

A BANKING UNION FOR THE EURO AREA:

TECHNICAL BACKGROUND NOTES

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I. SINGLE SUPERVISORY FRAMEWORK¹

This paper elaborates on the design of a single supervisory framework for the Euro Area.

A. Current Setup

This section describes the current national based set up of supervision in the Euro Area. The drawbacks of such a set up, against the backdrop of an integrated financial system, are discussed in the main paper, along with the advantages of a more integrated prudential system.

1. **Supervision.** Supervision aims to ensure bank soundness by verifying and enforcing prudential rules and providing discretionary powers to control undue risk taking.
 - *National-based supervision.* Banking supervision in the EU is performed at the national level. Minimum harmonization of regulations and supervisory principles in the EU is guided by the internationally agreed standards set by the Basel Committee on Banking Supervision in the Core Principles for Effective Banking Supervision, and implemented through EU Directives. Moreover, supervisory handbooks and practices vary across euro area countries reflecting *inter alia* different market structures, underlying laws, taxes and accounting rules. The draft Capital Requirements Regulation and Directive (CRR/CRD IV) will strengthen supervision (e.g., supervisory plans, onsite inspections, more robust and intrusive supervisory assessments) and harmonize sanctions, while the draft Directive on bank recovery and resolution aims at ensuring that national authorities have adequate preventative and harmonized tools and early intervention powers, including in relation to recovery planning.
 - *Cross-border cooperation.* Supervision of cross-border banks is coordinated within supervisory colleges. Stricter rules have been in effect in the EU since 2006, but the draft EU Directive on bank resolution and recovery clarifies home-host relations and responsibilities in EU colleges, albeit in a non-binding way, in particular in relation to the provision of intra-group liquidity provision. The establishment of supervisory colleges is a major step forward. However, the national emphasis in supervision may distort incentives away from sharing information and collaborating. Although supervisory colleges provide a forum for discussion, they may not always result in prompt action. From a practical point of view, college participation can be cumbersome, particularly for small countries.²

¹ Prepared by Thierry Tresselt, Pelin Berkmen (European Department), Fabiana Melo, Katharine Seal (Monetary and Capital Markets Department), and Wouter Bossu, Atilla Arda, Alessandro Gullo and Nikita Aggarwal (Legal Department).

² Smaller countries can also find themselves on the periphery of key decisions in the core colleges when their local branch or subsidiary is small in terms of the overall group, even if it is systemic from a host country perspective.

2. Regulation. Prudential rules have the objective of ensuring financial stability through the promotion of safety and soundness in the banking system, prescribing and proscribing what banks may or must not do to limit excessive risk taking, correct informational imperfections, and build buffers limiting the frequency and costs of bank failures. In the EU, prudential legislation is drafted by the EU Commission and decided upon by the Council and the European Parliament.

- *Single rule book.* Starting with the CRR and CRD IV that are to be adopted in the coming months, the Commission aims to create a single set of harmonized prudential rules, a “single rule book,” for all banks across the EU to ensure uniform application of Basel II and III by limiting national options and discretions. The CRR also tightens large exposure limits, liquidity ratios, and public disclosure requirements, and proposes an indicative leverage ratio. Ensuring full consistency of rules is a natural policy response to the high degree of financial and monetary integration in the EU in general and in the euro area in particular.
- *National flexibility.* The EU Council version of the CRR/CRD IV, the so-called “Danish compromise,” approved in May 2012 and being considered by the EU Parliament, acknowledges that financial stability risks differ across jurisdictions and institutions, and provides national authorities with the flexibility to impose stricter standards to respond to macroprudential concerns.³ The draft regulation allows member states to impose temporarily (for up to two years, but extendable) some stricter prudential requirements for domestically licensed financial institutions.⁴ The drafts maintain the national authorities’ capacity to require Pillar 2 capital add-ons for individual institutions, based on their risk profile.

3. Role of the EBA. The European Banking Authority (EBA), established at the start of 2011 following a recommendation of the De Larosiere High Level Group, is a cooperative body for EU bank supervisors and contributes to regulatory and supervisory standard setting of the EU. It is tasked with issuing technical standards in regulatory and supervisory areas (subject to fiscal safeguards) and contributing to the consistent application of EU legislations in regulation and supervision. It can organize and conduct peer review analyses of competent authorities, including issuing guidelines and recommendations and identifying best practices, to promote supervisory convergence, address breaches of EU law, and coordinate and ensure consistency of EU-wide stress tests. It also has the role of ensuring the smooth functioning of supervisory colleges, including by mediating disagreements. Further, it is expected to provide advice to EU institutions in areas of banking, payments and e-money regulation, corporate governance, auditing, and financial

³ Under the draft legislation, Common Equity Tier 1 capital ratios can be increased by up to 3 percent (“systemic risk buffer”) on all exposures or up to 5 percent on domestic or non-EU exposures without the Commission’s pre-approval. For higher buffers, pre-approval is required.

⁴ For example, sectoral risk weights up to 25 percent beyond what will be established in the common rulebook for real estate and financial sector exposures, as well as stricter large exposure limits (up to 15 percent), public disclosure requirements and liquidity requirements.

reporting. The EBA also has back-up enforcement authority in specific cases and under strict conditions and safeguards.

4. Macroprudential oversight. National authorities are responsible for macroprudential oversight, but adequate frameworks are lacking in several euro area countries. Where they exist (e.g., Germany and France have a framework in place), institutional frameworks are not necessarily consistent across countries. Coordination and internalization of cross-border spillovers is achieved at the EU level by the European Systemic Risk Board (ESRB) through a (non-binding) “comply or explain” mechanism. In December 2011, the ESRB issued recommendations on the macroprudential mandates of national authorities. Guidance for establishing common macroprudential toolkits is being developed.

B. The EU Commission Proposal and the EU Council Agreement

This section describes the initial September 12, 2012 EC proposal for a single supervisory mechanism (SSM) and roadmap toward a banking union, and provides an overview of the December 14, 2012, agreement of the Council of the European Union.

5. Initial proposal. The Commission published on September 12, 2012 a draft Regulation conferring supervisory tasks on the ECB as part of a roadmap toward establishing a Banking Union. The proposal is based on Article 127(6) of the ESCB/ECB Statute and provides a clear mandate and broad powers to the ECB to perform supervision of all euro area banks, starting January 2013. While the ECB may start carrying out supervisory tasks on any institution from that date, the draft Regulation proposes that banks receiving or requesting public financial assistance would be targeted first. Systemically important banks will be subject to ECB supervisory activities from July 2013, and from January 2014 all other credit institutions.⁵

6. Roadmap. The Commission also announced that the draft EU legislations that will contribute to creating a “single rule book” (CRR/CRD IV) and on harmonizing and strengthening national resolution regimes and deposit guarantee schemes should be adopted by the end of 2012. The Commission announced plans of a proposal for a single resolution mechanism (the plans were adopted by the EU Council on December 14, 2012), and confirmed its views of the powers of the EBA to harmonize technical standards for regulation and supervision and a non-binding mediator of cross-border supervision and resolution for the EU. However, the Commission did not specify any steps to establish common safety nets and backstops for deposit insurance and resolution funding.⁶

⁵ These dates have subsequently been pushed back. The October 18–19, 2012 European Council meeting called for agreeing on the legislative framework by the start of 2013, with the effective operation of the single supervisory mechanism in the course of 2013. The draft of the regulation, agreed upon by EU leaders on December 13, 2012, calls for entry into force of the SSM regulation on March 1, 2013, while the Council conclusions postpone the adoption of the other EU draft legislations.

⁶ On November 27, 2012, the EC published a blueprint for a “deep and genuine economic and monetary union,” including plans for a single resolution mechanism that will be proposed in the coming months following the adoption of the SSM as well as a fiscal backstop in the longer term. The European Parliament committee on

(continued)

The December 14, 2012 conclusions of the EU Council postponed the timeline for the adoption of the draft Directive for bank recovery and resolution and for harmonization of deposit guarantee schemes (DGS) to June 2013. Adoption of the CRR/CRD IV was noted to be “of the utmost priority so as to develop a single rule book.” The EU Council conclusions also called for an operational framework to be in place before June 2013 that would allow the ESM to have the possibility to directly recapitalize banks when an effective SSM is established.

7. Main elements. The draft Regulation provides clear tasks and strong supervisory powers to the ECB over all credit institutions authorized in the euro area. The main elements:

- *Risk-based approach.* The transition is rapid, sequenced in a pragmatic manner, with a focus first on banks requiring public support, then systemic banks. The Council agreed that the SSM would come into operation in March 2014, or one year after the legislation enters into force, whichever is later. The agreement provided that when the ESM requests the ECB to take over direct supervision of a credit institution as precondition for direct recapitalization, the ECB may immediately assume its supervisory duties concerning this bank, regardless of the starting date of the SSM.
- *Coverage.* The SSM would cover all credit institutions established in participating countries, although most tasks related to the supervision of those institutions considered “less significant” would normally be carried out by the national authorities. The criteria under which banks would be under the direct supervision of the ECB include size, importance for the economy of the EU or of a member state, and significance of cross-border activities.⁷ The ECB appropriately retains the power to bring any bank under its direct supervision, if it deems necessary.
- *Mandate.* The ECB is provided with a clear mandate for bank safety and soundness and financial stability.
- *Tasks and powers.* The ECB is provided broad powers available to competent supervisory authorities under EU legislations. Broad investigatory and supervisory powers include enforcing compliance with prudential norms, regarding own funds, large exposure limits, liquidity requirements, leverage, disclosure requirements, licensing and withdrawal of

economic and monetary affairs put forth its views on the need for a strong, accountable, and inclusive EU banking supervision. The ECB also issued its opinion welcoming the proposed establishment of an SSM, but calling for strong powers to be provided to the ECB. The four Presidents’ report, “Toward a Genuine Economic and Monetary Union,” published December 5, 2012, and the EU Council conclusions reiterated the need for rapid establishment of a single resolution mechanism, built around a single resolution authority, as the ECB assumes its supervisory authority in full.

⁷ Under the criteria specified in Art 5(4) of the Council agreement of the regulation, banks accounting for about 80 percent of euro area banking assets would be under the direct supervision of the ECB. A bank will be under the direct supervision of the ECB if any one of the following conditions is met: (i) assets exceed €30 billion, (ii) the ratio of total assets to GDP of the home member state exceeds 20 percent, and (iii) national competent authorities consider the institution to be significant. An institution may also be considered as significant by the ECB if it has significant cross-border assets or liabilities, relies upon ESM financial assistance, or is among the three largest institution in the home member states (to ensure direct supervision of banks of smaller countries).

authorization, assessing mergers and acquisitions, performing on-site inspections and requesting all necessary information, carrying out stress tests and assessment for public recapitalization, imposing macroprudential (capital and liquidity) buffers, conducting consolidated supervision and supervision of financial holding companies, carrying out early intervention tasks in relation to the listed prudential requirements, and assessing governance and internal capital adequacy processes. Operational arrangements now need to be specified—these must ensure an adequate division of labor between national authorities and the ECB, make incentives compatible, and provide for appropriate information sharing within the SSM to underpin effective supervisory decision making at the supervisory board. The ECB is to adopt a detailed framework for the practical modalities of supervisory cooperation within the SSM by mid-2013.

- *Other EU countries and institutions.* Non-participating member states will be able to enter into close cooperation with the ECB, under the condition that the national authority will abide by ECB guidelines and requests, and provide all necessary information that the ECB may require. The ECB is tasked to coordinate and express a common position of euro area national supervisors at the Board of Supervisors and at Management of the EBA for issues relating to the supervisory tasks conferred on the ECB.
- *Governance.* A supervisory board (aided by a Steering Committee) will be created to achieve appropriate governance and facilitate timely supervisory decision making by, or subject to the oversight and responsibility of, the Governing Council. The Council agreement strengthened the governance arrangements relative to the EC proposal reflecting concerns related to the separation between monetary policy and supervision (to minimize conflicts of interest between the two functions) and to ensure that non-euro area countries have a voice in the SSM (since non-euro area “opt ins” cannot be represented on the ECB’s Governing Council). Strict differentiation between monetary policy and supervision will apply, including by strengthening the power of the supervisory board with a complex voting procedure that ensures representation of the non-euro area members. Draft decisions of the supervisory board will follow a “silent procedure,” i.e., they will be deemed adopted unless the Governing Council objects within a short period (10 days in normal times, and 2 days in stressful times). A mediation panel and a Steering Committee are to be created to help resolve disagreements and aid decisions. In practice, it will be important to balance the representation of national interests and public officials from the ECB in the governance structure of the SSM. It will also be important to ensure that the complexity of the setup does not undermine effective and prompt supervisory decision making.
- *Accountability.* The Governing Council, and in particular the Chair of the supervisory board, is accountable to the Eurogroup and the EU Parliament through, among other things, an annual report on the execution of the ECB’s supervisory tasks and transparency of its supervisory budget. Moreover, the ECB is subject to internal and external audits, also by the EU Court of Auditors, and judicial scrutiny by the EU Court of Justice. Both the ECB and the national authorities are responsible for the banks under their direct supervision, although the ECB is responsible for the effective and consistent functioning of the SSM.

- *Role of national authorities.* National authorities will prepare and implement ECB acts under the oversight of the ECB, perform day-to-day supervision activities, and directly supervise banks not classified as “significant.” They will remain exclusively responsible for consumer protection and AML tasks, receiving notifications from credit institutions related to the right of establishment, supervising activities of third countries credit institutions’ branches, and supervising payments services.
- *Macroprudential policies.* The ECB will be able to impose capital buffers, such as a countercyclical capital buffer, in addition to capital requirements, and any other measures aimed at addressing systemic or macroprudential risks as specified in EU acts, such as the CRR/CRD IV legislative package. The Council agreement provided both national authorities and the ECB with powers to make use of macroprudential instruments, in close collaboration with each other, and includes specific reporting to national parliaments to strengthen accountability. But the ECB powers are limited to those specified in the relevant EU Directives. Either party that takes such a step needs to inform and hear the other party ahead of time. In practice, cooperation will be critical to ensure coherence and effectiveness of measures.
- *Resources.* Supervision could be financed partly by risk-based levies on credit institutions.

8. Assessment. There are several positive aspects to the proposal and agreement that mention all elements necessary to make the Banking Union effective (Table I.1). Among these are that the ESM can request the ECB to take over direct supervision of a credit institution as a precondition for direct recapitalization, regardless of the starting date of the SSM—direct bank recapitalization by the ESM is critical for stabilization in the near term.⁸ The ambitious, though risk-based, approach will require putting in place rapidly the resources and frameworks needed for effectiveness. The proposal specifies a clear mandate and accountability of the ECB, and appropriately confers broad investigatory and supervisory powers to it. Moreover, the proposed fast adoption of the draft Directives on regulation, DGS and Bank Recovery and Resolution is a welcome step. The call for a single resolution mechanism is welcome, including the need for appropriate and explicit backstops.

9. Clarity needed. However, further clarity is needed on how the delegation of supervisory tasks and the associated control will be realized, macroprudential oversight, the powers to assume national discretion as defined in the CRR/CRD IV, the allocation of powers to intervene and to enforce administrative sanctions and to trigger resolution (alongside a single resolution authority to be established), home-host supervisory arrangements for non-EU banks, and the interaction with the EBA. While Article 127(6) ESCB/ECB Statute allows the EU to confer some supervisory tasks on

⁸ The requirement for the SSM to be in place before direct recapitalization by the ESM is permitted was set out in the statement of euro area leaders at the EU Summit of June 2012.

the ECB, over time, strengthening the legal basis of the new framework with a view to minimizing litigation risk may require Treaty change.⁹

10. Risks. The EC proposal and agreement carries risks of an incomplete framework. While it sketches a swift implementation of a single supervisory mechanism, it lacks a roadmap toward a common safety net (essential for depositor confidence and to weaken the sovereign-bank links). Greater clarity would be useful on how and when a single resolution authority (essential to complement the single supervisory mechanism) can be established, as the proposal by the Commission and by the EU Presidency is conditional on prior agreement on the draft Directives on deposit guarantee schemes and bank recovery and resolution. Clarity is also needed on whether implementation of a single supervisory mechanism would require changes to national legislations.

⁹ In particular, the legality of the legal instrument establishing the SSM and its decisions could be challenged before the EU Court of Justice by EU Institutions (including the EU Parliament), member states, and any private person or entity affected by SSM decisions.

Table I.1. European Commission Proposal and the EU Council Agreement

EU Proposal and Council Agreement	Assessment
<p>Supervision:</p> <p>Single supervisory mechanism centered at the ECB:</p> <ul style="list-style-type: none"> - starting March 01, 2013; and - full effect by March 01, 2014 (or 1 year after the legislation enters into force, whichever is later). 	<ul style="list-style-type: none"> - The ECB is provided with broadly adequate governance, powers, and accountability to perform supervisory tasks. - Some areas require more progress/clarity: <ul style="list-style-type: none"> o allocation of powers to intervene and enforce administrative sanctions and trigger resolution; o adequate degree of delegation to national authorities (although the Council agreement includes some clarifications on allocation of banks and some tasks); o home-host supervision with non-EU countries; o macroprudential oversight (although the agreement involves giving both ECB and national authorities some powers). - Governance agreements (for SSM and EBA) are complex; in practice, it will be important to ensure that they promote timely and effective decision making.
<p>Regulation:</p> <ul style="list-style-type: none"> - As soon as possible: adopt “single rule book” while providing some flexibility to national authorities. - Role of the EBA as standard-setter for the EU is confirmed. 	<ul style="list-style-type: none"> - Fast adoption is necessary, aligned with Basel III requirements. - Some areas lack clarity: <ul style="list-style-type: none"> o ECB’s power to assume national regulatory discretion; o EBA’s role in supervisory/resolution colleges.
<p>Resolution:</p> <ul style="list-style-type: none"> - By June 2013: adopt EU directive harmonizing and strengthening national resolution regimes. - Announce steps toward a single euro area resolution authority when agreement on the Directive is achieved in the course of 2013. 	<ul style="list-style-type: none"> - Fast adoption of the resolution directive is welcome. - A single resolution authority, with adequate backstops, is a necessary and urgent step. - Transposition of the Directive into national laws should be accelerated relative to the current deadlines (01/2015, and 01/2018 for bail-ins).
<p>Safety net:</p> <ul style="list-style-type: none"> - By mid-2013: adopt EU directive harmonizing national deposit guarantee schemes. 	<ul style="list-style-type: none"> - A roadmap toward common safety nets is missing in the proposal. - Common deposit insurance and backstops are crucial to restore confidence and weaken links between banks and sovereigns.

