



From Supervision to Resolution: Next Steps on the Road to European Banking Union

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INTRODUCTION

Special resolution regimes for banks and systemically important financial institutions are an attractive alternative to both insolvency and public bailouts, and have a compelling

track record. The European Council meeting of December 14, 2012 has outlined a policy sequence that we interpret as three successive steps including the Single Supervisory Mechanism (SSM) with the European Central Bank (ECB) at its core; the Bank Recovery and Resolution (BRR) Directive and the operational framework for direct recapitalizations by the European Stability Mechanism (ESM); and the Single Resolution Mechanism (SRM). We also identify an implicit fourth step of completing a sustainable banking union, which unlike the first three, will require treaty changes and deeper fiscal and political integration, and may include a European insolvency regime, a European resolution regime, and a more integrated fiscal and deposit insurance framework supported by enhanced democratic accountability.

Implementing this sequence will involve a complex balancing of short-term, medium-term, and long-term objectives. The creation of the SRM will be a key milestone and should take place as early as possible, not least to forestall risks to the credibility of the SSM and of the ECB in its absence. Nevertheless, some of these objectives should be addressed even before, and others cannot be met until a later stage. In the very short term (2013 or early 2014), proactive initiatives (involving system-wide bank balance sheet assessments, state aid control, imposition of losses on creditors of failed banks and proportionate involvement of the ESM in bank recapitalizations) should be deployed to reverse the gradual “zombification” of Europe’s banking system.

Bank resolution

“Bank resolution” refers to specific legal regimes for the orderly restructuring and/or liquidation of certain financial institutions. For such institutions, the general-purpose insolvency process can be unsuited given their importance for the economy, the existence of systemic risk, and the possibility of contagion that is specific to financial activities including banking. The experience of past crises has convincingly demonstrated both the unsuitability of insolvency processes for

such financial institutions, at least in some situations and given the delays and uncertainties associated with insolvency courts, and the ability of well-designed special resolution regimes for banks to enable an orderly process that safeguards the interests of the public.

Much of this experience comes from the United States, where a special resolution regime for banks was introduced decades ago and reformed following the Savings and Loan (S&L) crisis of the 1980s, in contrast to most European countries which had not introduced special resolution legislation until the current crisis. The US resolution regime for banks is administered by the Federal Deposit Insurance Corporation (FDIC), a federal agency created in 1933 and headquartered in Washington DC. In the recent crisis it has operated reasonably well, as the FDIC has overseen the resolution of close to 500 banks, including very large ones, at times of systemic instability, such as Washington Mutual (which had more than \$300 billion in assets) in late September 2008, without large-scale disruption in spite of significant losses imposed on creditors, including senior unsecured ones. The Dodd-Frank Act of 2010 has extended the resolution authority of the FDIC to systemically important non-bank financial institutions, a category that would have included firms that were judged “too-big-to-fail” and were bailed out in 2008 (Bear Stearns, Fannie Mae, Freddie Mac, AIG, and GMAC) as well as Lehman Brothers. In April 2011, the FDIC published an analysis that suggests that, had the Dodd-Frank Act been in place in September 2008, it would have been possible to resolve Lehman Brothers in an orderly manner, as was the case for depositary banks (FDIC 2011).

A bank resolution regime should not be seen as a magic bullet that would as of itself put an end to moral hazard and systemic risk. There are cases of fairly effective resolution of a systemic banking crisis without a prior resolution regime in place for crisis, such as in Sweden in the early 1990s. Conversely, a country may have introduced a special resolution regime in its legislation but fail to use it when appropriate, or use it in a manner that does not avoid systemic contagion. Even with well-designed processes to impose losses on creditors, a resolution regime cannot guarantee that no use of public money will ever be necessary, especially in very severe crisis scenarios. A number of EU member states have passed legislation that creates special bank resolution regimes since 2007, but most of these remain essentially untested yet. International coordination is recent in this area of banking policy, and has met a significant milestone with the first-time publication by the Financial Stability Board of “key attributes of effective resolution regimes for financial institutions” (FSB 2011). Crucial factors of effectiveness include the speed of the process, which requires carefully designed decision-making processes and very professional management,

and its ability to intervene early. As noted by an experienced observer, “Whatever the mechanism for resolving a bank, the sooner that is done, the less the likely burden that will have to be subsequently met” (Goodhart 2012).

In Europe, the difficulty of introducing an effective framework for bank resolution is compounded by a number of specific factors: the European Union is in a state of systemic banking fragility and unusual institutional uncertainty; its financial system is dominated by banks, with a high degree of banking sector concentration in many of its member states; its insolvency framework is fragmented along national lines, and so is its fiscal framework for most purposes in spite of recent tentative steps towards fiscal integration in the euro area; its policy-makers and investors have almost no experience of orderly bank resolution, as most past cases of bank failures have been handled through public bailouts and/or nationalizations (Goldstein and Véron 2011).

Conversely, a powerful motivation to create or strengthen effective resolution regimes in Europe is provided by the “doom loop” that has developed in the euro area between credit conditions that apply to vulnerable countries as sovereign issuers on the one hand, and to banks included in these countries on the other hand. The reality of this “doom loop” or vicious circle is illustrated by the high correlation between credit ratings and credit market indicators between these sovereigns and banks (Angeloni and Wolff 2012), and its acknowledgement has prominently driven policy initiative since at least early 2012. Well-designed resolution regimes hold the promise of both limiting banking sector instability, and minimizing the fiscal cost of future bank failures.

THE EUROPEAN COUNCIL DECISIONS OF MID-DECEMBER: A FOUR-STEP APPROACH

The European Council conclusions of December 14 include dense and somewhat complex content which justifies a detailed analysis. In our analysis, the European Council has defined an approach to the buildup of a European banking union that includes four successive steps, the first three of which are explicitly framed in the European Council Conclusions, and the fourth one kept voluntarily implicit.

