



Chapter C: The Single Resolution Mechanism: credibility and continuity of banking union project

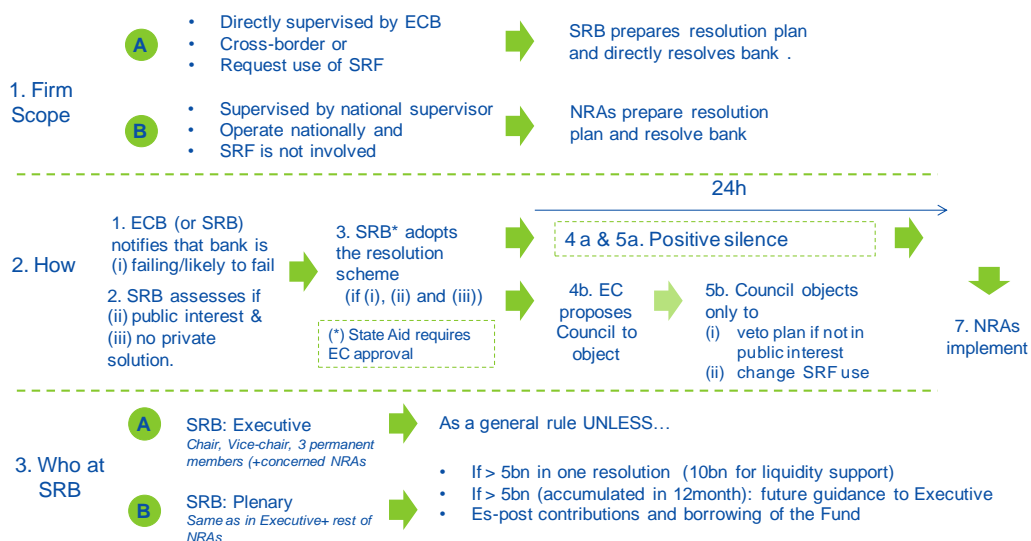
1. Introduction

The euro zone will have a Single Resolution Mechanism in place since January 2015, composed of a Single Resolution Authority, a Single Resolution Fund and a single set of resolution tools that will be fully aligned with the BRRD.

The SRM is the second pillar of banking union, an ambitious project that the EU leaders are taking forward at record speed in order to get Europe out of the crisis and restore financial integration. In this context, the SRM will complement the other key pillar of banking union, the Single Supervisory Mechanism (SSM), elevates banking supervisory decisions in the EU to the same European-centralized level as that of monetary policy decisions. Under the SSM the ECB will assume, from November 2014 on, full responsibility for the supervision of all euro zone banks and will directly supervise the most significant ones (around 130 banks).

Figure 11

SRM overview



Source: BBVA Research

The Single Resolution Authority will take on resolution powers since January 2016. From that moment on, whenever the ECB raises the flag for a given ailing bank, the Single Resolution Authority will step in to conduct resolution in order to preserve the public interest. Bank resolution will be conducted by a new Single Resolution Board, in which the national authorities of all participating member states will be represented. The Single Resolution Board will directly resolve significant banks, cross border EU banks and all banks which resolution required the use of the Single Resolution Fund. The rest of banks will be resolved by the national resolution authorities but the Single Authority will be able to step in at any time.

Resolution processes will be guided by the Bank Recovery and Resolution Directive (BRRD), which the Single Resolution Authority will apply uniformly across all countries participating in the banking union project. The Commission and the Council will have the power to change or veto the



resolution plan proposed by the Single Resolution Board, but they will have to do so quickly (24h) and generally owing to some pre-established conditions. There will be a private Single Resolution Fund with and ex-ante €55bn capacity at the disposal of the Authority in order to help cover resolution costs after having applied a bail-in over the bank.