<p>Other EU countries:</p> <ul style="list-style-type: none"> - Close cooperation as non-voting member of the single supervisory mechanism; - Abide by ECB guidelines and requests, subject to safeguards; - EBA confirmed in its current role, but further possible reforms postponed to 2014 review of the ESFS. 	<ul style="list-style-type: none"> - Non euro area EU countries that wish to opt in may require strong governance safeguards but should not be allowed to opt out too easily after they join. Countries that peg to the euro or have large FX liabilities (or euro area bank presence) may have relatively larger benefits from opting in than others. - To improve home/host supervision with other EU countries, the EBA should be provided with stronger powers in colleges.
<p>ESM recapitalization:</p> <ul style="list-style-type: none"> - Agreement on operational framework, including the definition of legacy assets, by June 2013. 	<ul style="list-style-type: none"> - Framework must be in place to ensure that the ESM will have the possibility to swiftly directly recapitalize banks.

C. Design of the Single Supervisory Mechanism

This section elaborates on design issues pertaining to a single supervisory mechanism.

11. Lessons. It may prove useful to draw on cross-country experiences. In federations such as the United States and Canada, supervision, safety nets and resolution are established at the federal or central level.¹⁰ Different models of organization may be chosen, whether delegation or full centralization. The Board of Governors of the United States Federal Reserve, for example, delegates supervisory tasks to regional reserve banks, with strong internal governance mechanisms, while the Federal Deposit Insurance Corporation (FDIC), a supervisory and resolution authority, operates as a fully centralized body. The experience of the United States and Canada demonstrates that supervision and resolution functions can be centralized in a monetary union (Annex I.1). It also suggests clear benefits of having in place mechanisms to ensure effective coordination and information flows between sister agencies (including between regulators and the resolution agency), on the benefits of creating overlaps rather than living with gaps, but also on the need for strong corrective action mechanisms and early intervention, and the case for horizontal checks and balances between sister supervisory bodies.

12. International standards. The “Core Principles for Effective Supervision” or Basel Core Principles (BCPs)¹¹ issued by the Basel Committee on Banking Supervision are the accepted minimum standards for sound practices in prudential regulation and supervision of banks. They

¹⁰ There is more than one banking supervisory agency in the United States. While the Federal Reserve has a range of supervisory responsibilities, including supervising bank holding companies, and must coordinate with the Financial Stability Oversight Council for systemic issues, it shares supervisory and regulatory responsibilities for domestic banking institutions with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, and with the banking departments of the various states.

¹¹ Core Principles for Effective Banking Supervision, September 2012 (<https://www.bis.org/publ/bcbs230.htm>)

provide guidance for designing and assessing the new single supervisory mechanism for the euro area.

13. Considerations. However, designing an effective supervisory mechanism for the euro area has added complications. The ECB will be formally accountable for supervision but will have to rely on competencies and resources at the national level. This is not just because of resource constraints in the near term, but also differences in legal, accounting and tax frameworks, as well as differing local language, business and supervisory cultures, and local knowledge and relationships that are important to assess bank activities. In such an environment, the center will need to delegate, but also monitor, supervisory operations to contain reputational risks. The design of this interaction between the center and national authorities, of the decentralization and delegation of tasks, and the allocation of powers between the two levels will play a key role in achieving effective supervision.

Preconditions and prerequisites

14. Preconditions. According to the BCPs, a number of preconditions for sound banking supervision must be met in the longer term. A clear framework for financial stability policy must be in place, including to provide strong macroprudential oversight, and for crisis management and resolution to deal effectively with bank failure and minimize disruptions. An appropriate common safety net is essential to deal with risks to confidence in the financial system and contagion to sound banks while minimizing distortions.¹² Some preconditions are beyond the jurisdiction of supervisors, and some elements are not yet in place at the euro area level. For example, resolution regimes (and safety nets) remain nationally based and, in most countries, need to be strengthened to be aligned with FSB Key Attributes for Effective Resolution.

15. Prerequisites. A set of prerequisites are essential to establish a sound basis for the single supervisory mechanism. The supervisory mechanism should have operational independence consistent with its statutory responsibilities, legal protection of supervisors, transparent processes, sound governance and adequate resources, and should be accountable for the discharge of its duties. Among these, the following considerations are noteworthy:

- *Objectives and mandates.* As supervisor, the ECB should ensure the safety and soundness of credit institutions, while adopting a systemic approach to financial stability that contributes to preserving the integrity of the Single Market for financial services. Under the EU Treaty, the primary objective of the ECB is price stability, and its secondary objective is to support the general economic policy objectives of the EU, e.g., a high level of employment and sustainable and non-inflationary growth. Involving the ECB in supervision will give it access to supervisory information in support of its monetary policy and lender of last resort (LOLR) functions, and provide the ECB with more information to separate illiquid from insolvent

¹² The BCP preconditions for effective supervision also include the implementation of coherent and sustainable macroeconomic policies and a well-developed public infrastructure and effective market discipline.

banks. Housing supervision and monetary policy under one roof can also lead to difficult choices when monetary policy choices impact the soundness of important banks. A revision of ECB objectives through Treaty changes may be warranted to provide clarity with respect to the interaction between the ECB's monetary mandate in the monetary union and its supervisory mandate in the banking union, as is explicitly specifying that the ECB's supervisory mandate includes financial stability and macroprudential oversight.

- *Operational independence and legal protection.* Operational independence regarding the ECB's supervisory mandate derives legally from the ECB/ESCB statutes. But bringing supervision under the umbrella of the ECB creates risks for its independence (and hard-won reputation), given the added potential for political interference. Modifications to the Treaties should be considered to safeguard the ECB's independence also for its supervisory mandate and to strengthen the legal protection for supervisors.
- *Governance.* The Governing Council is the decision making body of the ECB, and is responsible for supervisory tasks according to Article 127(6) of the Treaty. Sound governance will be crucial, to ensure early identification of risks and timely and effective decision making in the interest of the whole banking union (and not of individual countries). Because supervisory decisions have distributive implications, the decision making body may have to adopt a mechanism that protects effective and timely decision making (e.g., to ensure the "will to act").
 - A one-member-one-vote rule would ensure that regional interests are better accounted for and provide a balance to large countries' influence. On the other hand, allocating voting rights based on economic size would align countries' rights with the relative importance of their economies. A balance between the two could be considered (perhaps a uniform set of basic votes, combined voting rights relative to economic size). Consideration should be given to providing non-euro area members that join the supervisory mechanism with voting rights.
 - Regardless, erecting robust firewalls between monetary policy and supervision would protect the independence and credibility of each function of the ECB, ensure the confidentiality of supervisory information, and help limit potential conflicts of interest (which may arise when interest rate policies impact weak banks, or when the LOLR function safeguards financial stability but risks lending to insolvent banks), while ensuring that synergies between the two functions are exploited. In the U.K., e.g., the supervisory function is being established as a subsidiary of the central bank.
 - One way to ensure swift decision making based on delegation is to establish a Supervisory Board within the ECB, assisted by a Steering Committee and a Supervisory Department, which could be given supervisory tasks and related decisions (under the EC proposal). Under this model, agreed to by the EU Council in December, monetary policy and supervision decisions would be reconciled at the Governing Council. Alternatively, a

separate body from the Governing Council could be established to provide stronger firewalls. However, it could make coordination and synergies more complex to achieve, could be legally complex to establish, and would require Treaty change.

- Additional considerations relate to the delegation of supervisory tasks to national authorities and the need to establish clear chains of command and adequate incentives.
- *Accountability.* Independence must be complemented with accountability to European citizens. Pursuant to the Treaty, the ECB's standard monetary policy reporting is addressed to the European Parliament, the EU Council, the Commission, and the European Council. Given the fiscal implications of supervision, stronger (such as more frequent) reporting to the EU Parliament and to the euro group could be envisaged for the supervisory function.
- *Resources.* Any supervisor needs secure and adequate funding. Pragmatism will need to govern decisions related to funding and implementation, both in the near term and in the steady state, but the resources obtained should allow the ECB to build adequate capacity, while protecting it from influence by national authorities or the industries. In particular, the ECB will need to establish highly trained and independent staff at the center, including, but not only from, national authorities, to be able to directly supervise a subset of banks (including globally systemic banks). This will take time. In this regard, the challenge of developing the requisite competence at the ECB and building credibility in supervision should not be underestimated. At the same time, national supervisors must retain sufficient resources to perform their tasks. Funding models could consider combinations of industry levies (based on the size and the risk profile of supervised banks) and central bank support (seigniorage) that balance these considerations, provided that budgetary transfers from the ECB's monetary policy leg (seigniorage income) to its supervisory leg do not hamper the execution of its monetary mandate.

Table I.2. Number of Banks to Supervise: Euro Area and the United States

	# of banks
 U.S. FDIC INSURED	7246
# OF BANKS REGULATED BY:	
FEDERAL RESERVE	6027
OF WHICH ASSETS > US\$ 100 BIL	26
FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)	4551
OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)	2036
NATIONAL CREDIT UNION ADMINISTRATION (NCUA)	7094
 EA CREDIT INSTITUTIONS	6180
OF WHICH ASSETS > €100 BIL	> 30
<small>SOURCES: ECB, FED, FDIC, AND NCUA</small>	

Bank coverage

16. Steady state. The single supervisory mechanism should eventually cover all of the roughly 6000 credit institutions licensed in the eurozone:

- *Sovereign-bank links.* The motivations for the Banking Union include weakening, or severing, sovereign-bank links and limiting the buildup of systemic risk. Large and cross-border banks should be included. But, as the experience of Spain and others has demonstrated, small banks with correlated risks can represent a major fiscal risk for the sovereign and a systemic risk for the euro area. Covering only “systemic” banks (with a difficult decision to make when demarcating systemic from non-systemic banks), while potentially easier to implement technically and politically, would only partially address these risks.
- *Competitive distortions.* A Banking Union covering only a subset of euro area banks would have implications for the level playing field and could encourage regulatory arbitrage between centrally and nationally supervised banks.
- *Uneven distribution of costs and benefits.* Because banking size and activities differ greatly across euro area countries, a partial Banking Union that covers only a subset of large banks would benefit some countries more than others, and would therefore have implications on the distribution of costs and benefits of the Banking Union across countries.

17. Transition. Bringing all euro area banks under the supervision of the ECB is a major task, and entails many practical difficulties and risks.

- *Positives.* A swift transition to covering all banks would reduce risks of regulatory forbearance between the announcement of the decision to create a single supervisory mechanism and the actual transfer of supervisory responsibilities. An “effective” single supervisory mechanism would also open the possibility of starting direct ESM recapitalization of banks.
- *Risks.* Unless supervisory capacity at the center is put in place quickly and incentives at the national and central levels are well aligned, there would be risks of information losses, and supervisory drift and regulatory forbearance. The challenge of putting in place an effective capacity at the center should however not be underestimated, which puts greater emphasis on urgent efforts to plan for and ensure success under a realistic but ambitious timeline.
- *Sequencing.* A pragmatic approach would be to bring banks in need of—or nearly in need of—recapitalization by the ESM or other public funds, and large and systemic banks, under the single supervisory mechanism first. Other banks should be progressively brought under supervision of the ECB, at a speed balancing risks of supervisory drift.

Tasks and powers conferred on the ECB

Steady-state

18. Principles. To ensure effective supervision, bank supervisors should have clear responsibilities and objectives for each authority involved in supervision (BCP 1). To the extent that the ECB will be a supervisor in its own right, it will have to comply with the Basel Core Principles. Assessing the single supervisory mechanism will also require discerning how effective is a supra-national setup sharing some responsibilities with national authorities and delegating some of the

tasks. Effectiveness would depend, among other things, on the functions delegated, capacity constraints, and the accountability and control mechanisms.

19. Tasks. The ECB should have clear responsibilities over the life cycle of banks to fulfill its safety and soundness mandate. This implies that the ECB should be tasked with authorizing banks, assessing and authorizing mergers and acquisitions, ensuring compliance with prudential requirements, imposing additional buffers (including countercyclical and systemic buffers), applying requirements regarding internal governance and processes of banks, imposing all measures determined necessary to address early on unsafe and unsound practices by banks, carrying out stress tests, conducting consolidated supervision, and taking on tasks related to home-host arrangements for cross-border banks. The EC proposal broadly confers these tasks on the ECB.

20. Powers. To carry out its tasks effectively, including potentially solo supervision of a set of banks (without delegation to national authorities), the ECB should have adequate formal powers to:

- enforce minimum prudential standards and any restrictions prescribed by the supervisory review, including increasing the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance (BCP 1 and 16);
- request information and have full access to banks' boards, management and staff records, and perform general investigations and onsite inspections (BCP 1 and 10);
- require all necessary early corrective actions to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system, and prevent banks from breaching standards (BCP 11);
- ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related entities in matters that could impair the safety and soundness of the bank or the banking system (BCP 11);
- take measures and sanctions in line with the gravity of the situation, including revoking the license (BCP 11);
- determine supervisory plans (BCP 8);
- review, reject, and impose conditions on transfers of ownership and major acquisitions (BCP 7);
- perform consolidated supervision, including application of prudential standards for the entire group (BCP 12);
- withdraw licenses, and collaborate with relevant authorities in deciding when and how to effect orderly resolution (BCP 11); and
- identify and assess the build-up of risks, trends and concentrations within and across the system, in coordination with other relevant authorities, and address proactively any serious threat to the stability of the banking system (BCP 8 and 9). See below on macroprudential responsibilities.

21. Formal versus real powers. Distinguishing formal and real power is important: because supervisory incentives are skewed at the national level, it is essential that the ECB has real powers (requiring adequate resources) and does not simply validate (and take responsibility for) decisions proposed by national authorities. A prerequisite is to confer formal supervisory powers on the ECB, and ensure monitoring of supervisory tasks during a transitional phase as real powers may continue to reside partly with the national authority until supervisory decision making and capacity are in place at the ECB. Having a mechanism of effective delegation and monitoring of supervisory tasks is also important in the steady state when a common backstop is in place.

22. Ensuring real powers. To ensure that national incentives are aligned with those of the center, and that the center has real powers in the conduct of supervision, further arrangements could be considered. For instance, the ECB could be provided with the ability to immediately conduct peer reviews and joint inspections, including lead supervisors from other countries or the ECB, with cross-country teams. The ECB could use a range of metrics, solvency, and liquidity stress tests to discern which banks warrant particularly close attention or review by the ECB.

Design of a delegated supervisory mechanism

23. “Hub and Spokes” model. Since all banks are to be included in the single supervisory mechanism, a division of labor between the center and national authorities is necessary while all information should be shared among supervisory bodies of the SSM. The two extreme models of division of labor—full centralization or full decentralization—are neither practical nor desirable: (i) a fully centralized system is not an option, given that supervisory knowledge and resources remain at national levels; and (ii) a fully decentralized mechanism in which the center validates the decisions taken locally is not desirable either, particularly when common backstops are fully in place at the euro area level, as consistency of the quality of local implementation of supervisory practices cannot be assured. Conferring formal responsibilities on the ECB without adequate enforcement power could result in weak supervision and put the ECB’s reputation at risk.

24. Common risk based supervision in a supra-national setting. A common analytical approach should be agreed and applied to the SSM comprising the ECB and national supervisory bodies. A risk-based framework would attribute a risk classification to each banking organization within the euro area. Based on this methodology, the ECB would develop a protocol for supervision and establish the frequency, level, and type of supervisory action to be conducted. The level of centralization, intrusiveness and the mix of multinational members in supervisory teams would be proportionate to the supervisory assessment of risk. The model would also define a non-rigid perimeter of institutions subject to supplementary intense scrutiny by the ECB, allowing fluidity of response to emerging information.

25. Principles. The framework should create a coherent and consistent supervisory mechanism with final decisions taken at the centre. To promote incentive compatibility in the delegated supervisory mechanism, the extent to which tasks and supervision of a set of banks between national authorities and the center could be derived from a set of principles such as: (i) *the systemic*

dimension: the center will have a comparative advantage in adopting a systemic approach to supervision and internalizing cross-border externalities inherent to the supervision of systemically important financial institutions (SIFIs); (ii) *local knowledge and know-how*; (iii) *risks of regulatory capture*: national supervisors may be more likely to favor national banks, which would create distortions that can have financial stability consequences for the region; (iv) *discretion in decision making*: the degree of delegation must decrease with the degree of discretion associated with specific tasks; and (v) *consistency of delegation*: when tasks are delegated, consistency of approach among national authorities, and between the national authority and the center, is essential.

26. Grouping banks. For example, an initial framework would classify banks on the basis of size, interconnections, complexity and cross-border orientation, and whether the bank requires common funding:

- *Group I*: global SIFIs (G-SIFIs), banks determined to be systemic for the euro area, and banks requiring (or nearly requiring) direct recapitalization by the ESM;
- *Group II*: banks of intermediate size, simple but potentially systemic for their sovereign (individually or as a group); and
- *Group III*: very small banks unlikely to be systemic or to require access to a common backstop.

27. Delegation by group. The degree of delegation of day-to-day supervision by the ECB would vary by group. Group I banks would be under the direct and intrusive supervision of the ECB, which would maintain an onsite supervisory presence, with a mix of international supervisors in teams led by an ECB supervisor. Group II could be supervised mainly by national authorities, which would maintain an onsite presence, with supervision performed by teams of mixed nationalities appointed and compensated by their home countries (e.g., for governance purposes), and offsite monitoring by the ECB and the local supervisor. Day-to-day supervision of Group III banks would be fully delegated to the national authority, but the ECB would be entitled and ready to request participation equivalent to the other groups at anytime (e.g., if a group of banks become systemic because of correlated exposures). For all groups, offsite monitoring should be carried out by the ECB and the local supervisor.

