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Quo Vadis Banking Union? Discussions over the Resolution of Banks

Abstract: Transferring the right to make the decision concerning a bank's resolution onto the international level has long been the bone of contention between the European Union's Member States. The aim of this article is to provide a review of the discussions on this topic, while attempting to evaluate whether the consensus reached allows the achievement of goals set for the resolution mechanism. The article is composed of five parts. The first part introduces the concept of single supervision over the banking sector and explains the importance of having harmonised resolution rules. The second part discusses the process of reaching a consensus towards the establishment of the Single Resolution Mechanism. That part is followed by a description of the final structure agreed for the mechanism back in 2014. The fourth part outlines the review procedure of the established regulations currently under way. The final part of the article summarises the contents and attempts to identify the core issues that still need to be resolved in order to guarantee reliability of the second pillar of the banking union.

Keywords: SRM, resolution, banking union, credit institutions

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1. Introduction

After experiencing the heavy burden of bailing out non-performing banks during the economic and financial crisis, European countries came to an agreement on the need for a reform of the banking system in order to strengthen its resilience (COM/2012/0510). While agreeing on the principles came almost naturally, discussing the merits of what was named a “banking union” turned out to be a very long path (Veron, 2015: 12–16). The first step was establishing a Single Supervisory Mechanism (SSM), granting the European Central Bank (ECB) a new, central monitoring role over all the banks inside the euro area countries and in non-euro EU countries who join on a voluntary basis (Regulation (EU) no. 1024/2013).

Having a joint control over institutions that in most cases operate at least at the regional level was not really a controversial concept, apart perhaps from designating the central body for the mechanism (Kern, 2016: 488–490). Allowing the EU to decide on a bank’s resolution, however, most certainly was – and in fact, at the time of preparing this article, still is (Gianviti et al., 2010: 3–5). In principle, the Single Resolution Mechanism (SRM) was formally proposed in July 2013 as a key element of the banking union’s credibility and efficiency (European Commission, IP/13/674, 2013). The SRM was proposed as “[...] orderly restructuring of a bank by a resolution authority when a bank is failing or likely to fail” (Purpose of the single supervisory mechanism, n.d.).

The harmonised rules for the SRM were formally set out by Regulation No. 806/2014 and came into force in 2016. The regulation introduced the Single Resolution Board as the central body for the SRM (Regulation (EU) no. 806/2014). The mechanism was also equipped with its own fund of a total of 55 billion euro, to be financed by the banks themselves in the period between 2016 and 2024. The purpose of the fund is to finance and streamline the resolution process. It is also to guarantee that no Member State will be forced to finance the resolution process out of its own budget. Difficult as it was to arrive at such a structure of the mechanism, the underlying legislation is already under review in 2017.

The aim of this article is to provide a review of the discussions over the SRM, while attempting to evaluate whether the consensus reached allows the achievement of the goals set for it. The underlying research is to verify in particular whether an impartial decision on a bank’s resolution is possible under the new mechanism. The research methodology used is a detailed analysis of the source materials published by the European institutions in the course of the negotiations. A review of publications is also performed in order to reinforce some of the statements made, when necessary. No quantitative methods have been considered at this stage, but they may become the focus of further studies once the relevant data allowing the evaluation of effectiveness of the resolution mechanism are made available.

The article is composed of five parts. The first introduces the concept of single supervision over the banking sector and explains the importance of having harmonised resolution rules. The second part discusses the process of negotiations towards the establishment of the Single Resolution Mechanism. That part is followed by a description of the final shape agreed for the mechanism back in 2014. The fourth part outlines the review procedure of the established regulations currently under way. The final part of the article summarises the contents and attempts to identify the core issues that still need to be resolved in order to guarantee reliability of the second pillar of the banking union.