Step 1: Integrated Supervision

This first step, which the European Council conclusions imply should be completed by March 2013, is centered on the Single Supervisory Mechanism. In addition to the adoption of the council regulation establishing the SSM (SSM Regulation), this includes the adoption of the regulation reforming the

European Banking Authority (EBA Regulation) to adapt it to the new situation created by the advent of the SSM, as well as the adoption of the Capital Requirements Regulation (CRR) and its complement the fourth Capital Requirements Directive (CRD4), so that the SSM can implement a harmonized supervisory “rulebook” based on the Basel III accord, instead of the currently applicable (and often divergent) national regulations. The operational buildup of the SSM would follow; actually its initial phase has already started at the ECB with the cooperation of national supervisors.

One important parameter in this buildup phase is the question of which non-euro area member states will enter “close cooperation arrangements,” which would make them participating members of the SSM. While Sweden and the United Kingdom have indicated they did not consider entering such arrangements in the foreseeable future, other non-euro area member states still have to make a decision. Another significant operational question is the pace of expansion of the ECB’s supervisory staff and the specific arrangements it will establish with national supervisors.

Step 2: Coordinated Framework for Bank Resolution

Beyond supervision, the council identified two initiatives that it wants completed before the end of June 2013. They are:

- First, an “operational framework” for the direct recapitalization of banks by the ESM—the euro area crisis management fund created in 2012, which is mentioned in connection with the “imperative to break the vicious circle between banks and sovereigns.” In the language of the council conclusion, this document, which is currently under negotiation among member states, should “include the definition of legacy assets” and “be agreed as soon as possible in the first semester 2013.”
- Second, the adoption of two pieces of legislation whose initial proposals predate the June 2012 council decision to create a banking union: the Bank Recovery and Resolution (BRR) Directive, adopted by the European Commission in early June 2012, which would create or reform national bank resolution regimes along a harmonized pattern in compliance with the Financial Stability Board’s recommendations (FSB 2011), including a provision for the “bail-in” of unsecured bank debt; and the proposed recast of the Deposit Guarantee Scheme (DGS) Directive, adopted by the commission in July 2010, which would further harmonize national deposit insurance sys-

tems. The council “urges the co-legislators to agree” on these proposals “before June 2013.”

Step 3: Single Resolution Mechanism

The December European Council conclusions state that “the [European] Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM, to be examined by the co-legislators as a matter of priority with the intention of adopting it during the current parliamentary cycle.” The SRM should “safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises,” and should be based on “contributions by the financial sector itself and include appropriate and effective backstop arrangements.” The commission has announced it would publish a proposal “before the summer” of 2013 (Barroso 2013), and the adoption of the final text is desired in advance of the European elections scheduled in June 2014. Other documents from the commission and the council suggest that the SRM proposal will be published only after the adoption of the BRR and DGS Directives (e.g., Van Rompuy 2012b). The reference to “co-legislators” in the European Council conclusions is a hint that the SRM may take the form of a directive and/or regulation of the European Parliament and the council, but with no indication of the underlying treaty base.

Step 4: Completion of the Banking Union Beyond the SRM

The December European Council conclusions leave implicit the need for any further initiatives beyond the SRM. However, the banking union would remain incomplete and arguably unstable without further integration, particularly in the areas of insolvency, resolution, and deposit insurance (Pisani-Ferry et al. 2012). The need for steps beyond the SRM has been obliquely acknowledged by European policymakers, including the acknowledgement by ECB executive board members that further integration of deposit insurance beyond the DGS Directive will be needed but is not urgent (e.g., Constancio 2012 and 2013). The European Commission has also referred to the desirability of future treaty changes to perfect the design of the SSM (European Commission 2012, 4.3). For the sake of simplicity we bundle all these post-SRM steps into a single fourth step (even though a longer and more complex sequence might also happen) and discuss their possible objectives and content in the next sections.

Banking Structure

The reform of banking structures has taken high political prominence in Europe as in the United States, where the Dodd-Frank Act of 2010 introduces the Volcker Rule of separation of proprietary trading, even though the implementing regulations are still being discussed by federal agencies. At the level of individual EU member states, it has given rise to legislative initiatives in the United Kingdom, France, and Germany. At the EU level, the European Commissioner for the Internal Market and Services has commissioned a report that also rec-

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ommends a form of structural separation (Liikanen 2012). The December European Council conclusions include the sentence “The European Council looks forward to the Commission’s rapid follow up to the proposals of the high level expert group on the structure of the EU banking sector,” but do not set a deadline. As a consequence, this issue is on the agenda and may interact with the previously outlined four steps, but when, and at which stage exactly, remains unspecified.

POLICY OBJECTIVES AND SEQUENCING

The complexity of the agenda outlined in the previous section justifies a specific focus on the timeline and sequencing, and how it responds to the objectives that policymakers should set themselves, before we move to specific (and non-exhaustive) policy recommendations for the previously identified three steps in the next section.

The EU bank resolution agenda combines short-term and long-term challenges at once: in a nutshell, resolve the current banking crisis (which includes the objective of breaking the “doom loop,” accepted by the European Council as a short-term “imperative”) in the short term; and build a sustainable EU banking policy framework, or banking union, in the longer term. The combination of short- and long-term aims is well-known to be both unavoidable and exceedingly difficult in a context of systemic financial crisis. Too much focus on the short-term challenges can sow the seeds of future disruption.

Conversely, excessive focus on the long-term challenges carries the risk of ignoring the urgency of the situation at hand, and the usually high cost of delaying decisive action.

