ISSN: 1791-35 35

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GLOBAL ECONOMIC &
MARKET OUTLOOK
April 3, 2014
Eurobank
FOCUS NOTES

Euro area: Lack of a common backstop poses a risk on restoring confidence in the banking sector

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- The lack of a common backstop to cover capital shortfalls identified by the ECB's comprehensive assessment of banks does not break the doom loop between banks and sovereigns, with negative consequences on fragile public finances.
- This raises concerns about the rigorousness of the ECB's comprehensive assessment of banks and its effectiveness to restore market confidence in the euro area banking sector, reduce financial fragmentation and increase the ability of banks to finance the real economy.
- The agreed framework for resolving ailing banks remains complicated, involving three bodies, the Single Resolution Board, the Commission and the ECOFIN. The perplexity of the scheme raises fears about its ability to eliminate political interference, allow for a speedy resolution process and constrain contagion risks.

After long negotiations, the tripartite consisting of the European Parliament, the commission and the EU Council have reached an agreement on a Single Resolution Mechanism to manage ailing banks. The mechanism is backed by a common pot of funds, the Single Resolution Fund, to shoulder any resolution costs that cannot be covered by private investors. The SRM is the second building block of the European banking union, which complements and reinforces the supervision of banks by a single authority, the ECB, based on a common set of rules (Single Supervision Mechanism)

The SSM/SRM institutional framework is an important step towards the integration of the euro area. It aims at expediting the winding down of unviable banks, minimizing the risk of contagion to the financial sector, eliminating the burden of bank deficiencies on taxpayers and limiting the room for local interests interfering with the resolution procedure. The ECB has been conferred with the right to trigger the resolution process, when it identifies a bank failure. A resolution board (Single Resolution Board) will then decide on a resolution plan according to common rules as agreed in the Bank Recovery and Resolution Directive. According to these rules, private bank creditors have to bear the burden of the resolution costs to an extent of at least equal to 8% of total liabilities. Any additional needs will be covered by the SRF. The latter's funds comprise of contributions from all participating financial institutions, representing a mutualization of banking sector risks.

Doom loop between banks and sovereigns inadequately addressed

While the common resolution framework reduces the doom loop between banks and sovereigns, it does not completely break it, not least for the current crisis. Before taking over its duties as a common supervisor, the ECB executes an asset quality review (AQR) of all banks it will directly supervise, which it will subsequently test under stressed scenarios. The tripartite negotiations have resulted in speeding up the mutualization of national compartments into the SRF with 40% of the total funds of about €55bn being available within the first year (as opposed to a meager 10% according to the December proposal by the Council). However, it is very unlikely that the common fund be used to cover capital shortfalls in the current AQR, given the reluctance of core countries to use common funds to cover legacy problems stemming from inefficiencies of local supervising authorities

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Another initiative to break the vicious link between bank woes and sovereign debt sustainability, concerning the ability of the ESM to directly recapitalize banks, has stalled. The provision to allow the ESM to directly recapitalize banks has been agreed in mid-2012 amidst an acute phase of the euro area crisis in order to alleviate market pressures on public finances. Since then, the continuous normalization of conditions in financial and sovereign debt markets has allowed policymakers to drag their feet on finalizing this measure. Political reluctance to use taxpayers' money to directly inject capital in banks without imposing conditionality on the relevant sovereign remains politically controversial. In our view, any involvement of the ESM in bank recapitalization will follow the Spanish model, where money has been funneled to banks through the state.

Furthermore, before 2016, when the bail-in rules agreed in the BRRD come into force, the pool of private creditors that can share the burden of a bank's restructuring/resolution is limited. According to the BRRD, private investors liable for bail-in include junior and senior unsecured bond holders as well as some categories of depositors. However, until the end of 2015, when the state aid rules are in force, only junior bond holders are on the hook for covering resolution costs, without any specified threshold of involvement.

As a result, national backstops need to shoulder all costs that cannot be covered by private investors, with negative repercussions on already fragile public finances. This is in contrast to the US experience, where the government first created a pool of funds to cover ensuing costs, the TARP, and then proceeded with the stress tests.

The lack of a common backstop raises concerns about the rigorousness of the ECB's asset quality review and its effectiveness in shedding ample light on banks' balance sheets. Yet, identifying all remaining vulnerabilities and force unviable banks to close down is crucial to restore confidence in the banking sector, reduce financial fragmentation and increase the ability of banks to finance the real economy.

Room for political interference remains

The compromise agreed in March for a single resolution mechanism has not eliminated the risk of political power games influencing the resolution decisions. In principle, the Commission is responsible for assessing the resolution scheme proposed by the SRB. The ECOFIN, however, may object the Commission's decision if the latter modifies the amount of resources drawn from the SRF. It can also object the decision if there is no public interest in resolving a bank, which is a rather vague notion, leaving unclear who will decide that and under what criteria.

The risk of political interference may increase in the case of resolving large banks. According to the agreement, the plenary session of the SRB (i.e including representatives from all participating members) will take decisions if more than €5bn of the SRF will be used. The involvement of three bodies, the SRB, the Commission and the Council in the resolution process raises concerns about the ability of the agreed framework to provide a speedy process and reduce contagion risks. Given that extensive use of the SRF will likely be associated with resolving a systemic bank which may pose a significant contagion risk, the resolution process becomes increasingly perplexed exactly when speedy action is required.

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ISSN: 1791-3535