2. Negotiations over the Single Resolution Mechanism

The first compromise proposal came following the Council project near the end of September 2013 (Council of the European Union 2013/0253(COD), 14056/1/13). The proposal envisaged the Commission's right to have the final call over an institution's resolution, but the decision could be taken only after receiving a recommendation from the Resolution Board. The implementation process was to be governed by the national authorities, formally obliged to cooperate with and monitored by the Board. The Board itself was to be composed of the executive director, a deputy, two members appointed by the Commission and the European Central Bank (ECB) respectively, as well as a representative from each participating Member State. Only the Director and the Member States representatives were to be granted voting rights. The compromise also envisaged an explicit guarantee that no national budget will be burdened with the expenses stemming from the agreed resolution process.

As the agreement on the proposal had not been reached, the second proposal was submitted by the Council on 15th October 2013 (Council of the European Union 2013/0253(COD), 14754/13). Article 6.2a of the proposal envisaged the Member States' financial support in the resolution process, only if the national law allowed such support to be granted. The proposal also included a provision where special attention was to be given to the significant adverse consequences of a bank's insolvency, potentially leading to a conclusion that a given institution cannot be resolved under the Regulation. The priority of claims under the resolution was proposed to override the national law and to first satisfy the claims related to deposits held by the failing institution – Article 15.

The third compromise proposal was issued on 28th November 2013 (Council of the European Union 2013/0253(COD), 17055/13). This draft included additional provisions, obliging all the parties involved in the resolution process to comply

with the rules and standards developed by the European Banking Authority (EBA). An additional provision was also added to Article 7, formally obliging a given bank's home country's national authority to prepare a draft of the resolution plan. Additionally, the previously proposed order of claims to be satisfied was deleted, returning the priority to the national law in this respect. The updated proposal also provided a more precise description of ex-post contributions collection procedure in case the actual inflows to the fund turned out to be lower than anticipated.

The fourth proposal update was issued just eight days after the previous document (Council of the European Union 2013/0253(COD), 17410/13). According to this version, the resolution procedure should be considered pursuant to a motion issued by the ECB or a national monitoring authority. If the Resolution Board agreed on the resolution plan and it was approved by the Commission afterwards, the implementation phase was to be managed by the European Council. The draft also presented a more detailed procedure on reaching a consensus over the draft resolution plan for cross-border institutions between the national authorities involved.

3. Agreed shape of the Single Resolution Mechanism

The fifth and final consensus proposal was presented on 18th December 2013 (Council of the European Union, 17983/13). The agreement formally approved the establishment of the SRM with a fund to be gradually built up over a ten-year period. The final draft gave more powers to the Board of the SRM, which was to decide on a bank's resolution programme, and its proposal could only be opposed by the Council within 24 hours after its adoption. The Board became the only body to manage and use the Resolution Fund. Financial support from the fund could be granted pursuant to a consent from the Board's executive session (its director plus representatives of the affected countries) or plenary session, depending on the scale and type of support. The executive session has the right to approve support of up to 20% of the fund's capital when granting liquidity support and 10% of the fund's capital for recapitalisation purposes. The plenary session is the only body to approve any support higher than these thresholds and it also retains the right to block a decision taken by the board.

The final regulation took the form of a detailed, unclear compromise which was welcomed with reservation by most stakeholders. The complex nature of the mechanism was seen as a threat in terms of using the fund in an emergency – when decisions are to be taken swiftly, since the level of information available to the executive session members will most likely be far greater than this accessible by the entire plenary session (Gros, 2013: 1–2). Another accusation was that the actual functioning of the fund and the merits of its bridge-financing had to be

facilitated through an intergovernmental agreement. On top of that, there were voices that the Resolution Fund was simply too small (Pozzolo, Calzolari, Navaretti, 2016: 12–18).

