Benoît Cœuré: The Single Resolution Mechanism – why it is needed

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the ICMA Annual General Meeting and Conference 2013, organised by the International Capital Market Association, Copenhagen, 23 May 2013.

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Ladies and Gentlemen,

The financial crisis has highlighted the weaknesses of the institutional framework of Economic and Monetary Union. The negative feedback loop between banks and sovereigns as well as signs of market fragmentation made European leaders take an extraordinary decision last summer, namely to establish the European Banking Union.

This is a historic step forward, but not unprecedented. As some of you might know, before the National Banking Act of 1864, banks in the United States were state-chartered corporations, subject to the oversight and resolution regime in the state in which they operated. And only the Banking Act of 1933, often referred to as the Glass-Steagall Act, established a system of federal deposit guarantees and created a new entity, the Federal Deposit Insurance Corporation (FDIC).[1]

Of course, one important difference is that in the United States, the banking union came after, and not before the fiscal union. Establishing a banking union without a fiscal union is certainly more challenging. Nevertheless, and as I will argue later, it is desirable and possible, provided the right sequence is in place.

In this respect, today I would like to outline my thoughts on the three pillars of a true European Banking Union: (i) the Single Supervisory Mechanism (SSM); (ii) the Single Resolution Mechanism (SRM); and (iii) a common system of deposit protection. I would like to emphasise that for there to be a genuine banking union, by which I mean a situation where confidence in deposits is independent of the jurisdiction in which they are located, all three pillars have to be in place. While good progress is being made on the supervisory mechanism, therefore, there should be no doubt in anybody's mind that the single resolution mechanism is its indispensable complement. The two have to proceed in parallel. They can be complemented at a later stage by a common system of deposit protection, but eventually all three pillars will need to be in place for the banking system to be truly one.

The Single Supervisory Mechanism

The first pillar of the banking union will be the Single Supervisory Mechanism. A strong and independent supranational supervisor will contribute significantly to the smooth functioning of the monetary union and to restoring confidence in the banking sector. This restoration of confidence in the banking sector is key to restarting a well-functioning interbank market and to amplifying recent developments towards financial reintegration.

The Single Supervisory Mechanism will comprise national competent authorities from the euro area as well as the ECB, with the possibility of non-euro area members participating. The scope of the proposed regulation is very broad, covering all of the more than 6,000 credit institutions in the euro area. However, not all of them will fall under the direct responsibility of the ECB. The ECB will directly supervise those banks and banking groups

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[1] See Thomas J. Fitzpatrick, Moira Kearney-Marks and James B. Thomson: "The History and Rationale for a Separate Bank Resolution Process", Federal Reserve Bank of Cleveland.

that are considered to be significant. The national authorities will retain their responsibilities for prudential supervision of the other banks. However, the ECB may at any time, on its own initiative and after consulting with, or at the request of, a national competent authority, decide to exercise direct supervision. The banks falling under direct supervision will be identified by using a methodology based on the criteria mentioned in the Regulation. We expect that it will cover more than 80%, or more than 25 trillion euro, of the euro area's banking assets. It will represent the largest single supervisory jurisdiction by assets.

The precise assignment of tasks within the Single Supervisory Mechanism will be specified in a Framework Regulation that the ECB will publish six months after the publication of the SSM Regulation. A public consultation will precede this publication – it will be very important to have input from the industry on this matter.

As you may know, the current position is that a political agreement was reached on 18 April between the European Council and the European Parliament on a Regulation conferring supervisory tasks on the European Central Bank. In our view, the Regulation will provide an effective framework for the ECB to exercise prudential supervision, while also providing for the necessary separation between the supervisory and monetary policy tasks of the ECB, as well as setting a high level of democratic control on the SSM.

The Single Resolution Mechanism

The second pillar of the banking union will be a Single Resolution Mechanism (SRM). Although the framework for the SRM still needs to be defined as part of a collective effort by the European Commission, the European Council and the European Parliament, I would like to discuss why the SRM is needed, what its main components should be and how it can be established.

The crisis has shown the importance of having a framework in place for resolving failing banks swiftly and impartially. As the ECB stated in its Opinion on the Commission's proposed Bank Recovery and Resolution Directive (BRRD): "…all financial institutions should be allowed to fail in an orderly manner, safeguarding the stability of the financial system as a whole".[2] This will provide the right incentives to financial market participants and minimise public costs and economic disruption.

