EUROPEAN COMMISSION

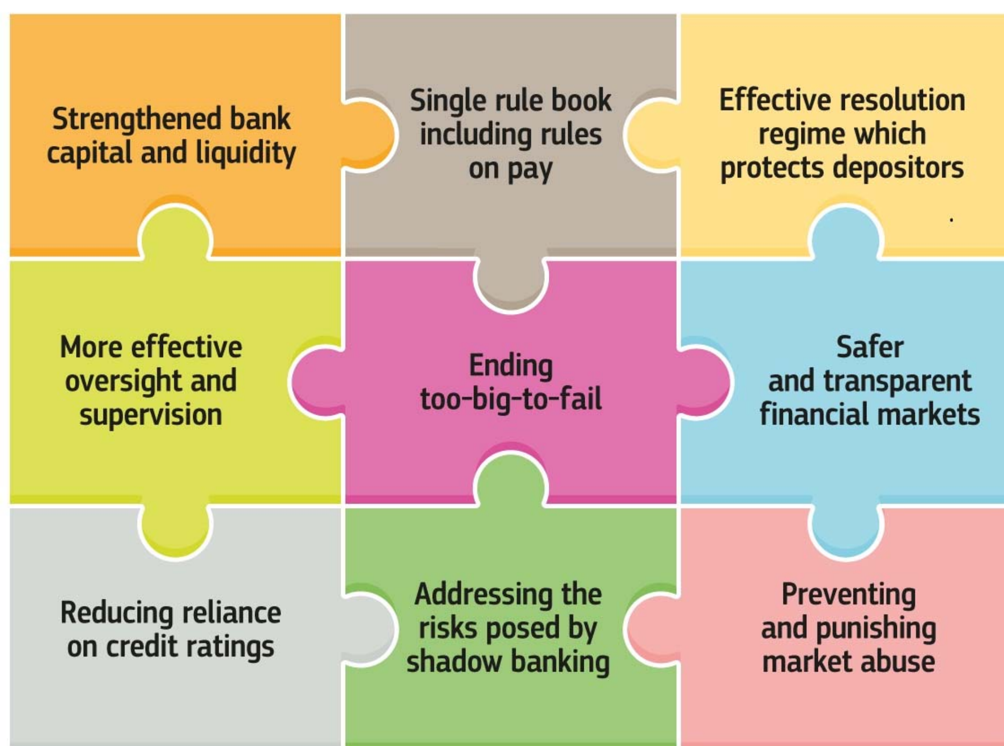
MEMO

Brussels, 15 April 2014

Banking union: restoring financial stability in the Eurozone

1. Banking union in a nutshell

Since the crisis started in 2008, the European Commission has worked hard to learn all the lessons from the crisis and create a safer and sounder financial sector. The Commission has proposed 28 new rules to better regulate, supervise, and govern the financial sector so that in future taxpayers will not foot the bill when banks make mistakes. Most of these rules are now in force or being finalised.



Graphic 1: **Key pieces of the EU-wide financial reform puzzle**

As the financial crisis evolved and turned into the Eurozone debt crisis in 2010/11, it became clear that, for those countries which shared a currency and were even more interdependent, more had to be done, in particular to break the vicious circle between banks and national finances. (See box 1)