In the author's opinion, the regulation – just as every other compromise – took the form of a solution tolerable by all the stakeholders. Given the complexity of this matter, reaching any compromise at all should be considered as a success. Reaching a joint decision on a bank's resolution under the mechanism is obviously a different subject, but supplementing the mechanism with financial independence should substantially increase the chances of reaching a consensus (Micossi, 2013). Similarly, while it is clear that the mechanism itself cannot secure the liquidity of the entire trillions-worth banking system of Europe in the event of a massive economic shock, it should be noted that the Resolution Fund is not intended to do that. It is to act case by case through an orderly resolution of failing institutions and indirectly limit the detrimental impact of their bankruptcy on the entire system. When it comes to having a proper legal framework for the functioning of the mechanism, it has become clear on numerous occasions that the existing treaties will need to be updated at some point in order to strengthen the cooperation and integration in terms of banking supervision (Chopin, 2014: 7).

The first reading of the agreed version happened in the Parliament on 6th February 2014 (Regulation (EU) no. 610/2014). The amendments proposed by the Parliament added a direct reference to the Bank Recovery and Resolution Directive (BRRD), as the backbone of the harmonised resolution rules (Directive 2014/59/EU). At the time, the BRRD was still a document in preparation, but it was intended to harmonise the framework for managing the resolution or recovery of a credit institution. The said framework had long been discussed as part of the fundamental documents laying down the rules for future banking crisis management and had been one of the Commission's core proposals in this respect back in 2012. The detailed contents of the directive shall not be analysed in this article, but it is worth mentioning articles 10 to 14, which effectively describe the procedure for preparing recovery and resolution plans for single institutions and their groups. As for the general resolvability assessment, the directive has obliged the EBA to prepare the relevant standards necessary for the process. It should be noted that the BRRD was adopted on 15th May, so three months after the regulation establishing the SRM.

4. Current status of the SRM discussions

After reading the outline of the discussions over a bank's resolution, one might think that, with the compromise regulation in place and the BRRD adopted, the difficult part of establishing the banking union's second pillar was completed back in 2014. Yet

the BRRD is now being reviewed (European Commission 2016/0362(COD)). In November 2015, the Financial Stability Board (FSB) published the *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* and the so-called *Total Loss-absorbing Capacity Term Sheet* (TLAC). These documents underline the need for the Global Systemically Important Banks (G-SIBs) to hold the sufficient capital to cover a certain degree of expenditures under the resolution procedure. This minimum level should guarantee that the fundamental actions of the failing institution are continued and the resolved institution does not pose a threat to the general financial stability. The TLAC rules were agreed upon as an international standard to be implemented by the end of 2019, hence the need for adjusting the BRRD.

The BRRD update proposal from the Commission came as part of a wider review of the banking supervision rules currently under way. The proposal is to update the relevant rules of the BRRD so that the banks are not facing double requirements, as well as to provide a set of additional adjustments that would improve the existing rules (European Commission 2016/0362(COD)). The TLAC standard introduces certain thresholds as a common minimum capital requirement to be adopted worldwide (16% of the institution's RWA and at least 6% leverage ratio as of 2019), but these may then be further increased by the implementing authorities. This requirement comes on top of the Basel capital requirements and it will not be permissible to use the same instruments to satisfy several thresholds at the same time – certain conditions apply though, as described in point 6 of the TLAC (Financial Stability Board, 2015).

One notable change proposed is to waive the existing obligation to add an additional clause to EU banks' contracts with parties outside the EU, enforcing recognition of the EU's authority to terminate them in the event of resolution. Another change proposed is replacing the existing provisions granting the resolution authority with power to suspend a given bank's payments with more detailed provisions so that a greater level of harmonisation is reached in this respect between the Member States.

Overall, the author believes that the proposed revision provides an opportunity to strengthen the regulations and reinforce a harmonised approach to a bank's resolution. With the adoption of the TLAC standards, a more comparable regulatory environment for the banking sector may be introduced worldwide, which is certainly appropriate given the global presence of many credit institutions. This global presence of credit institutions remains to be the largest challenge in the entire resolution process. Complex ties between different subsidiaries within a financial group usually suggest a resolution at a group level as a solution preferred to resolving only certain subsidiaries (de Groen, 2016: 5). This is, however, the core issue for any bank's effective resolution – there will be different priorities for the home and host countries of a given group, just as there will be a different level of dependence of branches on the central institution.

