capital.
- Additional capital (tiers 1 and 2).
- Loans of senior executives and directors.
- Other subordinated loans.
- Non-preference and unsecured loans.
- Other unsecured deposits and loans of deposit guarantee systems.

2) Liabilities excluded from internal recapitalization, no specific order of priority:

- Guaranteed deposits.
- Other guaranteed liabilities[4].
- Liabilities arising from customer assets or money or from a fiduciary relationship.
- Interbanking liabilities, excluding institutions in the same group, with original maturity of less than seven days.
- Liabilities arising from participation in a payment or securities settlement system with a remaining maturity of less than seven days.
- Liabilities to employees for wages, pensions or fixed remuneration and, in some cases, variable remuneration.
- Trade payables for essential goods and services for daily operations.
- Tax authorities and social security.

To comprehend the novelty and complexity of these matters from the perspective of Spain, we might consider the law currently in force in Spain on bank resolution, law 9/2012, which does not envisage recapitalizing unsecured deposits, as we have upheld with a degree of insistence, in order to not harm the funding of banks, and it does not contain the same level of detail we have just seen.

The SRM is also subject, under the same directive, to minimum equity and eligible liabilities, in principle, of 8%. This is to enable internal recapitalization to function, although this liability level will be set in the SRM later by the Single Resolution Board mentioned below, pursuant to Article 10 of the proposed regulation. Based on the aforementioned general levels, the balance sheet data to March 2013 of the largest institutions adjusted for capital injections, hybrid management processes under way and asset sales, we may conclude, as shown in Exhibit 2, that only three

Exhibit 2

Distribution of Spanish banks by ratio of net equity and subordinated debt to total liabilities

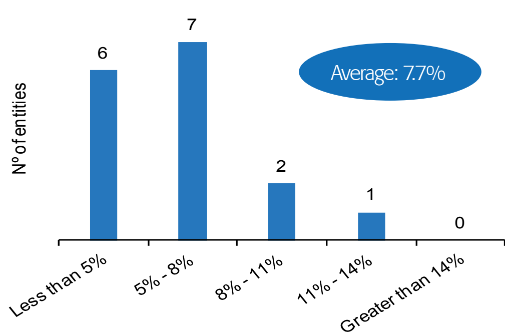
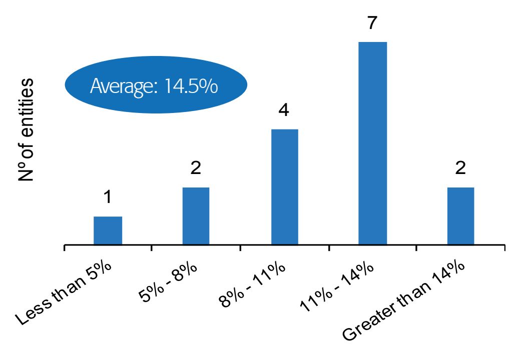


Exhibit 3

Distribution of Spanish banks by ratio of net equity, subordinated debt and senior debt to total liabilities



Sources: Afi, Bank of Spain, CECA, AEB, AIAF, Bloomberg.

[4] Such as *cédulas hipotecarias* [covered bonds] in Spain.

institutions are capable of absorbing that level of losses without affecting other liabilities, assuming a total depletion of funds. In other cases, at least senior debt would be affected.

With regard to senior debt, Exhibit 3 shows that only three banks would need recapitalization of at least part of the unsecured deposits.

The point of this exercise is merely to estimate the possible effect of the new regulations, including the SRM, on resolution in the Spanish banking system. It shows that, although this is currently an open subject for the reasons discussed above, it may still have a significant impact. It is not surprising that the resolution of banking crises requires seemingly complicated processes, as the clear purpose of both laws is to minimize the cost of banking crises for the public sector. This would, inevitably, allocate the cost to the shareholders and certain creditors of the banks. We must also bear in mind that the resolution of a bank crisis is generally considered preferable to liquidation of the bank, an option that is always open, but under insolvency law.

