Non paper

8 September 2015

The EMU needs a stronger Banking Union, but must get it right

One key objective of the Banking Union is to decouple banking sector risks from public sector risks and thereby breaking the vicious link between sovereign risks and bank risks.

The Greek experience has made clear that not only bank failures can imperil public finances, but also political failures can destabilise banks. Therefore, there are two sides of the nexus of sovereign risks and bank risks which both have to be addressed:

- First: Banks should not be able to pull sovereigns into financial distress. This requires an effective resolution mechanism, including effective bail-in rules, as well as an effective supervision and resilient banks (see below "I. Effective resolution mechanism and supervision").
- Second: At the same time, sovereigns should not be able to pull banks into financial distress. In addition to a sound fiscal and economic policy in Member States, ensured by effective implementation of European fiscal rules, a more effective coordination of economic policy, and effective use of the ESM when needed and appropriate, this requires inter alia limiting the amount of sovereign risk on bank balance sheets (see below "II. Reduce the level of sovereign risk")and introducing a sovereign debt restructuring regime (see below "III. Introduce a sovereign debt restructuring regime").

Next steps for a stronger Banking Union

To achieve the stated objective, the following steps should be taken:

I. Effective resolution mechanism and supervision

1. Swift transposition of the Bank Resolution and Recovery Directive (BRRD) in all Member States (as demanded in the Five Presidents' Report) and proof that the SRM is fully operational

The completion of the Banking Union requires that all Member States implement the BRRD. Furthermore, the SRM as a whole must function effectively. That includes, firstly, that BRRD/SRM contributions are collected effectively, fully, and in a timely manner at the national level and transferred to the SRF in accordance with the conditions set out in the IGA in the next years, and secondly, that the bail-in instrument has been tested and proved efficient.

2. Strengthen the Single Resolution Mechanism: Sufficiently high bail-in cushion (MREL at least 8%)

The restructuring of banks without taxpayers' money will function only if sufficient resources are available for a bail-in and if Member States ensure that the bail-in is legally enforceable. In any case, there should be high binding standards for bail-in resources (MREL at least 8% of total liabilities) for SRB banks.

3. Addressing possible pre-resolution funding problems of distressed banks. Such problems could arise both from sustained deposit outflows – as in the case of Greece – or from runs in the wholesale market, which played a central role in the transmission of the Lehman crisis. It has to be discussed whether the current set of instruments to deal with liquidity issues prior to a resolution is appropriate. Do the responsible authorities have sufficient early intervention powers and instruments, and are they likely to make sufficiently timely use of their powers? Do we need additional tools to contain outflows and hence prevent the hemorrhaging of banks while maintaing the option carry out a subsequent restructuring? Who should exercise competencies like the enforcement of a moratorium? Is the use of ECB instruments, such as the ELA, adequate to provide pre-resolution liquidity, in particular, to deal with wholesale funding runs?

4. Strengthen the Single Resolution Mechanism: Agreement on a bridge financing mechanism for the Single Resolution Fund (SRF) during the transition phase (as demanded in the Five Presidents' Report)
As mandated in the BRRD/SRM, the SRF can be utilized following the application of bail-in. To bolster the SRF's resources in the transition period, a bridge financing mechanism can be put together on the basis of individual credit lines from the Member States for their respective national compartments, until the target level of financing is met. Member States experiencing financial difficulties can, in individual cases, receive assistance of the ESM by using existing ESM instruments subject to the appropriate conditionality. Such conditionality as part of an assistance programme is essential in order to ensure that the respective Member State's economic policies do not damage its banks.

5. Strengthen the Single Supervisor: Further harmonising the rules under CRR and CRD IV
CRR and CRD IV should be modified where necessary on the basis of the findings and recommendations of the Single Supervisor in order to provide for a level playing field amongst all member states of the Banking Union.

6. Strengthen the independence of EMU supervisory and resolution authorities through treaty changes
European authorities must have the capacity to take effective action. Firstly, monetary policy should be kept completely separate from supervisory decisions. This means that the Bboard or authority in charge of supervisory affairs should have final decision-making powers on supervisory issues. Secondly, the SRB should be able to make final decisions on questions involving bank resolutions. Both of these measures would require amendments to the EU treaties.

<u>II. Reduce the level of sovereign risk on bank balance sheets / Modify the regulatory treatment of sovereign debt (as demanded in the Five Presidents' Report)</u>

This issue needs to be addressed now. It is crucial to cut the link also between sovereigns and banks. For this reason, the European Union/ Eurozone should not constrain itself by waiting for global agreements (Basel/FSB). Instead, it should commit itself quickly to specific regulatory steps within an appropriate transitional time frame (which should give supervisory authorities some discretion to prevent disorderly deleveraging). This also applies to the treatment of Deferred tax assets (DTA) as equity capital. An upfront European solution should include

- a clear commitment to introduce such rules in Europe; this may in turn help promote an international solution,

- a signal of credibility. This could be achieved by supervisors being more coordinated and demanding under Pillar 2 regarding risk weighting and concentration risk, requiring banks with internal models not to resort to exceptions (partial use) any more.

III. Introduce a sovereign debt restructuring procedure that supports prevention and facilitates resolution of potential future cases of sovereign debt overhang

The Euro area has no procedure to deal with overly indebted countries who lose market access, particularly when the debt is in the hands of dispersed bond holders. As a result, debt restructurings are legally and practically difficult to carry out and potentially destructive. In anticipation of this, there will be a tendency to undertake them too late. There is hence a danger that the ESM may be used inappropriately, and/or that a country may be forced into excessive fiscal adjustment as a substitute for needed debt restructuring. This in turn creates unnecessary economic and social hardship and may compound a crisis.

In order to complete the financial architecture of the Euro a sovereign debt restructuring procedure may be the way forward and needs to be further explored. Possible options include (1) modifying bond contracts to deter free riding by "hold-out creditors" (e.g. include collective action clauses with single-step aggregation in all new sovereign bond issues); (2)automatic prolongation of government bonds when ESM assistance is granted; (3) debt sustainability analysis by the IMF, potentially supplemented with a public debt threshold or other relevant debt sustainability indicators. Introducing this measure would require an appropriate transitional timetable to allow and encourage countries to reduce sovereign debt levels.

The way forward

In order to build a reliable and solid Banking Union, and to break the vicious circle between sovereign risks and bank risks, the implementation of the steps mentioned above must have priority over further mutualization of bank risks. Without adequate facilities to limit bank risks effectively, taxpayers' and depositors' money would again be put undue risk.

We should therefore only move forward with the work on a common backstop for the SRM, once all the prior measures mentioned above that do not require treaty change have been implemented, the relevant treaty changes have been agreed and once the effective functioning of the SRM and the bail-in tool has been proven. To now start a discussion on further mutualization of bank risks through a common deposit insurance or an European deposit reinsurance scheme is unacceptable.