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Should "precautionary recapitalisations" make taxpayers nervous?

ECB stress tests - why taxpayers are still at risk and what can be done to protect them?

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This policy note looks at what could happen if the ECB's comprehensive assessment reveals capital shortfalls at banks that cannot then raise funds on the market. The EU's State Aid and Resolution frameworks require shareholders and certain creditors to contribute to a "precautionary recapitalisation". But both frameworks contain safety valves that allow public money to be used in some cases without shareholders' and creditors' participation to protect financial stability. This highlights the fragile nature of the European banking sector and one of its major causes: bank interconnectedness. The policy implications are to address the problem at source with measures including bank structure reform.

> "When a big bank fails, bail-in is never a soft option ... the temptation is always there for governments to reach for the chequebook."

Andrew Haldane[1]

Summary

This policy brief looks at the EU's rules for dealing with capital shortfalls revealed in bank stress tests and points to weaknesses in the use of 'escape' and 'safeguard' clauses that could put taxpayers at risk. The EU's 2013 rules on State Aid for banks require losses to be allocated to shareholders, hybrid capital instruments holders and junior creditors before public money can be used ('burden-sharing'); from 2016 the EU's new bank recovery and resolution framework (BRRD/SRM) will generally require all unsecured creditors to participate in loss-taking ('bail-in') before public money can be used.

Both sets of rules aim to avoid the injection of public funds unless shareholders and creditors have taken losses first. However, BRRD/SRM contains an 'escape' clause under which, if an otherwise solvent bank cannot fill a capital shortfall identified in an ECB stress test, a Member State can inject public money without first bailing in creditors. The circumstances in which this can happen, linked to protecting financial stability, are open to some interpretation, thus undermining the BRRD/SRM regime and its ability to curb moral hazard.

If the 'escape' clause is invoked, any use of public funds must still comply with State Aid rules on burden-sharing. However a 'safeguard' clause in the State Aid regime also allows for creditors to be spared if burden-sharing would endanger financial stability or lead to disproportionate results. Since the holders of bail-in able debt are usually other financial institutions the tool could transfer losses from one institution to another, risking contagion.

There seems to be a trade-off: the very high interconnectedness of the financial system means that the application of burden-sharing or bail-in could worsen systemic risk. The policy implications are therefore to tackle interconnectedness stemming mainly from finance-by-finance-for finance activities and banks' over-reliance on wholesale funding, through measures including bank structure reform.

[1] "BOE's Haldane: Worried Bail In Rules Won't Be Enough", Wall Street Journal, 28 May 2013
http://online.wsj.com/article/BT-CO-20130528-703047.html?mod=googlenews_wsj

Introduction

If a bank fails in a way that could have systemic consequences, the EU's current procedures allow public money to be used to protect depositors, payment systems and market confidence. Public support may take different forms such as direct recapitalisation (when a Member State buys the newly issued shares of a bank) or so-called impaired assets measures.[2] Under the current State Aid regime, the so-called "**burden-sharing**" principles mean that shareholders, hybrid capital instruments holders and junior creditors must contribute to the recapitalisation before any public funds are used. These rules provide for an exemption from burden-sharing in the case of threats to financial stability, called a safeguard clause.

Under the **new framework for the recovery and resolution** of credit institutions (BRRD/SRM), which will enter into force in 2015 and apply fully from 2016, the scope of private creditors that would contribute to recapitalisation before and after bank failure will be widened to generally include all unsecured creditors, although some specific categories of creditors will be excluded.[3] The idea is to reduce **moral hazard**: since a wider pool of private creditors would take losses, the risk of taxpayer's involvement should be lower. If creditors and shareholders are to take the losses instead of taxpayers it should also increase accountability and limit excessive risk taking.

BRRD/SRM contains however an 'escape' clause in case of a precautionary recapitalisation: should a bank fail the ECB stress tests but be otherwise solvent, a Member State can under certain conditions choose to provide public support without involving the wider scope of creditors. The rationale for the 'escape' clause is that involving most of the creditors could threaten market confidence, stability and possibly create a bank run and hence it is deemed preferable to use public money.

Because the escape clause allows for **different interpretations**, there is a risk that in some cases it could be used to protect a Member State's financial sector. In our view, this room for interpretation weakens the robustness of the BRRD/SRM regime and reduces its effectiveness against moral hazard.

A second major concern is that due to very high interconnectedness of the financial system there is a **significant threat that even the application of bail-in tools will bring systemic risk**. Since the holders of bail-in-able liabilities are to a large degree other financial institutions, the tool might transfer the losses from one institution to others and increase the risk of contagion. This could actually disarm existing and new burden-sharing tools as authorities might choose not to use them. It might be also the case that the level of 'bail-in able' liabilities is not sufficient, due to the high reliance of large banks on secured funding, which is excluded from the scope of bail-in (senior unsecured debt made up 41% of the term debt of European Banks at the end of 2012 (IMF 2012)).