28. Delegation by task. Tasks that are more difficult to standardize, that require more intrusion and discretionary decisions, or that are more critical for the system as a whole or are more subject to political interference would be less conducive to delegation. National authorities could perform day-to-day assessment of banks' soundness and carry out some examinations (subject to consistency with the allocation of tasks by groups of banks). Assessment of internal risk models and monitoring of their use could be performed locally, under general guidance from the ECB. But supervisory reviews, licensing, corrective actions, inspections, and decisions related to imposing higher individual or macroprudential buffers, sanctioning and initiating resolution should be less amenable to delegation. Approval for the use of advanced approaches, approval of certain capital instruments, model validation, and thematic/horizontal inspections would be done by the center or with mixed nationality supervisors. The ECB should be closely involved in stress tests to identify pockets of

vulnerability among euro area banks, perform (or request from national authorities) intrusive examinations, approve M&As, and if needed initiate early corrective actions.

29. Escalation of decision making. Supervisory responses should be escalated appropriately. Preliminary recommendations to address problems detected during supervision would need to be left behind by each inspection team, regardless of their level of risk. For banks with a higher risk classification, such as I and II above, review by the center would be required. For less-systemic banks, the national level would implement corrective action and only elevate the issue to the center if concerns have not been addressed by the institution in the established timeframe. As a first step in escalation, inspection reports could be shared with different teams for a “peer review.”

30. Two-dimensional delegation. The allocation of tasks within the supervisory mechanism between the ECB and the national authorities could be based on a flexible approach, combining delegation by bank category and by task, with escalation to the center as institutions become more systemic and tasks become more critical to financial stability and subject to discretion.

Transition

31. Steps toward the steady state supervisory mechanism include:

- *In a first, urgent phase of the transition*, the ECB must be provided with the full legal powers and protections needed to perform its supervisory tasks, including the powers to impose a complete range of corrective actions and initiate resolution. An embryo off-site supervisory structure and a decision-making body must be created at the ECB; standardized templates of information should be developed and supervisory data should be shared. The centralized analysis should be used to create the first thresholds for centralized supervisory actions, and the classification of banks should be established. A solvency and liquidity stress test of the most important euro area banks may be considered.
- *In a second stage*, the ECB should develop a consistent risk-based supervision approach (establishing protocols that would specify, for example, the frequency, level, and type of supervisory action, and the levels of centralization, intrusiveness, and mix of multinational members in supervisory teams) and the characteristics of supervisory processes that will prevail in the steady state. The development should ideally be front-loaded of common corrective action protocols, where minimum actions by supervisors are spelled out; common timeframes for banks to address detected deficiencies; and common settings for the escalation of corrective actions and sanctions.
- *In a third stage*, systemically important banks (SIBs), and more generally banks higher in the supervisory risk matrix, would be brought under the direct supervision of the ECB, and common protocols and design of the system of delegation finalized.¹³ When the ECB starts

¹³ Note that the draft regulation published by the Council of the EU stipulates that the ECB may also start, from the date of entry into force of the SSM regulation, directly supervising a bank if the ESM unanimously requests the ECB to take over the direct supervision of this bank (Art 27(3)).

supervising SIBs, international teams would start to perform risk assessments of each institution and develop supervisory plans of these banks. These plans would identify areas which will need to involve mixed-nationality teams, and estimate the workforce and skills needed at headquarters and at the national level. ECB will decide the most suitable approach, including the need for a permanent presence in some banks, for others intensive diagnostic onsite inspections before a regular cycle of onsite programs can be restored, or the use of mixed teams only for the supervisory review process and authorization for advanced approaches.

D. Risks

Risks associated with the establishment of an SSM include insufficient resources, skewed incentives, powers not commensurate with responsibility, governance conflicts, and incomplete reforms.

Inadequacy of resources, skewed national incentives, and lack of real power

32. Central supervisor. To be an effective central supervisor, the ECB must be properly resourced, able to perform some key supervisory tasks itself, and able to effectively control the actions of and solve disagreements with national authorities, particularly when ESM recapitalization is in place. Otherwise, it could be excessively dependent on national authorities, which would retain real power, may favor national banking systems, but with unclear accountabilities. In that context, the possibility of delegating supervision to national supervisors is useful and adds flexibility, particularly during the transition when the ECB builds resources. But it also carries risks of locking in an imperfect practice of delegation in the SSM.

Governance

33. Conflicts of interest. The governance of the single supervisory mechanism must be robust enough to ensure that monetary policy and LOLR functions and ECB reputation are not compromised by conflicts of interest. Risks arise when monetary policy decisions (such as interest rate decisions) impact solvency, or when LOLR functions safeguard financial stability (and in the process risk lending to insolvent banks). As a creditor, the ECB may also face conflicts of interest when, as a supervisor, it is required to withdraw a license and trigger resolution, resulting in losses to bank claimants. This is where the governance of the decision-making process and accountability become critical.

Incomplete framework

34. Coherence. A single supervisory mechanism requires a single resolution authority and an adequate common safety net. Without centralized resolution, the single supervisory mechanism would face the difficult task of coordinating corrective actions and decisions to initiate resolution with many national resolution authorities; least cost resolution would be hard to achieve; and conflicts of interest over the distribution of losses may arise with national authorities, with potential stability implications. Without an adequate common fiscal backstop and funding for resolution, the

supervisory mechanism may not obtain political buy-in, jeopardizing incentives within the delegated system of supervision if potential fiscal costs remain national. Under such a scenario, the ECB-centered supervisory mechanism would face high reputational risks when supervisory decisions have direct fiscal implications at national levels, or if resolution and bail-ins have confidence effects on bank deposits.

35. Urgency. It is thus urgent that a plan for a more complete Banking Union be spelt out, and that decisions on critical design aspects are not deferred too far into the future. Clarity on the implied and required complementary reforms would help to avoid a piecemeal and potentially incoherent approach. Steps toward the creation of a single resolution authority and resolution fund should be taken as soon as possible, and ideally advance in parallel to the shift toward to the single supervisory regime.

36. Single market. With some member states remaining outside the Banking Union, there are risks to the single market for financial services arising from a “variable geometry” of coverage. While the Banking Union would benefit the single market by helping reverse financial fragmentation, an efficient framework is needed to ensure collaboration between the SSM and those not participating in the Banking Union. In particular, the EBA should play a role, e.g., by developing a single supervisory handbook in the EU.

Other risks

37. TBTF and evolving risks. Creation of the Banking Union will not, by itself, solve the too-big-to-fail (TBTF) problem. Some of the G-SIBs may continue to grow, including beyond the euro area, complicating cross-border supervision and resolution. Common fiscal backstops and a single resolution authority, with powers and tools aligned with the FSB Key Attributes, would support stability, while the SSM could contain incentives to grow excessively (including, e.g., through capital surcharges for SIFIs). The regulatory environment (e.g., as risk weights are adjusted) would reinforce the benefits and consistency of the Banking Union. But changes in the structure of finance could create new, unanticipated risks, including through new interconnections and mergers among financial institutions, and facilitation of financing larger and more lasting external macroeconomic imbalances. These raise new challenges for the euro area, requiring continued vigilance and further strengthening of the supervisory mechanism. (Legal risks are covered in Box 5 of the Main Paper.)

E. Further Considerations

Additional considerations in the setting up of an SSM include the degree of centralization in macroprudential oversight and relations with non euro area EU countries.

Macroprudential oversight

38. Case for centralization. A case can be made that the ECB should be given responsibility and powers to perform the macroprudential oversight in the euro area, involving national authorities.

- *Benefits.* The ECB should act as a macroprudential oversight institution for euro area countries, with binding powers to be able to use macroprudential instruments if it deems necessary. The high degree of financial integration calls for a coherent approach to macroprudential policies that internalizes cross-border externalities and addresses information and home-host coordination problems when using macroprudential tools. Centralization of decision making does not imply homogeneity of policies across countries. Policies would still need to be adapted flexibly to macrofinancial developments in particular countries or asset markets, and would apply to all financial institutions active in these countries or markets.
- *Costs and limitations.* There are costs to building capacity for designing macroprudential policies tailored to specific country conditions. But given the ECB's established expertise in financial stability, these costs may not be high. There may be an overlap with the role of the ESRB requiring some coordination. There could be a risk that taking macroprudential responsibilities could subject the ECB to political pressures or disagreements with national authorities, adding rigidities to the framework. As the ECB mandate does not include insurance firms or securities' markets, it would need to collaborate with competent authorities whenever such institutions are involved.
- *Mixed model.* A pragmatic approach may be a mixed model that would involve both the ECB and national authorities to ensure effective macroprudential oversight of the euro area, as implied in the legislative proposal for a single supervisory mechanism. In particular, the ECB may be conferred power to impose a systemic or countercyclical capital buffer if national authorities do not act, thus countering the lack of "will to act." Other tools not included in the CRR/CRD IV (such as limits on debt-to-income and loan-to-value ratios) may also be provided to the ECB when a common macroprudential toolkit is in place. Thus, the ECB would be provided a macroprudential mandate for the euro area as a whole and for individual countries. Alternatively, if national authorities retain some macroprudential policies as foreseen in the Council agreement, the use of tools may have to be coordinated and validated by the ECB, and mechanisms may be designed to resolve conflicts of interest that may arise between national authorities and the ECB (the ECB could be more prone to act than national authorities who may be subject to political pressures).

39. ESRB. The ESRB should remain the EU macroprudential oversight body, and closely cooperate with the ECB. Under the current framework, the ECB provides resources to the ESRB and is represented at the ESRB General Board by the President (who chairs the ESRB Board), the Vice President and the Governors of the NCBs. The ESRB should interact with the ECB on macroprudential toolkits when the ECB takes on macroprudential responsibilities. Going forward, considerations may be given to strengthening the ESRB powers and resources.

Implications for other EU countries

40. Concerns. Some non-euro area EU countries have questioned whether uneven access to safety nets and backstops or policies implemented to the benefit of the euro area could adversely

impact the single market. Others have wondered whether their interests would be taken into account by a powerful single supervisory mechanism, in the case where they choose to either opt out and are impacted by the decisions of the single mechanism or opt in but not have a vote in the Governing Council. Still others have voiced hope that the opt-in could be made more attractive, e.g., through access to backstops.

41. Benefits for other EU countries. A Banking Union would contribute to greater stability in the euro area and, therefore, enhance the functioning of the EU single market for financial services and generate positive cross-border spillovers to other EU countries. A single euro area supervisory mechanism should simplify the supervision of cross-border banks. Within supervisory colleges, non-Member States would coordinate home-host supervision with the ECB instead of having to interact with multiple individual euro area supervisors.

42. EU Commission/Council proposal. Flexible supervisory arrangements, such as close cooperation of the ECB with supervisors in non-euro area Member States as envisaged by the Commission and the Council agreement, may suffice to achieve effective supervisory convergence under the current Treaty. But housing supervision within the ECB necessitates consideration to provide non-euro area countries with a say within the single supervisory mechanism, through a robust governance mechanism as envisaged in the draft legislation by the Council of the EU.

43. Opt-ins. Given the high degree of financial integration in the EU, other EU countries may want to join the Banking Union, especially if they are pegged to the euro, or sustain high levels of foreign currency liabilities, or have a significant presence of euro area banks in their domestic financial system. In the steady state, a common safety net would strengthen insurance mechanisms and depositor confidence for all, and provide a stronger basis to ensure private sector participation in bank resolution. It could improve supervisory quality (in particular, in small countries where resources are scarce), help internalize cross-border effects, and solve coordination problems arising in supervision or resolution. But it requires shifting control to the center.

44. The role of the EBA. To ensure balance of power at the EBA, voting procedures are to be modified for decisions requiring qualified majority. Double majority voting, as envisaged by the EU Council agreement, would balance the interests of the “outs.” In addition, reforms of the EBA should go beyond the proposal. The EBA role in supervisory and resolution colleges should be strengthened, together with the SSM, to reinforce coordination and cooperation in home-host issues for cross-border banks operating outside the single supervisory mechanism.

F. Summary

45. Benefits. A single supervisory mechanism is an essential step toward a Banking Union covering all banks in the euro area. It is part of a comprehensive response to the crisis—a precondition to direct recapitalization of banks by the ESM. In the longer term, it should provide the momentum and the vehicle to deliver consistently higher standards of supervision, remove national distortions, internalize cross-border effects, and deliver more uniform enforcement of regulations

across the region. In concrete terms, higher standards of supervision in place before the crisis may have meant a swifter identification of an unsustainable build-up of risk (for example, in Ireland or Spain) and a more timely and effective intervention to diffuse such risk (for example, through applying higher capital buffers or restricting excessive concentrations). It can provide benefits over the present nationally-based setup, provided it is in line with international best practices, including clear statutory responsibilities and objectives for the ECB, strong legal powers to carry out its supervisory tasks, operational independence, legal protection, sound governance, and adequate resources.

46. Practical issues. To be effective, the supervisory mechanism needs to overcome the practical challenges of setting up a delegated system, as no new single body can effectively supervise all euro area banks. While local information and know-how argue for delegating responsibilities to national authorities, the need for a systemic perspective, the prospect of local regulatory capture, greater standardization of tasks, and the need for public recapitalization argue for giving the ECB the conduct of certain tasks and the final responsibility for banking supervision. Real power must be aligned with responsibility, as merely reorganizing supervisory structures or granting responsibility to the center but not the power, would risk distorting incentives. Strong governance is important to contain conflicts of interest that may arise between monetary policy and LOLR functions and supervisory functions.

47. Essential package. The speed and sequencing of implementation need to be chosen carefully to minimize disruptions to supervision during the transition. In parallel, progress is needed toward a single resolution authority and resolution fund and toward an adequate common safety net. Their absence could strain incentives (e.g., regarding the distribution of losses in resolution), expose the ECB to political pressures, and compromise the effectiveness of supervision. Full commitment and a clear and time-bound roadmap with key deliverables toward establishing a single resolution authority and safety net would minimize such risks.

48. The “outs.” Establishing a single supervisory mechanism will benefit other EU countries. Indirect benefits include more effective interactions in cross-border colleges, and a more stable monetary union. Other EU countries may want to join the Banking Union, to benefit from more uniform and higher supervisory quality and stronger safety nets, although these economies and those that choose to opt-out would require stronger governance safeguards.

Annex I.1. Regulatory Models in Federations

A. Bank supervision and regulation in the United States¹⁴

49. Multiple regulators. Banking regulation in the United States has traditionally been fragmented, with multiple regulators with varying jurisdictions and mandates with some overlaps. The advent of deposit insurance in the 1930s made all deposit taking institutions, whether federally or state chartered, subject to at least one federal regulator. A potential concern with a system of multiple regulators was that it could create “under-laps” (if incentives to supervise are weakened by lack of clarity over regulatory boundaries), with externalities to institutions outside the perimeter of the weaker regulator. An advantage of multiple regulators is that it permits a variety of views that could prove valuable to limit risks of capture.

50. Agencies. Bank regulation in the United States is currently shared among four agencies. The primary federal regulator for nationally chartered banks is the Office of the Comptroller of the Currency (OCC). The primary federal regulator of state-chartered banks that are members of the Federal Reserve System, of institutions designated by the Financial Stability Oversight Council (FSOC) as systemically important, and of Bank Holding Companies is the Board of Governors of the Federal Reserve System (which partly delegates supervision to regional Federal Reserve Banks). State-chartered banks that are not regulated by the Fed have the Federal Deposit Insurance Corporation (FDIC) as their primary federal regulator. State-chartered banks are also subject to oversight at the state level. Credit Unions are regulated by the National Credit Union Administration, NCUA, (which also administers its own deposit insurance). All institutions covered by the deposit insurance of the FDIC but with another primary federal regulator are also subject to the backup regulatory oversight of the FDIC. Following the Dodd-Frank Act, state- and federally- chartered thrifts are now under the responsibility of the OCC and the FDIC, and thrift holding companies are under the responsibility of the Fed.

51. Dodd-Frank. The Dodd-Frank Act consolidated supervision in fewer agencies (by abolishing the Office of Thrift Supervision), created the Financial Stability Oversight Council (FSOC) headed by the U.S. Treasury to carry-out and coordinate macroprudential oversight and provide a forum for exchange of information among agencies, gave oversight authority over institutions designated by the FSOC as systemically important to the Federal Reserve, and resolution authority over such institutions to the Federal Deposit Insurance Corporation. The Dodd-Frank Act also included enhancement to the deposit insurance system, imposed new requirements for emergency lending facilities of the Fed, and strengthened capital requirements for institutions designated by the FSOC as systemically important.

¹⁴ Sources: Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; “Who regulates whom? An Overview of US Financial Supervision,” Mark Jickling, Edward Murphy, Report of the Congressional Research Service, December 2010.

Role of the FDIC

52. Role. The FDIC has broad jurisdiction because all banks and thrifts, federally- or state-chartered, carry FDIC insurance. It manages the federal deposit insurance fund (DIF) which is funded by risk-based levies on depository institutions and backed by the Treasury, and has access to credit lines from the Treasury. The fund is primarily used for resolving failing or failed banks. The FDIC sets the designated reserve ratio that supports the DIF. The deposit insurance ceiling was raised to US\$250,000 during the 2008 financial crisis. As a result of Dodd-Frank, the FDIC also has the authority to establish a widely-available program to guarantee liabilities of solvent insured institutions and their holding companies, under certain conditions during times of severe economic distress. In October 2008, the FDIC established such a program based on a provision of then current law that was suspended by Dodd-Frank.

53. Powers. Under its regulatory role, the FDIC has the power to examine individual institutions and to issue regulations that apply to all depository institutions. It also has powers to initiate early intervention and require corrective actions, which are triggered leverage ratios, and some elements of discretion.

