Five Presidents' Report Series
Issue 02 / 2015 | 09 November

European Commission

European Political Strategy Centre

Strengthening the EU's Financial System

Bridge Financing Options for the Single Resolution Fund

The Single Resolution Mechanism (SRM) for the Banking Union establishes a common set of rules to guide the unwinding of banks in participating Member States – either euro area countries or any other Member State joining voluntarily. The SRM regulation entered into force in August 2014. One of its key aspects is the creation of a Single Resolution Fund (SRF), financed by bank contributions. In the initial phase, the Fund is composed of 'national compartments', which will be merged after a transitional period of eight years. Managed by the Single Resolution Board (SRB), the Fund is expected to reach a target size of €55bn by 2024 (See Figure 1 on the Single Resolution Board Capital Key, p. 2).[1] Underlying its open nature, all EU Members States – bar Sweden and the UK - signed the founding SRF treaty.

The Single Resolution Mechanism was part of a series of complementary and mutually reinforcing actions aimed at strengthening the EU's financial system in the wake of the global financial crisis. Other measures include the Bank Resolution and Recovery Directive and the harmonisation of deposit guarantee schemes across the EU. Together, these measures constitute the so-called Banking Union, which seeks to break the link between sovereigns and their banking systems through (partial) risk-sharing at EU level. The Single Resolution Fund plays a crucial role in achieving this goal.

Bridge Financing is Needed to Fill Potential Gaps

As the Single Resolution Fund becomes operational at the start of 2016 but does not reach its targeted size before 2024, a swift agreement on a bridge financing mechanism for the Fund is necessary as a way to ensure that enough money is available if a bank needs to be unwound while Single Resolution Fund financing is not yet sufficient.

Three Options for Bridge Financing

There are three possible options for bridge financing: cross-lending by the Member States on the basis of their national funding for the Single Resolution Fund; borrowing from private sources using Member State guarantees; or public financial credit lines either by the European Stability Mechanism (ESM) and/or Member States.

Accelerating Mutualisation

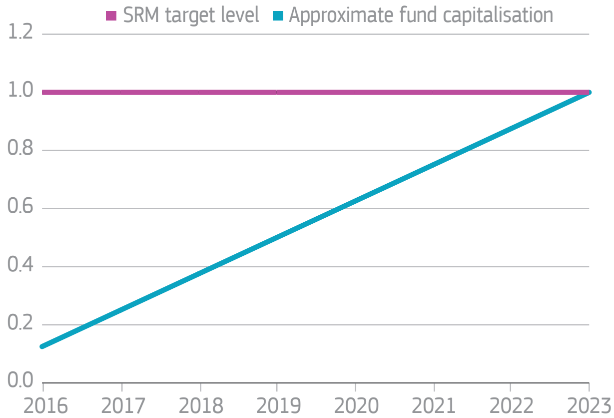
The ultimate solution will imply a combination of guarantees and credit lines by Member States and an acceleration of the Single Resolution Fund (SRF) mutualisation timeline. This could be complemented by a medium-term goal of a permanent credit line by the European Stability Mechanism, through a corresponding change in the ESM Treaty. The lesser the degree of mutualisation in the SRF, the more important a common 'backstop' becomes.

1. Bridge Financing: Commitments and Alternatives

Single Resolution Fund resources are to be tapped only after other sources of resolution funding have been exhausted. The Directive on Bank Recovery and Resolution outlines a hierarchy that starts with shareholders, followed by 'bail-in able' creditors, then any extraordinary national public financial support (bearing in mind EU state aid rules), and finally the resources of the national Deposit Guarantee Schemes. Only after the previously listed contributions reached at least 8% of the liabilities of the bank being resolved would available SRF funds be used. Furthermore, the need for bridge financing would only come into question after the existing SRF funds were exhausted. For example, in 2016 the total amount of resources available in the Single Resolution Fund would be only around €5.5bn. If the SRF contribution to the resolution of a bank is larger than this amount, additional resources via bridge financing would become necessary (Figure 2). **A bridge financing setup is of essential importance given the long timeline until the full capitalisation of the Single Resolution Fund.** It is also crucial in order to meet the potential costs associated with any resolution that may occur between now and the completion of the SRF. It is also a vital element to establish credibility among market participants.