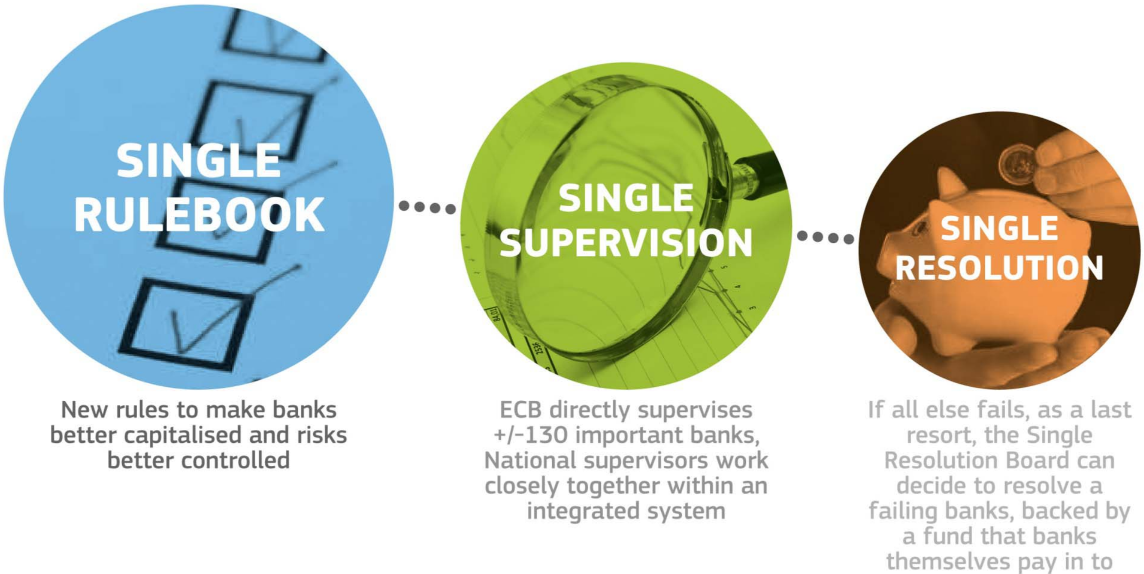
That is why, in June 2012, Heads of State and Government agreed to create a banking union, completing the economic and monetary union, and allowing for centralised application of EU-wide rules for banks in the euro area (and any non-euro Member States that would want to join).

The new regulatory framework with common rules for banks in all 28 Member States, set out in a single rulebook, is the foundation of the banking union. Common rules will help to prevent bank crises in the first place (in particular Capital Requirements Directive and Regulation MEMO/13/690) and, if banks do end up in difficulty, set out a common framework to manage the process, including a means to wind them down in an orderly way (Directive on Bank Recovery and Resolution (BRRD) MEMO/14/297). Common rules will also ensure that all EU savers are guaranteed that their deposits up to €100 000 (per depositor/ per bank) are protected at all times and everywhere in the EU (Directive on Deposit Guarantee Scheme –DGS MEMO/14/296).

The banking union ensures the common implementation of those rules in the Eurozone. First, as of November 2014, the European Central Bank (ECB) will be the supervisor of all 6000 banks in the euro area in the framework of the Single Supervisory Mechanism (MEMO/13/780). In order to ensure that the ECB has a clear view of the situation of banks it supervises from the outset, a comprehensive assessment of banks' financial health is currently being carried out.

Second, in the rare cases when banks fail despite stronger supervision, the recently adopted Single Resolution Mechanism (SRM) (MEMO/14/295) will allow bank resolution to be managed more effectively through a Single Resolution Board (SRB) and a Single Resolution Fund (SRF). If a bank fails, the SRM with clear decision-making rules for cross-border banks and highly experienced staff will be much more effective in carrying out resolutions than the existing patchwork of national resolution authorities.

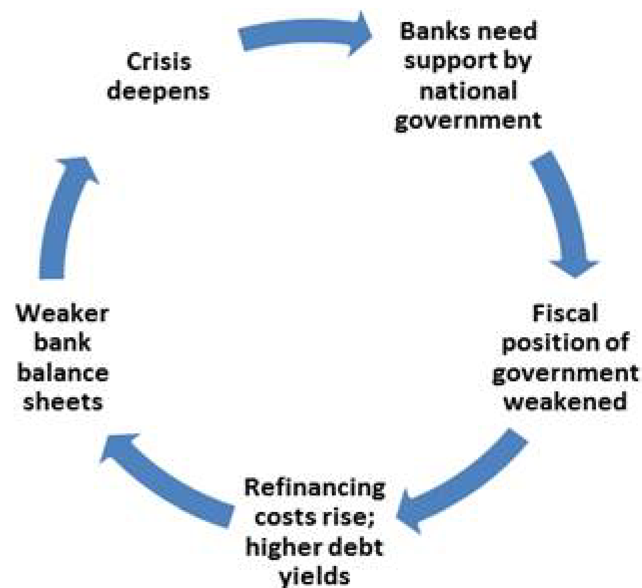
Together with the new EU wide regulatory framework for the financial sector, the completed banking union is a big step in the economic and monetary integration of the EU (MEMO/14/244). It will put an end to the era of massive bailouts paid for by taxpayers and will help restore financial stability. This, in turn, creates the right conditions for the financial sector to lend to the real economy, spurring economic recovery and job creation (see box 2).



