COMMENTARY

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KEY POINTS

- **The recent agreement between the European Parliament and the European Council on the SRM completes the banking union.**
- **It is a clear improvement over the December proposal, but the litmus test of whether a bank could be closed over a weekend remains to be seen.**
- **The impact of the agreement on bank-sovereign links and fragmentation is likely to appear only gradually over time.**

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BANKING UNION: PROGRESS MADE, BUT THE DEVIL IS IN THE DETAILS

The March 20, 2014 agreement on the Single Resolution Mechanism (SRM) is a major step toward repairing the euro area's financial architecture. The SRM is the second pillar of the blueprint for banking union, following agreement on the Single Supervisory Mechanism (SSM), which will take effect when the European Central Bank (ECB) takes over the supervision of systemic banks in November 2014. Both pillars are needed to align banking supervision and resolution at a central level, thus avoiding any tensions between EU-level supervision and national resolution schemes.

The agreement broke a deadlock between competing visions of the bank resolution framework proposed by the European Parliament and the European Council last December. The disagreement concerned the fiscal backing that a banking union requires and its distributional implications. A clear improvement over the framework proposed in December, the SRM deal shortens the period by which the banking union will be fully operational and streamlines the decision-making process to address bank failures. If ratified by member states, which represent 80 percent of contributions to the Single Resolution Fund (SRF), it would enter into force on January 1, 2015, and bail-in and resolution functions would apply from January 1, 2016. The deal allows the European Parliament to approve the law before going into recess ahead of EU elections in May 2014, but some details need to be worked out.

The euro-area crisis highlighted the need to address a number of gaps in the financial architecture of the euro area in order to:

- **Break the link between banks and sovereigns:** In the run-up to the crisis, Ireland and Spain began with strong fiscal positions, but ended up borrowing tens of billions of euros from the European Financial Stability Facility's European Stability Mechanism (ESM) to shore up their banks. Steps toward banking union would help break the vicious circle between undercapitalized banks and over-indebted sovereigns by ensuring that taxpayer funding of bailouts is minimized. The ESM, currently, may only contribute to bank recapitalizations indirectly, via the sovereigns. Direct recapitalization would break the circle, which has deepened the euro area's debt crisis.[1]
- **Establish a clear pecking order on bank losses:** Until recently, supervisors felt compelled to recapitalize — with public funds — large banks that became insolvent, because they considered that the financial stability risks of liquidation were too high. But publicly funded bailouts impose heavy costs on taxpayers and give rise to moral hazard. The Cyprus rescue in April 2013 became the catalyst for a different approach: Cyprus was forced to opt for a bank bail-in, as an Irish-style bailout would be incompatible with debt sustainability. What made the bail-in chaotic, however, was the lack of clarity on the hierarchy of claims. The EU has now agreed on a bail-in regime that would apply clear rules for loss sharing by shareholders, bondholders and large depositors to deal with failing banks, similar to those applied by the Federal Deposit Insurance Corporation in the United States.
- **Reverse fragmentation:** Despite significant narrowing of credit spreads since ECB President Mario Draghi's "whatever it takes" statement in July 2012 and Outright Monetary Transaction announcement in August 2012, bank risks and corporate borrowing costs remain significantly higher in the euro-area periphery than in the core. The "balkanization" of the financial system stems from the perception that sovereigns in the periphery lack the fiscal backstop needed to address potential capital needs. Financial fragmentation hampers cross-border interbank lending and impedes the flow of credit to the periphery.

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The key building blocks of banking union consist of the SSM, the SRM and the potential to use the ESM to recapitalize banks directly. However, last December's European Council proposal on the modalities governing the functioning of the system were flawed:

- The design of the common backstop was problematic. The — potentially insufficient — €55 billion SRF would be financed by bank levies at a national level. It would initially consist of national compartments that would be gradually merged over a 10-year period, delaying the common backstop.
- The decision-making process was tedious. In principle, decisions would be made by the five-member executive board of the SRM, but if certain limits were breached, a plenary session would be called and, if needed, the European Council. It is unlikely that this process could be completed over a weekend, which would be required to avoid a bank run and market turbulence.

The European Parliament considered the European Council's proposal to be inadequately funded and subject to political interference. Full details on the compromise reached on March 20 are not available, but here are the key elements:

- Euro-area banks will contribute the full €55 billion to the new SRF over eight years instead of 10; the fund would be mutualized at a faster pace, with 40 percent of the funds available to all participating countries from year one.
- The decision-making process would be streamlined when a bank is failing, but the litmus test of whether a bank could be closed over a weekend remains to be seen.
- European officials and EU lawmakers agreed to establish a credit line as a backstop to the SRF.
- The SRM and SRF will not be involved in the ECB's comprehensive balance sheet assessment.

The ECB welcomed the agreement,[2] but a number of issues remain to be clarified:

- How would the backstop to the bank-financed SRF be funded? Would the SRF be allowed to borrow from the market from day one? Would the ESM act as a backstop?
- Will risk-weights be used to calculate bank contributions? Smaller German banks are already complaining about the fees they will need to pay, claiming that systemic banks should foot more of the bill.
- Who will fund any capital shortfalls identified by the ECB's asset quality review later this year? Would direct bank recapitalization be available?

The SRF was set up through an intergovernmental agreement, just like the ESM, so member states will retain veto powers over any subsequent changes. The agreement is a compromise between the original German vision of coordinated national resolution schemes and a system with shared euro-area risk from the outset. Germany is unlikely to agree to any further compromises, so we should expect the impact of the agreement on bank-sovereign links and fragmentation to appear only gradually over time.

Endnotes

1 EU Council. 2013. "ESM Direct Bank Recapitalization Instrument." June 20. www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf.

2 ECB. 2014. "Statement of the ECB on SRM Agreement." ECB press release, March 20. www.ecb.europa.eu/press/pr/date/2014/html/pr140320.en.html.