RESEARCH

Regulation Flash

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Economic Analysis

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Green light to Single Resolution Mechanism

Deal ensures needed credibility and continuity of banking union project

After a record 17-hour negotiating session, the Council and the Parliament finally reached a provisional agreement on the Single Resolution Mechanism (SRM). The outline of the agreement was presented in a press conference by the Parliament this morning and the Presidency has submitted it to Member States in order to get their final approval. Member States are expected to endorse the agreement on 26 March (in Coreper) and the Parliament will vote on 15 April. In parallel, the final text of the Intergovernmental Agreement will be agreed and presented in the coming days.

Who will take the resolution decisions and how?

A bank will be placed in resolution only after the ECB determines that it is about to fail, and the Single Resolution Board ("The Board") decides that there are no private alternatives to resolution and that such resolution is in the public interest. Once the Board communicates a resolution plan to the Commission (EC), the EC has 12 hours to react if it does not agree with it. In that case it may ask the Council, after due reasoning, to (i) veto the resolution if it is not in the public interest, or (ii) materially change the amount of money that would be used from the Fund. The Council has 12 hours to decide upon the EC proposal, and if it accepts it (acting by simple majority) the Board then has 8 hours to amend the resolution plan. If no objection is raised by either the Council or the EC within 24 hours, the Board's original plan will be adopted. Regarding the Board, most decisions will be taken by its Executive session, composed of a chair and vice-chair, four independent members appointed by the Council and the national resolution authorities of the countries involved in the resolution file. Only when the resolution plan requires tapping more than €5bn from the Resolution Fund will the Plenary session (where all countries have a vote), and always upon express request from at least one of its members, be able to veto or amend the Executive proposal. In this calculation, any money used for liquidity purposes will only count for half of its value. Therefore, up to €10bn with liquidity purposes, the decision would be taken by the Executive. When the accumulated use of the Fund over the previous 12 months reaches the €5bn threshold, the Plenary will be allowed to step in to give the Executive guidance on future resolution decisions.

How will resolution costs be covered?

There will be a Single Resolution Fund ("The Fund") in place from 2016, composed of national compartments. The Fund will be built-up from contributions of banks in eight years. It has an ex-ante capacity to cover resolution funds of €55bn. Banks' contributions will be determined by the Council in the coming months, in line with the BRRD and on the basis of riskiness and overall significance for the banking sector. Regarding the mutualisation of costs, that will also be completed in eight years (40% first year, 20% second year, then increasing by 6.6% annually), reaching 60% in two years. The sequence of bearing resolution costs will be as follows:

- **Step 1.** The national compartments of the affected host and host Member States would be used in the first instance to cover the resolution costs remaining after the bail-in

- **Step 2.** If this is not enough, then a portion of all compartments (including those of the concerned Member State) would be used.
- **Step 3.** If still insufficient, any remaining funds of the concerned compartments would be used

Overall, this design represents a substantial improvement over the Council's December agreement, as it not only shortens the transition period but also guarantees a significant pooling of European private contributions in the first two years.

What if the Fund's existing money proves insufficient to cover the cost of a resolution process?

The Fund will be able to rely on a private loan facility to borrow funds when needed, to cover any residual resolution costs since 2016. The details of this credit are not yet defined (for example, regarding the collaterals to be used) but the SRM text calls on both the Council and the Board to establish such a facility in due time (i.e. by January 2016 at the latest). There will be no public guarantee or support for the time being in terms of collateral here, so we assume that the Fund will be borrowing funds, using the banks' future contributions as collateral.