Box 1: The vicious circle between banks and national finances

The Eurozone sovereign debt crisis highlighted the potentially vicious circle between banks and sovereign debt.

How does the vicious circle work?



The banking union will help to break the link between banks and sovereigns:

- **Banks will be stronger and more immune to shocks**: Common supervision will ensure effective enforcement of stronger prudential requirements for banks, requiring them to keep sufficient capital reserves and liquidity. This will make EU banks more solid, strengthen their capacity to adequately manage risks linked to their activities, and absorb losses they may incur.
- **Failing banks will be resolved without taxpayers money, limiting negative effects on governments' fiscal positions**: bank resolution will be financed by banks' shareholders and creditors, and by a resolution fund financed by industry. Banks should not be bailed out and government fiscal position will not be weakened further.
- **Banks will no longer be "European in life but national in death",** as they will be supervised by a truly European mechanism and any failure will also be managed by a truly European mechanism.

Box 2:

Making it easier for banks to lend to businesses and households

Uncoordinated national responses to bank failures, sometimes recurring to ring-fencing of funding within national borders, and high interdependencies between banks and the Member States where they are based led to a serious fragmentation of the Single Market in lending and funding. This fragmentation was particularly damaging within the euro area, where it impeded efficient lending to the real economy and thus growth.

Recent figures show that 80% of German SMEs who ask for a loan succeed in getting all of the credit requested. This percentage falls to 40% in Southern European countries and even to 25% in Greece. Moreover, there are still differences in interest rates offered to businesses and households, which could impair the emerging recovery.

As in the Banking Union all banks are subject to the same supervisor and to the same resolution mechanism, confidence in **all** banks should increase. Banks' market credibility will depend on their specific risk profile and less and less on the financial strength of the Member States where they are based. This should make it easier for banks in all Member States to access funding on equal terms which in turn makes it easier for them to lend once again to households and businesses across the EU.

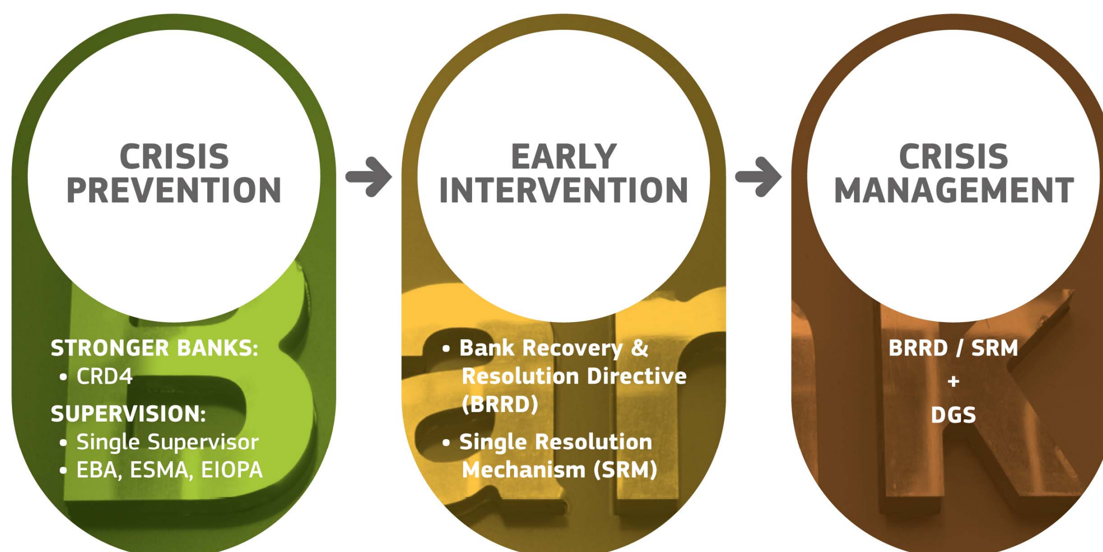
2. How does the banking union create a safer banking sector in the Eurozone?