54. Resolution. The FDIC manages receiverships, assumes and disposes assets of failed banks. The Dodd-Frank Act expanded the role of the FDIC in liquidating financial institutions, in particular by giving the FDIC similar authority over financial institutions designated as systemically important, whether banks or non-banks. As part of this new responsibility, the FDIC is the relevant authority, with the Fed, in the review of the “living wills” by systemically important financial institutions with assets of US\$50 billion or more, or designated by the FSOC. A Systemic Resolution Advisory Committee was established to provide advice and recommendations on issues regarding the resolution of systemically important financial companies, and will report to the FDIC Chairman, but has no formal decision-making role. The Office of Complex Financial Institutions (OCFI) has responsibility for carrying out the new responsibilities.

Role of the Fed

55. Supervisory role. The Board of Governors of the Federal Reserve System, in addition to the conduct of monetary policy, has safety and soundness examination authority for bank and non-bank financial institutions under its jurisdiction. In addition, the Dodd-Frank Act gave the FSOC authority to designate whether a firm is systemic and represents a “severe threat” to financial stability and the Fed may decide to trigger resolution, and to perform the systemic risk oversight of the financial system (a role that was not clearly defined until the 2008 crisis).

56. Scope. Financial institutions under the regulatory oversight of the Fed include bank holding companies, U.S. branches of foreign banks, state chartered banks that are member of the Federal Reserve System, and financial holding companies.

57. Systemic importance. The Dodd-Frank Act brought under the regulatory perimeter of the Fed all financial firms designated by the FSOC to be systemically important, savings and loan holding companies and securities holding companies, and payment, clearing and settlement systems determined to be systemically important (in conjunction with the CFTC or SEC). It also gave

the Fed responsibility to perform the Comprehensive Capital Analysis and Review (CCAR) to evaluate the capital planning processes and capital adequacy of the largest bank holding companies. This exercise includes a supervisory stress test to evaluate whether firms would have sufficient capital in times of severe economic and financial stress to continue to lend to households and businesses.

Roles of the OCC and NCUA

58. OCC. The Office of the Comptroller of the Currency created in 1863 is part of the Treasury supervising federally chartered banks. It was created to replace the circulation of state bank notes with a single national currency. The OCC supervises federally chartered banks and thrift institutions; it has examination powers to enforce safety and soundness of supervised banks, including the ability to issue cease and desist orders and revoke bank charters.

59. NCUA. The National Credit Union Administration, which became an independent agency in 1970, regulates all federal credit unions and state credit unions that are federally insured. It administers Central Liquidity Facility (a LOLR function) and a Credit Union Share Insurance Fund (which insures credit union deposits).

B. Financial supervision and regulation in Canada¹⁵

60. Framework. Canadian regulatory and supervisory framework spans both federal and provincial levels. At the federal level, the Department of Finance (DOF) is responsible for the overall stability of the financial system, and it legislates the financial sector. While the Bank of Canada (BOC) assesses risks to financial system stability, the Office of the Superintendent of Financial Institutions (OSFI) is the prudential regulator and supervisor of federally regulated financial institutions (banks, trust and loan companies and insurance companies) and private pension plans. OSFI is an independent agency of the Government of Canada that reports to Parliament through the Minister of Finance. Canada Deposit Insurance Corporation (CDIC) insures deposits of member institutions and is the Canadian bank resolution authority.

61. Banks. In the case of banks, the federal government is responsible for both their prudential and market conduct regulation. However, if a bank has a subsidiary engaged in trustee and securities dealing activities, it would also be subject to provincial regulation.

62. Credit unions. Most credit unions are almost exclusively regulated at the provincial level and insured by provincial deposit insurers/deposit guarantee corporations, which are backed by provincial governments. In 2010, the government enacted a legislation aimed at providing a national framework for credit unions (federal credit unions). In July 2012, the federal credit union legislative framework was proposed. Accordingly, credit unions that are currently regulated at provincial level would become federally regulated institutions if they want to function across provincial borders, and the proposed regulations would be administered and enforced by the OSFI, CDIC, and Financial Consumer Agency of Canada (FCAC).

¹⁵ "Supervisory Framework," Office of the Superintendent of Financial Institutions Canada, December 2010. "Peer Review of Canada," Financial Stability Board, Review Report, January 2012.

63. Other financial institutions. Trust and loan companies and life and health insurance sector are regulated at the provincial level for market conduct and at the federal level for prudential purposes. The regulation of pension plans is also shared.

64. Harmonization. Even though each province has its own regulatory authority (that relies on Self-Regulatory Organizations—SRO) for the regulation and supervision of securities, laws and regulations are harmonized across the provinces, and there is also a voluntary umbrella organization of provincial securities’ regulators (the Canadian Securities Administrators—CSA) whose goal is to improve, coordinate and harmonize regulation of the Canadian capital markets through the passport system. (However, Ontario, Canada’s largest capital market, is not a member of the CSA.) There are ongoing discussions about constructing a federal framework with a possibility of a delegated arrangement.

65. Coordination mechanisms. Focusing on securities activities, collaboration between the regulatory bodies at the federal level and the main provincial securities commissions is facilitated through: (i) The Financial Institutions Supervisory Committee (FISC), which is chaired by the Superintendent of OSFI and is mandated in the OSFI Act to facilitate consultation and exchange of information on issues related to the supervision of financial institutions between OSFI, CDIC, BOC, FCAC and the DOF; (ii) The Senior Advisory Committee, which is chaired by the Deputy Minister of Finance and acts as a discussion forum for financial sector policy issues, including macroprudential oversight and financial stability issues (in addition to FISC members, other agencies are also invited if necessary); and (iii) The Heads of Agencies committee, which is chaired by the BOC Governor and includes the DOF, OSFI, the four largest provincial securities regulators and the Chair of the CSA. This Committee is a forum for exchanging information and views and coordinating actions on issues of common concern, including hedge funds and OTC derivatives. Other coordination mechanisms include the CDIC Board of Directors and the CSA Systemic Risk Committee established in 2009.

66. Macroprudential oversight. While there is no single entity that is formally responsible for undertaking macroprudential oversight of the financial system and there is no legislated framework, such discussions take place at the Senior Advisory Committee. Both BoC and OSFI work together on stress tests, with BoC focusing on macro stress tests. Therefore, in practice, BoC monitors systemic risks but DOF is responsible for macroprudential issues.

67. Resolution. The bank intervention framework in Canada is based upon inter-agency consultation requirements that provide a check on supervisory discretion and forbearance. While the prudential supervision of individual financial institutions is discussed at the FISC, bank resolution is the responsibility of the CDIC, which is subject to a least-cost resolution requirement. CDIC Board includes the BOC Governor, OSFI Superintendent, FCAC Commissioner and the Deputy Minister of Finance, as a built-in consultation mechanisms and checks. In addition, the CDIC has the power to terminate an institution’s deposit insurance, which would mean closing the institution, unless objected by the Minister of Finance for exceptional circumstances. OSFI’s legislated early intervention mandate complements the intervention regime and provides a framework for accountability. Finally, OSFI’s Guide to Intervention provides a transparent framework for intervening, and OSFI’s Advisory for Non-Viability Contingent Capital provides defined triggers for non-viability situation for federally-regulated institutions.

II. SINGLE RESOLUTION AND SAFETY NETS¹

This paper elaborates on the design of a single resolution framework and a common safety net with backstops for the Euro Area.

A. Current Setup

This section describes the current national based set up of resolution and safety nets in the Euro Area. The drawbacks of such a set up, against the backdrop of an integrated financial system, are discussed in the main paper, along with the advantages of a more integrated prudential system.

Bank resolution framework

1. National regimes. The current setup remains established at the national level and, in many cases, has not been suited for winding down large and systemic banks. Many EU countries rely on general corporate insolvency proceedings to deal with bank failures, an approach that can be very complex (e.g., liquidations), lengthy (e.g., negotiations with shareholders), costly, and inefficient (e.g., procedures, such as automatic stay, are not suited for banks). Several countries (e.g., Germany, the U.K., and Ireland) recently strengthened their bank resolution frameworks with enhanced tools to facilitate quick resolution of failing banks, in line with international best practices, such as the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. In Germany, for example, the new resolution framework provides broad early intervention powers and resolution tools, including the possibility to “bail-in”—obtain a debt write-down from—senior unsecured creditors (Annex II.1). It also stipulates the creation of a resolution fund, partially prefunded by levies on the industry. In the U.K., the Vickers commission has proposed the creation of a resolution fund and the power to bail-in creditors in addition to the other powers already taken under the U.K.’s special resolution regime for banks.

2. Proposals. The EU Commission has taken steps to harmonize and strengthen national resolution regimes. In June 2012, the Commission issued a draft directive for harmonized crisis management and resolution framework in all EU countries, which is expected to be adopted by the EU Parliament in early 2013. The new national resolution regimes would be consistent with the FSB Key Attributes and endow EU countries with strong early intervention powers (e.g., the power to impose capital raising and conservation measures, restrictions on activities, and implementation of recovery plans) and resolution tools (e.g., the possibility to set up bridge banks, perform asset separations, override shareholders rights, replace management, divest non-essential businesses, or trigger a debt write-down or bail-in). Furthermore, the EC blueprint of November 27, 2012, stated that a proposal for a Single Resolution Mechanism will be put forth in the months following the

¹ Prepared by Thierry Tresselt, Ali Al-Eyd, Pelin Berkmen (European Department), Marc Dobler, Simon Gray, Tommaso Mancini Griffoli (Monetary and Capital Markets Department), and Wouter Bossu, Atilla Arda, Alessandro Gullo, and Nikita Aggarwal (Legal Department). The paper benefited from inputs from Dell’Ariccia et al (2012).

adoption of the Single Supervisory Mechanism. The December EU Council agreement reaffirmed that a single resolution mechanism with adequate powers and tools is required to make the SSM “more” effective. This mechanism will be based on financial sector contributions and backstop arrangements that recoup taxpayer support over the medium term, and the EC will make a proposal for such a mechanism in 2013.

3. First steps. Mechanisms for the resolution of cross-border banks envisaged by the EC are crucial and urgently-needed first steps. The EU Directive on bank recovery and resolution offers principles for early intervention and resolution of cross-border banks, such as on liquidity provision within cross-border groups, and establishes resolution colleges to develop non-binding mechanisms for crisis planning and resolution (with the EBA in a mediating role). But the absence of binding ex ante agreement on burden sharing would leave the key coordination problem in resolving cross-border banks unsolved (e.g., Fortis, Dexia) and put into question the capacity to achieve least-cost resolution. Fast implementation of the Directive at the national level is highly desirable and could set the stage for further legislation, including Treaty change, to create an integrated resolution regime in the EU that could, ultimately, result in the creation of a fully centralized and autonomous European Resolution Authority.

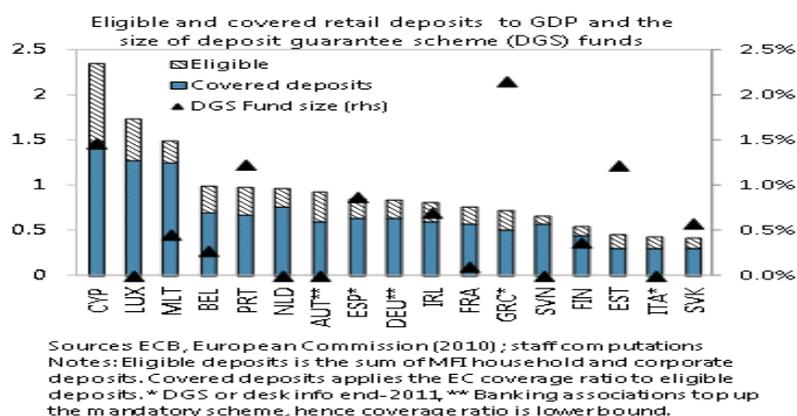
Safety nets

- 4. Deposit insurance.** Schemes are national and remain diverse across EU countries.
- *Differences.* Most national deposit guarantee schemes (DGS) differ in term of coverage, mandate, payout, and funding arrangements. In some cases, mandatory schemes are supplemented by voluntary schemes. For example, the complex voluntary DGS for commercial banks in Germany insures accounts up to 30 percent of bank capital per depositor (in practice offering a blanket guarantee; Annex II.1). The German bank safety net includes the possibility of mutualization of liabilities among participating banks. Under current arrangements, resources from the private DGSs and mutual protection schemes of various categories of banks could be committed to finance the restructuring of banks on a going-concern basis. However, there are no clear coordination mechanisms between various funds.
 - *Funding.* Many national DGS have limited prefunding, and rely on ex post funding mechanisms. In 22 Member States, contributions to DGS include a regular prefunding mechanism, where, however, the ratios of prefunding to eligible deposits remain very low. For example, the funds available for payouts of the French Fonds de Garantie des Depots reached about €2 billion at the end of 2010, about 0.1 percent of insured deposits. Some countries such as Austria and the Netherlands rely exclusively on ex post funding.
 - *Harmonization.* After the 2008 crisis, at the time when several EU member states announced, in rapid succession, increases in deposit insurance limits or blanket guarantees to forestall the possibility of a run, the EU harmonized the limit of deposit insurance to €100,000 per depositor and bank. However, the harmonization was not accompanied by clarification

about how the new liabilities would be covered (and in some cases, there appears to be no basis), which could hamper implementation.

- Proposals.* In 2010, draft legislation at the EU level proposed further steps to harmonize national DGS, including shorter payout periods (that would be limited to seven working days) and funding arrangements, where the lack of common standards has allowed for diverging models of ex ante and ex post funding schemes. The draft DGS Directive of July 2010 proposed a target level of pre-funding of 1.5 percent of eligible deposits and the possibility of mutual borrowing. The recent Directive of June 2012 on bank resolution establishes “financing arrangements” for bank resolution and payouts of deposit insurance, requiring a target pre-funding of one percent of the total liabilities, excluding own funds, within 10 years. It characterizes the possibility of borrowing arrangements between resolution funds across countries, but it is subject to safeguards that constrain the ability to delink sovereigns from bank health.² It also provides the possibility of borrowing from the central bank for the purpose of resolution funding. In the banking union roadmap, the Commission expected the Directive to be adopted by end 2012.

Figure II.1. Euro Area: Deposit Insurance Schemes



5. Backstops. Fiscal backstops and guarantees of bank liabilities or assets remain nationally-based. Since the 2008 crisis, many European countries have resorted to recapitalization programs and guarantees of bank liabilities (e.g., blanket guarantees, guarantees of unsecured or secured debt, on bond issuance) or assets. While contributing to stabilizing markets and limiting contagion, these guarantees created, in some instances, large contingent liabilities that reinforced adverse sovereign-bank links, raised questions about the effectiveness and fairness of the resulting burden sharing, and worsened moral hazard.

² Article 97(2) states, “national financing arrangements shall not be obliged to lend to another national financing arrangement in those circumstances when the resolution authority of the Member State of the financing arrangement considers that it would not have sufficient funds to finance any foreseeable resolution in the near future. In any case they should not be obliged to lend more than half of the funds that the national financing arrangement has available at the moment when the borrowing request is formalized.”

6. LOLR. In the Eurosystem, lender of last resort (LOLR) responsibilities are well defined but stratified by the quality of collateral. Banks can refinance eligible assets with the ECB or, for a wider class of collateral, with their national central banks, and, if collateral constraints bind, resort to costly emergency liquidity assistance (ELA) from their national central banks. While stabilizing banks, the setup tends to reinforce sovereign links to the weakest or failed banks through the national central bank (NCB) balance sheet: losses from bank failures associated with ELA would remain the responsibility of the sovereign (as the weakest banks are not able to access ECB refinancing operations).

B. Design of the Single Resolution Authority

This section elaborates on design issues pertaining to a single resolution authority, including the preconditions and prerequisites for a successful design; the scope, powers, tools and institutional issues in the future steady state; and transition issues.

7. International standards. The powers of a single resolution authority for the euro area should be in line with emerging best practices laid out in the “FSB Key Attributes of Effective Resolution Regimes for Financial Institutions.” Its objective should be to make the resolution of financial institutions feasible without severe systemic disruption, while minimizing costs to taxpayers. Burden sharing mechanisms should ensure that shareholders and unsecured and uninsured creditors absorb losses in a manner that respects, where possible, the hierarchy of claims in liquidation. Furthermore, the single resolution authority should comply with preconditions and prerequisites for effective resolution as set out by the FSB.

8. Specific considerations. In addition to complying with international best practices, the single resolution authority should be designed in a way that addresses concerns arising specifically from the multicountry setting of the euro area. Having a single, fully centralized, supranational resolution authority would set the right incentives, correct externalities and coordination issues, provide a mechanism for swift decision making, and avoid duplication at national levels. It would also ensure that individual countries are not forced to internalize all the resolution costs and the spillovers to others at enormous cost to itself, as was the case for Ireland and that could, in theory, be the case for any of the member states. But issues related to burden sharing, governance, accountability and interaction with the SSM need to be addressed. Legal difficulties would also arise (e.g., the need for a Treaty change to establish a new EU institution and an insolvency regime that supersedes national regimes). In contrast to supervision, complete centralization of tasks is easier to achieve in the steady state, and there would be no need to design a mechanism delegating some tasks to the national level. However, in the short run, some delegation of tasks may remain necessary, raising issues of monitoring of delegated tasks and of the interaction with the SSM. The question of common backstop also becomes essential, as a resolution framework requires adequate backing to be effective, in particular to deal with systemic crises.

Preconditions and prerequisites

9. Preconditions. Emerging best practices include a set of pre-conditions to ensure effective resolution: (i) a well established framework for financial stability, surveillance and policy formulation; (ii) an effective system of supervision, regulation and oversight of financial institutions; (iii) effective protection schemes for depositors, insurance policy holders and other customers; (iv) a robust accounting, auditing and disclosure regime; and (v) a well developed legal framework and judicial system. In the context of the Banking Union, these preconditions have implications for EU legal regimes and for the existence of an effective and credible single supervisory mechanism and deposit insurance scheme for all banks.

10. Prerequisites. To establish a sound basis for effective resolution, a resolution authority with a common fiscal backstop should be operationally independent consistent with its statutory responsibilities; have transparent processes, legal protection, sound governance and adequate resources; and be subject to rigorous evaluation and accountability mechanisms. Some considerations are particularly relevant in the supranational context of the Banking Union.