Figure 1. Single Resolution Fund Capitalisation Timeline

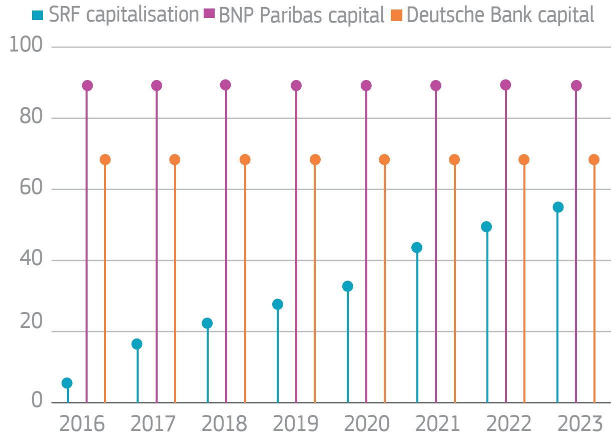
% of the amount of covered deposits in all the participating Member States



Source: Single Resolution Board

Figure 2. Total Initial SRF in Comparison with European Banks' Capital

Billion euro



Source: Single Resolution Board

The following options could be considered as ways of providing bridge financing for the Single Resolution Fund:

Option 1: Inter-compartmental Member State lending (over and above what is already agreed during the transition period, see Box 1 on p. 3): the Fund will be composed of national compartments that will be gradually mutualised over eight years. In other words, the resources for resolution would initially be largely the responsibility of the Member State itself. However, if one Member State's compartment is insufficient, it is possible for the other Member States' national compartments to lend to each other, within pre-agreed limits, during the transition phase. This is a way to lessen the initial exposure of Member States to resolution costs in other Member States.

Option 2: Borrowing from private sources using Member State guarantees: a loan guarantee is a promise by one party to assume the debt obligation of a borrower if that borrower defaults. Given that they do not imply an actual immediate financial or fiscal commitment,[2] they were widely used during the EU financial crisis as a way to support a number of national banking systems, and were also provided by Member States to multilateral institutions like the European Stability Mechanism and to funding facilities like the European Fund for Strategic Investment (EFSI).

Option 3: Public financial credit lines, by multilateral institutions and/or by the Member States: direct credit lines could be provided to the Single Resolution Fund by either Member States and/or by an institution like the European Stability Mechanism.

A combination of those three options is not only possible, but likely. Indeed, option 1 above is restricted, given the limited amount of funds available for intra-compartmental lending. It is also likely that the Single Resolution Board will not be ready to seek financing in the capital markets before the second half of 2016. Therefore, in order to ensure that the financial capacity of the SRB/SRF is perceived as sufficient from the onset, in early 2016, **some sort of public bridge financing arrangement, possibly a combination of options 2 and 3**, would be required.

Assuming that the ultimate solution involves either Option 2 or 3, or a combination thereof, the focus needs to shift to operationalisation of this outcome.

The Mutualisation Path of the Single Resolution Fund

The use of SRF resources for a bank resolution is to be progressively 'mutualised' – i.e. transformed from costs largely paid by the individual Member State concerned into costs shared by all euro area countries - over an eight year period.

Concretely, bank resolution costs are to be paid:

- if they happen in 2016, by using the total amount of funds available in the national compartments, and if this is not enough, by using up to 40% of the money in the other national compartments;
- if a bank resolution happens in 2017, the cost is covered by the concerned national compartment by using up to 60% of the amount available in it, and if more money is needed, by using up to 60% of the money in other national compartments;
- if a bank needs to be unwound in 2018, the concerned national compartment can use up to 40% of its resources and then, if more is needed, up to 2/3 of the money in the other national compartments can be used.

In the following years, so from 2019 onwards, the limit for use of the resources in the national compartments falls by an additional 6.66% each year, while the limit for use of all national compartments increases by 6.66% further each year, until full mutualisation is reached in 2024, meaning all resolution costs are fully shared.