Short-Term Objective: Addressing Europe’s Banking System Fragility

Europe’s banking problem is an essential element of the “doom loop” but is also harmful in its own right, in a way that predates the sovereign debt crisis (Posen and Véron 2009). Unaddressed banking system fragility, often the result of the bias of many policymakers towards supervisory forbearance, results in a vicious cycle of its own in which banks keep extending credit to insolvent borrowers to avoid the pain of recognizing losses on non-performing loans (ESRB 2012). The banks’ lending is increasingly absorbed by borrowers who will not repay, while creditworthy new borrowers are starved of credit: While aggregate credit figures may show no evidence of credit contraction, in reality the allocation of credit is increasingly dysfunctional and results in an increasingly severe drag on economic growth, and on employment as a consequence. This perverse spiral has been vividly described as “zombie banks lending to zombie borrowers,” a metaphor coined in the US S&L crisis (Kane 1987) and often applied to the Japanese crisis of the 1990s (e.g., Caballero, Hoshi, and Kashyap 2008). Sadly, the same pattern is increasingly recognizable throughout Europe.

The European banking system has required increasing life support from the ECB and national central banks, including Long-Term Refinancing Operations (LTRO) programs with maturities increased from an initial three months to six months (March 2008), one year (June 2009), and eventually three years (December 2011), with the banking fragility then sharply made worse by doubts about the risks of euro exits or breakup and national supervisory actions that curtailed cross-border financial flows. Several coordinated initiatives, such as Europe-wide “stress tests” in September 2009, July 2010, and July 2011, and a recapitalization effort coordinated by the EBA in 2011–12, may have brought marginal improvement but have generally failed to restore normal conditions in the European interbank market following the initial shock of 2007–08. The European Commission’s control of state aid has enabled it to act to some degree as an EU-wide coordination mechanism of member states’ responses to banking crises, but has been generally able to intervene only at a late stage and in a reactive manner.

Europe’s banking problem has been further compounded by the general willingness of policymakers, particularly in the early years of the crisis, to guarantee all bank creditors and avoid imposing losses to any of them or at least to senior unsecured ones (Goldstein and Véron 2011). However, European

policymakers have gradually woken up to the political and practical unsustainability of this approach as it entails spiraling risk-taking by governments and exacerbates the “doom loop” for those countries whose fiscal sustainability becomes questionable. This realization has led an increasing number of EU member states (including in chronological order, Ireland, the United Kingdom, Denmark, Spain, and most recently the Netherlands with SNS Reaal) to force subordinated creditors of failing banks to incur losses. For now, however, almost all member states have stopped short of imposing losses on banks’ senior unsecured creditors.¹ This can be attributed partly to general concerns about systemic contagion in the event of “haircuts,” especially given the prominent role played by unsecured senior debt in the financing of European banks, and partly to each country’s fear of putting “their” banks at a financial disadvantage in a context of pan-European market integration and competition. But the sheer size of the potential contingent cost is increasingly prompting European policy leaders, including those at the ECB,² to envisage a financial participation of senior unsecured bondholders in future restructurings, in spite of the potential destabilizing effects this may entail.

The experience of earlier crises in Europe and elsewhere suggests that the objective of addressing systemic banking fragility and restoring trust can only be achieved through a hands-on, centralized approach of system-wide balance sheet assessment (triage), recapitalization, and restructuring. The creation of the SSM holds the promise of a genuinely consistent triage process, something that the EBA could not achieve as it lacked direct access to bank-level information and supervisory authority of its own. The newfound emphasis on burden sharing with bank creditors holds the promise of keeping the collective public cost of restructuring at a politically manageable (though probably still high) level, while the prospect of banking union should increase the stability properties of the system as a whole, thereby reducing the financial stability risk emanating from the imposition of losses on senior unsecured bondholders. Finally, the proclaimed aim to break the “doom loop” makes it possible to envisage some sharing of residual public financial burden between national budgets and the European level (Pisani-Ferry and Wolff 2012), with a possible role for the ESM as an instrument of financial risk sharing.

For all these reasons, the prospects for addressing banking crisis fragility are now better than at any time at least since

1. The only relevant exceptions appear to have been Denmark for a brief time in 2011, and Ireland to a limited extent in the recent case of Anglo Irish bank, according to Mary Watkins and Matt Steinglass, “Burden of banking losses poses threat to bondholders,” *Financial Times*, February 8, 2013.

2. Sakari Suoninen, “ECB’s Draghi: senior debt burden sharing evolving,” *Reuters*, July 17, 2012.

the start of the euro area sovereign debt crisis in early 2010. The early steps of implementation of the Spanish programme are encouraging in this respect. It involved an initial system-wide stress test followed by speedy triage and restructuring/resolution of banks found undercapitalized, including the imposition of losses on subordinated creditors. This appears to have eased the pressure on the Spanish sovereign, and suggests some broader lessons on how to deal with failing banks, even though it is too early to consider the Spanish banking system restructuring as complete.

Long-Term: Complete Banking Union Within Europe’s “Fourfold Union”

The long-term aim, which has gathered remarkable acceptance in Europe’s policy community through 2012, is to complete Europe’s banking union as part of a broader agenda deemed necessary to ensure the integrity of the single financial market and the sustainability of the euro. A seminal moment in this process was the release of the European Council president’s report *Towards a Genuine Economic and Monetary Union* on June 26, 2012 (Van Rompuy 2012a), which envisaged the eventual crisis resolution agenda as consisting of four “building blocks,” now commonly referred to as banking union, fiscal union, economic union, and political union (e.g., Draghi 2012). The multiple interdependencies among these dimensions of a desired “fourfold union” are a helpful way to analyze the unique complexity of Europe’s crisis and to understand why it may take so long to be eventually resolved (Véron 2012).

Among the four, banking union is actually the one that currently draws the largest consensus in terms of definition (Pisani-Ferry et al. 2012; Goyal et al. 2013). By contrast, fiscal union, economic union, and political union mean very different things to different people, resulting in a lack of consensus on how close they are to being reached (Vaisse et al. 2012).

An additional source of complexity is the long-term uncertainty about the geographical perimeter of the European Union, reinforced by the possibility of an in-or-out referendum in the United Kingdom by 2017 (Cameron 2013), and about whether the boundaries of the four “unions” will ultimately coincide with those of the European Union, the euro area, or somewhere in between, as is likely for the SSM at its launch.