A timely resolution of a bank should avoid that problems in one bank spill over to other banks, possibly affecting European financial stability. Moreover, the uncertainty surrounding the use of *ad hoc* solutions in Europe, as we all saw recently in the case of Cyprus, has shown the importance of establishing a clear and credible legal framework to underpin the resolution of banks. Without such a framework, decisions are often taken late and in an improvised way. Any solution which does not imply an outright bailout seems to take creditors and markets by surprise. This will need to change. I would say that after the events of Cyprus, markets should be convinced that Europe is serious and committed to bailing in and thus ending the bailout culture.

While Europe has already demonstrated that it has the resolve, the establishment of a credible resolution framework will ensure that it will also have the powers and the tools. Ending bailouts is key not only to enhancing market discipline, but also to ensuring that those who appropriate the gains are also those who cover the losses. It would, however, be a mistake to assume that there will be no more troubled banks once the SSM is in force and supervisory responsibility is transferred to the ECB. So if the Single Supervisory Mechanism is to be effective, it needs to be complemented by a Single Resolution Mechanism to deal with non-viable banks. It is thus crucial that the SRM framework is in place once the SSM is

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[2] ECB Opinion 29 November 2012, (CON/2012/99), http://www.ecb.int/ecb/legal/pdf/c_03920130212en00010024.pdf

operational. From the ECB's point of view, only if the SSM is complemented by a Single Resolution Mechanism with a common backstop can the negative feedback loop between sovereigns and banks be broken, ensuring thereby that monetary policy transmission is fully restored.

The SRM would need several components to be effective. Although the European Commission is still defining the framework for the SRM, let me nevertheless mention what, from my point of view, the main features of such a mechanism should be.

First, the SRM should be based on a strong and independent Single Resolution Authority (SRA) entrusted with the necessary powers. This would enable prompt and coordinated resolution action to be taken, specifically where cross-border banks are concerned. Experience has repeatedly taught us that mere coordination between national authorities does not suffice in a cross-border bank resolution. Successful resolution needs prompt and decisive action. Although the organisational aspects of the SRA still need to be decided, in order to achieve its objectives, the SRA should be strong, independent and preferably a standalone authority and should collaborate closely with the SSM and the European Commission.

Second, the SRA should have adequate funds for resolution financing. Indeed, for the resolution framework to work well and be credible, the SRA must have access to a privately-funded European Resolution Fund. This Fund should be pre-funded by levies from the private sector. This would ensure that the SRA has access to the necessary financing to take resolution action and achieve least-cost solutions, as the Federal Deposit Insurance Corporation (FDIC) does in the US.

Third, in order to ensure the credibility of the Fund, it should have access to a temporary and fiscally neutral fiscal backstop at euro area level, to be used only as a last resort.

Indeed, in order for the SRM to be effective, it will require a common resolution framework, containing comprehensive powers and tools. A harmonised toolbox of resolution powers is foreseen in the Bank Recovery and Resolution Directive, so it is crucial that this Directive is adopted as an immediate priority and passed into law before the SSM is operational.

A key resolution tool included in the Directive, one that all authorities should have, is the possibility of bailing in by creditors. Bailing-in is conducive to achieving a specific policy goal, namely that the burden of bank failures should be borne first and foremost by the private sector, rather than the taxpayer.

In accordance with the Financial Stability Board's Key Attributes of Efficient Resolution Regimes for Financial Institutions, which have been incorporated in the BRRD, resolution authorities should be able to write down or convert into equity liabilities in a manner that respects the hierarchy of claims in a liquidation. Thus, when a bail-in by creditors takes place, legal certainty and predictability are essential. Despite the limited spillovers, the idiosyncratic aspects of the bail-in by uninsured depositors in Cyprus may remain a cause for concern among investors. Creditors need to have a clear picture of what could happen in the event of a bank failure. This is key to avoiding excessive market volatility, bank runs, underprovision of capital and liquidity and/or overpricing of risk. This can be done by respecting the hierarchy of creditors in the event of insolvency, i.e. the order in which creditors will suffer losses in a bail-in.

In order to enhance legal certainty and predictability, a clear pecking order has to be established regarding the financing of resolution measures. Losses and resolution costs should first and foremost be borne by the shareholders and subsequently by the creditors of the failing institution. Only at that point should the private sector be called in to finance resolution via the resolution fund. Then and only as a last resort in case the accumulated funds in the resolution fund are insufficient, should there be a temporary public backstop providing credit to the resolution fund. But any such support should be fiscally neutral and

recouped through *ex-post* levies on banks. This will ensure that financial sector repair is ultimately financed by the private sector itself.