2. Operationalising Option Two: Single Resolution Board Borrowing Backed by National Guarantees

One could consider establishing **formally agreed and pre-committed individual guarantees**, perhaps of a size equivalent to the national compartments in the Single Resolution Fund, whose share is equivalent to the national share of total euro area customer deposits.[3] These guarantees could be granted by each Member State to the Single Resolution Board for resolution operations on their territory during the transition period, and therefore used on an operation-by-operation basis.

A system of **pro-rata guarantees** - say, equivalent to the size of their national compartment in the Single Resolution Fund - is another possibility. All participating states would provide a pro-rata guarantee to the Single Resolution Board under a specific pre-established contribution key. In case of a shortfall, guarantees would be called from each Member State in proportion to the key. As such, the guarantees would be based on individual rather than joint responsibility. However, as the Single Resolution Board will borrow from markets as a single legal entity, and not as an individual national compartment, this effectively would follow the mutualisation logic of the Single Resolution Board.

Finally, one could also design a guarantee system that **progressively moves from a set of individual guarantees by Member States to a set of pro-rata guarantees** over a transition period.

Given the legally binding nature of the guarantee, Member States would probably need some sort of national, even parliamentary approval in each of these cases.

Given that one of the main aims of the Banking Union is to break the bank-sovereign feedback loop, individual guarantees would be the least effective way forward. Mutualised solutions would be much more effective.[4] **Also, the effect of using national guarantees will be that, in practice, Member States would collectively back an ever-shrinking share of the total SRF. Therefore, if this option is chosen, it is essential that the Member States also begin discussions on a more robust mutualised credit line/backstop,**

possibly via the European Stability Mechanism. Another important consideration with these options is how much the Single Resolution Fund will be able to borrow from the markets without endangering its prospective credit rating (presumably, the Single Resolution Fund would aim for a credit rating at least as high as that of the European Stability Mechanism, which is currently AA/Aa1, depending on which of the big three credit ratings agencies is used as a reference).[5] The borrowing amount possible for any given credit rating would of course depend on the nature of the guarantee provided amongst the options above, and on its size.

3. Operationalising Option Three: A Multilateral or National Credit Line to the SRF

As an alternative to – or possibly in combination with - guarantees, the **Single Resolution Fund could also receive a direct credit line**. Even if the European Stability Mechanism currently has an unused lending capacity of around €370 billion, since it was established with the objective to provide financial assistance to European Stability Mechanism Member States only, it cannot lend to the Single Resolution Fund under the current ESM treaty.

Were the Single Resolution Fund to spearhead the resolution of a bank with subsidiaries in non-ESM Member States, this could create a situation where credit would be provided by the European Stability Mechanism outside the euro area.

Furthermore, the procedures for granting financial support stipulated in the ESM treaty would not fit well even if an entirely new instrument were created for the specific purpose of lending to the Single Resolution Board. For example, the ESM treaty requires country-specific conditions to be attached to a rescue programme, set out in a Memorandum of Understanding. Since the Single Resolution Board would use the funds to finance resolutions in various banking systems or to support the financing of their debt, such a prerequisite cannot be applied. The ESM treaty also requires it to conduct a debt sustainability assessment and establish a Financial Assistance Facility agreement with the beneficiary Member State, conditions that would again prove out of context for an SRB credit line. Hence, the credit line cannot be implemented through a simple review of the list of financial assistance instruments (an option that would be allowed by the current ESM treaty).

Alternatively, instead of creating a new credit facility, non-euro area Member States could enter into a parallel agreement with the European Stability Mechanism, which would enable financial support to the Single Resolution Board. This would also be possible through the establishment of an ESM subsidiary, supported by the ESM and the non-euro area sovereigns.

Nevertheless, in any of the cases above, **the ESM treaty would need to be revised.** This would certainly imply a political agreement among all ESM members, and could conceivably either precede or coincide with the ESM being brought under EU law.[6] In any case, this option would still be more likely in the medium term.

