

## **European Shadow Financial Regulatory Committee**

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### **Legacy Problems as a Threat to the European Banking Union**

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**Statement No. 43**

*The planned recapitalization of Monte dei Paschi di Siena illustrates how national legacy problems may threaten the credibility of the single resolution mechanism and, thereby, the banking union.*

*In this statement, the European Shadow Financial Regulatory Committee recommends that the systemic risk exception for resolution of failing banks in the SRM must be specified more clearly to avoid that the exception becomes used to protect interest groups from bail-ins. Furthermore, we recommend that the European Stability Mechanism (ESM) should play a more prominent role as the fiscal backstop in resolution and recapitalization rather than national authorities in order to reduce political influences on resolution decisions.*

#### *Objectives of the banking union and the Single Resolution Mechanism (SRM)*

The banking union within the EMU was created to delink sovereign risk from banking risk, reduce fragmentation of the monetary transmission mechanism and to enhance market discipline on banks' risk-taking. However, since the perception has been that distressed banks' debt-holders will be bailed out market discipline has been weak.

The SRM as one pillar of the banking union plays an important role in that it should allow the closing of "zombie banks" and enable healthy banks to thrive without excessive risk-taking. Bail-

in rules have a prominent role in the SRM as well as in the Bank Recovery and Resolution Directive (BRRD) for the EU as a whole. The bail-in rules should allow a recapitalization and structural change of a failing bank without burdening taxpayers. To achieve these objectives the rules must be credible and the principles for the allocation of losses to creditors as well as shareholders must be predictable.

In its first statement in June 1998 the European Shadow Financial Regulatory Committee (ESFRC) emphasized the importance of allowing banks to fail at the expense of important groups of creditors. The BRRD and the SRM are welcome reforms from this point of view. As the ESFRC pointed out in a statement commenting on the SRM in November 2014, just after the ECB became the supervisor of the largest banks in the eurozone, weaknesses remain with respect to the credibility of the bail-in rules.

One weakness lies in the transition of a distressed bank from the ECB as a supervisor to the resolution board. The BRRD and the SRM state that the transition from early intervention under the authority of a supervisory board takes place when an entity is deemed to be “failing or likely to fail.” The main criterion for this event is that “extraordinary public financial support is required.” Under the SRM for eurozone countries a resolution scheme adopted by the Single Resolution Board (SRB) can be implemented only if there are no objections from the European Council and the European Commission.

The second weakness lies in the systemic risk exception that allows substantial leeway to keep a failing bank outside the resolution mechanism on the grounds that the prospects of bail-ins may have systemic consequences. This exception opens the door to publicly funded recapitalization with weaker bail-in conditions than those specified in the BRRD.

The BRRD allows the use of public funding for a precautionary recapitalization as an alternative to resolution when the bank complies with capital requirements but, nevertheless, requires recapitalization that cannot be obtained in private markets. The precautionary recapitalization in the eurozone requires the approval of the ECB as well as the European Commission. The former has power to put conditions for liquidity support while the latter must approve any state aid within the EU. Systemic risk considerations are important in this context.

### *The case of MPS*

It seems clear that the Banca Monte dei Paschi di Siena (MPS) at the end of 2016 qualified for resolution under the SRM based on the criterion in the BRRD that the bank required extraordinary public support to survive. Its non-performing loans were approximately 45 percent of its assets on a gross basis (about half of this on a net basis). The Italian government favored a public sector recapitalization to protect the unsecured debt holders, which to a large extent are households. Such a recapitalization violates in principle the EU's state aid rules.

In December 2016 the European Commission and the European Central Bank approved a recapitalization to the tune of €8.8bn with limited bail-ins of creditors. The bail-in amounts to 25 percent of junior institutional bondholders' while households would be protected against losses. The total value of the bail-in amounts to around 600m euros.

There is little doubt that the bail-in would have been substantially larger if the SRM had been applied. Thus, the ECB and the European Commission practiced forbearance when they allowed for recapitalization with such a small part funded by the bank's creditors.

The fear of systemic consequences of more widespread losses is understandable since a large part of the Italian banking system is under pressure from €350bn worth of non-performing loans and a large share of subordinated debt held by households.

However, the systemic risk exception under the SRM must not be used as an excuse to protect particular groups from losses. One must ask to what extent the forbearance practiced by the Commission and the ECB undermines the credibility of the SRM by creating the perception that the bail-in rules will not be applied fully. Recapitalizations with mild bail-ins may become the rule rather than the exception for European banks in distress. If so, the objectives of the SRM to eliminate the implicit subsidization of bank debt and to strengthen market discipline on risk-taking will suffer.

It is inevitable that a systemic risk exception from the application of bail-ins must exist. However, the conditions for systemic risk to be important enough to justify an injection of government funds must be defined more clearly to avoid that the exception becomes abused.

### *Legacy problems as a hindrance to harmonization*

The Italian banking sector shows how legacy problems in particular countries threaten to undermine the credibility of the SRM and, therefore, the harmonized rules for banking supervision and resolution. The diversity of legacies such as the non-performing loan problem in the Italian banking system may not have been taken sufficiently into consideration when harmonized rules and procedures were designed. On the other hand, the legacy problem must not be used by national politicians to succumb to short-term political pressures for bailouts.

Two reforms may reduce the tendency to use the systemic risk exception for political purposes. First, the criteria for systemic risk to be a valid justification must be defined with greater clarity as noted above. Second, we propose that the European Stability Mechanism (ESM) rather than national authorities should be empowered to provide funds to support bank recapitalizations under strict conditions.

### *National vs European fiscal backstop*

In the MPS case the Italian government provides the fiscal backstop. If, on the other hand, an EU authority like the ESM would provide the backstop it is likely to offer less forbearance than the Italian government. The ESM would be free from national influence activities in its determination of the need for public funding. It would be able to provide a backstop based on concern for systemic risk alone. Our argument is that the fiscal backstop on the European level will be able to impose more discipline on fiscal costs of bank bailouts.

### *The future of legacy problems*

Legacy problems can be symptoms of deeper institutional or structural weaknesses. For example, it is possible that the non-performing loan problem in the Italian case will appear again after some time unless governance structures and competitive conditions in the Italian banking system can be improved. In this case, it would be a mistake from both a European and a national perspective to focus exclusively on the short-term solution to the problem. Institutional and structural reforms on the national level are required to facilitate harmonized rules for resolution of banks.