As regards the use of bail-in, let me stress that it should not create wrong incentives to the original entity by just continuing with "business as usual". Following the resolution process, only the critical functions and "good parts" of the original entity should survive, either because they are sold to a private sector purchaser – as commonly done by the FDIC with the Purchase & Assumption approach used in the US – or because they are transferred to a bridge bank. It needs to be clear that the aim of resolution is not to preserve the failing institution as such, but to ensure the continuity of the functions that are critical for the financial system as a whole.

Another important way of providing legal certainty and predictability in resolution would be to introduce harmonised depositor preference for eligible deposits in the EU. Currently, deposits have a preferential status in the hierarchy of claims in some Member States, while in others the deposits rank alongside any other senior unsecured creditor of the bank in insolvency. This may imply different treatment of depositors depending on the location of their deposits and lead to further market fragmentation.

Introducing harmonised depositor preference for eligible deposits in the EU would lower the risk of bank runs as it reduces the incentive for uninsured depositors to withdraw deposits. In addition, it would aid the resolvability of banks, since it avoids the cumbersome task of splitting the eligible deposits into covered and uncovered parts. It would also enable uninsured deposits to be transferred or sold along with the insured deposits and thus increase the franchise value of the bank under resolution and its essential parts. Nevertheless, it should be acknowledged that depositor preference may lead to increasing secured lending and decreasing maturity of the funding of banks. However this can be limited (i) by introducing a minimum requirement for bail-in-able instruments, calibrated to provide an adequate buffer of loss absorbency as foreseen in the draft EU framework; as well as (ii) by the introduction of the Net Stable Funding Ratio that banks will have to fulfil.

Another argument often raised against deposit preference is that it may also raise the cost of senior unsecured funding for banks. This is a discussion that we need to take seriously. However I would make here two observations.

First, one has to recognise the change in the liability structure of banks that is brought about by the deleveraging of the system. With generally lower loan to deposit ratios in the future relative to the pre-crisis period, and a clearer priority ranking of bank creditors, the role of senior unsecured wholesale funding for banks has evolved and will likely continue to evolve. If we accept that a smaller and less leverage banking system is desirable, then this evolution is not to be feared or resisted.

Second, the overall effect on funding costs of banks is not straightforward, given the potential offset provided by cheaper deposit funding. Currently, more than half of the G20 countries already have depositor preference, among them the US, with no appreciable cost difference to banking systems without depositor preference. Furthermore, deposit preference can in principle reduce the probability of default of financial institutions. Depositor preference could further strengthen the incentives of unsecured creditors to exercise more effective discipline over banks' risk-taking. This implies that while the loss given default for senior unsecured creditors increases as a result of depositor preference, the probability of default is likely to decrease. Also, as I argued before, lowering the risk of bank runs also reduces the future probability of default.

Clearly, when applying the pecking order, the Single Resolution Authority should take into account all relevant factors. Particularly, it should consider (i) the least-cost principle for the taxpayer, (ii) financial stability considerations and (iii) the impact on the real economy. These elements call potentially for some flexibility in the application of the bail-in tool. But despite the undisputed need for flexibility, consistency should be ensured at the European level and exemptions should be clearly defined and strictly limited.

Finally, the third pillar of the banking union is an integrated framework for deposit protection. A first step towards this aim would be the adoption of the pending legislative proposal of the Commission on a Directive for Deposit Guarantee Schemes (DGS). This framework should ensure depositor confidence and enable the national guarantee schemes, built on common EU standards, to interact with the SRM. Bail-in rules, with a clear treatment of depositors in resolution and insolvency, and with depositor preference making it less likely that the DGS is drawn upon, will make this interaction much easier in a real crisis, and will facilitate the implementation of a common DGS at a later stage.

Conclusion

Let me conclude. The decision to establish a genuine banking union is a fundamental step towards completing the architecture of Economic and Monetary Union, therefore making it more effective and more resilient. It goes without saying – but it goes perhaps better with saying it – that it is not the only step. It will have to be complemented itself by the completion of the Union in the fiscal, economic and political fields, as identified by President van Rompuy last year. In the area of banking policy as in those other fields, we have to heed the lessons of the past: we have to make the new architecture comprehensive and internally consistent. We cannot again leave the project half-completed. It is for that reason that we, at the ECB, have been insisting that the Single Supervisory Mechanism must be completed with the other pillars of the banking union, and the banking union must be completed with action in other areas too. So while we have made considerable progress, there is still much work to be done.