Considered in this light, the eventual completion of banking union is affected by multiple linkages with the other components of the fourfold agenda, among others:

- Banking union/fiscal union: Even assuming extensive burden sharing by creditors, cases or scenarios will always remain in which systemic crisis resolution requires ex-

tended access to public money, and the aim to break the “doom loop” means that at least some such money must come from the European level (Pisani-Ferry and Wolff 2012; Wolff 2012).

- Banking union/economic union: Certain economic policies, including housing policy, aspects of tax policy, and personal and corporate insolvency legislation, can have significant impact on the accumulation and distribution of risk in the banking system and justify adequate “macroprudential” oversight (Wolff 2011).
- Banking union/political union: Bank crisis management and resolution can have widespread economic and social consequences and therefore must be subjected to appropriate mechanisms of political accountability (Véron 2012).

We view further and significant progress on fiscal union, economic union, and political union as a necessary condition for Europe to eventually resolve its current crisis and find a sustainable footing.

Likely Sequence of Implementation of the December Conclusions of the European Council

A literal reading of the December council conclusions would suggest that all the initiatives outlined, while negotiated in a clear chronological sequence, could actually become effective at around the same time in the first half of 2014. As for Step 1, the council’s communication of its position on bank supervision (December 13, 2012) states that “The ECB will assume its supervisory tasks within the SSM on 1 March 2014 or 12 months after the entry into force of the legislation [SSM Regulation], whichever is later, subject to operational arrangements.” As for Step 2, the European Council conclusions state that the BRR Directive and DGS Directive “should be implemented by the Member States as a matter of priority,” which, assuming enactment in June 2013 and a six-to-nine-month national transposition lag, imply effectiveness in early spring 2014; moreover, the ability of the ESM to recapitalize banks directly is delayed to “when an effective single supervisory mechanism is established,” i.e., at the same time as the entry into force of Step 1. As for Step 3, the “intention” is of adopting the legislation creating the SRM “during the current [European] parliamentary cycle,” i.e., during the spring of 2014 at the latest. If these intentions were all fulfilled, and assuming that the legislation creating the SRM (unlike the SSM Regulation) is immediately applicable, then Steps 1, 2, and 3 would all become operational between March and

June 2014, amounting to a “big bang” transformation of the European policy framework.

However, in the real world the implementation of the three steps is likely to be phased and to give rise to significant transition issues.

- The EBA Regulation, CRR, and CRD4 are all in “trilogue” phase, and the SSM Regulation is likely to be enacted together with the EBA Regulation. A realistic timeframe for their final adoption is in March or April 2013, but it cannot be ruled out that part of this package may be delayed to May or even June 2013.
- The proposed DGS Directive and especially the BRR Directive raise very complex legal and financial issues, partly but not exclusively linked to the untested nature of the proposed bail-in mechanism. Combined with the possible delay in adopting the Step 1 legislation, this would suggest that their final version is more likely to happen in the third or even the fourth quarter of 2013 than in the second quarter as called for by the European Council.
- Conversely, the wording about the possibility for the ESM to recapitalize banks directly makes it conceivable that this instrument might be mobilized earlier than the assumption by the ECB of its full supervisory authority in 2014, if the euro area leaders so decide. This is unlikely to happen before the German general election of September 2013, but may be implemented in the last quarter of 2013, especially if justified by a situation of emergency.
- The above mentioned idea that the legislative work on the SRM should only start after the BRR Directive has been adopted appears logical from a political standpoint and, if confirmed, would introduce a clear sequence between Step 2 and Step 3. The SRM itself is likely to give rise to unprecedented legal, financial, and political questions that may lengthen the time needed for its legislative discussion. The European Council’s objective of having the SRM adopted “during the current parliamentary cycle” therefore appears ambitious to say the least. The ECON Committee Chair was recently reported as commenting that “It’s unrealistic to expect that we will have a resolution authority or resolution fund [under the SRM] in time for the new ECB bank supervision in March 2014.”³

3. John O’Donnell and Eva Kuehnen, “Cracks appear in European banking union scheme,” *Reuters*, February 8, 2013.

Transitional considerations will be crucial in this context.⁴ Given the sensitivity of banking issues to matters of trust, reputations, and expectations, all new arrangements must be fully effective from their very first day of operation. This is inevitably challenging as there is no direct precedent or working model of a supranational banking policy framework. The smooth introduction of the euro in 1999–2002 attests that large-scale unprecedented policy projects can be successful if carefully designed and planned, but the necessities of the crisis impose a compression of the planning and preparation phases that creates important risks as regards both design and execution. Among the concerns:

- The credibility of the ECB during the likely phase when the SSM is up and running and has to operate without the SRM may be endangered, if a situation arises in which the ECB may have to delay supervisory decisions due to the unwillingness or inadequacy of the national resolution system to take appropriate actions.
- Another risk is related to the possibility of wide cross-country differences in resolution practices. Following a supervisory decision of the ECB and in the absence of a clear SRM framework, the concern is that national resolution authorities may undertake resolution action in a way that is harmful to the single financial market.

Implications for the Timing of Proactive Banking Crisis Management

Given Europe’s worrying current growth prospects, the above observations lead us to conclude that Europe’s policymakers should not wait until the creation of the SRM before decisively tackling Europe’s banking system fragility. This fragility has been with us since 2007, and each month that passes increases the economic, social, and political cost of its implications in terms of credit scarcity and misallocation, and ultimately it is a drag on growth. Even assuming that an operational framework for the ESM to recapitalize banks directly would be in place by mid-2013, the risk is that bank restructuring would happen only in a reactive firefighting mode, as has been the case so far in most member states since 2007.