According to the calendar established by the European Council on June 27-28th, 2013, the SRM is to be implemented from January 1st, 2015, along with the Bank Recovery and Resolution Directive. In both cases, internal recapitalization would be postponed to January 1st, 2018.

In the meantime, national resolution regimes would remain in force. The EC states that such regimes would have to progressively converge owing to the aforementioned allocation of losses to shareholders and other eligible creditors. This shift would be reinforced by the following:

1) Changes in rules governing State aid to banks adopted on the same date as the SRM. See *Banking Communication*[5] entering into force from August 1st, 2013 and replacing that of 2008.

2) Possible direct recapitalization by the European Stability Mechanism (ESM).

Functioning

According to the EC proposal, the SRM would function through execution of the following steps:

1) The European Central Bank (ECB), as supervisor, would decide when an SRM bank is facing grave financial difficulties and should be resolved.

2) A Single Resolution Board (SRB), composed of representatives of the ECB, EC and national resolution authorities, would prepare the resolution of the bank, with broad powers to analyze and define the appropriate approach for doing so. The affected national resolution authorities would be closely involved in this task.

Following a parallel path to the SSM, specifically to the ECB Supervisory Council, SRB members would be appointed at the highest political level by the EU Council, subject to the approval of the European Parliament. The SRB would be accountable to both institutions, and would even have to report on its activities to the national parliaments of participating countries.

The SRB would function in plenary and executive meetings. The latter would handle the resolution of specific institutions, in which only the involved national authorities would participate. For cross-border groups, all host authorities would have a single aggregate vote in order to reflect the greater responsibility of the origin authority, which would also have a vote.

3) On the basis of the SRB recommendation, or through its own initiative, the EC would decide if and when a bank would undergo

[5] Communication from the Commission on the application, from August 1st 2013 , of State aid rules to support measures in favor of banks in the context of the financial crisis (“Banking Communication”), published in the DOUE C 216 of July 30th 2013.

resolution and it would define a framework for the use of resolution instruments.

The EC's explanation for this is that a resolution decision could only come from an EU institution[6]. Leaving aside political and legal institutions, only

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the ECB and the EC remain. However, as the former acts as supervisor, it should not play this role owing to the conflicts of interest involved. Further, the EC is not only free of any conflict of interest, but is also considered to have sufficient experience in the matter, given the role it has played in bank restructuring in the present crisis.

In our view, it would be preferable to develop a European resolution authority with sufficient power to exercise its functions autonomously, although we believe this may require a reform of the TFEU. Hence, in the meantime, this role can be played by the EC. Indeed, European supervisory agencies like the EBA function subject to the approval of the EC with regard to technical rules, apart from the ex-post-facto oversight of the EU Parliament and Council.

4) Under the supervision of the SRB, national resolution authorities would be responsible for executing the resolution plan, which is entirely necessary, bearing in mind the national laws that may apply, such as general commercial law and insolvency law. At the same time, it reveals the limitations of the EC in this field, despite what we have stated above.

If one of the authorities should fail to comply with an SRB decision, the board may directly issue executive orders to the affected banks.

5) A Single Bank Resolution Fund (SBRF) would be established under the control of the SRB in order to ensure the availability of medium-term financial assistance for the restructuring. It would be financed from contributions by banks, and it would replace national resolution funds, although it remains to be seen whether countries with the largest contributive capacity would accept such a plan.

Given that the majority of the resolution cost is to be borne by shareholders and other creditors, under burden sharing rules, the role of the fund would be to provide financial backing where its absence could harm the credibility of resolution processes.

As we can see, the SRM has a lighter structure than the SSM, but this is natural: while supervision is an ongoing task that affects each of the involved institutions on a daily basis, resolution tends to be occasional and is only required when a bank has serious problems.

Funding

The initial funding of the SBRF is based on bank contributions to be made over a large number of years: in principle, 10, but extensible to 14[7], to avoid immediately affecting a bank's profitability and lending capacity. In fact, this funding is already envisaged in the recovery and resolution Directive.

