EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

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Resolution and Recovery in a European Banking Union

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Short- and long-term crisis management

It is unfortunate that European crisis management has become hostage to the negotiations to create a European Banking Union. Crisis management requires prompt action to allocate losses in asset values while the European Banking Union is a longer term project to enhance integration, efficiency and stability of financial markets and institutions. The solutions to the present crisis should not be made conditional on agreement with respect to controversial aspects of the banking union.

There is little doubt that there are potential benefits to be gained from a European Banking Union but its design must be carefully considered so as to avoid potentially serious unintended consequences. In particular, the introduction of the Single Supervisory Mechanism (SSM) in which the overall supervisory responsibility for the euro-zone banking sector is transferred to the ECB already in 2013 requires agreement within the EU on controversial economic, legal and political issues.

The rush towards a European Banking Union is motivated by the need to de-link sovereign crises from banking crises, notably in a country such as Spain. In this respect, the European Council decided on June 28-29 that recapitalization of problem banks directly out of the European Stability Mechanism (ESM) would be possible under the condition that an effective SSM has been put in place. This decision led to strong pressure to have the SSM operational in 2013. The European Council of October 18-19 reconfirmed this approach.

In the meantime, recapitalization of Spanish banks directly out of the ESM may have become less necessary due to the decision published by the ECB on September 6 that it will provide unlimited support to sovereign debt under the condition that the sovereign has agreed to a budgetary and reform package with the ESM. Spain is reportedly in the process of arranging such a package. Once such a package is in place, Spain should be able to recapitalize its troubled banks without triggering a severe confidence crisis in its sovereign bond market.

In the longer term there are substantial potential benefits from a European Banking Union but the implementation of its components (supervision, recovery and resolution procedures, and pan European deposit insurance) must be considered carefully from an economic as well as a legal point of view. The advantages of shifting responsibility for banking supervision from the national to the EMU level are that an

EMU supervisor can apply consistent standards across the union, conflicts of interest between national supervisors in host-and home countries of cross-border banks can be avoided, costs of dealing with several supervisors can be reduced, and “regulatory capture” of national supervisors by large systemically important financial institutions (SIFIs) on the national level becomes less likely. Furthermore, the de-nationalisation of supervision reduces national fragmentation of financial markets and improves the transmission mechanism for monetary policy within the euro zone.

A harmonised regime for recovery and resolution would reduce fragmentation further. Incorporation of bail-ins in the resolution regime would reduce the risk that excessive bank risk-taking creates sovereign risk. However, there are substantial hurdles to overcome before a common regime for recovery and resolution can be realized. In the short term, an agreement to implement recovery and resolution procedures on the national level should be sufficient from the perspective of short term crisis management. In the longer term, the issue of how to coordinate the role of the common supervisor with national recovery and resolution procedures must be solved.

Common resolution

A “*c*ommon resolution regime” is one of the three pillars of banking union as outlined in the Commission proposals of September 12, 2012. However, the proposals do not specify what common resolution implies. While it is generally accepted that common rules are required, there is significant disagreement on the structure (centralised or decentralised), authority and funding of the resolution authority.

In this statement we emphasise the importance of adopting harmonised rules and we advocate the adoption of a common framework empowering the ECB to enter resolution contracts with individual member states.

Common rules: The proposed directive of June 6, 2012 for bank recovery and resolution is the first EU hard law in the field of cross border resolution and insolvency. In principle, it is a very significant and positive development. One of its key components is incorporation of bail-in instruments. Bail-ins offer a way to avoid value destruction by keeping an institution as a going concern, which in turn provides the supervisory authority with viable alternatives to recapitalization of failing institutions.

Member States are not required to implement most of the directive’s requirements before 2015, whilst the deadline for bail-in provisions is pushed forward to 2018. In view of the critical role of resolution procedures for the supervisory authority to be effective and credible, the allocation of supervisory authority to the ECB without having resolution rules in force would create ambiguity with respect to the consequences of supervisors’ findings and recommendations. Therefore, the directive should implemented on the same time table as the SSM.

Institutional arrangements: The proposed directive for bank recovery and resolution is very vague on cooperation between the supervisory authority, i.e. the ECB and the resolution authority. There are two main reasons for this. One is a difference of opinion on whether there should be a single EU/EMU resolution authority or national resolution authorities. The second reason is that there are different views among Member states about the allocation of responsibilities between the supervisor and the resolution authority although there is agreement that supervisory and resolution authorities must cooperate closely.

The framework for crisis management must be clarified if the banking union is to achieve its objectives. In particular, while the ECB as supervisor will have powers for early intervention and withdrawal of licenses under the proposals, it may lack legal authority to act on its judgment. Thus, it is unclear how the transition from early intervention by the supervisor to crisis management by the resolution authority should take place. The ECB has no power to order national resolution authorities to take a bank into resolution.

Adapting the approach suggested for the fiscal compact, we advocate the empowering of the ECB to enter individualized 'resolution contracts' with each member state. The supervision by the ECB of any member state's banks can be made contingent on the signing of such a contract. The incentives of member states to enter such contracts would be strong because they would, in particular, facilitate bank recapitalization. Moreover, given the flexibility of the approach, there should be fewer objections to harmonized resolution on the EU level.