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Thinking ahead for Europe

Tough love for sinners in the eurozone banking union

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1 July 2013

Under its founding treaty, the Eurozone Stability Fund (ESM) may provide stability support to its member countries in financial difficulty in the form of loans, by purchasing their bonds in primary and secondary debt markets, by providing precautionary financial assistance in the form of credit lines, and by financing the recapitalisation of financial institutions through loans. In June 2012, the eurozone summit decided that the ESM should also be able to recapitalise banks directly, in order "to break the vicious circle between banks and sovereigns". In December 2012 the European Council further agreed that the building blocks of the banking union would consist of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the possibility for the ESM to recapitalise banks directly.

The ministers of finance and the economy of the eurozone have now agreed on the main features of a new ESM instrument for the direct recapitalisation of euro area banks (Eurogroup, 2013) and on a framework for the recovery and resolution of credit institutions (Council of the European Union, 2013).

The new ESM instrument will enter into force only after the SSM is effectively in place and the legislative proposals for the SRM and Deposit Insurance directives are finalised by Council and Parliament; in all likelihood, therefore, well into 2014. This accommodates widespread demands for a delay – not only by Germany – and is somehow also at variance with the urgency of the eurozone summit decision last year. The truth is that, once again, as soon as financial markets tensions begin to ease, institution-building also slows down, and with it the reduction in market fragmentation.

Utilisation of the new ESM instrument will be subject to strict conditions, in line with the instructions of the eurozone summit. Accordingly, it will only be made available when the requesting member state cannot help its banks on its own without endangering the sustainability of its sovereign debt, aid is indispensable to the eurozone's financial stability, and the financial institution concerned is undercapitalised (in breach of CRD IV prudential requirements) and unable to attract sufficient capital from private sources. In order to preserve the top credit rating of the ESM, it has also been decided that the available funds under the new instrument must not exceed euro €60 billion – not an insignificant sum, but

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hardly sufficient when there is a need to intervene for several banks and across several member states. It may be recalled that market participants apparently consider a ceiling that is double the amount consistent with the ESM's top rating.

The decision to grant the capital injection will be subject to thorough due diligence of the institution's balance sheet quality and loss-absorption capacity, in order to assess its continuing viability and need for restructuring. It will only proceed after an adequate capital contribution by shareholders (capital write-down) and creditors (debt conversion into equity or write-offs) of the beneficiary institution, in line with the proposed directive on resolution (discussed below). In addition, the requesting member state will be required to inject capital into the distressed institution as required to bring its common equity (CE Tier 1) up to its legal minimum (4.5% of risk weighted assets under the CRD IV rules), as well as more broadly to participate in the capital injection, alongside the ESM, for an amount equivalent to at least 20% of the total public contribution in the first two years, and 10% thereafter. These provisions entail that the ESM assistance does not cover 'legacy' debts – one of the 'red lines' drawn on the negotiating table by (potentially) creditor countries.

It is envisaged that the ESM will intervene by purchasing common equity (CET 1 capital) and will acquire strong rights of involvement in the institution's business decisions and even choice of management – while ensuring, as the text goes, "a careful balancing between influence by the ESM and the maintenance of independent commercial business practices", so as to leave open the possibility of a return of the institution to "market functioning".

The system for financial assistance to ailing banks is based on the broader foundation of the principles that have been agreed upon for the resolution of ailing banks within the member states of the Union and that, once adopted as a directive, will guide national legislation in this matter. A separate Commission proposal, to be published shortly, will cover the creation of the SRM, as mandated by the December 2012 European Council.

Under the directive just agreed upon, all members states will be required to entrust their resolution authority with the power to sell part or all of a business; establish a bridge institution to manage the 'good' activities of a bank; transfer impaired assets to an asset management vehicle (the 'bad' bank); impose losses (bail-in) on creditors with an order of seniority, starting with shareholders and unsecured creditors.

Two main features are worth stressing in the final compromise. The first is that certain types of liabilities, including secured liabilities and covered bonds, would be permanently excluded from bail-in, while deposits would have preference status in the creditors' pecking order, but would not be excluded. According to the official text posted by the Council, this also applies to deposits under €100,000 (which would only have preference over other deposits). This provision makes a run on deposits more likely should a bank seem unable to stand on its own. It is also likely to encourage an increase in the 'encumbered' share of banks' assets (i.e. the share pledged as a guarantee for bond issuance), which can make the return to unsecured funding more difficult and "leave banks reliant on liquidity support by the ECB for longer than warranted" (European Commission 2013, p. 26)

The second feature worth noting is that national authorities maintain some discretion to exclude liabilities from bail-in for reasons such as the need to avoid contagion or to ensure the continuity of critical functions (interbank liabilities and liabilities arising from participation in payment systems are always excluded).

On the whole, establishing common principles for the resolution of ailing banks is a necessary foundation of the banking union, in order to eradicate moral hazard from the system, and the proposed directive should therefore be welcome. However, the text that has come out of the frantic late-night negotiations in the Ecofin Council seems to leave unwelcome uncertainty as to the real scope of the new rules in the different national jurisdictions, while the lack of depositor preference in the bail-in pecking order may result in destabilisation.

As for direct recapitalisation of banks by the ESM, the proposed system appears not only highly intrusive but it also places a considerable burden of aid to the failing institution on the member state, raising doubts about its ability to “break the vicious circle between banks and sovereigns”. It also displays a profound mistrust of anyone in need of assistance; hardly the remedy to restore confidence among market participants. The emphasis is on individual institutions, leaving little room to address a generalised need for strengthening bank capital as a result, for instance, of a protracted recession affecting banks economy-wide – as many believe is the case in the eurozone today (European Commission, 2013; IMF, 2013, and Benin & Huizinga, 2013). The conditions imposed on the requesting member state and the distressed institution are very harsh, so that resorting to the new instrument will probably be delayed as long as possible; in all likelihood raising the eventual cost of the rescue.

A world of difference, in sum, from the approach taken in 2008 by Secretary Paulson of the US Treasury with his Capital Purchase Programme (CPP). The CPP was designed to bolster the capital of ailing institutions, in extremely adverse economic conditions, so as to release the flow of credit to the economy and restore confidence. To this end, the US Treasury initially committed $250 billion, and eventually invested about $205 billion, to provide capital to 707 financial institutions throughout the country. Against the capital injections, the Treasury received preferred (non-voting) stock yielding a 5% dividend for the first five years and 9% thereafter, but there was no deadline for the investment and little intrusion into the banks’ business decisions. As of April 30, the Treasury has recovered more than $222 billion from CPP from dividend income and repayments and expects to recover additional funds.

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