

Is the Single Resolution Fund an effective backstop?

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1. Introduction

As we have shown in the previous chapter, the Single Resolution Mechanism (SRM) requires the setting up of a Resolution Fund to complete the restructuring of a bank in difficulties, since the bail-in process towards shareholders and debt claimants may be insufficient to meet all the bank's obligations and – in particular - to protect the holders of covered deposits and other covered bonds. The European Commission addressed these problems even before the starting of the Banking Union (BU) process (Fall 2012) by proposing a Directive aimed at harmonising the national systems of deposit guarantee (the Deposit Guarantee Schemes Directive – DGSD, 2010), and a Directive aimed at building new recovery and resolution mechanisms in each Member State and at coordinating these national mechanisms at the European level (the RM Directive, 2012). With the launch of the BU, the European Commission immediately undertook to design a SRM after approval of the above two Directives. Subsequently, at the end of June 2013, the Council of the European Union (EU) actually approved the Banking Recovery and Resolution Directive (BRRD) and transposed the older DGSD within the BRRD.

On December 11th 2013 the EU Council involved the European Parliament and the Commission in a trilogue to implement the BRRD legislation. According to the Council's main proposals, each national resolution fund (NRF) would have to be funded – that is, to have ex ante coverage – by means of the yearly transfers, compulsorily made by all banks belonging to the EU's Member States which apply

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to the BU. The amount of these transfers should be based on the level of asset risks of each specific bank. In general, every NRF should have a capacity equal, at least, to 0.8% of the total amount of the guaranteed deposits in the national banking sector. However, the NRFs could enjoy a long transition period (ten years) to reach this relative size. Moreover, the mutual aid between NRFs in terms of reciprocal lending activity would have to be set on a voluntary basis; and the access of these funds either to market loans or to European aid mechanisms (typically, the ESM) would have to be treated as an exceptional case. Finally, each NRF could be supported by ill-designed national public backstops.

This chapter is not devoted to analysing the drawbacks of the BRRD. Nevertheless, the latter are important since they influenced the European initiatives on the SRM and the SRF. Indeed, one week after starting to implement the BRRD (i.e. December 18th 2013), the European Commission set its regulation on both the SRM and SRF. Finally, the functioning of the SRF was established by Directive 2014/59 and by Regulation 806/2014 approved by the European Parliament.

In the remaining of this chapter, we examine three main topics. In section 2 we analyse the working of the SRF. In section 3 we point out the major weaknesses of this European fund and the related need of a public backstop. This first conclusion leads us to emphasise that the role and the specific features of the possible public backstop are insufficiently specified by the European rules, and that this institutional deficiency could have a negative impact on the whole construction of the SRM.

2. The functioning of the SRF

The SRF is managed by the Single Resolution Board (SRB), which operates in a plenary session as well as in an executive session. The SRB calculates the individual contributions of each of the credit institutions which are subject to the SRM, that is which belong to an EU Member State involved in the BU. The single

Member State remains competent to levy the contributions from the organisations located in its territory, and to transfer these national contributions to the SRF. However, in the short term, there will just be the NRFs set up under the above-mentioned banking resolution Directive; hence each national flow of contributions will be allocated to its NRF. Starting from 2016, the NRFs will be replaced by the SRF; during a long transition period (eight years), the NRFs will act as compartments of the SRF. In this period, the national compartments will progressively merge in the sense that they will transfer increasing shares of the collected contributions to the SRF. At the end of the eighth year, this process of mutualisation will be completed such that all the contributions will be incorporated by the SRF and the national compartments will cease to exist.

The SRF as well as the provisional national compartments will be ready to provide temporary support to banks under resolution. Support includes loans, guarantees, asset purchases and capital for the creation of bridge banks. As specified in the previous chapter, losses, direct costs or other expenses incurred with the resolution procedure (that is, the resolution costs) should be borne by the fund or by its national sections, only if the claimants of the bank (shareholders and debtholders) participating in the bail-in process have covered at least 8% of total bank liabilities including its own funds. During the transition period, these residual resolution costs must be primarily sustained by the compartment(s) of the Member State(s) where the institution under resolution is established. To be precise, in the first year of the transition period, the resources should be fully taken from the compartment(s) specified above; in the second year the latter should contribute 60% and in the third year 40%; in the subsequent years, this fraction should continue to decrease gradually until it reaches 0 at the end of the eighth year. Should the financial resources of the compartment(s) involved not be sufficient to cover the residual resolution costs, there might be the support of the other national compartments. The SRB can activate temporary (remunerated) transfers between the national compartments. Decisions by the SRB on temporary transfers are taken by simple

majority. However, any Member State whose compartment had to contribute to one such transfer can object to the decisions. In any case, the disbursement of the SRF or of its national compartments cannot exceed either 5% of the total liabilities of the bank under resolution including its own funds or the resources available and attainable in the near future from the SRF (see below).

Contributions to the SRF are divided into two components. The first one is determined by the ex ante contributions that each of the specified credit institutions has to make every year. These contributions are formed by two parts. The former is determined by a flat portion of the bank's total liabilities net of its own funds and of the amount of its covered deposits. The latter depends on the fact that the flat part has to be adjusted by the risk profile of the bank's net total liabilities. Thus the ex ante contributions paid yearly by individual banks depend on their size and on their risk profile. However, the technicalities for the calculation of these contributions are still to be defined. The European Commission has to specify the indicators for assessing the risk profile of banks in order to adjust contributions in proportion to a bank's risk profile. That said, the total amount of the ex ante contributions will have to reach at least 1% of the total amount of the covered deposits, held by the whole set of the credit institutions within the Banking Union (approximately 55 billion euro). This target has to be met in eight years at the latest; hence, in normal times, the yearly amount of contributions from all the European banks involved will not exceed 12.5% of the final target.