We are learning all the lessons of the crisis. And we now have a toolbox of measures to deal with banks comprehensively. We are:

- making all banks safer in the first place (crisis prevention),

- ensuring that if they do face problems, supervisors can intervene early to manage them (early intervention)

- and if the worst still happens, making sure that we have the tools in place to manage a crisis effectively (bank resolution).



2.1 Stage 1: Crisis prevention

The European Commission has made 28 legal proposals covering all financial actors and products to better regulate, supervise, and govern the financial sector. They form the single rulebook. Banks have to comply with it across the Single Market. This is crucial to ensure that there is strong regulation everywhere, without loopholes, so that we can guarantee a level playing field for banks and a real Single Market for financial services. It benefits banks, the wider financial sector as well as citizens, consumers and taxpayers.

2.1.1 A stronger, independent supervisor to ensure that banks apply the rules

The Single Supervisory Mechanism gives the European Central Bank (ECB) responsibility for supervision over banks in the euro area (and other SSM participating Member States).

The ECB will ensure a truly European supervision mechanism that is not prone to the protection of national interests, will weaken the link between banks and national finances and will take into account risks to financial stability. The ECB will take over its new role as single supervisor in November 2014. It will ensure that the single rulebook is applied consistently and coherently in the euro area. In the meantime, the ECB is carrying out a comprehensive assessment of significant banks and the balance sheets of those banks. Danièle Nouy was appointed as the first Chair of the Single Supervisory Mechanism board (MEMO/13/1155).

2.1.2 Stronger prudential requirements for more resilient banks

The package on capital requirements for banks, the so called "CRD IV package (consisting of the Capital Requirements Directive IV)" and the Capital Requirements Regulation)" (see MEMO/13/690) implements the new global standards on bank capital (commonly known as the Basel III framework) into the EU legal framework.

The new rules in force since 1 January 2014, ensure banks now hold sufficient level of capital, both in quantity and in quality. With these rules, the EU has met its commitment to the G20 to implement the Basel III framework in a timely manner.

2.1.3 Timely planning for banks in a critical condition

The financial sector in the whole European Union can now rely on a strong framework for when banks get into difficulty. This bank crisis and resolution (MEMO/14/297) framework requires banks to draw up **recovery plans** describing the measures they would take to remain viable if their financial situation were to deteriorate and **resolution plans** for their orderly resolution if they are no longer viable.

In the banking union, that authority is the ECB. These plans should set out the options for applying **resolution** tools (for example transferring assets to a bridge bank, writing down capital instruments or other liabilities in a bail in) and ways to ensure that critical functions can continue.

2.2 Stage 2: Timely corrective action when problems occur - early intervention

We now have rules allowing for early intervention when banks face problems. Bank supervisors are accorded an expanded set of powers to enable them to intervene if an institution faces financial distress (e.g. when a bank is in breach of, or is about to breach, regulatory capital requirements), but before the problems become critical and its financial situation deteriorates irreparably. They are set out in the recovery plans of banks and include the possibility of dismissing the management and appointing a special manager, convening a meeting of shareholders to adopt urgent reforms, and prohibiting the distribution of dividends or bonuses. Other measures which the relevant supervisor can insist on are requiring the bank to reduce its exposures to certain risks, increase its capital, or implement changes to its legal or corporate structures.