As mentioned above, the entry into operation of the SSM, combined with harmonized bank resolution regimes and a growing acceptance of the need of burden sharing with senior unsecured creditors, can mark a significant improvement in the quality of Europe’s banking policy framework. Thus, a more

proactive approach to Europe’s banking problem could be adopted without waiting for the eventual implementation of the SRM. It will require, however, a more centralized process for steering a system-wide process of triage, recapitalization, and restructuring (Posen and Véron 2009). It appears logical in this context to rely on the legal tools as well as the experience accumulated by the European Commission and particularly its Directorate-General for Competition (DG COMP) in the assessment of state aid cases.⁵ Here again, the Spanish programme, in which the disbursement of ESM funds was made contingent upon the commission’s approval of bank restructuring plans, appears relevant and offers lessons for Europe as a whole. A revision and tightening of state aid rules (see appendix) including a systematic ex-ante involvement of DG COMP in cases of individual banking fragility may significantly improve the European Union’s crisis management in this respect.

One juncture that may foster such a proactive approach is the phase that will immediately precede the assumption of direct supervisory authority by the ECB. Article 27.4 of the proposal for the SSM Regulation, as published in December 2012, states that the ECB “shall carry out” “a comprehensive assessment, including a balance-sheet assessment,” of all the banks that will be brought under its direct supervisory authority “in view of the assumption of its tasks” (Council of the European Union 2012). This assessment could be complemented by a stress test, possibly involving the EBA as well as the ECB. Presumably, those banks that would be found undercapitalized following this system-wide assessment process would be asked to improve their balance sheet and, if unable to do so, be restructured in a process that may involve national authorities as well as possibly the ESM in accordance with its Operational Framework for direct recapitalizations. This sequence, if properly planned and executed, could contribute decisively to the restoration of trust in Europe’s banks.

OPTIONS FOR THE FORTHCOMING LEGISLATIVE AGENDA

This section is specifically about the legislative agenda at the EU level⁶ and options that need to be considered in this context. Our strongly held impression is that, in spite of the relatively precise language of some sentences of the European Council’s conclusions in December, in fact, a number of key questions remain undecided and even partially unexplored, even at the level of general principles. Our expectation is thus

4. Goyal et al. (2013), which was published just as this policy brief was being finalized, presents a similar analysis of the transition risks.

5. An early analysis of the articulation between state aid control and resolution processes is developed in Dewatripont et al. (2010).

6. It also includes the Operational Framework for ESM direct recapitalization, which will not be a text of legislation.

that some aspects of the December conclusions may require adjustments or modifications as their implications gradually become clearer, and we have correspondingly assumed a degree of flexibility in our analysis. Specifically, we are unsure a comprehensive legal analysis has been undertaken and always supports the chosen wording. We expect more clarity on some of these aspects, including legal but also financial and political ones, to emerge in the course of the next weeks and months.

Step 1: EBA and SSM Regulations, CRR and CRD4

As previously mentioned this step is now close to completion.

The EBA and SSM Regulations form a single package in practice, even though in principle the European Parliament only has a consultative voice in the adoption of the latter. In our opinion, the parliament should not seek to disrupt the general balance of the compromise found by the council on December 13, 2012. In particular, significant amendments to the EBA Regulation may endanger the whole outcome of the successful intergovernmental negotiation in 2012 and would risk compromising the significant success that the timely implementation of the SSM would represent for the entire European Union. Thus, it is important to avoid a significant delay and aim at enactment of both regulations in March 2013. Moreover there will be an opportunity to review EBA arrangements soon anyway, as its review is planned for 2014 together with that of the other European Supervisory Authorities and the European Systemic Risk Board.

However, in our view the parliament should seek stronger accountability of the SSM and specifically its Supervisory Board.⁷ We believe there is a strong case for granting the European Parliament a right of consent (or veto) over the appointment of the Chair and Vice Chair of the Supervisory Board, as well as of two of the four members appointed by the ECB (as a compromise between the concerns to preserve a degree of discretion for the ECB while enhancing accountability). This would further strengthen the alignment of the SSM with the European public interest.

The CRR and CRD4 have proven more difficult to finalize than was initially anticipated by many observers. Among other issues, we are concerned by the material noncompliance of the CRR with the international Basel III Accord as regards the definition of capital, in particular as it waters down the requirements on banking groups with insurance operations and allows the counting of so-called “silent participations” as

7. This agenda is reinforced by the recent frustrating episode of Executive Board appointment at the ECB, see John O'Donnell and Robin Emmott, “Mersch takes ECB executive board job despite gender row,” *Reuters*, November 23, 2012.

common equity (BCBS 2012). Even at the current late stage of negotiation, it would be worth considering corresponding changes that would apply at least to large internationally active banks, so that the “single rulebook” that the SSM will start applying in 2014 is in line with an international standard-setting process that the European Union has long endeavored to promote and strengthen.⁸ We also believe that the finalization of the CRR and CRD4 in the early spring of 2013 is highly desirable.

Step 2: BRR and DGS Directives, Operational Framework for ESM Direct Recapitalizations

The adoption of the proposed Bank Recovery and Resolution Directive is an important and logical prior step to the establishment of the SRM. This is because the SRM will have to work at least partly through national special resolution regimes, as we expose in the next subsection. Thus, the BRR Directive should be devoted priority attention as soon as Step 1 is completed.

While the detailed discussion of this complex text exceeds the scope of this note, we believe that it should mark a clear step towards a much greater ability and readiness to impose losses on banks' creditors including senior unsecured ones. Unless the economic environment dramatically improves and reduces credit risk across the board, this appears to be the only way to chart a path towards crisis resolution and the eventual restoration of trust in the European banking system. As the overall stability of the euro area financial system will be strengthened by the introduction of the SSM, the adverse impact on banks' perceived creditworthiness would be partly mitigated. This suggests two changes from the original directive proposal. First, depositors should be granted clear preference over senior unsecured bondholders in the hierarchy of banking liabilities: The US experience in particular suggests that depositor preference creates a favorable framework for adequate burden sharing by senior creditors in bank resolutions. Second, the main emphasis should be on mechanisms that enable the imposition of losses on existing senior creditors to be in place immediately upon transposition of the directive, while the current text puts much focus on “bail-in” provisions that are delayed until 2018.⁹ The empowerment of authori-

8. Especially as our assessment is that, contrary to the perception of many European observers, the United States is on track to implement Basel III in a largely compliant manner in the course of 2013.

