European Shadow Financial Regulatory Committee

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Preparing for a European Banking Union

Statement No. 37

Brussels, September 16, 2013

Five years after Lehman ... and still urgent problems to solve

Five years after the Lehman Brothers bankruptcy that contributed to the deepening of the financial crisis a European Banking Union seems more urgent than ever. The banking system in the euro area remains undercapitalized, fragile and fragmented. The lingering euro-zone debt crisis has amplified these problems and increased the urgency of coming to grips with both the fragmentation problem and the credit crunch hurting small- and medium-sized businesses. Without the instruments to allocate losses of banks to both shareholders and unsecured creditors, taxpayers in the euro zone are likely to bear the burden of losses. The fiscal capacity to cover these losses is limited in the crisis countries and taxpayers in other EU countries are unwilling to pay for a bill that must be counted in hundreds of billions of euros.

The banking union is envisioned as a remedy to these problems. It would create entities for supervision and resolution with authority and capacity to deal with the largest banks in the euro zone with a minimum demand for taxpayer involvement. The ‘too-big-to-fail’ problem would be addressed by the creation of a mechanism for resolution that would allocate losses to shareholders as well as unsecured creditors of the banks in a pre-determined and predictable order. This ‘bail-in’ mechanism would also alleviate the distortion of risk-taking incentives of banks with access to excessively cheap funding from creditors expecting to be bailed out.

The progress to the envisioned full banking union is slow for reasons that are easy to understand and entirely predictable. So far, there is agreement on the Single Supervisory

Mechanism (SSM) for the largest 130-150 banks in the euro area and other EU countries that will voluntarily join the mechanism. This is an important first step but without effective resolution mechanisms on the national or the EU level the objectives of the banking union cannot be achieved.

While the agreement that the ECB will become the single banking supervisor in the middle of 2014 is an important step, it is still not clear how to achieve the important objectives which the Banking Union is expected to reach. These objectives need to be addressed urgently but the EU´s Recovery and Resolution Directive sets a deadline of 2018 for national resolution mechanisms with bail-in provisions to be in place. In the meantime, there will be ambiguity with respect to the consequences of the supervisor's findings. In particular, bail-outs are likely to remain the rule for resolving large banks in distress or bail-ins will be ad hoc and politically tainted as in the Cyprus case.

According to press information from last week's meeting of the EU Ministers of Finance in Vilnius the final institutional form of the Banking Union and, in particular, the controversial question of which institution should be the common resolution authority were debated. This is an important question but it is not the most urgent one. More urgent, in our assessment, is another question: how can the agreement on the SSM be leveraged to solve the current urgent problems of fragility and fragmentation in the euro zone?

The three phases of Banking Union implementation

The implementation of the envisioned European Banking Union can be divided into three possibly overlapping phases. We consider it important to separate these three stages in the debate since their implementations involve different challenges.

The first phase is that of the preparation of ECB as the SSM for most of the banking system in the euro zone. A critical aspect of this preparation is the so-called Asset Quality Review. The ECB plans to execute this review during the course of the next twelve months.

The second phase is that of creating largely similar national rules for the restructuring and resolution of banks as envisioned in the Recovery and Resolution Directive. Several euro and EU countries lack bank resolution procedures and authorities completely. The urgency of implementing this Directive, or the creation of temporary intervention laws for banks allowing bail-in of unsecured creditors, is high since the results of the Asset Quality Review may lead to the identification of several problem banks, which must be either resolved (or bailed-out if no bail-in mechanism is in place). We argue below that this phase should begin before the Asset Quality Review is completed.

The third phase is that of creating a EU-wide or at least Eurozone-wide resolution regime, consisting of common rules and one common implementing institution. The disagreements about this phase are substantial and it may require a Treaty change. Nevertheless, the implementation of the first two phases must be done with the ultimate objectives of the Banking Union in mind.

Phase 1 and 2: the Asset Quality Review (AQR) and national resolution and recovery procedures

It is clearly important for the ECB to have a clear view of the strengths and weaknesses of the banks, particularly the large ones, when it takes over the responsibility for supervision in 2014. Having a sound informational basis is evidently important for a supervisor that needs to be taken seriously. Moreover, it would be detrimental to the reputation of the ECB in its new supervisory role if a major bank would collapse only shortly after it has taken on its new role.