2. What is the main purpose of the SRM and when will it be operational?

By introducing a centralized mechanism for banking resolution in the euro zone, the SRM will provide a credible counterparty to the SSM in resolution aspects. The SRM will also contribute to the Single Market in to different ways:

- Preserving the level playing field by ensuring a uniform implementation of the EU bank resolution rules (BRRD) across the SSM-area. The wide discretionality allowed in the BRRD does not sit well with the uniformity of rules that is required at the Eurozone level. The SRM will bring certainty and predictability on the application of the BRRD and the DGSD within the SSM, avoiding gaps arising from divergent national positions.
- Enhancing cross-border resolution processes in the EU. The Single Market needs to rely on an effective cross border resolution framework to ensure financial stability and avoid competitive distortions. In the SSM, the Single Resolution Authority would act in the interest of the whole area, facilitating the signature of Cross-border Resolution Agreements wherever needed.

The SRM Regulation was agreed in March 2014 and will be formally passed by the Council at some point along the summer. It will be officially published around September 2014 and will enter into force in January 2015. Still, the SRM will not undertake resolution action until January 2016 (along with the bail-in tool introduced by the BRRD). The SRM legislative pack also includes an Intergovernmental Agreement which rules the main aspects of the Single Resolution Fund and which is expected to be passed along a similar timescale as the SRM Regulation (assuming all Contracting Parties ratify it on time).

3. The decision-making process under the SRM

Most of the resolution decisions will be taken by a Single Resolution Board (SRB) although from the legal standpoint the ultimate resolution authorities are both the Commission and the Council. The SRB will meet in two different sessions. The Executive session will be composed of a Chair (appointed for a non-renewable term of 5 years), a Vice-chair, three independent members (appointed by the Council) and a representative from each National Resolution Authorities of the countries involved in the resolution file.⁷ The Plenary session includes all these members plus a representative from the national resolution authorities of the rest of countries participating in the SSM/SRM.

A bank resolution decision will be taken in less than a weekend (32 hours) in a process in which political interferences will be minimized to the maximum extent possible. The decision-making process will be as follows:

⁷ There will also be one a representative from the ECB, one from the EC and one from the EU Parliament. These representatives will not have a vote.



- **Resolution trigger.** A bank will be placed in resolution only after the ECB determines that it is about to fail, and the Board decides that there are no private alternatives to resolution and that such resolution is in the public interest.
- **Approval of resolution plan.** Once the SRB communicates a resolution plan to the Commission, 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.
- **Council (potential) action.** 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.
- **Potential Plenary involvement.** Only when the resolution plan requires tapping more than €5bn from the Resolution Fund (or twice this amount if it is used only for liquidity purposes) will the Plenary session, (and always upon express request from at least one of its members) be able to veto or amend the Executive proposal. 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.

4. How will the Single Resolution Mechanism be funded? Will there be appropriate backstops?

On the funding front, there will be a Single Resolution Fund ("the Single Fund") in place from 2016 on. It will therefore not be used in the context of the recapitalizations associated to the legacy assets.

The Single Fund will be composed of national compartments and will be built-up from the individual contributions of banks in an eight-year period, when it will reach an overall ex-ante capacity to cover resolution costs of €55bn. Banks' contributions will be determined by the Council in the coming months, in line with the BRRD principles and on the basis of riskiness and overall significance for the banking sector. Full mutualisation of costs will also be achieved within an 8-year period but reaching 60% already in the second year (40% first year, 20% second year, then increasing by 6.6% annually). The sequence for bearing resolution costs will be as follows:

- **Step 1.** The national compartments of the affected host and host Member States would be used first in order 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

Since 2016 the Fund will be able to rely on a private loan facility in order to borrow funds when needed to cover any residual resolution costs. 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, so it is assumed that the Fund would be borrowing funds, using the banks' future contributions as collateral.



Overall, this design represents a substantial improvement over the Council's December agreement, as it not only shortens the transition period but also enhances the credibility of the Fund and guarantees a significant pooling of European private contributions in the first two years (60%, vis-à-vis the 20% initially supported by the Council). This is very positive to breaking the link between sovereign and banks.