The above-mentioned issue of multiple jurisdictions in the group's resolution process is quite clear – if the group resolution procedure is invoked, some of the funds and assets in possession of branches and subsidiaries will need to be transferred onto the central institution, to bear the costs of the procedure to the highest extent possible. This may not be welcome by the host country's authorities, as it may be seen as a threat to the solvency and stability of the local subsidiary, which is naturally closely tied with local businesses and consumers (de Groen, 2016: 5). If the subsidiary's assets are in turn ruled out as a source of financing for the resolution, the entire procedure becomes more costly for the Resolution Fund and the financial standing of the central institution deteriorates even further.

The issue of interdependence within a group is not that intuitive – the level of dependence on the parent institution varies greatly. While the rules clearly state that the core business activities still need to be carried out by the institution during its resolution procedure, it may not be possible to resolve a single institution within a group due to complex financial and/or operational ties. In other words, some subsidiaries would not remain operational without the support from the central institution¹.

5. Conclusions

Despite its imperfections, the consensus reached on the Single Resolution Mechanism provides a solution that may be operational and effective. The decision to give up the authority to have the final say in a home institution's resolution is not easy to take, but the cross-border nature of the banking business today needs to be born in mind. It becomes clear that no resolution can effectively take place without the cooperation between different authorities.

Five negotiation rounds for shaping the SRM may indirectly provide an example of how intense the negotiations over a bank's resolution can be. Although the Member States agree that cooperation and harmonisation are key for an effective resolution process, little support is given to provisions that may override existing national rules. In practice, there is still a great risk that a decision on a bank's resolution becomes stuck at the SRB's executive session level. Similarly, even when such a decision is taken, a lack of cooperation in terms of streamlining the entire group's resolution may make the process so lengthy and costly that it will bring little value in terms of preserving the banking system's stability.

In conclusion, the effectiveness and workability of the SRM will stem not so much from the quality of the underlying legislation as from the willingness and readiness of different stakeholders to cooperate within the given framework.

¹ An analysis of this issue may be found in de Groen (2016).

Transferability of funds between branches and subsidiaries under different authorities will need to be smooth, unrestricted and coordinated in order to ensure uninterrupted operations of all the entities within a group. Similarly, the financial and operational links within a group facing financial troubles need to be analysed in detail so as not to exaggerate the risk of disrupting the entire financial system.

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Quo vadis unio bankowa? Dyskusja nad mechanizmem likwidacji i uporządkowanej restrukturyzacji banków

Streszczenie: Przeniesienie prawa decyzji odnośnie likwidacji banku na poziom międzynarodowy od lat stanowi kość niezgody między państwami członkowskimi Unii Europejskiej. Celem artykułu jest przegląd przebiegu dyskusji na ten temat, przy jednoczesnej próbie oceny, czy osiągnięty konsensus umożliwia realizację celów wyznaczonych dla mechanizmu uporządkowanej likwidacji. Artykuł składa się z pięciu części. Pierwsza przedstawia ideę utworzenia jednolitego nadzoru nad sektorem bankowym oraz kluczowe znaczenie harmonizacji zasad w zakresie uporządkowanej likwidacji banków. Druga część opisuje proces negocjacji na drodze do osiągnięcia konsensusu w sprawie utworzenia Jednolitego Mechanizmu Restrukturyzacji i Uporządkowanej Likwidacji. Następnie opisywany jest ostateczny kształt, jaki nadano temu mechanizmowi w 2014 roku. Czwarta część przedstawia prowadzony obecnie przegląd regulacji odnoszących się do restrukturyzacji i likwidacji banku. Ostatnia część artykułu podsumowuje jego treść, identyfikując równocześnie podstawowe problemy, które muszą zostać rozwiązane, by zapewnić wiarygodność drugiemu filarowi unii bankowej.

Słowa kluczowe: restrukturyzacja, likwidacja, unia bankowa

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