The AQR is likely to have consequences. It is possible and not unlikely that the review reveals that many banks are in a worse condition than it is generally believed. If so, steps must be taken to write off asset values and/or increase their equity capital. Some banks may have to be closed down or resolved in such a way that contagion effects are minimized. At present, the ECB is not in a legal position to request – and enforce – measures to alleviate such situations. Thus, the ECB can find itself in the awkward position of starting its supervisory role with problem banks under its purview without the means to take effective action.

The ESFRC recommends that the effective implementation of resolution and recovery procedures, following a bail-in mechanism based on the Recovery and Resolution Directive or the adoption of a temporary intervention law, must exist when he results of the AQR become available. The ECB should not accept supervision of banks from countries without effective procedures. It lies in the strong interest of banks to be supervised by the ECB and, therefore, they can be expected to put pressure on national legislatures to act. The reputation effect for banks being shut out from ECB supervision can be strong.

In a previous statement, the ESFRC argued that the ECB should enter contractual agreements with national authorities for clarifying responsibility between the ECB as supervisor and the national resolution authorities. These contracts could include early intervention and appropriate actions on the national level to avoid actual failures. Furthermore, the contracts should include agreements that restructuring and possibly recapitalization must not amount to bail-outs of shareholders and unsecured creditors but follow agreed upon rules for bail-ins. As mentioned, the enforcement mechanism for the ECB would be the reputation effects for the banks of countries that violate the contracts.

Finally, we note the AQR should not be conceived and implemented in the narrow sense that the term “asset quality review” suggests. The quality assessment should also address the viability of a bank’s business model and its governance structure.

The issue of complex and cross-border banks

An important lesson from the Lehman Brothers bankruptcy is that great value losses can occur in insolvency proceedings when there are jurisdictional conflicts and the financial institution is opaque. In the case of Lehman Brothers the bankruptcy of its US entities went relatively smoothly but the bankruptcy of its subsidiaries in several jurisdictions was costly and time consuming. The main reason why substantial and unnecessary losses occurred was that the legal organization of Lehman Brothers did not resemble its operational and functional organization. The operations of its legally separate subsidiaries were tightly integrated with the consequence that subsidiaries found themselves cash strapped when the parent went bankrupt. Assets associated with activities in one subsidiary could be booked in another subsidiary.

European cross-border banks are generally operating as subsidiaries in host countries in spite of close operational and functional integration. The host country banks operate as de facto branches in spite of being separate legal entities under host country jurisdiction.

The resolution of a cross-border bank in the EU will for these reasons encounter exactly the problems of Lehman Brothers if responsibility for resolution is entirely a national responsibility. The Banking Union in its complete form represents a remedy for this problem but in the phases before a Single Resolution Mechanism has become reality the Lehman problem will exist.

The Recovery and Resolution Directive requires national resolution authorities to address this issue but it offers no specific solution except that resolution authorities in host and home countries should cooperate. The conflicts among these authorities are not easily resolved, however, if the bank in distress is opaque and de facto organized as a bank with several branches.

The jurisdictional conflicts can be minimized with a requirement that host country subsidiaries must be operationally separable from a distressed home bank within 24 hours. New Zealand has such a requirement as a part of its Open Resolution Procedures.

The ESFRC recommends that the EU implements a 'separability' rule for the period before the Single Resolution Mechanism is in place. This rule would require that subsidiaries must be able to conduct its important functions within 24 hours after closing as a result of distress of the home bank. Without such a rule the complexity of resolving a cross-border bank may leave the authorities with no choice except a bailout. The separability includes information and risk-management systems, participation in payment systems, customers' access to deposits and clarity with respect to the booking and origination of assets and claims. Living wills can help prepare resolution authorities but without a clear separability requirement the jurisdictional conflicts are most likely inevitable.

Phase 3: Towards a European Resolution Authority

During the meeting of the EU Ministers of Finance there has been a lot of discussions on the question how a truly European resolution authority should be created. Important divisions exist between member states, also on the question of Treaty change and the question whether the European Commission should play an important role in the process.

The ESFRC thinks that it is unfortunate that a large part of the discussions has been focusing on this issue while urgent questions on the first two phases of implementation of the Banking Union are not yet answered and deserve urgent attention.