9. See in this context Jim Brunsten and Rebecca Christie, “German Push to Accelerate Bank Bail-Ins Joined by Dutch, Finns,” *Bloomberg*, February 4, 2013.

ties to impose losses on holders of existing debt should be as robust as possible.¹⁰

The proposed recast of the DGS Directive should be examined in a joined-up manner with the BRR Directive. Linkages between the two include the question of depositor preference; the possible participation of deposit guarantee funds in bank resolution; and the quantitative calibration of these funds. However, we are skeptical about the practicality and current relevance of the idea, present in both texts' initial versions, of national (deposit and/or resolution) funds lending to each other. Now that Europe has decisively started to create a banking union, any funding for deposit insurance and crisis resolution that does not come from national funds in their respective territories should be drawn from pooled European funding sources, including possibly the ESM but not permanently limited to it.

As regards the preparation of the Operational Framework for direct bank recapitalizations by the ESM, we see it as a potentially useful complement to the involvement of the ESM in national assistance programs as currently in place. In our assessment, the discussion of this framework among euro area member states has already been useful as a collective learning process, as we understand a lot of technical work is happening under this heading. We believe however that the Operational Framework should leave considerable flexibility to possible future interventions by the ESM, both in terms of recapitalization instruments (which may include voting common equity, hybrid securities such as preferred stock, and various forms of debt) and in terms of the respective modalities and shares of financial intervention by the ESM on the one hand, and national authorities on the other hand. This is because the exact features of future crisis situations may be difficult to predict with accuracy, and in such future situations of emergency, constraints on the ability of the ESM to act may result in a higher collective cost for Europeans.

Much attention has been devoted to the issue of so-called "legacy assets." In September 2012, a joint statement of the ministers of finance of Germany, the Netherlands, and Finland, released from a meeting near Helsinki, stated that "the ESM can take direct responsibility of problems that occur under the new supervision [under the SSM from 2014], but legacy assets should be under the responsibility of national authorities." Taken literally, this wording implies that all assets that were brought on the bank's balance sheet before the cutoff date cannot be kept in the entity in which the ESM would invest, which means the ESM is practically prevented

from recapitalizing the bank. This stance would render successive European Council conclusions that refer to ESM direct recapitalizations meaningless.

However, we believe the ESM should be an instrument for risk sharing, not loss sharing. In other words, if the ESM recapitalizes a bank that until then has been under the exclusive control of national authorities, such direct recapitalization should be structured as arm's-length transactions in which the ESM does not assume assets at a price that it deems below their economic value. This requires that the ESM have access to adequate financial assessment and evaluation resources as a prerequisite to any recapitalization, and that any concessional financial intervention in such circumstances should be performed by the member state itself under the European Commission's state aid control.

Step 3: The Single Resolution Mechanism Itself

Ideally, the resolution framework for Europe's banking union should involve a centralized and exclusive decision-making authority over all banks covered by the SSM. Achieving a high degree of centralization is desirable for a number of reasons.

- Bank resolution crucially requires the ability to make high-risk decisions very quickly and under intense pressure. The decisions may in particular include the liquidation of a bank, the assumption of risky assets on a public-sector balance sheet, and mandating the immediate sale of assets or activities to third parties. This requirement, by all experience, implies a high degree of centralization of authority. In the case of large banks operating across borders within Europe, the current distribution of decision-making power in bank restructuring between the national and supranational level has sometimes led to considerable delays. In some instances (e.g., Fortis and Dexia) the breakup of multinational banks along national borders could not be avoided, harming the single market.
- A system where supervision is centralized but resolution is not may harm the effectiveness and credibility of the supervisor. While the new SSM could in principle force a resolution by withdrawing a banking license, national resolution authorities may refuse to act. This knowledge could lead the ECB to delay the supervisory decision in order to avoid a disorderly scenario. In principle, Article 13(2a) of the SSM Regulation as amended by the council (Council of the European Union 2012) is designed to prevent a deadlock in such circumstances, but how it will function in practice remains to be seen. Through its current liquidity policy the ECB may lend to banks

10. This arguably calls for basing them to the extent possible on tried-and-tested processes such as those administered by the US FDIC.

that could be insolvent, but it does not have the institutional responsibility for this assessment. Such liquidity provisioning forms part of monetary policy and the supervisory responsibility is squarely with the national authorities. Once the ECB has supervisory responsibility, it would breach its mandate by providing liquidity to banks it deems insolvent.

- The incentive structure of a decentralized resolution system cannot be easily aligned with a system that involves burden sharing among member states. If resolution remains primarily a responsibility of member states while the fiscal cost of resolution is already partially mutualized, national resolution authorities will not have the appropriate incentives to minimize the overall public costs of bank resolution.

However, a fully centralized system cannot be reached in Step 3, assuming, as we do, the absence of significant revision of the European treaties, and the absence of a dramatically more integrated fiscal framework. Under these assumptions, the SRM cannot be strictly parallel to the SSM in its design and establishment, for at least two major reasons.

First, special bank resolution regimes are established in parallel and as an alternative to insolvency regimes.¹¹ Our assessment is that a European bank insolvency regime is out of reach in Step 3—even though it should be considered as part of what we called Step 4 in the first section of this note. We fail to identify in the current treaties an adequate and sufficiently robust legal basis for a European insolvency regime. Even assuming a proper such basis, the creation of an effective supranational insolvency regime is bound to require a long time for planning and preparation. For example, the creation of a European insolvency court should not be envisaged in a rushed process. We have not analyzed in depth the option of establishing a supranational insolvency regime by a specific, ad hoc treaty (as was done with the ESM) within the timeframe envisaged for the creation of the SRM, but we are skeptical about its feasibility. Even a harmonization of national bank insolvency regimes would take more time than is available for the creation of the SRM. Our conclusion is that national bank resolution regimes must remain and play a core role in the operation of the SRM.