- *Objectives and mandate.* A common resolution authority for the euro area should seek to maximize recovery value in resolution, and minimize the overall cost of resolution and losses to creditors. Establishing a strong and autonomous resolution authority will ensure that home-host concerns are internalized within the euro area, but the cost and stability impact on other jurisdictions (in the EU or outside) will have to be taken into account. The resolution authority should pursue financial stability and ensure continuity of systemically important financial services and functions, while protecting depositors and other claimants protected by insurance schemes and arrangements.
- *Operational independence and legal protection.* Treaty changes that would establish a strong and autonomous resolution authority should provide for an appropriate level of operational autonomy. Complementary Treaty revisions should be considered to ensure legal protection of officials for their actions and decisions in the exercise of resolution powers.
- *Accountability.* Independence must be complemented with accountability. Resolution is an intrusive process with fiscal implications; it involves difficult and complex decisions about burden sharing and the distribution of costs between various claimants and taxpayers. In the context of the future Banking Union, it would potentially involve choices about the distribution of losses between taxpayers of different countries, and it may impact ownership and competitive conditions domestically and for the entire eurozone. These considerations call for particular attention to designing even more rigorous accountability mechanisms and evaluation of resolution measures in the context of a Banking Union. Transparency of the single resolution authority would be essential, as well as strong accountability and reporting to eurozone finance ministers (Eurogroup/EU Council) and European citizens (EU Parliament). If national authorities retain the prime responsibility for the resolution of a subset of banks (an option not to be favored), an accountability mechanism operating at two levels (with national authorities also accountable to the national Parliament and to the Ministry of Finance) will need to be in place.

- *Sound governance.* Sound governance will be crucial to ensure early action and effective resolution decisions in the interest of the Banking Union as a whole. Specifically, conflicts of interest may arise during the phase of preparation of recovery and resolution plans, or during early intervention and resolution, for cross-border systemically important financial institutions given that ownership structures remain national while assets and liabilities cross borders. A single resolution authority should provide the mechanism to remove these impediments to effective resolution, but its effectiveness and timeliness will depend on its governance, decision-making structure and access to fiscal resources. It would have to prevent undue political interference and long negotiations that could hold up decisions of the resolution authority. For example, a possible model could be to rely on a two-tier governance structure to balance effective decision making with the need for oversight. An Executive Board could be tasked with making decisions affecting specific financial institutions in the interest of the Banking Union. A Resolution Council including national representatives from all countries participating in the single resolution mechanism could be tasked with the oversight of decisions made by the Executive Board, and with decisions on broader policy matters, such as related to burden-sharing mechanisms and fiscal backstops. The voting mechanism should ensure that resolution decisions would not be blocked and guarantee the “will to act.” Effective resolution also requires cooperation and exchange information with the single supervisory mechanism, and having checks and balances.
- *Resources and competencies.* The resources allocated to the central resolution authority should be sufficient to build capacity at the center while protecting it from undue influence by national authorities and the industry. Given the importance of G-SIBs in the euro area financial system, the central authority will need to hire independent staff with the expertise and operational capacity to implement preventative, early intervention and resolution measures with respect to large and complex financial institutions. Pragmatism, in the interim period, would call for relying on national resources and expertise. But to avoid duplication of resources at the national levels, swift centralization of resources and expertise would be essential to ensure that capacity is built for the resolution of these financial institutions.
- *Funding.* To be effective, the central resolution authority will require access to common funding and a fiscal backstop (more on this below).

Scope

11. Coverage. Consistent with the scope of the SSM, the common resolution mechanism should eventually include all the banks licensed in the eurozone. No bank should remain under non-bank national insolvency proceedings. Consideration should be given to extending the scope of the resolution authority to other financial institutions such as holding companies, non-regulated operational entities within a financial group or conglomerate, and branches of foreign (other EU, and non-EU) banks. Covering these institutions would be important insofar as they can be systemic and therefore would need to be dealt with adequate tools when they fail. Extending the coverage of the SSM to these institutions (if this turns out to be possible) would ensure consistency and help contain risks of failure.

Powers and tools

12. Preparation and prevention. The central resolution authority should be able to ensure preparation and prevention, in close cooperation with the SSM, and should have powers to:

- Review and validate *recovery plans* of systemic banks. This task should be performed in close cooperation with the SSM, who should also be involved in the process.
- Prepare *resolution plans* for systemic banks. Critically, these plans would include details on the application of resolution tools and ways to ensure the continuity of critical functions, and the ECB as the center of the SSM, should be closely involved.
- Take *investigatory actions* to ensure preparedness of the resolution authority, including requests for information and on-site inspections.
- Require actions to *remove impediments to resolvability* to ensure that available tools allow resolution in a way that does not compromise critical functions, threaten financial stability, or involve undue costs to taxpayers. These could include changes to a firm’s business practices, structure or organization to reduce complexity and other potential costs.
- Be involved in decisions related to *intra-group support agreements*, alongside the ECB.

13. Early intervention. Powers to take early intervention measures should also be provided to the resolution authority that should be able, alongside the SSM, to:

- Require *capital conservation* measures.
- Impose *restrictions on activities*, including implementation of measures set out in the recovery plan.
- Trigger *resolution*.

14. Resolution powers and tools, performed partly by taking control of the failed institutions should include the possibility to:

- Take over the control of the firm, including by nominating a *special manager* and remove the senior management and directors.
- *Transfer assets and liabilities* (“P&A”) to a sound acquirer.
- Set up a *bridge bank* taking over good assets or services to ensure continuity of essential services.
- Separate bad assets by setting up an *asset management vehicle* (a “bad bank”), in conjunction with other measures.
- Apply a “bail-in tool,” involving the SSM and used to recapitalize or wind-down the bank with shareholders wiped out or diluted, and creditors would have their claims reduced, wiped out, or converted to shares.
- Override shareholders’ rights regarding any decision needed in resolution, subject to the condition that shareholders should not be worse off than under liquidation of the firm.

15. Coordination with the SSM. Decisions to trigger early intervention or resolution will be highly sensitive and have distributional consequences that may bring conflicting interests among member states to the fore. In that respect, providing powers to the resolution authority that overlaps with some powers of the SSM may contribute to a strong and robust financial stability framework for the euro area. For example, the resolution authority would also have investigatory powers, be able to trigger early intervention, require prompt corrective actions and be able to initiate resolution (e.g., by withdrawing deposit insurance).

Central resolution authority and institutional issues

16. Central resolution authority. A fully-centralized euro area resolution authority should be able, in the steady state, to handle the resolution of failed euro area banks with possible delegation of some tasks to internal offices located across member states. It should have powers and tools, mandates, independence, governance, and accountability to ensure effective resolution in line with international best practices and the EU Directive on bank recovery and resolution, but with reinforced mechanisms or rules to ensure its effectiveness in a multi-country setting.

- *Positives.* This centralized approach is the best solution that would internalize cross-border effects and solve coordination failures, help build solid resolution expertise for systemic institutions, provide flexibility to intervene and allocate resources where needed, and avoid national duplications. It would ensure that the ECB would interact at par with a strong supranational institution that would complement its functions and mandates. A strong resolution authority would contribute to ensuring effective supervision, provided there is clear coordination and information sharing between the two institutions. Conversely, a strong supervisory mechanism would also contribute in establishing the credibility of the resolution authority and in making it robust. In short, the two institutions would reinforce and complement and balance each other. It would also provide mechanisms for clear ex ante burden sharing arrangements, provided an adequate fiscal backstop is also in place.
- *Obstacles.* For an effective central resolution authority to be credible, an agreement on common resolution funding and fiscal backstops (and including a loss sharing mechanism involving taxpayers) is needed. Also, any Treaty change to create a strong supranational resolution authority would require time. Such authority should also be able to apply a single resolution regime, overriding national insolvency laws.

17. Burden sharing. Clear and workable burden-sharing arrangements, including between participating member states and the common backstop, are essential for an effective resolution mechanism. In line with international best practices, the euro area resolution authority would have power to override shareholders' rights and impose losses according to clear ex ante rankings of claimants that would respect the hierarchy of claims with some flexibility to depart from the *pari passu* principle. A bail-in mechanism for haircutting or converting senior unsecured creditors would provide a tool towards burden sharing. Meanwhile, depositor preference should be included in the framework to further protect depositors and the funding provided by the deposit insurance scheme (see below). Next, pooled contributions from the euro area industry would be needed to finance the

costs of normal resolution. Pooled contributions from euro area taxpayers (which would follow specific ex ante rules) would be needed only insofar as private sector contributions and allocation of losses among uninsured claimants are insufficient to cover the costs of resolution, subject to a systemic exemption. In addition to more standard burden-sharing rules that apply to any resolution authority, the single resolution authority should also be provided with a clear mechanism for decision making (see discussion on governance above) and ex ante burden sharing rules across member states (which could be based on capital keys similar to the capital contributions at the ECB).

18. Funding. A euro-area resolution fund would finance the costs associated with bank resolution. Such a fund would build resources from risk-based contributions levied on all euro area countries. The contribution base would, ideally, not only be total deposits but would also include other liabilities, possibly adjusting for risk taking and externalities. A good benchmark would be to build a fund targeted to cover the net fiscal costs of up to a large or a few medium-sized bank failures. Adequate common fiscal backstops, which would be particularly important for systemic events, would also be crucial for the effectiveness of the resolution authority. A transition period would reduce the immediate impact on banks and, meanwhile, other costs could be recouped ex post from banks, although this may create moral hazard.

19. Institutional considerations. Since resolution involves sensitive decisions over distribution of losses and, given the need for checks and balances, an independent body should be established that would operate alongside the ECB supervisor. To ensure effectiveness, this resolution authority should be an EU institution established on par with the ECB, even if there could be merit in a transitional arrangement, e.g., the creation of a temporary EU agency. At the same time, governance arrangements would need to ensure close cooperation with the SSM and the resolution authority. These arrangements would be complemented by joint technical committees and working groups.

Transition

20. Scope. A possible approach would be to bring all euro-area banks under a central resolution authority as soon as possible after they are brought under the supervision of the ECB.

- *Positives.* Bringing banks under a single resolution authority in parallel with the transition toward the SSM would ensure a more consistent treatment of resolution in the euro area, and would greatly simplify the operational complexity of the supervisory tasks awaiting the ECB. Having a unique resolution authority in charge would be particularly relevant for banks being restructured and in need of, or nearly in need of, public support.
- *Temporary body.* To facilitate the process, there may be merit to establishing a temporary body or creating urgently an EU agency tasked with the coordination of bank crisis management and resolution among national authorities and the ECB. It could be linked to the ESM, with accountability to the Eurogroup. Experience of the Swedish Bank Authority of the 1990s and the United States Treasury unit set up to restructure AIG provide examples of the usefulness of temporary bodies.

- *Risks.* Time would be needed to build resources and capacity at the center. In the event of a delayed transition, the ECB would become tasked with supervising systemic banks, including complex ones, and would have to interact with multiple competent national authorities, including with respect to early intervention and corrective actions. Ensuring consistency of preparedness measures and of mechanisms to deal with cross-border considerations and systemic banks also suggests that a delayed transition would be inefficient and result in duplication of tasks. But a slow and delayed transition toward a single resolution mechanism would create risks of an incomplete framework if political support weakens over time.

21. Speed. There are two main strategies.

- **A “big-bang” approach** envisages a rapid move toward the establishment of a central resolution authority and supra-national insolvency regime. This is the preferred approach, but may be constrained by political realities and practical considerations.
 - *Pros.* It would help ensure a smooth transition to the single supervisory mechanism by moving supervision and resolution in tandem. Building resources at the center may take time, but the temporary body mentioned above could be the stepping stone to a permanent framework. This approach would build cross-border expertise in early intervention, supervision, and recovery and resolution planning for systemic institutions.
 - *Cons.* Securing a Treaty change could be daunting in the near term. It would also require establishment of pan-euro area insolvency laws (requiring regulations) and involvement of courts (the European Court of Justice) to supersede national regimes. The temporary body or EU agency, which may require its own Treaty or could possibly be established under Article 352 of the TFEU, could remain active during the interim.
- **A gradual approach.** A gradual approach would consist of three steps. First, national regimes would be harmonized and strengthened, as prescribed in the EU Directive on the recovery and resolution of credit institutions. Harmonized national resolution funds would be set up, allowing cross-border borrowing arrangements. Second, an EU body, similar to the EBA, could be established by an EU Regulation, and tasked with the coordination of resolution in the euro area. It would play a coordinating role in ensuring a single approach to resolution. In the long term, a supranational central authority could be established.
 - *Pros.* This approach would ensure that no disruptions in resolution structure would happen during the transition. It would guarantee full compatibility across national regimes, between national and federal bodies, and between “ins” and “outs.” It would not require changes in national laws, beyond those needed to harmonize and ensure robustness of resolution regimes.
 - *Cons.* Until a federal agency is created, the SSM would have to interact with multiple national authorities, which could be unwieldy, and constrain effectiveness. It could create incentive problems within the SSM insofar as national authorities would refrain from sharing with the ECB information that might result in a decision to trigger resolution (that may have to be financed by domestic taxpayers). The national approach to

resolution funding would achieve little risk diversification, and would therefore be inferior to a centralized approach to resolution funding. A long transition toward the most robust solution would increase the risks of a stalled process and of an incomplete framework. Harmonization of frameworks could itself take time, as transposition into national law would be required in each EU country.

C. Risks to the Single Resolution Mechanism

Risks associated with a single resolution mechanism include stalled reforms, the consequences for cost or risk sharing from the crisis, and dealing with too-big-to-fail institutions.

22. Stalled reforms. The main transitional risk is that of a stalled reform process in a gradual approach. The risk should be addressed by having a clear roadmap that would be time bound and indicate the main steps and key deliverables including toward a common safety net. This could occur at an early stage, e.g., while harmonizing national resolution regimes; or at an intermediate stage, e.g., while setting up a mechanism to centralize resolution in the euro area:

- *Harmonization stage.* A fully-harmonized system of rules with resolution authority remaining at the national level and co-existing with a common ESM backstop would create incentives to shift the costs of resolution to the euro-area taxpayer. It could create an unwieldy system in which the SSM would have to interact with many national authorities during crisis time, but also during the steady state to be able to supervise the euro area systemic banks. The framework would achieve little to weaken the link between sovereign and bank funding costs. Lastly, the transposition of the EU Directive into national laws would still leave the door open to different interpretations and, therefore, to different practices.
- *Centralization stage.* The Banking Union could transition to a framework with a resolution authority akin to the European Banking Authority (e.g., an EU agency) tasked with the coordination and mediation of resolution that would remain nationally-based. Depending on the actual powers of this body, the framework may have to progress in the direction of centralizing bank resolution and internalizing cross-border externalities arising in the resolution of cross-border banks or in the use of a common backstop. However, risks are that the federal agency would lack adequate binding powers, and could be subjected to fiscal safeguards preventing infringements of member states' sovereignty, which would impede effectiveness.
- *Need for burden sharing and adequate fiscal backstop.* To be fully effective, the single resolution authority must be accompanied with burden sharing rules and, at a minimum, provide a mechanism for swift decision making. Adequate common fiscal backstops are also required to ensure effectiveness of a centralized resolution authority.

23. Precedent. Divergent interests during the transition may have consequences for the future as how legacy is addressed during this crisis creates a precedent for the future. The costs of existing bad bank debt should be left as much as possible to those that have been primarily responsible for them, i.e., creditors and national supervisors. But as government solvency is endangered, direct

recapitalization by the ESM becomes necessary. Creditors may insist on control, but resist enhancing backstops for fear that imperfect control would result in a “transfer union.” And debtors may insist on the need to delink banks from sovereigns as a condition for transferring control to the center. An incomplete solution might result in an instable Banking Union:

- *ESM direct recapitalization but no central resolution.* Some form of a common backstop, albeit imperfect (such as the announced mechanism of direct ESM recapitalization) would give strong incentives to national resolution authorities to shift the costs on to the euro area taxpayers away from national creditors.
- *Central resolution but no adequate common fiscal backstop.* Centralizing resolution decisions without adequate common fiscal backstop and lasting solution for burden sharing would not help address the sovereign-bank links and would not be conducive to information sharing. The fiscal consequences of decisions made at the center would fall entirely on national taxpayers and may generate political risks while jeopardizing the credibility and effectiveness of a single resolution authority.

24. TBTF. Complexity, cross-border dimensions, and systemic roles of G-SIBs place a high value on establishing quickly a robust supranational resolution authority, with powers and tools aligned with the FSB Key Attributes, and with adequate common fiscal backstops. In contrast, national approaches to resolution and fiscal resources would become inadequate to resolve a systemic institution. The need to ensure preparedness suggests a key benefit to pulling scarce resources together and building shared knowledge and capacity at the center, and of the single resolution authority requiring steps to remove impediments to resolvability of systemic institutions.

25. Legal considerations. A change in the Treaty would be necessary to establish a strong and autonomous resolution authority. The accompanying supranational insolvency regime would also have to override national insolvency laws. In the interim, a temporary resolution authority could coordinate bank restructuring in the euro area.

D. Common Safety Nets and Backstops

This section elaborates on design issues related to common safety nets and backstops, both in a future steady state and during the transition.

26. Essentials. Backstops and common insurance mechanisms form an essential element of the Banking Union. Absent backstops and safety nets, the Banking Union would be unable to delink, or weaken, sovereigns and banks; it would possibly be unstable and risky and could jeopardize the credibility of the ECB. To be set up, they require a transfer of control to the center, and must follow only after some preconditions are met.

- *Common fiscal backstops.* Adequate common backstops are essential to deal with systemic crises, as pre-funding by DGS and/or resolution funds would likely not suffice to deal with the gross fiscal costs of a crisis. Common backstops are thus needed to create a framework that is robust and breaks sovereign-bank links in tail events. During the transition, direct

recapitalization by the ESM will allow to break the link between banks and sovereigns when solvency concerns about the latter arise. To the extent that DGS and resolution funds will progressively accumulate contributions from the industry, agreements on fiscal backstops and burden sharing may even be more important during the transitional phase.