Assessment of the agreement

- **Positive for the eurozone, positive for Europe.** We welcome the agreement. It is a milestone in the European integration project. It will contribute to reinforcing the integrity of the euro, to the credibility of the European banking system and ultimately to underpinning the real economy.
- **Unthinkable only a few years ago.** The progress achieved in a very short period is extremely significant. Both the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism agreed today represent the greatest transfer of sovereignty to the European level since the creation of the euro.
- **A more European SRM than expected only days ago.** The final outcome is less dependent on national interests for two main reasons. First, the role of the Council and the Plenary Board has been considerably limited. Second, the mutualisation is quicker and higher, which is positive to breaking the link between sovereign and banks. The achievement of 60% mutualisation in just two years, vis-à-vis the 20% initially supported by the Council, significantly enhances the credibility of the Fund and ensures the risk-pooling of European private funds since the very beginning.
- **Timely delivery.** The deal has been struck under severe time constraints, as the last Parliamentary plenary session of the current legislature is scheduled in four weeks (15 April). This ensures that the SRM package will be enacted before the ECB fully takes on its supervisory responsibilities over the eurozone banks, in November 2014. The resources of the single resolution fund will be used only after the legacy asset issue is solved at the national level, and on the basis of the results of the ECB's comprehensive assessment.
- **The uncertainty on the backstops should be urgently dispelled.** Further work is needed regarding the strengthening of the financial firepower of the Fund. The inclusion of a credit line is an important step forward, especially when assessed in combination with a swift mutualisation. However, the absence of a common public backstop could undermine the credibility of the SRM and jeopardise the positive stabilisation effects expected from banking union. We expect that the finalising of the ESM direct recapitalisation rules in May will ease market concerns in this sense for, even if it will not act as a public common backstop to the Fund, it will have the potential to directly assist a bank in difficulties in a stress country, without taking their sovereign to the abyss.
- **Further pressure for banks.** The shortening of the build-up period for banks to contribute to the Fund will put additional financial pressure on banks results, which are already subject to significant regulatory costs and constraints. Nonetheless, the discussion on the

design of contributions has been postponed to a future implementing act by the Council (in the BRRD context).

- **This is not the end of the road**. Further work is needed. Banking union is a necessary condition to stop the problem of increasing fragmentation, but is insufficient on its own. Further progress is needed in the economic, fiscal and political union.

Looking forward

- **Intergovernmental agreement:** Despite having been a central element in the negotiations, most key details of the Single Resolution Fund (i.e. the build-up and mutualisation transition profiles) will not be included in the SRM Regulation text, but rather in an Intergovernmental Agreement to be signed by the Member States. The final IGA text is expected to be finalised soon, and its enactment also requires endorsement by all the national parliaments. The chances of any negative surprises on this front are low considering today's agreement, which officially concerns the SRM text but in fact also relates to the key elements of the IGA.

- **SRM text:** Parliament will take its final plenary vote on 15 April, and after that the final Council endorsement will be required. Meanwhile, the agreed text will undergo the usual final review by the EU legalists before being published in the Official EU Journal (after due translation into the 28 official EU languages).

- **ESM direct recapitalisation:** This would be a new tool for the European Stabilization Mechanism, to directly recapitalise ailing banks in stressed sovereigns, and would be available once the single supervisor becomes fully operational (November 2014). The Eurogroup already agreed on draft rules for the direct recapitalisation tool in June 2013, and is expected to finalise them this May, in its next meeting. At this moment there some uncertainty remains as regards the future role that the ESM might play in bank resolution. It is expected that it will be available as a very last resort measure, to recapitalise banks that are found to be in a very poor condition after the AQR/Stress test exercise (see below), but this has not yet been confirmed. On the other hand, once the single supervisor is launched, it is assumed that the ESM could again play a pivotal role as a last resort public backstop, but again this has yet to be decided by EU leaders.

- **Legacy issue:** The ECB is now embarked on a comprehensive assessment of the health of the Eurozone banks that it will be directly supervising from November onwards. Those banks showing a capital shortfall as a result of the AQR exercise and/or the stress test will be recapitalised using private sources (markets and partial bail-in among others). If needed, public national sources would be tapped after all private solutions have been used, but applying for European aid is only foreseen as the very last resort measure (either through the sovereign or as a direct recapitalisation if EZ leaders agree, but in any case involving strong conditionality). The idea is thus to solve the legacy issue before even one euro of the Single Resolution Fund is used to resolve a European bank. From January 2016 on, any resolution of a Eurozone bank will be dealt with in the context of the SRM, which means that all significant decisions will be taken at the EU level, from the ECB's initial warning flag to the final SRB decision to trigger resolution (including, in between possible actions required by both the Council and the Commission as the ultimate resolution authorities).