Second, bank resolution regimes are linked to fiscal or quasi-fiscal resources. Unlike insolvency processes, they can result in the public assumption of significant financial risk

11. Even though we have not explored this issue in sufficient depth, we understand that this is even more the case in the European Union than in the United States given the content of the Charter of Fundamental Rights of the European Union.

and liabilities. Experience suggests that some bank resolution processes eventually result in a financial gain to public authorities, but others result in a financial loss and it is often impossible to predict the eventual financial outcome at the start of the process. An increased willingness to impose losses on bank creditors can help reduce the public cost of future bank resolution, but not to the extent that this cost could be assumed away entirely.

The SRM should be able to draw on ESM resources in future SRM-conducted resolutions. However, the ESM should not necessarily finance all the public cost and/or assume all the public risk of resolution processes in the context of the present crisis and a strong reliance on national funding

The core challenge of designing the SRM is how to combine the lingering relevance of national structures as regards insolvency processes and resolution funding with the need for quick and effective decision making on a system-wide basis

mechanisms and institutions will remain necessary at least for a transitional period. Because of its size limit and governance, the ESM is not suited as an instrument to provide the kind of fiscal guarantees that may become necessary to address a systemic crisis (Pisani-Ferry and Wolff 2012). Furthermore, the involvement of national resources may remain necessary at least in some cases, including to mitigate the possibility of moral hazard arising from national economic policy decisions that shape banks' risk while not being part of the European banking policy framework, e.g., housing policy.

One option would be to create an industry-funded European resolution fund together with the establishment of the SRM. However, a European fund would take time to build up and it is unlikely to gather significant financial firepower before a number of years, well beyond the SRM's start of operation. Moreover it could raise issues of moral hazard of its own. The upshot is that the SRM will have to operate in relationship with both national and European counterparties for any public funding of resolution processes.

The core challenge of designing the SRM is how to combine the lingering relevance of national structures as regards insolvency processes and resolution funding with the need for quick and effective decision making on a system-wide basis. Because resolution decisions are high risk, the bar must be set high in terms of accountability, which in the SRM's case must

prominently involve accountability at the European level. Thus, the SRM should be based neither on a broad committee structure with weak decision making structures preventing quick and effective decision making, nor on a delegation of authority to the home-country resolution authority alone, which does not provide European-level accountability.

We believe that the SRM can meet the objectives set out by the European Council only if it has at its core a central body with a significant degree of binding decision-making authority. Whether this may work by some direct empowerment of the central body by the relevant member states' national legislation, or through a form of injunction authority (possibly with some safeguards) over national resolution authorities, remains to be explored.

Predictably, a lot of the early debate on the future SRM has centered on what this central body could be. Proceeding by elimination, we believe it can be neither the ECB nor the ESM.

- The ECB's mandate is defined in the European treaties and does not include bank resolution. Furthermore, the politically charged nature of bank resolution strikes us as difficult to square with the ECB's independence. We also do not believe that the current political institutions of the European Union are compatible with the concentration of powers within the ECB that such a choice would entail. Additional incompatibilities may arise from the fact that the geographical perimeter of the SRM is likely to include some member states outside of the euro area (see below).
- The ESM's decision-making framework makes it unsuitable to the rapid action requirement that applies to a resolution authority. The fact that the ESM exists outside of the EU treaty framework would raise major questions about judicial review. Furthermore, granting the ESM direct resolution powers would give it conflicting incentives for the use of public money in case of banking and/or sovereign crisis emergencies.

In our current (and tentative) understanding this leaves two practical possibilities, each of which merits further study. In one option, the European Commission would host the central body of the SRM, for which adequate relationships should be defined both with the College of Commissioners (perhaps using as a partial template the existing arrangements for competition policy) and with DG COMP (which could provide expertise and support based on its track record of state aid control). Crucially, a sufficient degree of independence in the resolution task should be ensured. In an alternative option, a new body would be created, on either a temporary or permanent basis. Doing so within the framework of EU

institutions raises questions about the treaty basis and the decision-making autonomy that such a new body would have (Meroni jurisprudence). If it were established by a specific treaty as was done with the ESM, the relationship with the existing European institutions is likely to raise even more difficult questions than was the case with the ESM, including in terms of accountability and judicial review.

To fulfill its aim of contributing to breaking the "doom loop," the SRM should have immediate authority over all euro area member states and not only those that have requested an assistance program. The December 2012 European Council conclusions state that its authority should be extended to all non-euro area countries participating in the SSM, but how this is articulated with the fact that the ESM currently does not cover those countries remains to be debated.¹² As for which banks should be subject to the SRM's authority among those headquartered within its geographical perimeter, there are three broad possible options: (1) only those banks with significant cross-border presence or systemic significance at the European level; (2) all banks directly supervised by the SSM; or (3) all banks, including smaller ones that escape direct SSM supervision. We have not yet carried out a detailed analysis of these options' respective merits and flaws.

Among other operational concerns, the SRM's central body should be able to recruit specialist staff with the financial restructuring experience needed to steer complex bank resolution processes. It should have the financial flexibility to build up its operations quickly, as its first few years of operation are likely to be uniquely active given the current condition of the European banking system. Over a longer-term basis (Step 4), the same body could also be considered for playing a role in a future European deposit insurance system, not unlike the structure in place in the United States where the FDIC acts as the bank resolution authority.

The creation of the SRM should also include a consideration of the role that the European Banking Authority and European Systemic Risk Board may play in future resolution processes. This should be on the agenda with the planned review of both these institutions in 2014, in application of the European legislation that created them.

Banking Structure

In spite of its political prominence, we believe the discussion on regulating banks' structures should be best delayed until the features of Europe's single resolution mechanism and banking

12. In any case, it appears logical to assume that the SRM will not have authority beyond the geographical scope of the SSM.

union have been more precisely shaped. There is no one-size-fits-all response to the challenges posed by banking structures, which should be different in different financial systems. Thus, we feel that the European Union as well as individual member states should refrain from introducing significant new legislation in this area until the completion of Step 3 and the establishment of the SRM.