- *Deposit insurance.* As noted, common deposit insurance is needed for stability reasons. A pooled mechanism would be more effective in protecting confidence (subject to an adequate fiscal backstop) and in diversifying risks across large numbers of banks. But the need for a common DGS also follows logically once a single supervisory mechanism and a single resolution authority are in place. To the extent that a resolution authority would require common funding from the industry, postponing the centralization of DGS makes little sense. Additional national DGS could be allowed to complement the euro area DGS.

Deposit Insurance and Resolution Funds

27. EU Commission proposal. The EU Commission aims at a swift adoption of its DGS Directive and Bank Resolution Directive (originally intended by end 2012). After adoption by the EU Parliament, the Directives will require transposition in national laws.

- *Deposit insurance.* The DGS Directive will pave the way for harmonizing national DGS (payouts speed, coverage, funding)—in particular setting a 75 percent share of ex ante financing and a target coverage ratio of 1.5 percent of eligible deposits after 10 years, permitting ex post financing of up to 0.5 percent of covered deposits (Table II.1). Borrowing arrangements across national schemes are permitted, up to 0.5 percent of eligible deposits of the borrower, and must be repaid within five years, with the claim ranking first in liquidation proceedings. Alternative funding arrangements should also be sought. After 10 years, the size will be recalibrated on the basis of covered deposits (instead of eligible deposits). Bank contributions to national DGS reflect risk, based on core indicators such as capital adequacy, asset quality, profitability and liquidity. DGS can be used for resolution funding, provided that the primary function of the DGS is not impeded.
- *Resolution funding.* Financing arrangements funded with contributions from banks and investment firms in proportion to their liabilities, risk profile and systemic importance must be established at the national level. Contributions will be raised from banks (on total liabilities, excluding own funds) at least annually to reach a target funding level of at least one percent of covered deposits after 10 years. If the ex ante funds are insufficient to deal with the resolution of an institution, further contributions will be raised (ex post). Mutual borrowing arrangements across schemes are allowed, subject to safeguards designed to protect creditor resolution funds. Funding already available in DGS could be used for resolution (in which case contributions for resolution would be based on total liabilities, excluding own funds and insured deposits). But the DGS would rank *pari passu* with unsecured creditors in insolvency proceedings for the amount of covered deposits. Finally, alternative funding means (such as borrowing from the central bank) should be enabled.

28. Alternative. An alternative (potentially long-term) preferred approach is to create a pan euro area deposit guarantee scheme and resolution fund.

Table II.1. Euro Area: Deposit Insurance—Eligible and Covered Deposits

	Eligible deposits (March 2012)	Covered deposits	Coverage ratio	Country share in covered deposits
AUT**	277	176	63.6	3.3
BEL	364	255	70.2	4.8
CYP	42	26	62.7	0.5
DEU**	2,157	1,609	74.6	30.5
ESP*	909	671	73.8	12.7
EST	7	5	66.7	0.1
FIN	104	85	82.0	1.6
FRA	1,511	1,127	74.6	21.4
GRC*	153	106	69.5	2.0
IRL	126	93	73.6	1.8
ITA*	675	460	68.2	8.7
LUX	75	55	73.6	1.0
MLT	10	8	83.2	0.1
NLD	581	451	77.6	8.5
PRT	165	112	68.3	2.1
SVK	28	20	71.3	0.4
SVN	23	20	85.0	0.4
EUROAREA	7,205	5,279	73.3	100.0

Source: ECB MFI statistics, European Commission (2010) impact study for coverage ratio

Notes: Eligible deposits are the sum of MFI household and corporate deposits. Covered deposits apply the EC coverage ratio to eligible deposits. * DGS or desk info end-2011, ** Banking associations top up the mandatory scheme, hence coverage ratio is lower bound.

- *Scope.* All euro area banks should be covered by the resolution fund and by the deposit insurance scheme for consistency with the single supervisory mechanism and the single resolution authority. Covering only a subset of banks could be destabilizing by inducing reallocations of deposits between the national segment and the euro area segment, and could create distortions to competition within the single market, but additional schemes could be allowed to top-up the pan-European scheme. Given different sizes of banking systems across euro area countries, the coverage would be skewed towards the largest financial systems in the core of the euro area.
- *Funding.*
 - *Resolution fund.* The resolution fund should be pre-funded through ex ante risk-based premiums (reflecting at least capitalization, profitability, liquidity and asset quality) also adjusted for systemic importance of an institution. Use of funds could be complemented

by arrangements to recoup losses through ex post levies on the industry. To the extent that ex post levies are procyclical and induce moral hazard, their share in the industry funding should be limited. The resolution fund should also have access to *common backstops* (which would be particularly important during the transition when the fund has insufficient reserves and for systemic events). The tax rate should be chosen to smooth the cyclical burdens on the industry while building a target prefunding ratio within 10 years. The tax base should include all liabilities (including wholesale funds) excluding capital.

- *Deposit insurance.* The DGS should be to a significant extent prefunded through ex ante risk-based premiums levied on the industry, and complemented, if needed, by ex post levies on the industry. The tax base should be the total eligible deposits. The tax rate should be chosen to minimize the cyclical burdens on the industry while ensuring that the deposit insurance fund reaches its target level within 10 years. As above, it should be risk-based and reflect the systemic importance of a bank. The prefunded element of the DGS should, in steady state, maintain a ratio of about 1.5 percent of total eligible deposits (hence, total fund size of about €100 billion). This would allow covering deposit payments for 2–3 medium-sized bank failures, but having a backstop available would be critical.
- *Coverage limit of the DGS.* The coverage limit per account holder and per bank could remain at the current €100,000.
- *National DGS.* Specific national schemes could be allowed to continue operate in addition to the pan euro area deposit insurance, provided they are aligned with the EU Directives.

29. Merging resolution and deposit insurance fund. A single integrated fund for resolution and deposit insurance would have benefits. There are synergies between DGS and resolution funding, as both contribute to stabilizing financial systems. There are economies of scale of jointly administering the funds. Objectives do not conflict when the ranking of claimants is clear and adequate, provided insured depositors are protected. Furthermore, separating funds does not preclude fungibility of fiscal outlays during banking crises. Having said that, DGS and resolution funds have different objectives. The former must ensure that eligible depositors are reimbursed up to the coverage limit, while the latter must ensure that failed banks can be wound up and cover all resolution costs while minimizing losses of value and contagion risks.

30. Mixed model. There is discussion also of creating a common resolution fund, administered by the single resolution authority, while harmonizing deposit insurance schemes but allowing them to remain at the national level. Such a model would go some way to enhancing the effectiveness of the SSM while providing common financing for resolution, although without common backstops its impact would be limited. Under this model, it will be essential that national deposit insurance funds are available to contribute to resolution, up to the amount available for payout. Even so, the disadvantages would be less efficient risk pooling, which would not effectively decouple sovereigns and banks; complexities in cost allocation and implementation in the case of cross-border failures,

requiring close coordination between national deposit guarantee schemes and the single resolution authority; and duplication of costs and administrative resources, as both funds would be assessed on the same banks.

31. Desired size. While there is no well-established good practice, the typical target size of deposit insurance and resolution funds could range from about 1–2 percent of insured deposits in large systems (as in the EC proposal, or as in the United States) to 4–5 percent in smaller systems, where the aim is to cover 2–5 mid-size banks or 4–6 small bank failures. Part of the gross outlays will be recouped from asset sales during resolution and from ex post contributions from the industry.

32. Legal concerns. A single resolution fund would require having a supranational resolution framework in place. This would require establishing a euro-area insolvency regime, which may require a Treaty change. Treaty change would be required if the Euro Area Deposit Insurance and Resolution Fund is “joint and several.” The no bail-out clause of Article 125 prohibits the EU, euro area or member states to be liable for or assuming liabilities of another state or of its public bodies. However, voluntary loans to other member states (as envisaged in the EU Directive on bank resolution), or multiple several guarantees (as under the ESM) would not appear to be in contradiction with the current Treaty.

Fiscal backstops and burden sharing arrangements

33. Decision making. At a minimum, clear rules for decision making should be put in place to ensure that resolution decisions can be taken promptly. These should include some ex ante agreed burden sharing rules to ensure an orderly process—a clear hierarchy of claims (including bail-ins of unsecured senior creditors) and some ex-ante rules for allocating fiscal costs across member states. To minimize moral hazard and conflicts of interest, rules allocating fiscal burdens across countries would be especially important insofar as some banks would remain under the supervision of national authorities while more systemic ones come under the direct responsibility of the ECB. The governance of the single authority should also leave some room for discretion to allow for swift decision making (“over a weekend”) in situations of emergency. Least cost resolution and the allocation of losses should also weigh in stability concerns.

34. Pecking order. The probability and severity of banking crises is minimized by effective supervision and ambitiously high capital requirements. But when crises occur, burden sharing, subject to a systemic exemption, should follow the ordering of: (i) haircutting shareholders; (ii) junior creditors; (iii) bailing-in senior unsecured creditors; (iv) bailing-in resolution and deposit insurance funds; and (v) taxpayer contributions (see paragraph 37 for a discussion of rules that could govern the allocation of losses between the national sovereign and a common fiscal backstop).³ Insured depositors should come last in the ordering of losses, and there should be depositor preference

³ Secured claims should be secured up to the value of the collateral, and the remainder would be unsecured and treated as such.

(e.g., the deposit insurance fund should be senior to other claimants). In most crises, the hierarchy of losses would not conflict with stability concerns and would support market discipline *ex ante*. However, in systemic crises, taxpayer funding would become inevitable. Since 2008, according to the EC, over €4.5 trillion has been used to rescue banks in the EU (including liquidity provision measures and asset guarantees by governments).

35. Plan for tail events. A common fiscal backstop and agreements on burden sharing would help ensure that banking crises do not endanger the solvency of the sovereign. Historical evidence shows that one-fourth of banking crises had gross fiscal costs in excess of 16 percent of GDP, although net costs are invariably lower, as values of distressed assets recover. In the steady state, private sector resources will not suffice to cover the gross costs of systemic crisis, but fiscal costs cannot be left entirely on national taxpayers.

36. Layers of backstops. A series of common backstops, including elements of a fiscal union, must therefore be created at the euro area level to prevent downward spirals between sovereigns and the banks in tail scenarios. The following is one type of scheme that could be considered:

- *Common resolution fund.* A euro area fund of the kind described above would provide a first buffer to weaken the link between sovereigns and bank failures. It would cover a proportion of banking crisis that would depend on its level of agreed prefunding. Ex-post levies on the banking sector may also help reduce fiscal contributions in the medium term, although achieving full fiscal neutrality may be difficult in the case of systemic crises.
- *ESM direct recapitalization.* In extremis, if all ESM resources were used for directly recapitalizing banks and serve as a loss-sharing mechanism (i.e., invest in going concern banks with negative equity), its eventual size would be able to cover crises requiring up to about 5 percent of euro area GDP of fiscal outlays. Its capital keys would provide an *ex ante* burden sharing agreement, while its governance would facilitate swift decision making. In practice, a fraction of the resources would likely be available for bank recapitalization (and the rest for sovereign support).
- *Earmarked contingent euro-area taxation.* A more ambitious approach would be to grant a eurozone institution (under the eurogroup) with limited taxing power that could be relied upon to back blanket guarantees during systemic events.
- *ECB line of credit.* Temporary ECB lines of credit to the resolution authority, guaranteed by the common fiscal backstop, may be essential to finance bank resolution in an emergency, contingent on a fiscal backstop being in place to cover the eventual net fiscal costs of the

Belgium	7.0
Ireland	41.2
Germany	12.2
Greece	6.1
Netherlands	14.1
Spain ¹	19.5
United Kingdom	6.8
United States	5.3

Sources: Fiscal Monitor, Spain FSAP, staff estimates
¹ Includes use of debt guarantees, asset purchases and capital support from the FROB as of March 2012 and the ESM/EFSF loan announced on June 9, 2012.

banking crisis.⁴ A similar set up is used, for example, in the United States, where the Fed was involved in financing the asset management company dealing with AIG's and Bear Sterns' toxic assets. In Switzerland, the SNB funded the Swiss Stabilization Fund to deal with UBS's legacy assets.

37. Co-financing by the national sovereign. If there are residual imperfections in the SSM, the presence of a common backstop could create incentive problems, reinforce regulatory forbearance, and unduly shift costs of bank failures to the euro area taxpayers. To mitigate this risk, consideration could be given to involving national taxpayers—the ex ante burden-sharing arrangements designed by the single resolution authority could, for instance, specify the share of losses borne by national taxpayers (on top of loss-sharing rules associated with a common backstop), conditional on sovereign solvency being protected and on strong national fiscal rules. This is not unlike standard insurance with deductibles and co-payments. However, the need to delink banks and sovereigns could constrain the usefulness of such arrangements. Allowing co-financing also raises difficult questions. For example, after a bank is recapitalized by the sovereign, would the sovereign's shares be diluted should the situation worsen and require additional recapitalization by the common backstop? Several ex ante burden-sharing approaches could be considered:

- *Fixed amount of loss to national taxpayer.* Losses would be allocated to national taxpayers up to an ex ante defined maximum that could be expressed in percent of GDP. The threshold would balance the needs to align incentives and to attenuate the sovereign-bank nexus. Above the threshold, losses would be allocated to the common backstop. This approach could suffice in the steady state, but it may also be dynamically inefficient when the threshold limit is about to be breached.
- *Co-financing starting with the first euro.* National taxpayers would contribute a minimum ex ante agreed share of the gross fiscal costs of each bank failure. While cumbersome, this approach would help align incentives, regardless of the size of the banking crisis.
- *Liquidity backstops.* Under the current setup, national authorities would bear the risks of resolution but would be eligible for ESM loans. This approach may only marginally weaken the link from the banks to the sovereign, and may therefore not be desirable (as discussed in the third background paper).

Transition

38. Harmonized national resolution funds and DGS. The EU Commission approach could be a stepping stone towards the creation of a single pan-euro area scheme in the long term. However, it would achieve little risk diversification in the interim (as risk sharing would take place at the national level), in particular in countries with smaller, less diversified banking systems. It also would not

⁴ The possibility of such central bank lines of credit are envisaged in the EC draft Directive for bank recovery and resolution.

delink banks from sovereigns. The degree of harmonization of national funds achieved through a Directive may not suffice to merge national resolution funds into a single euro area fund.

- *Transitioning heterogeneous banks into the resolution fund.* A slow transition to a single fund by gradually extending coverage to a larger sample of banks, e.g., in conjunction with the extension of the SSM, could be problematic. In countries with weak sovereigns, such an approach may create liquidity pressures for the banks remaining under the national DGS. A rapid phasing in of a resolution fund might raise concerns about the cyclical effects of bank levies, if the transitioning period is too short.
- *Euro-area “reinsurance scheme.”* A reinsurance scheme for national DGS could also be created, funded at the euro area level through levies on the industry (although this too could suffer from the problem of procyclicality) and/or annual contributions from member states. Ex ante agreement on the degree of national funding and supranational funding in depositor payouts would prevent moral hazard. Over time, the reinsurance fund would build administrative capacity, and could become a step toward the creation of a permanent euro area DGS and resolution fund.

39. Fiscal backing. As noted, resolution funds and DGS require explicit fiscal backing, complemented at times by liquidity lines from the central bank, to cover the gross costs of systemic crises. Thus, agreement on backstops is required to transition to a euro-area resolution fund.

E. Lender of Last Resort

The section makes the case for centralizing lender of last resort functions at the ECB in steady state.

40. Current system. The system is anchored on the Eurosystem, which provides reserve money (liquidity) to euro area commercial banks against acceptable collateral. The provision of liquidity is conducted via Open Market Operations (OMO), currently using a full-allotment procedure, and the credit Standing Facility (SF). If a bank lacks eligible collateral to access the OMO and/or SF, it may be able to borrow from its National Central Bank (NCB), provided the amount borrowed by the bank is within the NCB’s overall limit for ELA, as agreed with the Eurosystem.⁵ To participate in OMO or access the credit SF, a bank should be considered “financially sound”; in the case of ELA, the requirement is less stringent, but a bank must be judged to be solvent. The Eurosystem sets the interest rates applicable to SF transactions, and currently fixes the rates on OMO as well. ELA loans are subject to a minimum interest rate set by the Eurosystem, and in practice most loans are harmonized around this level.

41. Credit risk. Any potential losses associated with ELA would in principle be borne by the NCB in question,⁶ although in practice the Eurosystem may need to share the costs. Currently, monetary

⁵ In addition to national limits, the ECB’s approval is required if lending in any particular case exceeds certain levels.

⁶ By contrast, any losses associated with OMO and SF are borne jointly by all Eurosystem members, shared on the basis of the capital key.

policy (OMO and SF) and ELA lending are associated with TARGET2 positions, where the weaker countries' NCBs have a liability position with the ECB. If an ELA-borrowing bank fails and losses are substantial, the relevant government may be hard pressed to support the NCB through recapitalization, given weak fiscal and debt positions. To the extent the eurosystem would have to cover any substantial ELA losses, the argument for the ECB taking on full ELA powers from NCBs is stronger.

42. Centralization. The euro zone banking union concept logically entails centralized LOLR responsibilities. ELA lending should be moved from NCBs to the ECB when the ECB takes over the supervisory role for the euro area commercial banks, in the process delinking sovereigns from potential losses arising through the provision of ELA. At this point, the NCBs would lose their ability to extend ELA, and ELA would be solely at the discretion of the ECB. In this case, when deciding whether or not to provide ELA, the ECB may well set the bar higher than that currently set by the NCBs. The decision should be taken case-by-case and reflect the ECB's assessment regarding the solvency of an institution and its systemic importance against the potential risk involved in such lending. Determination of "systemic importance" would undoubtedly be difficult in some cases. A bank may not have systemic importance for the eurozone as a whole, but still be very significant at a national or regional level. Should a bank be refused ELA, it would presumably be handed over to the resolution authority (whether national or euro-zone level).