On the other hand, credit lines by members, either individualised or mutualised, and presumably backed by bank levies (and hence fiscally neutral for the Member State over the medium term, making them compatible with the Stability and Growth Pact) have already been politically agreed at the level of the Economic and Financial Committee, but the operationalisation of this decision is still ongoing. While they might need different types of national-level approval, they would likely not face the same legal constraints and delays in terms of implementation that an ESM credit line would, and therefore be more feasible as short-term options.

Conclusion

Although bridge financing is merely an additional source of funding for the Single Resolution Fund, whose normal resources would only be used after several other sources of resolution funding have been depleted, it is a fundamental tool to enable the Single Resolution Fund to fulfil its mission. The ultimate solution will imply a combination of the provision of guarantees and conditional credit lines by the Member States – all with fairly marginal actual fiscal implications - and an acceleration of the Single Resolution Fund mutualisation path, not only of the Fund itself, but also possibly of the guarantees.

To emphasise the common euro area nature of the Single Resolution Fund, speeding up the mutualisation timeline in the short term (i.e. within Stage 1 of the implementation of the Five Presidents' Report), combined with the accelerated provision of pro-rata guarantees by the Member States, may be the most desirable outcome. It would go a long way to maximise the objective of further weakening the bank-sovereign feedback loop.

This could be complemented by a medium-term goal (already at the beginning of Stage 2, 'completing EMU'): the provision of a permanent credit line by the European Stability Mechanism to provide the now missing 'backstop' to the resolution fund, through a change in the ESM treaty, possibly introduced even before its incorporation into the EU Treaty. As highlighted above, the lesser the degree of mutualisation in the SRF, the more important a common 'backstop' becomes.[7]

Annex

Comparative Table of SRF Bridge-Financing Funding

	Expand inter-compartmental MS lending	**Market borrowing using MS guarantees**				**Public credit lines, by multilateral institutions and/or MS**
		An 'Informal' Public Guarantee	**Formally Agreed Guarantees Between the SRB and MS**			
			Formal **Individual** Guarantees	Full Pro-Rata Guarantees	Combined Individual and Pro-Rata Guarantees in Line with the SRF Mutualisation Path	
Pro	Uses existing framework	No increases in public debt	No increases in public debt	No increases in public debt, greater credibility gains and stronger weakening of the Sovereign-bank link, as effectively stronger mutualisation outcome	No increases in public debt, greater credibility gains and stronger weakening of the Sovereign-bank link, as effectively stronger mutualisation outcome	Very large amount of resources (ESM), structural mutualisation solution 'breaking the link' (ESM)
Con	Limited additional resources	Likely coordination questions, MS-level approval needed, limited credibility gains and weakening of the Sovereign-bank link	Likely coordination questions, MS-level approval needed, limited credibility gains and weakening of the Sovereign-bank link	MS-level approval needed	Longer timeframe towards mutualisation, MS-level approval needed	Need to change ESM treaty, so likely more time-consuming, MS approval needed, if only MS credit line, Sovereign-bank links still there (if those MS-credit lines are not mutualised)

Notes

1. This amount is roughly equivalent to 1% of the amount of covered deposits of all credit institutions authorised in all the participating Member States. As a reference, the 2014 total shareholders' equity of two of the largest euro area banks, Deutsche Bank and BNP Paribas was, respectively, €68.4 and €89.4 billion.
2. They are so-called 'contingent liabilities': even though data on these are collected by Eurostat, they are not part of the government debt (as defined in Council Regulation (EC) No 479/2009 of 25 May 2009).
3. *Informal* guarantees by the MS would also be possible. However, any informal, ad-hoc option implies coordination questions that may lead to delays. As this would cause both practical implementation problems and fail to effectively anchor market expectations, this seems an undesirable option.
4. Véron, N., (2015) 'Europe's Radical Banking Union'.
5. See ratings on http://www.esm.europa.eu/investors/rating/index.htm.
6. Namely, the Five Presidents' Report proposes for 'Stage 2' the integration of the ESM into the EU Treaty, which would necessarily imply a change in the ESM treaty.
7. A consideration that lends support to the ESM option (as opposed to Member State ones) is that a large pool of resources available via simple and transparent arrangements would increase the chances that markets would react positively to the chosen setup.