The €55bn overall capacity ex-ante of the Single Fund has been criticized for being too low. However, it is important to keep in mind that the Single Fund would be used as a private backstop, after an 8% bail-in has already been applied to cover the capital gap, in line with the BRRD. Moreover, a cap of 5% of the banks liabilities would apply in the use of the Single Fund (again in line with the BRRD) which makes it extremely unlikely that the Fund might get depleted prematurely (indeed this sum would have been sufficient to cover losses in most of the recent banking crises in Europe, according to the EC). Finally it must be recalled that the €55bn refer to an ex-ante target level and that ex-post financing mechanisms are also foreseen to increase the firepower of the Single Fund in case of need (ex-post contributions, private loans from the markets or a credit facility).

Even if extremely unlikely, the scenario under which the Single Fund needs to raise extra resources ex-post or even resort to a public backstop cannot be fully discarded, be it because the 5% cap has been exceeded or because the Single Fund has run out of funds. In this sense, the lack of details regarding the loan facility that the Council and the EC shall establish by 2016 introduces some elements of uncertainty that should be dispelled as soon as possible. Moreover, the absence of a common (European) public backstop until 2026 is clearly a weakness as it somehow undermines the credibility of the SRM and could eventually jeopardize the positive perceptions about the stabilization effects anticipated from banking union. During the ten-year transition period a bridge financing will be available either from national sources, backed by bank levies, or from the ESM in line with existing tools, which points to a potential significant role to be played by the ESM direct recapitalization tool.

FSB Key
Attributes

BRRD

SRM

US SPE
approach

US vs. EU

Box 3. Interlinks between the EU Resolution and Deposit Guarantee Funds

From the resolution standpoint, the Deposit Guarantee Scheme Directive (DGSD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) Regulation include interlinked elements that are related to the procedures and financing arrangements to be used in case of bank failure.

In this sense, EU Member States shall establish two types of financing arrangements. On one hand, the BRRD sets up the Resolution Fund to ensure the effective application of the resolution tools and powers that are needed to resolve a failed bank. Moreover, this fund is always used as a private backstop only after an 8% bail-in has already been applied to cover losses. On the other hand, the DGS reimburses a limited amount of deposits (up to €100,000) to depositors whose bank has failed.

When thinking about interlinks among these funds, four key questions arise to understand the connection between them.

Can the Resolution Fund and the DGS be merged?

Although the Resolution Fund and the DGS have different goals and may, in principle, be used at different stages of the crisis management process, the BRRD establishes that Member States may use the same administrative structure as their financing arrangements for the purposes of their DGS.

Nevertheless, in the Eurozone, the Single Resolution Fund will co-exist with its national DGS (until the single DGS pillar gets incorporated into banking union, which may require a revision to the Treaty and hence will take some years).

Figure 12
Institutional Resolution Scheme based on current regulatory framework (BRRD, SRM and DGS)

	In 2015	From 2016
Eurozone (EU-18)	Local DGS + Local RF (*)	Local DGS + Single RF (SRM)
Non-Eurozone	Local DGS + Local RF(*)	Local DGS + Local RF (*)

(*) Merger is possible in the same jurisdiction.

Source: BBVA Research

Could the contribution be replaced?

The BRRD states that contributions to the DGS shall not count towards the target level for resolution financing. Thus, the contributions would be at least 1.8% of total covered deposits (1% from the resolution fund contribution and 0.8% of the deposit guarantee scheme contribution).

Will the contribution for the Resolution Fund change between 2015 and 2016?

The calculation of individual contributions to the resolution fund will change for the banks in the eurozone, as in 2015 the contribution will be determined in proportion to the weight of the banks' adjusted liabilities (that is, net of shareholders' fund and covered deposits) with respect to the national total. However, from 2016 when the Single Resolution Fund is implemented, the individual contribution will be calculated *pro rata* to the relative weight of entities' liabilities vs. the total liabilities of the new system that comprises the banking union.

When will the resolution fund be used?

In the case of the DGS and national resolution funds, the mutualisation of funds is not feasible, but voluntary borrowing is allowed. So the DGS may lend to other schemes within the EU.

For banks, this new scenario implies new costs in the form of contributions to the new resolution fund and potentially higher contributions to the DGS.



5. Next Steps

- **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:** After Parliament's approval the text will be 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).