43. Duration. ECB ELA should be relatively short term, perhaps up to one year, and accompanied by supervisory intervention. (The ECB's two 3-year LTROs have provided longer-term finance to many banks, but are exceptional thus far.) In the meantime, the bank should be required to provide a funding plan, and undergo a thorough supervisory examination (and perhaps supervisory sanctions, such as a ban on dividend distributions, or constraints on some operations to avoid "gambling for resurrection") that can determine its long-term viability. In the case of a systemic liquidity crisis and prolonged pressure on the interbank market, the short-term emergency lending could be rolled over for another period of up to one year, but again, this should be preconditioned upon even stricter supervisory oversight.

44. Collateral policy. Shifting responsibilities to the ECB for ELA would require changes to the ECB's collateral policy. Almost by definition, euro zone banks in need of ELA cannot access the OMO and SF because of collateral constraints. The ECB will therefore have to accept a wider pool of collateral when it provides ELA. This could involve broad guidelines for likely acceptable collateral for use only in ELA circumstances, where lending is accompanied by supervisory intervention. But there should be scope for case-by-case judgments on what collateral would be acceptable. In case of any substantial losses on the ECB balance sheet, the ECB could rely on recapitalization in line with current capital keys following a decision by the Governing Council; or it could seek an additional, precommitted fiscal backstop for losses related to such lending. This, however, could be more difficult to achieve, and could raise questions about the ECB's independence.

45. Transitional issues. The change of authority responsible for providing ELA raises transitional issues. If the large commercial banks were to be moved to the ECB's supervisory oversight first, the ECB would be able to take over ELA responsibility solely for those banks. The ELA limits for the

NCBs—to cover banks remaining under national supervision—would need to be adjusted accordingly. The market would need to know which banks had moved from the NCBs to the ECB.

F. Relations with other EU members

Issues related to coordinating resolution with other EU member states and providing access to common safety nets for those who wish to opt-in must also be addressed.

46. Coordination. The design of burden-sharing arrangements and coordination of resolution with other EU countries is a crucial issue given the high degree of integration with non-euro area countries and the role of the U.K. as a key financial center. The EU Directive must be implemented as soon as possible to ensure that other EU countries have robust resolution regimes and harmonized DGS in place. Burden-sharing arrangements (especially for banks operating in the U.K.) may need to be established on a case-by-case basis. But, as noted in Chapter I, the mediation role of the EBA envisaged under the EU Directive may need to be strengthened; changes to the governance of the EBA are also needed. This would help to minimize or avoid situations where non-euro area EU members may have to bear some of the costs.

47. Opt-ins. Non-euro area countries may desire to join the Banking Union and benefit from the common safety nets. For this possibility, treaty change may be needed to create a common backstop open to non-euro area EU countries. But, during the transition period, ESM direct recapitalization would, under current rules, remain accessible only to euro area members.

G. Summary

48. Burden sharing and backstops. Establishing a strong and autonomous resolution authority is key to enhance the effectiveness of the single supervisory mechanism. To be effective, a centralized resolution authority requires clear rules for burden sharing and adequate common backstops to break sovereign-bank links. A pan-euro area resolution fund should be built over time from risk-based industry contributions. It should be complemented by a fiscal backstop that could be provided by the ESM, or in a longer term by earmarked pan-euro area taxes, as well as a liquidity line from the ECB. Establishing the single resolution authority may, however, require a treaty change. Centralizing DGS would enhance credibility and risk diversification. In the long-term, a single deposit insurance and resolution fund could be created by merging the resolution fund and national DGS.

49. Transition. Addressing transitional risks is key. A temporary body or EU agency, which would be an embryonic resolution authority, could be created to help deal with the resolution of failed banks. Designing appropriate cofinancing arrangements, e.g., clear ex ante burden-sharing arrangements with room for discretion, may be useful to fully align the incentives of national authorities with the common good, although due consideration should be given to how it might impact sovereign-bank links.

50. Risks. A key risk would be a stalled reform process. An SSM without a single resolution authority would weaken the effectiveness of the SSM. Centralized resolution without agreement on

burden-sharing rules and on adequate fiscal backstops would lead to an ineffective and non-credible resolution authority. To address transitional risks, a clear and time-bound roadmap, demonstrating a shared understanding of the end point by all member states, should be announced, with strict deadlines and key deliverables at each step of the reform process.

Annex II.1. Bank Resolution and Deposit Insurance in Germany⁷

Bank resolution

51. Upgraded framework. A new bank restructuring law came into force in 2011. It introduces broad powers and instruments to facilitate resolution of systemic banks, including the ability to transfer the banking business to another institution, stronger remedial powers, reorganization procedures involving the courts, the appointment of a special administrator to take over the management of a bank, and measures to improve own funds' adequacy and liquidity. The law provides the basis for the restructuring fund, administered by the Federal Agency for Financial Market Stabilization (FMSA). While the authorities are engaging with the large banks regarding the preparation of resolution plans, there is no specific requirement in the law for establishing resolution plans ("living wills"). Individual small banks are subject to corporate insolvency proceedings (i.e., bank liquidation).

52. European progress. The new law reflects many aspects for stronger bank resolution frameworks currently under discussion at the European level. The authorities decided to move forward with legislative reform (with the U.K. authorities taking the lead in Europe with the introduction of a special resolution regime in 2009) and are aware that some adjustments to the law might be needed once agreement has been reached at the European level.

53. Agencies. BaFin—Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)—is granted the lead in formulating resolution strategies. Several other agencies are also involved. The FMSA is tasked with providing resources to facilitate the resolution process and therefore becomes a key player. The Bundesbank will need to assess implications on overall financial stability, especially when granted a stronger role in macroprudential supervision. Finally, the BMF—Bundesministerium der Finanzen (Federal Ministry of Finance)—is understood to have a central role in systemic cases even though no direct responsibility is assigned in bank resolution (the BMF is represented on the FMSA's steering committee and oversees the operations of BaFin). Crisis management coordination will be a task of the Financial Stability Committee that will be established under the framework for macroprudential oversight.

54. Resolution fund. The new restructuring fund provides additional resources for bank resolution. The restructuring fund has a target size of €70 billion and is administered by the FMSA under the general oversight of the BMF. The restructuring fund is meant to facilitate the resolution of systemically relevant banks through the establishment of bridge banks, providing guarantees (up to €100 billion or 20 times the size of the restructuring fund), capital injections, and other support measures. The restructuring fund is financed ex ante by a bank levy, but expected receipts in the range of €650 million to €1.3 billion per year are low relative to the target size and the potential

⁷ Prepared by Pelin Berkmen (European Department) and Maïke B. Luedersen (Legal Department). See also E. Kazarian and M. Luedersen, "Germany: Technical Note on Crisis Management Arrangements," IMF Country Report No. 11/368.

costs of the failure of a systemically relevant bank. With limited amounts of resources built up so far, existing contingency funding arrangements remain important.

55. Levy. The bank levy will be higher for banks that engage in activities creating systemic risk (based on size and interconnectedness). The levy is being collected in addition to contributions to the various deposit insurance schemes to cover the costs of operating the restructuring fund and financing the support measures and is calculated according to government regulations. Subject to an overall ceiling linked to a bank's annual profit (over a multi-year period), the levy has been set at 2 bps of bank liabilities (excluding deposits and capital) up to €10 billion, 3 bps from €10 billion up to €100 billion, 4 bps from €100 billion up to €200 billion, 5 bps from €200 billion up to €300 billion, and 4–6 bps in excess of €300 billion. Small banks (e.g., cooperative banks) will benefit from this staggered structure of the levy. An additional element of the levy, based on the nominal value of off balance sheet derivatives, covers interconnectedness.

Deposit insurance

56. Fragmented. The German deposit insurance regime is fragmented in nature (see box), prefunding is limited, and its features lack transparency and legal certainty. While confidence among depositors was maintained during the crisis in part because of the authorities' public commitment to fully protect household deposits, limitations became apparent in the commercial banks' private scheme in connection with the failure of Lehman Brothers, and in the mutual protection scheme run by the savings banks association in the case of a large *Landesbank*.

57. Crisis measures. During the financial crisis, Germany, along with many other European countries, enhanced the existing deposit insurance arrangements. The main objective was to safeguard the confidence of mainly small depositors in the stability of the financial system by protecting them from incurring losses due to bank failures. In Germany, the minimum coverage limit under the statutory schemes was increased to €100,000 in 2011 from €20,000 before the crisis, with coinsurance eliminated in 2009. The current coverage level is estimated to cover more than 90 percent of retail deposit accounts at commercial banks (this ratio is higher when including retail deposit accounts at savings banks and cooperative banks protected under their respective mutual protection schemes). While there is little transparency on the financial condition of the various schemes in Germany, the coverage levels of the commercial banks' private deposit insurance scheme and mutual protection schemes are very high by international comparison (unlimited under the mutual protection schemes), and coverage is also very broad (encompassing all liabilities of the institutions under the mutual protection schemes).

58. Resource use. Under the current arrangements, resources from the private deposit insurance schemes and mutual protection schemes may be committed to finance the restructuring of banks on a going-concern basis (as an alternative to reimbursing the depositors). There is, however, no clear interaction and coordination mechanism between the restructuring fund and the private deposit insurance schemes and mutual protection schemes in the restructuring of systemic banks whose deposits are protected by one of the schemes.

Box II.1. Deposit Insurance Schemes in Germany

Commercial banks: statutory scheme—The coverage provided for deposits in private commercial banks under the statutory scheme is €100,000 and the claim for reimbursement is legally enforceable. Reimbursement of deposits is initiated by a declaration by BaFin and should be completed within 20 business days thereafter (an extension of 10 business days is possible). Banks' contribution rates have recently been doubled to 0.016 percent of the banks' balance sheet item "liabilities to customers."

Commercial banks: private scheme—The Bankers' Association offers for its member banks additional coverage amounting to 30 percent of the bank's capital per depositor (reduced over time to 8.75 percent by 2025), constituting a de facto full compensation scheme (for new member banks, limits of €250,000 per depositor are in place for the first three years). However, claims are not legally enforceable by depositors, an approach recently confirmed in a court ruling (a 2010 decision by the Berlin district court). The scheme came under significant pressure when faced with the successive failures of Düsseldorf Hypothekbank and Lehman Brothers Bankhaus in 2008. For the latter, substantial support by the FMSA in the form of a €6.7 billion guarantee was needed to ensure sufficient liquidity in a specially formed entity for the reimbursement of depositors, including large deposits held by insurance companies and municipalities. Contribution rates have recently been doubled to 0.06 percent of the banks' liabilities to customers. The parameters for ex post burden-sharing arrangements among banks in times of financial turmoil and heavy claims are not clear, and require ad hoc solutions.

Savings banks (*Sparkassen*) and *Landesbanken*—Partial ex ante funding (risk-based) is built up under regional arrangements and coupled with additional ex post burden-sharing provisions (in addition to any contributions from the local authorities as sponsors or owners of the institution) to protect the institutions in their entirety (mutual protection scheme). Further support is provided under the inter-regional arrangement among the 11 regional arrangements and a master arrangement (that includes the *Landesbanken* arrangement and the state building societies arrangement), if needed (without legal obligation). Financial support may be used to facilitate mergers, but there are limits under the arrangements as to the amount of support that could be made available for each support case. When a large *Landesbank* experienced financial strain in 2009, given the voluntary nature of the arrangements, only a small amount was made available under the mutual protection scheme of the *Landesbanken*, essentially representing its own paid-in contribution.

Public banks (other than savings banks and *Landesbanken*) have their own statutory and private schemes administered by the Association of German Public Sector Banks.

Cooperative banks (*Volks- und Raiffeisenbanken*)—The protection scheme run by the National Association of German Cooperative Banks is intended to protect cooperative banks in their entirety (mutual protection scheme). Ex ante funding (risk-based) is complemented by limited guarantees. When called upon, resources may be committed for broad purposes but there is no legal obligation to provide assistance. During the crisis, the Association provided guarantees to back several member banks. The Association takes the lead in resolving failed member banks, typically through purchase-and-assumption transactions or mergers and operates a dedicated "bad bank" to facilitate resolution.

III. BANK RECAPITALIZATION¹

This paper elaborates on issues relevant to bank recapitalization and repair of balance sheets to break the vicious loops between sovereign and bank funding costs.

A. Motivation

1. A potential turning point. On June 29, 2012, euro area leaders correctly identified the vicious circle between banks and sovereigns as a core problem with the monetary union and called for the establishment of an effective single supervisory mechanism and common backstop for bank capital. Mobilizing the ESM direct bank recapitalization tool in a timely manner is critical to developing a path out of the current crisis. In this regard, it is of critical importance that ESM direct recapitalization of banks, including migration to ESM of existing public support to banks, is not subjected to overly burdensome preconditions.² ESM investment decisions should take a long-term perspective, cognizant that gross upfront crisis outlays tend to dwarf ultimate costs net of recoveries and capital gains and, in many instances, generate positive financial returns.

2. Direct recapitalization. Timely and effective direct recapitalization by the ESM of domestically systemic banks in the euro area has a key role to play in breaking the vicious circle between banks and sovereigns, repairing monetary transmission, preparing for banking union, and, thus, helping complete the economic and monetary union. As a patient, deep-pocket investor, the ESM can maximize the financial stability benefits of, and long-run returns on, its investment. Conditional upon it standing ready to take material losses in a downside scenario, the ESM would be unlikely to actually incur those losses, because the investment would also improve the funding environment for banks and minimize the risk of the adverse scenario occurring.

B. Designing an Effective Solution

3. Purpose. The ESM Board of Governors would appear to be authorized to develop a direct bank recapitalization instrument that is effective in practice in breaking the sovereign-bank vicious circle. Such an instrument is consistent with the purpose of the ESM “to mobilize funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.” Member states ultimately decide on the scope of action that is

¹ Prepared by Craig Beaumont, Ashok Bhatia and James Daniel (European Department), and Marina Moretti, Michaela Erbenova, Michael Moore, and Constant Verkoren (Monetary and Capital Markets Department).

² ESM recapitalization of banks would in any case require unanimity in the ESM Board of Governors and approval by national parliaments in some jurisdictions (e.g., Germany).

allowed under the current ESM Treaty; in this regard, it appears that the current Treaty may leave sufficient flexibility to accommodate related financial operations such as ESM participation in or ownership of an asset management company (AMC).

What is needed for an effective instrument?

4. **Inter-related goals.** The mobilization of the ESM direct recapitalization instrument should: ensure systemic banks have adequate capital; and sever the link so banks are no longer a source of contingent fiscal liabilities.
5. **Confidence.** Achieving these goals will enhance market confidence in the credit standing of both the sovereign and the banks, including by reducing the extent to which exposure to the sovereign impairs market confidence in the banks. Nonetheless, the ESM recapitalization tool is not a panacea. Failing non-systemic banks should be resolved at least cost to national deposit insurance funds and taxpayers. Equally, systemic banks benefiting from ESM support will need effective supervision and sustained reform to be fully returned to private ownership, with state aid rules mandating formal restructuring plans, and the sovereign itself will need an adjustment program.

Some considerations on ESM ownership of banks

6. **Source of strength.** In a business where confidence is important, capital support of banks by the ESM would reassure creditors that, in the event of a negative surprise, potential future capital needs can be met—a virtuous dynamic codified in U.S. banking statutes as the “source of strength” doctrine, asserting that the financial strength of a bank is inextricably wedded to the financial strength of its owner, thus justifying supervision of banks’ holding companies. Confidence derived from ESM capital support, in turn, would feed into lower funding costs, restore profitability, and build capital over time. This much-needed fillip to lending and growth in the periphery would help facilitate needed fiscal adjustment, while also helping reverse capital flight from the periphery to the core. Positive effects would be further amplified where ESM equity investments would have a significant immediate impact on sovereign credit standing. For all these reasons, a large equity participation by the ESM in a bank is quite distinct from a share transaction in the market, as it changes prospects for banks and for the economy.
7. **The ESM as a patient, deep-pocket investor.** Although the treaty establishing the ESM appropriately provides for the possibility of losses, it is clear that such losses should not be expected in its financial operations, including bank recapitalization—the expectation is that the ESM as bank investor must be careful to take balanced risk positions. Taken to the extreme, however, if the ESM were to restrict its investments to sanitized banks valued at depressed market prices—terms no more beneficial than those available from the private sector—it would likely fail to achieve the policy goals of the instrument. A balanced approach is needed, therefore, one which prudently internalizes the benefits of ESM capital support by looking ahead over a time horizon sufficiently long to realize the benefits. As initial outlays rise to a threshold where banking stability and sovereign debt

sustainability can improve decisively, so too does the likelihood of durable economic recovery underpinning a positive return on investment.

Broad issues in applying the instrument

8. Which countries should be eligible? In view of moral hazard considerations and the need to husband finite ESM resources, the direct bank recapitalization instrument should only be applied where there is a paucity of private capital—including capital from burden sharing with creditors as appropriate—and where use of national taxpayer capital would threaten sovereign market access or significantly undermine the terms on which the sovereign has such access.

9. What types of institutions should qualify? At this time, the instrument appears to be limited to domestically systemic banks. In principle, however, asset management companies (AMCs) and resolution corporations used to restructure such banks by warehousing certain segregated assets should also be eligible. When such vehicles remain under national ownership, the sovereign is exposed to residual uncertainty around the value of their assets, leaving potentially the most important part of the bank-sovereign link intact.

10. What extent of capital shortfall should be covered? ESM bank capital holdings should eventually be marketable. Given the mandate of the ESM as discussed above, capital that a patient, forward-looking investor could not expect to recover over time could not be furnished. Thus, capital needed to bring a systemic bank out of insolvency would, in the first instance, need to be provided by shareholders and creditors, and then by the national government, with any remaining shortfall covered by the ESM. In principle, however, there would be significant advantages to breaking the vicious circle if all capital needed to ensure a systemic bank was adequately capitalized was ultimately provided by a central fiscal authority, especially if the scenario were to play out in a small jurisdiction.

11. How should bank equity be valued? Current depressed market valuations of bank equity would not be appropriate, as they reflect downside risks stemming from bank-sovereign links. An historical-cost approach to valuing bank equity could be considered where the analysis underlying bank recapitalization has been conducted in coordination with relevant European authorities. Even here, however, stress tests designed to calibrate prudent equity buffers for a downside scenario do not provide balanced valuations of bank equity, given that they deliberately take a conservative view on economic variables and potential credit losses and factor in net income over a time horizon of, at most, a few years. Instead, the assessment should be based on internalizing the benefits of the investment (e.g., for funding costs), factoring in reasonable baseline projections rather than a stress scenario and using, for instance, a real long-term economic value approach that takes into account underlying profitability under stable macroeconomic conditions.