In the banking union, if the viability of a bank is deemed at risk, the ECB as single supervisor will supervise the early intervention **in coordination with the relevant resolution authorities.**

2.3 Stage 3: When a bank's financial situation deteriorates beyond repair: crisis management which protects depositors and taxpayers

2.3.1 Protection of tax-payers

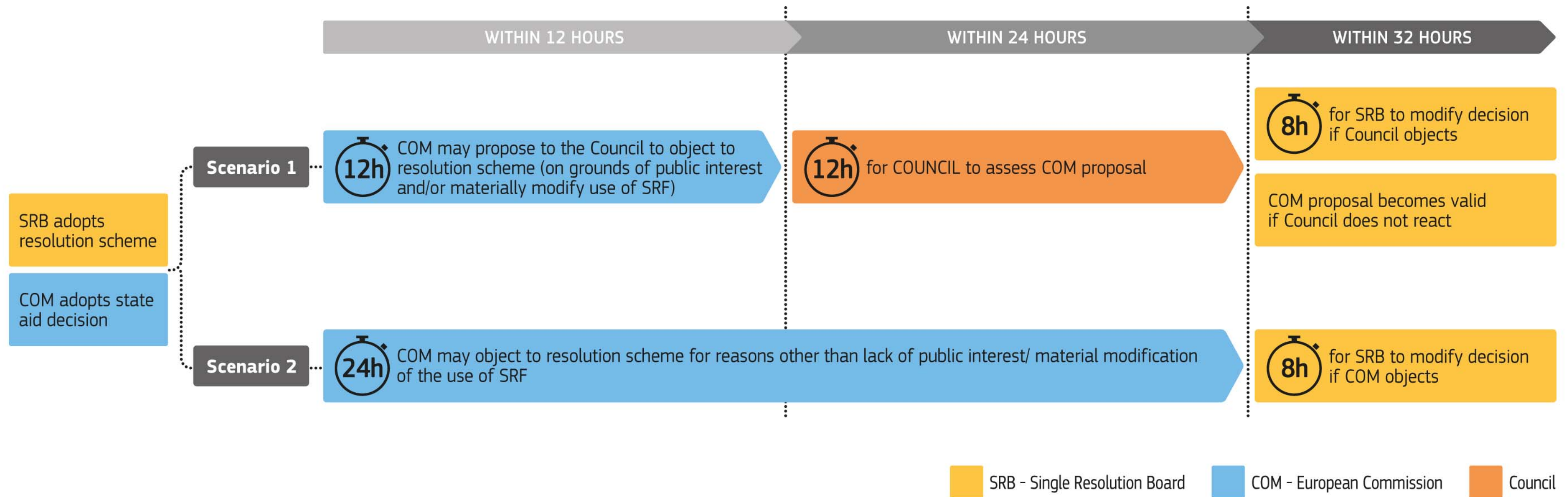
Repeated bailouts of banks have increased public debt and imposed a very heavy burden on taxpayers. The approved state aid measures in the form of recapitalisation and asset relief measures between October 2008 and December 2012 amount to €591.9 billion or 4.6% of EU 2012 GDP (Commission). If we include guarantees, this figure would amount TO€1.6 trillion or 13% of EU GDP (Commission) for the period 2008-2010 only. See IP/13/1301.

If the financial situation of a bank were to deteriorate beyond repair, the BRRD would ensure that banks' shareholders and creditors would have to pay their share of the costs through a "bail-in" mechanism. (see box 3)

The Single Resolution Mechanism ensures the centralised and effective delivery of those rules in the banking union. It ensures that the complicated decisions which have to be taken when a resolution happens, in particular a cross-border resolution, can be done quickly with binding effect for all Member States in the banking union.

The Single Resolution Mechanism is built around a strong Single Resolution Board and will involve permanent members as well as the Commission, the Council, the ECB and the national resolution authorities. In most cases, when a bank in the euro area or established in a Member State participating in the Banking Union needs to be resolved, the ECB will notify the case to the Board, the Commission, and the relevant national resolution authorities. The decision-making procedures have been carefully calibrated so that it will be possible to decide on a resolution case over a week-end. (see graphic 2)

Graphic 2



o avoid taxpayers being called upon, all banks in the EU will need to pay towards a fund to aid smooth resolution. In the banking union, those funds are pooled together gradually so that if additional resources are needed to make medium-term funding available to the bank to enable it to continue to operate while being restructured, these would be taken from the Single Resolution Fund to which all the banks in the banking union countries will contribute as from 2016 and which will amount to EUR 55 billion by 2024.