CONCLUSION

As this note suggests, the work program outlined in the December 2012 European Council conclusions, even with a limitation to the first three steps, entails a large number of policy questions of considerable complexity. It will be a challenge for European policymakers to explore all these questions in due time and in a reasonable sequence. As the recent experience with systemic banking crisis resolution is limited in most of Europe, it will also be advisable to have an in-depth look at past crisis experiences, in the United States but also in Japan and other countries, to better understand the nature and magnitude of the challenges ahead. The legislative steps needed to achieve the timely creation of the Single Resolution Mechanism represent a marathon run in which Europe cannot afford to fail.

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APPENDIX: EUROPEAN RULES FOR STATE AID TO THE FINANCIAL SECTOR

Since the start of the financial crisis, EU member states have provided significant support to financial institutions. Most of this support qualifies as state aid as defined in Article 107 of the Treaty on the Functioning of the European Union and therefore has required approval of the European Commission.

As of the collapse of Lehman Brothers, the commission has issued several communications to guide EU member states in their support of the financial sector and to coordinate their action providing member states first with more precise guidance on specific instruments such as public guarantees, recapitalizations, and impaired asset relief, and then on bank restructuring (see below). The European Commission has invoked four main principles to guide its state aid policy during the financial crisis:

- The granting of state aid has been subject to a principle of remuneration that reduces the cost for the taxpayer.
- The commission has requested that banks draw up restructuring plans with a view to returning to viability. Where the prospects of a return to viability were not credible, the Commission has asked for the orderly resolution of the bank.
- The commission has requested that the aid be minimized and the burden of the rescue be fairly shared as much as possible between the government and the bank and its main stakeholders, thereby reducing the risk of moral hazard;
- The commission has sought solutions that minimized the distortions of competition between banks and across member states with the overall objective of preserving the single market.

Based on this framework, the commission has already taken more than 60 decisions on bank restructuring and resolution, both in the context of programmes and outside of a programme context.¹³

Summary of the European Commission's State Aid Rules for the Crisis

The commission's “crisis communications” are rooted in its rescue and restructuring (R&R) guidelines,¹⁴ introduced in 2004 and applied to all sectors. However, the R&R guidelines

13. European Commission memo: state aid: recapitalization of Spanish banks—the commission's role under EU state aid control, November 28, 20.

14. Communication from the commission—Community guidelines on state aid for rescuing and restructuring firms in difficulty, Official Journal C 244, 1.10.2004, pp. 2–17.

proved in some aspects to be inadequate for the financial sector, as they were not designed to take into account a systemic crisis and a persistent threat to financial stability. As mentioned above, the European Commission therefore introduced a temporary set of guidelines for state aid granted to financial institutions, consisting of six communications based on Article 107(3)(b) which it published from 2008 onwards.

The first three communications provided precise guidance for specific aid instruments, recalled some of the basic principles outlined in the R&R guidelines and set out the commission's general approach on how it would reflect the financial stability objective in its assessment.

The Banking Communication¹⁵ reiterates general criteria for the design of state aid measures which “have to be well-targeted, proportionate and designed in such a way as to minimize negative spill-over effects on competitors, other sectors or Member States,” as well as provisions for guarantees on liabilities, recapitalization, and controlled winding up. Moreover, the communication introduced a distinction between fundamentally sound financial institutions and other financial institutions characterized by endogenous problems. The distinction was relevant as fundamentally sound institutions granted state aid were required to submit a viability plan, while institutions with endogenous problems needed to present a—comparatively further reaching—restructuring plan.

The Recapitalization Communication¹⁶ provided further guidance on the pricing of state recapitalization measures.¹⁷

The Impaired Assets Communication¹⁸ provides guidance on the design and implementation of asset relief measures.¹⁹

15. Communication from the commission—The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8.

16. Communication from the commission—The recapitalization of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition. Adopted on December 5, 2008, OJ C 10, 15.1.2009, p. 2–10.

17. The communication makes reference to the methodology proposed by the Recommendations of the Governing Council of the ECB of November 20, 2008

18. Communication from the commission on the treatment of impaired assets in the community banking sector, OJ C 72, 26.3.2009, p. 1.

19. Principles to design asset relief measures contained in the communication are: (1) ex ante transparency and disclosure requirements; (2) burden-sharing of the costs related to impaired assets between the state, shareholders, and creditors; (3) aligning incentives

The fourth communication (Restructuring Communication²⁰) complements the criteria already established in the first three communications. It sets out the essential requirements that a restructuring or viability plan has to display in order to be approved. In particular, restructuring plans need to demonstrate how a bank can restore its long-term viability without further state support, entail adequate burden sharing of the restructuring cost between itself, its stakeholders, and the state, and include appropriate measures to limit the distortions. This was the only communication with an expiration date, set at the end of 2010.

The fifth communication (Exit Communication²¹) extended the application of the fourth one until the end of 2011 and updated the conditions for guarantees to incentivize exit from state support. In particular, it established that both fundamentally sound and distressed banks benefiting from a state support measure have to submit a restructuring plan.

The sixth communication (Prolongation Communication²²) extended the crisis rules beyond the end of 2011, and took into account the sovereign crisis—it clarified that if a bank's difficulties are solely due to the exposure to sovereign debt (and no excessive risks had been taken), the required depth of restructuring will be proportionate.

for banks to participate in asset relief with public policy objectives; (4) eligibility, valuation, and management of impaired assets criteria; (5) the relationship between asset relief, other types of state support, and bank restructuring.

20. Communication from the commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules, OJ. C 195, 19.8.2009, p. 9.

21. Communication from the commission on the application, from January 1, 2011, of state aid rules to support measures in favor of banks in the context of the financial crisis, OJ C 329, 7.12.2010, p. 7.

22. Communication from the commission on the application, from January 1, 2012, of state aid rules to support measures in favor of banks in the context of the financial crisis, OJ C 356, 6.12.2011, p. 7.

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