12. Should banks first have a balance sheet restructuring? A flexible approach is needed, recognizing that distressed asset workouts are a core function of banking. In most cases, where banks are best suited to manage in-house their own distressed assets, such assets should be

retained on balance sheet at valuations that make prudent allowance for lifetime credit losses in a baseline scenario. Nonetheless, a separate legal vehicle may offer advantages in resolving certain asset classes, such as larger, more idiosyncratic loans with valuation uncertainty, while enabling banks to focus on improving their performance in their ongoing core businesses. Ideally, if a vehicle is used, it should also fall under ESM ownership; otherwise, effectiveness in breaking bank-sovereign links is diminished. Indeed, the ESM may choose to segregate assets of banks under its control into separate but affiliated entities that would nonetheless be captured in consolidated supervision of the banking group as a whole.

13. What types of risk-sharing arrangements are appropriate? To minimize contingent fiscal liabilities, a clean break would usually be best, with the sovereign providing no downside risk protection and correspondingly receiving no claim on future upside, except if it retains a minority equity stake. That said, simple option structures can help facilitate transactions where there are large valuation uncertainties.

C. Implementation Issues

Direct recapitalization by the ESM

- 14. Elements.** The ability of the ESM to support bank restructuring hinges on several elements:
- *Mandate.* The ESM can directly recapitalize banks, based on diagnostics performed by (or under the leadership of) the ECB-led SSM. As noted in the euro area summit statement of June 29, 2012, this would require a “regular decision,” albeit one that requires unanimity in the ESM Board of Governors and, in some jurisdictions, approval from national parliaments.
 - *Transparency, governance and accountability.* The strategic approach of the ESM would need to be communicated clearly so as to ensure investor understanding and acceptance, enhance confidence, and secure broad public buy-in. Elements that would help in this respect are a transparent investment strategy and governance mechanism, and an incentive structure in which the public sector shares any upside.
 - *Principles for access.* The modalities for ESM investment should provide incentives for banks to seek private sources of capital first, in particular by diluting existing shareholders. National authorities would then be expected to cover, at least, any negative equity that might remain subject to (as noted above) the need to ensure sustainable public debt dynamics and an exit from the crisis.
 - *Role of Bail-in.* Holders of capital instruments (such as subordinated debt and preferred shares), in both going and gone concerns, should be subject to burden sharing to reduce the fiscal costs of bank resolution. For banks undergoing resolution, losses could be imposed on remaining creditors in line with seniority of claims, including senior unsecured bond holders, if the systemic consequences can be contained. Insured depositors, which in most of Europe rank *pari passu* with senior creditors, would need to be protected to avoid contagion.

- *Operations.* The ESM will need to build capacity to manage its equity stakes in banks, including as warranted the exercise of ownership rights. Alternatively, a special vehicle could be established with a mandate to manage the ESM's investments at arm's length, similar to U.K. Financial Investments Ltd. In any event, the management of the ESM's investment should be at an arms-length from the political process and follow strictly commercial principles. But the ESM could forgo annual dividend income on its holdings as this would help reduce funding costs of these banks and increase the prospects of returning to profitability. At the same time, the beneficiary economies must not implement policies that could harm the profitability or viability of the recipient banks (e.g., through onerous taxes or ex post resolution levies).
- *Design of instruments.* Capital instruments utilized for ESM recapitalization should allow for transparency and flexibility. Recapitalizations should be effected via the acquisition of ordinary shares—resulting in dilution of existing shareholders. Any “first loss” arrangements with the sovereign would hamper efforts to weaken sovereign-bank links. For banks that have already been nationalized by member states, debt-equity swaps should be considered with the member states transferring the equity stakes in banks to the ESM with a corresponding reduction in their debt.
- *Adequate resources.* Direct equity injections into banks could absorb significant amounts of ESM capital. It would be important to ensure that the ESM has adequate capital to not only allay any investor concerns about ESM credit quality, and thereby limit any rating implications, but also play its potential role of a common backstop for bank recapitalization.

Supporting workout of impaired assets

15. Clean up. Resolving impaired assets in the euro area banking system is a necessary supplement to the roll-out of the banking union. While banks are in the business of collecting on delinquent loans, and thus must have the expertise, unresolved nonperforming assets can deepen the severity and duration of a systemic crisis, as they tie up bank managerial and financial resources—particularly in the case of non-marketable assets or when secondary markets become illiquid—and inhibit a recovery in lending. A clear segregation between impaired and performing assets would remove doubts about the quality of banks' balance sheets, and thus contribute to restoring confidence in the euro area banking sector.

16. AMCs. Asset Management Companies (AMCs) have been used in the past in systemic crises and as a part of a wider package of measures to facilitate (i) resolution of insolvent and nonviable financial institutions; (ii) restructuring of distressed but viable financial institutions; and (iii) privatization of government-owned and government-intervened banks. Examples of (i) include the U.S. Resolution Trust Corporation and the Thai Financial Sector Restructuring Agency. Examples of (ii) include the U.S. Maiden Lane LLCs established by the Federal Reserve to resolve Bear Sterns and AIG, and Sweden's Securum; combinations of (i) and (ii) include the Korea Asset Management Institution and the Malaysian Danaharta. An example of (iii) is the French Consortium de Realization.

The Indonesian Bank Restructuring Agency (IBRA) combined all three elements. Centralized AMCs, often with broad mandates, were also widely used during the 1990s transition in central and eastern Europe, for example in the Czech Republic, Georgia, Hungary, Kazakhstan, Lithuania, Macedonia, Slovakia and Ukraine.

17. Advantages and disadvantages. Centralized AMCs can remove balance sheet uncertainty by acquiring assets of unknown (or difficult to quantify) value; allow the consolidation of scarce workout skills and resources in one agency and the application of uniform workout procedures; help securitization through generating a larger pool of assets; provide greater leverage over debtors if AMCs are granted special powers of loan recovery; prevent fire sales or destabilizing spillover effects as banks deleverage; and allow the “cleaned up banks” to focus on their core business. Such considerations need to be balanced against potential disadvantages. These include the loss of banks’ specialized information about their borrowers; the AMCs’ limited ability (relative to the bank) to provide additional financing to support restructuring of nonperforming loans; and the risk of a deterioration in asset values following transfer to an AMC if the assets are not actively managed. It may also be difficult to insulate public agencies such as centralized AMCs from political interference, and centralized AMCs may raise concerns about asset warehousing, and extend their own lifespan by open-ended transfer arrangements that can ultimately also undermine credit discipline in banks.

18. Lessons. The experience with AMCs has been mixed and has helped identify common prerequisites and design features that can contribute to an AMC’s success:

- *Prerequisites:* an insolvency framework that supports rehabilitation of viable firms, liquidation of nonviable firms, and out-of-court debt recovery and realization of collateral; a neutral tax framework; and robust financial regulation, supervision, and bank resolution framework.
- *Design features:* strong leadership and operational independence; accountability, transparency and governance; adequate funding; strong legal basis; appropriately structured incentives (including forms that enable AMC owners to benefit from future increases in the value of bank assets); and commercial orientation.

19. Transfer price. Assets for transfer to the AMC need to be properly priced (Box III.1). The general rule is that assets be purchased at a price as close to a *fair* market value as possible based upon expected recovery, cash flow projections, and appraisal of collateral. But pricing nonperforming and illiquid or complex assets can be difficult, time consuming, and subjective, especially in the midst of a financial crisis—one reason why in the United States the Troubled Asset Relief Program (TARP) was ultimately not used to purchase mortgage-related assets. The Treasury decided to conduct a second round of capital injections into financial institutions instead, stating that the original plan of purchasing troubled assets would take time to implement and would not be sufficient given the severity of the problem. When a large number of assets is involved, the transfer can take place at an initial price with the explicit agreement that the final price of the transaction be established after the value of the assets has been estimated or the assets have been sold. Some form of profit-sharing arrangement may be utilized to make transactions more palatable for banks, but these should not remove the full update for the government sponsoring the centralized AMC.

The Malaysian Danaharta, for example, purchased impaired loans at an average discount of 55 percent, while banks that sold assets retained the right to receive 80 percent of any recoveries in excess of acquisition costs that the AMC was able to realize.

Box III.1. Key Considerations for Asset Management Companies

The transfer price at which impaired assets are removed from restructured banks' balance sheets is a key parameter with broad implications.

- The lower the transfer price, the larger the losses imposed on restructured banks: to the extent that they remain viable, this increases the need for capital injections. Transfer prices have a direct impact on whether or not there is "negative capital" to be filled in.
- Low transfer prices also limit the size and therefore the capital/funding requirements of the AMC, limiting the extent of fiscal costs to be incurred over time and perhaps even providing some potential upside as bad assets are liquidated, and spur the interest of private equity investors.
- There is therefore a trade-off between crystallizing large capital needs and setting up a large AMC that would also need to be capitalized and funded.
- The EC typically applies the principle that transfers should take place at the "real (long-term) economic value" which for impaired assets would typically be closer to the market value than to the historical value.

Long-term funding of asset run-off vehicles is critical to ensure that recovery values are not impaired by fire-sales.

- If the AMC has a banking license, it could in principle access Eurosystem refinancing directly. The bad assets are, however, unlikely to be eligible collateral under ECB operations, and ELA is not an appropriate vehicle for long-term refinancing purposes. Even if the AMC is capitalized with government bonds, the ECB may challenge the eligibility of the entity itself as a monetary policy counterparty, or challenge the appropriateness of Eurosystem refinancing on the basis of the monetary financing prohibition.
- There are precedents for central bank funding of AMCs, most involving protection of central banks' balance sheets against potential losses. However, even if the ECB were to provide funding, the risks on its balance sheet should be protected by a fiscal guarantee, for instance, from the ESM (which may require amendments to the ESM Treaty).
- A non-bank AMC can be funded by issuance of government guaranteed bonds that can either be placed directly in the market, or with the restructured banks as payment for the assets that are transferred. It is critical that such securities be eligible for Eurosystem refinancing (e.g., as per the Spanish MoU).

Private investors should be invited in AMCs, albeit with proper risk sharing arrangements, to maximize recovery values.

20. Competition policies. EU competition policies complicate asset pricing in the European context.³ The EC requires a clear ex ante identification of the magnitude of a bank's asset-related

³ Among others, the guidance to member states is provided by the 2009 European Commission Communication on the Treatment of Impaired Assets in the Community Banking Sector. See www.ec.europa.eu/competition/state_aid/legislation/impaired_assets.pdf

problems and a viability review, with assets valued at market prices whenever possible. As the current market value could be quite distant from the book value, the EC’s approach allows for a transfer value reflecting a “long-term economic value” of the assets, on the basis of underlying cash flows and broader time horizons. The experience with setting up Ireland’s National Asset Management Agency (NAMA) in late 2009 is that lack of a universally accepted methodology for this valuation led to a protracted process whereby bank book values were repeatedly discounted, prolonging uncertainty and delaying normalization of bank funding.⁴ In the case of Spain, this process was more rapid, with transfer prices set conservatively, based on haircuts in line with the adverse stress test scenario.

21. AMC funding. Funding of AMCs is another key design feature. The AMC must have sufficient funds to perform its intended functions, with the operating budget separate from funding for asset takeover. In past crises, funding came from either the proceeds of government bond issues or the AMC’s own bond issuance backed by the government, with losses absorbed by the budget as private investor participation is unlikely to materialize in the early stages. For instance, in Ireland, banks received government-guaranteed securities in return for assets transferred to the Irish NAMA. A key advantage of using a company without a banking license (an AMC) instead of a “bad bank” is that AMCs do not need to meet regulatory capital and liquidity requirements, thereby reducing their overall costs.

22. Sovereign-bank loops. In the current euro area context, funding by governments reinforces the sovereign-bank links and complicates AMC design. To the extent that AMC debt funding bears on public debt, there is an incentive to minimize the size of these vehicles, and therefore the scope of assets that are segregated. This raises a question on possible alternative sources of equity and liquidity of the AMC, and specifically of the potential roles of the ECB and ESM in these areas.

Potential role of ECB

23. Direct support. The ECB is subject to a number of legal protections to safeguard its balance sheet, but could have a role in funding AMCs. The ESCB Statute limits its credit operations counterparties to “credit institutions and other market participants, with lending based on adequate collateral.” Hence, the Statute may provide a leeway to fund non-banks. That said, funding acquisition of bad assets, or resolution of bad banks, remains a fiscal responsibility. Therefore, were the ECB to provide such funding, the risks its balance sheet should be protected by a guarantee from euro area member states, such as could potentially be extended by the ESM (Box III.2).

⁴ NAMA had acquired assets at an average discount of over 50 percent. The process lasted for over a year and required detailed asset-by-asset valuation. The EC Communication, however, allows for an alternative where valuation of assets appears particularly complex, including the creation of a “good bank” whereby the state purchases good rather than the bad assets. Nationalization combined with a creation of a “good bank” has been used in Latvia for resolving Parex bank in 2008-2010.

Box III.2. Central Bank Funding of AMCs

There are precedents for central bank funding of AMCs, most involving protection against potential losses:

- In the United States, the “bad bank” of Continental Illinois was owned by the former shareholders of the bank and funded with liabilities to the Federal Reserve, fully guaranteed by the FDIC (which owned the good bank).
- A number of central banks in Central and Eastern European transition economies were engaged in funding AMCs or bad banks; the losses incurred were covered by the national budget or, over time, via seigniorage.
- The Swiss National Bank (SNB) supported in 2008 the transfer of illiquid securities and other troubled assets of UBS to a special purpose vehicle—the Swiss Stabilization Fund—controlled and mainly funded by the SNB. Assets were transferred to the fund at market prices and thus, on average, with a discount to notional value. Asset transfer from UBS was financed by a 90 percent loan from SNB, backed by a security interest in all the fund’s assets, and 10 percent financing contribution from UBS. Management of assets was outsourced to UBS and UBS was given an option to repurchase the fund. Protection was provided to the SNB in the form of loan overcollateralization and warrants for UBS shares, to cover any losses on liquidation of assets. The broad recovery of secondary market asset valuations in 2010 allowed the fund to dispose of assets with sales mostly above their intrinsic values.

24. Indirect support. An alternative route would be for the ECB to support AMC operations indirectly, subject to the prohibition of monetary financing. In particular, the ECB could accept government-guaranteed AMC bonds issued to banks in exchange for their assets as collateral for Eurosystem financing operations, and for a range of safeguards such as an observer status in the AMC governing committee(s) and special access to the AMC internal information. Bond characteristics will be important in determining acceptance by the ECB as repo collateral, including interest rate, maturity, and marketability:

- Central banks accept collateral of a high credit quality and liquefiable in secondary markets, which help manage the risks associated with implementing monetary policy. They also typically accept government and quasi-government securities as collateral, subject to not being a direct party to monetary financing of the fiscal deficit.
- Conversely, central banks would not typically accept non-marketable securities (for example, special purpose government bonds that may not be on-sold in the market). Open market purchases of bonds or the general acceptance of a class of securities as collateral from all counterparties are the acceptable ways that central banks acquire government securities.⁵ Hence, the mechanism through which the central bank acquires government securities is

⁵ In the case of the ECB, various “opinions” discuss this matter. See, for example, CON/2010/2 in which the ECB indicated that “the prohibition of monetary financing prohibits the direct purchase of public sector debt, but such purchases in the secondary market are allowed, in principle, as long as such secondary market purchases are not used to circumvent the objective of Article 123 of the Treaty.” Also see recital 7 of Council Regulation (EC) 3603/93.

important in determining their acceptability by the central bank. A side deal where the central bank agrees to purchase or accept a particular class of non marketable securities that have been directly issued to just a few banks would not generally be acceptable practice.

Potential role of ESM

25. Broadened mandate. Consideration could be given to broadening the ESM mandate, allowing it to own, or lend support to, AMCs. The main argument supporting this would be that the risk of losses on impaired assets for creditor Member States (via the ESM) is likely to be much lower because of the retention of the long-term value of assets transferred to the AMC. In such circumstances, the transfer of conservatively valued assets from the banks' balance sheets to an ESM-owned AMC would be beneficial for all banking union participants (although, as noted, it would also increase the capitalization needs of banks).

26. Governance and accountability. There may be potential conflicts of interest between the various capacities in which the ESM is envisaged to operate. For example, the ESM could end up acting as a (co-)owner of banks following an equity injection and as purchaser through an AMC. Safeguards could entail: (i) clear and transparent evaluation criteria (guided by the ECB's diagnostics) on asset prices; (ii) clear rules on the interaction with the ECB in its capacity as single supervisor, as well as with resolution authorities; and if needed (iii) a potential revision of ESM governance and decision-making arrangements (which would require modifying the ESM Treaty).

D. Conclusions

27. Effectiveness. Banks benefiting from ESM participation will need time to reorder their operations and restructure their distressed loans. With moral hazard addressed through appropriate burden sharing, conditionality, and supervision, the ESM can act as the quintessential patient investor, taking a forward-looking approach to its equity holdings and internalizing the benefits of its ownership for the medium- to long-term outlook. Such an approach to ESM direct bank recapitalization would maximize effectiveness in breaking the vicious circle between banks and sovereigns which, by safeguarding the financial stability of the euro area as a whole, would serve the common interest.

28. Urgency. With the large international body of experience showing that delays almost always ramp crisis resolution costs upward (see, for instance, Laeven and Valencia, 2012), time is of the essence. Some euro area member states continue to face severe stresses in both sovereign and bank funding markets, with broad ramifications for the currency union. Others may be poised at a decision point between durably restored market access and potentially prolonged dependence on official financing. In no case would delay in applying the ESM direct bank recapitalization instrument improve ultimate outcomes. The sooner the ESM can move, the sooner current market dislocations in both the periphery and the core can be resolved, for the benefit of all.