In principle, the SBRF's target is 1% of the guaranteed deposits of all participant countries in

[6] For this reason, the EBA, European Banking Authority is excluded, apart from possible conflicts of interest, as it is an agency, as is the SRB.

[7] If the fund makes payouts greater than half the target figure during the process. If this were to occur, banks may have to make minimum contributions of ¼ of the fund target.

the BU. Based on 2011 figures, this would mean a total of 55 billion euros, which is not too large a figure, in view of the cost of the current crisis not to the EU as a whole, but in a country like Spain, where State aid committed in diverse forms of capital between May 2009 and early September 2013, amounts to 61,366 billion euros[8].

It is possible that these contributions will be viewed by some countries as a form of banking tax. In such a case, the unanimity rule for fiscal affairs in the EU would apply, which would clearly complicate matters.

Not all banks would participate in the same way, but rather in accordance with their business models and risk profiles. Details would be determined by further implementing regulation, apart from the content itself of the directive.

The Single Bank Resolution Fund would be funded in the amount equal to 1% of the guaranteed deposits of all participant countries in the Banking Union.

Countries with national funds that would be replaced by the SBRF may choose to have such funds make contributions for their own banks until the national funds are depleted, but this would assume that they have sufficient available funds, which will not always be the case, as seen in the current case of Spain.

The functioning of the SBRF would also be funded from the contributions by banks other than those of the SRM, but never by countries involved or by the EU budget. It would be similar to the SSM.

In no case would the SRM have the legal capacity to oblige countries to provide additional State aid for bank resolution. The budgetary sovereignty of member states is a principle that limits the effectiveness of such mechanisms, as it does of European supervisory agencies, such as the EBA.

Deposit guarantee

With the SRM, it seems that the EC considers the BU to be complete and has not proposed a common guarantee fund. Nevertheless, the proposed directive under negotiation since 2010 would allow deposit guarantee funds or systems of different countries to provide financial assistance to each other in the form of loans.

It must be recalled that the Bank Recovery and Resolution Directive obliges such funds or systems to contribute to funding resolution to the extent corresponding to them in guaranteed deposits for deposit losses if the bank is liquidated under insolvency law. That is, deposit guarantees cannot be simply separated from the resolution of banking crises.

If necessary, the SBRF may provide financial assistance to a deposit guarantee fund or system.

Cross-border groups

In line with single market rules, a quite important principle is that such groups cannot discriminate among creditors according to their member state of origin.

In groups that contain institutions based in countries both inside and outside the BU –for instance, in Spain and the United Kingdom– the SRM would not apply, but rather general rules, such as those of the board of resolution authorities or intermediation between them by the EBA, which are envisaged in the aforementioned directive.

In groups that operate in third countries, the recovery and resolution directive will be taken into

[8] See the press note of the Bank of Spain of September 2nd: http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/Briefing_notes/es/notabe02-09-2013.pdf

account. The SBRF can enter into non-binding agreements with the authorities of third countries on behalf of national authorities.

Conclusions

The SRM once again shows that decision-making processes in the EU are too often slow and complicated to be sufficiently effective in solving the problems they are meant to tackle. We must recall, as the recent history of banking crises in Spain and other countries has shown, that resolving such crises is frequently a dynamic and complex process.

This fact, which helps one understand the gradual approach the EU often takes in dealing with the current crisis, also shows that all the elements used to act in solving problems are somehow mutually related. Hence, this gradual approach is not always the most appropriate.

Nevertheless, and until it is proven otherwise, good progress is better than none at all. Accordingly, we positively assess the upcoming implementation of the SRM, although we have yet to see the obstacles it will encounter or its final form.

The latter point is due to the fact that some member states, especially important ones like Germany, have stated their opposition to the EC proposal. Therefore, we cannot assume that all the fundamental provisions will be approved as drafted.