The second component is fed by the ex post contributions that credit institutions have to transfer to the SRF or to its national compartments in extraordinary cases. These extraordinary contributions will become necessary if the SRF (or its national compartments during the transition period) does not have a sufficient amount of resources to cover the costs not absorbed by the bail-in process. The ex post contributions of every bank should not exceed three times its yearly ex ante contributions; the means available to the Fund and the expected amount of these ex post contributions in the following three years set the limit of the SRF's

disbursement in the case in which it is below 5% of the total liabilities of the bank under resolution including their own funds.

This case opens the possibility that the ex ante and ex post contributions to the SRF are insufficient to cover the actual resolution costs. In this event, the SRF should either borrow from European aid institutions (such as the ESM), financial intermediaries and other third parties, or ask for different forms of support from some of these institutions. In any case, in order to break any potential vicious circle between the European banking system and the management of sovereign debts, the working of the SRF should not have to impinge on the public budget or on the fiscal responsibilities of the EU Member States.

3. The main weaknesses of the SRF

Use of the SRF is subject to a number of constraints. First, once the Council, on a proposal from the Commission, decides on a resolution procedure, the existence of a public interest for this resolution action and for the use of the SRF has to be assessed. Moreover, the access of every beneficiary to the SRF can be subordinated to a series of conditions, commitments and undertakings. Finally, use of the SRF can be hindered more easily than the implementation of a resolution plan. The latter is decided by the SRB in its executive session; by contrast, any individual member of the SRB can subordinate the approval of the SRF's utilization above the threshold of 5 billion euro to the decision of the plenary board. A decision by the SRB plenary session is needed once the net accumulated utilization of the SRF resources in the previous consecutive twelve months reaches the threshold of 5 billion of euro. In this case, the SRB plenary session should evaluate the actual implementation of the resolution action and the related use of the SRF, and should provide guidance for the SRB executive session aimed at ensuring the non-discriminatory application of resolution tools in the future, and at avoiding depletion of the SRF.

Importantly, this third constraint has to be combined with the other two quantitative

limits in the use of the SRF mentioned above (that is: the bail-in process has to cover at least 8% of the total liabilities of the bank under resolution, including its own funds; the SRF's resources used cannot exceed 5% of these net total liabilities or – if more binding - the sum between the resources available to the fund and its expected ex-post contributions within three years). The combination of these three constraints significantly limits the role played by the SRF in a large part of the resolution process.

Furthermore, the full operativeness of the SRF still requires that a number of issues be defined. First, the European Commission should assess whether the appropriate target level of the SRF is represented by covered deposits or total liabilities, and whether the introduction of a minimum fund size in absolute terms is necessary. Second, a proportionality principle should be specified, with small credit institutions (smaller contributions) being handled differently with respect to large ones, due to the fact that the risks of the former have a lesser impact on the macrofinancial stability. Third, it should be decided, in the case of banking groups, whether the contributions should be based on the sum total of the single components or on the consolidated data. Finally, it is necessary to better specify the relative weight of the two criteria (size and risk profile) which determine banks' ex ante contributions, as well as the risk indicators characterising banks' risk profile.

This indeterminacy is strengthened by the uncertainty which is typical of the working of the SRF. For instance, the fund could have to face an unexpected disbursement in the case in which the hair cut provided by the bail-in process towards shareholders and bondholders of the bank under resolution would lead to a higher loss than that suffered under normal insolvency proceedings. This possible negative gap has to be filled by the SRF. There is also uncertainty about the borrowing capacity of the SRF. The agreement on the access of the SRF to ESM lending, which was reached after the new Regulation came into force, is unclear on the existence of a binding upper limit.

4. SRF as a backstop

The previous analysis shows that the SRF cannot play the role of an effective backstop in the case of a (systemic) financial crisis. In the European institutional design the SRF must be just a complement of the bail-in process. Indeed, the expectations of the regulators are that the great majority of the resolution actions can be managed through the bail-in, and that the remaining part of these actions calls for a marginal involvement of the fund. Moreover, the SRF introduces a principle of mutualisation across Member States, which contrasts with the desiderata of a number of European governments and citizens. These factors explain why use of the SRF is subject to a number of ambiguous but binding constraints. On the other hand, the size of the SRF is too small and its governance is too weak but – at the same time – too complex; and these features preclude significant and flexible transfers from the fund to a single credit institution. These limits are not overcome by the above-mentioned possibility, in extraordinary circumstances, of the SRB seeking funding from the ESM, other European institutions, or market financial intermediaries. This possibility is, indeed, too constrained and ill-based to strengthen the role of the SRF.

Our conclusion is that the SRF is a useful but temporary bridge to reach a new equilibrium, in the sense that it can manage (together with the bail-in) idiosyncratic shocks but not widespread or systemic shocks. It follows that complete and satisfactory working of the SRM calls for the presence of a common backstop which is sufficiently strong to face systemic shocks. The regulation of the BU has not yet implemented, or even conceived of, this kind of mechanism. On the other hand, none of the European institutions which are currently operative appears able to play this role. Hence, it seems unavoidable to have recourse to public funds: the architecture of the SRM requires a common and public backstop. In a sense, this is a contradiction since the BU was conceived to break the vicious circle between the banking crisis and the sovereign debt crisis, whereas a public backstop directly involves the public balance sheets. To avoid this contradiction, the solution could

be to build a common backstop financed by European funds.