Box 3: How will the bail-in mechanism work in practice?

Bail-in: Recapitalisation through the write-down of liabilities and/or their conversion to equity would allow the institution to continue as a going concern, would avoid the disruption to the financial system that would be caused by stopping or interrupting its critical services, and would give the authorities time to reorganise it or wind down parts of its business in an orderly manner.

In short: if a bank needs to resort to bail-in, authorities would first write down all shareholders and would then follow a pre-determined order in bailing in other liabilities. Shareholders and other holders of instruments such as convertible bonds and junior bonds would bear losses first.

Deposits under € 100 000 would never be touched: they are entirely protected at all times.

To the furthest extent possible, the responsibility of covering bank losses is placed on private investors in banks and the banking sector as a whole; not taxpayers.

2.3.2 Protection of depositors

Bank deposits in all Member States will continue to be guaranteed up to €100 000 per depositor per bank even if a bank fails. This guarantee gives savers a sense of financial stability and means that they do not rush to make excessive withdrawals from their banks, thereby preventing severe economic consequences.

Furthermore, depositors will have their money paid out more quickly, within 7 working days (down from 20), and national deposit guarantee schemes will be much better financed to back up their guarantees, notably through a significant level of ex-ante funding: 0.8% of covered deposits will be collected from banks over a 10-year period. If the ex-ante funds prove insufficient, the Deposit Guarantee Scheme will collect immediate ex-post contributions from the banking sector, and, as a last resort, the deposit guarantee scheme will have access to alternative funding arrangements such as loans from public or private third parties. There will also be a voluntary mechanism of mutual borrowing between deposit guarantee schemes from different EU countries. MEMO/13/1176)

Under the Bank Recovery and Resolution Directive (BRRD), individuals and small businesses with deposits of more than EUR 100 000 will benefit from preferential treatment ("depositor preference"). They will not incur any losses before other unsecured creditors so are at the very bottom of the bail-in hierarchy. Member States can even choose to use certain flexibility to exclude them fully.

2.3.4 Backstops

Once all of the above is in place, in the great majority of cases, no public financial support from taxpayers' resources will be needed. But in exceptional circumstances additional resources might be necessary, and for such cases clear and appropriate arrangements on backstops must be made. Any backstops must be fiscally neutral over the medium term and paid back over time by the banking sector from industry levies.

The SRM Regulation provides that the Board, in cooperation with the Member States, should contract a credit line to enhance the Fund's borrowing capacity by the entry into application of the Regulation. The SRM Regulation does not establish yet a common backstop to the fund, which will be looked at over the coming years as stated in a Council's declaration in December.[1]

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[1] http://www.eurozone.europa.eu/media/502738/20131218-SRM-backstop-statement.pdf

3. What happens if problems occur before the whole system is operational?

The ECB and the European Banking Authority are carrying out a comprehensive exercise to assess the state of banks and stress-test them before the Single Supervisory Mechanism becomes fully operational in November 2014.

If capital shortfalls are identified for banks in the banking union the existing agreed cascade for recapitalisation kicks in: in a first instance, banks should raise capital on the markets or through other private sources. Should this not be sufficient, public money could be engaged at national level, under strict conditions and in line with State aid rules (see box 4). In the second instance, if national backstops are not sufficient, instruments at the European level may be used, including the European Stability Mechanism. [2] If banks are no longer viable, they may be put into resolution according to national regimes.

Box 4: State aid rules

The European Commission adapted its temporary State aid rules regarding public support to financial institutions during the crisis. A European Commission Communication set out the updated EU crisis rules for State aid to banks during the crisis from 1st August 2013.

The main change was a strengthening of "burden-sharing": Banks are required to work out a sound plan for their restructuring or orderly winding down before they can receive recapitalisations or asset protection measures. Moreover, the burden-sharing requirements have been strengthened: if banks have capital shortfalls, their shareholders and junior creditors are now required to contribute as a first resort, before public funding is granted.

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See IP/13/672 and MEMO/13/886

[2] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139613.pdf