The framework therefore has a safety valve to protect financial stability, in the form of the escape clause and the safeguard clause. The problem lies with the **fragile situation** in the European banking sector, which might

Definitions

State Aid – an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities, in the case of banks usually in the form of recapitalisation, impaired asset measures or a combination of the two.

Hybrid capital instruments – debt that can be converted to equity subject to predefined events. These predefined events are agreed contractually whereas conversion of debt under resolution is a statutory power of a resolution authority.

Junior creditors refers to investors who have purchased a type of debt instruments that absorbs losses immediately after shareholders

Resolution means the restructuring of a bank by public authority (resolution authority) when a bank is failing or likely to fail and there is no other private solution that can restore the bank to viability within a short timeframe, whereas normal insolvency proceedings would cause financial instability. Thanks to the statutory powers of a resolution authority ('resolution tools') – such as exercising the power to sell or merge the business with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones and to convert to shares or write down the liabilities of failing banks – the continuity of banks' critical functions is guaranteed and financial stability is preserved. The framework for the recovery and resolution of credit institutions in the EU comprises the BRRD and SRM. The BRRD constitutes a single rulebook for the resolution of banks (and large investment firms) in all EU Member States. It introduces harmonized tools for dealing with bank crises both to prevent failure and to restructure banks if they do face failure. The Single Resolution Mechanism implements the BRRD in the Eurozone and any other Member State participating in Single Supervisory Mechanism.

Moral hazard – a situation in which risk is separated from reward, for example where banks engage in risky activities in the anticipation of public support if the activities bring losses.

Bail-in – a resolution tool, which allows restructuring of the liabilities of the institution by writing down its unsecured debt or converting it into equity in order to restore the Common Equity Tier 1 capital ratio of the bank under resolution. Eligible liabilities for the purposes of bail-in are defined as liabilities and capital instruments that do not qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments under CRD IV/CRR – for example senior unsecured debt – with certain exceptions.

[2] Such as asset purchase, insurance, swap, guarantee or a combination of these.

[3] The exemptions include, for example, liabilities to institutions outside of the group with a maturity less than seven days, and liabilities to employees. See BRRD Article 44(2).

lead to the extensive use of these clauses. In other words competent authorities and Member States might still be reluctant to use tools designed to protect taxpayers for fear of harming financial stability (or if they are reluctant to place their banks under resolution). Those fears result from **interconnectedness and contagion effects** in the banking system and the financial system as a whole. Almost one quarter of bank assets have another bank as counterparty, which means that other banks' liabilities may be subject to burden-sharing/ bail-in. On top of that asset managers, pension funds and insurers are investors in the bank debt instruments that provide wholesale funding, further adding to the system's interconnectedness. And large banks (especially those with large investment banking operations – see BIS 2013) rely heavily on secured funding to finance their activities, which limits the 'bail-in-able' liabilities.[4] In a nutshell: the newly created system of resolution/burden-sharing might not be effective unless further steps are taken.

Why a resolution framework was needed and what does it actually mean?

Prior to the financial crisis there was no unified European framework to prevent and deal with bank failure.[5] It meant that banks were not obliged to have restructuring plans in place, which would describe the set of possible actions in case of trouble and authorities did not have any predefined tools to intervene early. Moreover **there was no legal framework defining** who would bear losses and in which order prior to bankruptcy. It meant that the failure of a systemic bank would bring a major disruption to the financial system. It also meant that taxpayers would be made to contribute earlier: since private creditors would bear losses only after a bank was declared bankrupt whereas bail-out was meant to prevent banks being declared bankrupt, so taxpayers were involved earlier in the process than private creditors.

In order to tackle this moral hazard issue it was decided to set the framework for the instruments and procedures used to deal with bank failure in a way that transfers bank losses to private creditors in an orderly manner before public support.

Those problems were addressed first by the European Commission in its **Crisis Communications with regard to State Aid** control and especially in its 2013 Communication through the introduction of burden-sharing principles applied also to subordinated debt holders.[6] This new measure imposed a requirement that junior creditors would bear losses in addition to shareholders and hybrid capital holders before any public funds were injected into the bank.

From 2016 and with full implementation of bail-in, the **BRRD/SRM** should widen the scope of creditors absorbing the losses of banks to all unsecured liabilities.[7, 8]

[4] The minimum ratio of own funds and eligible liabilities needed to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the capital ratio restored, is to be determined by the resolution authority after consulting the competent authority. The introduction of harmonized minimum levels in EU legislation has been left for a later decision.

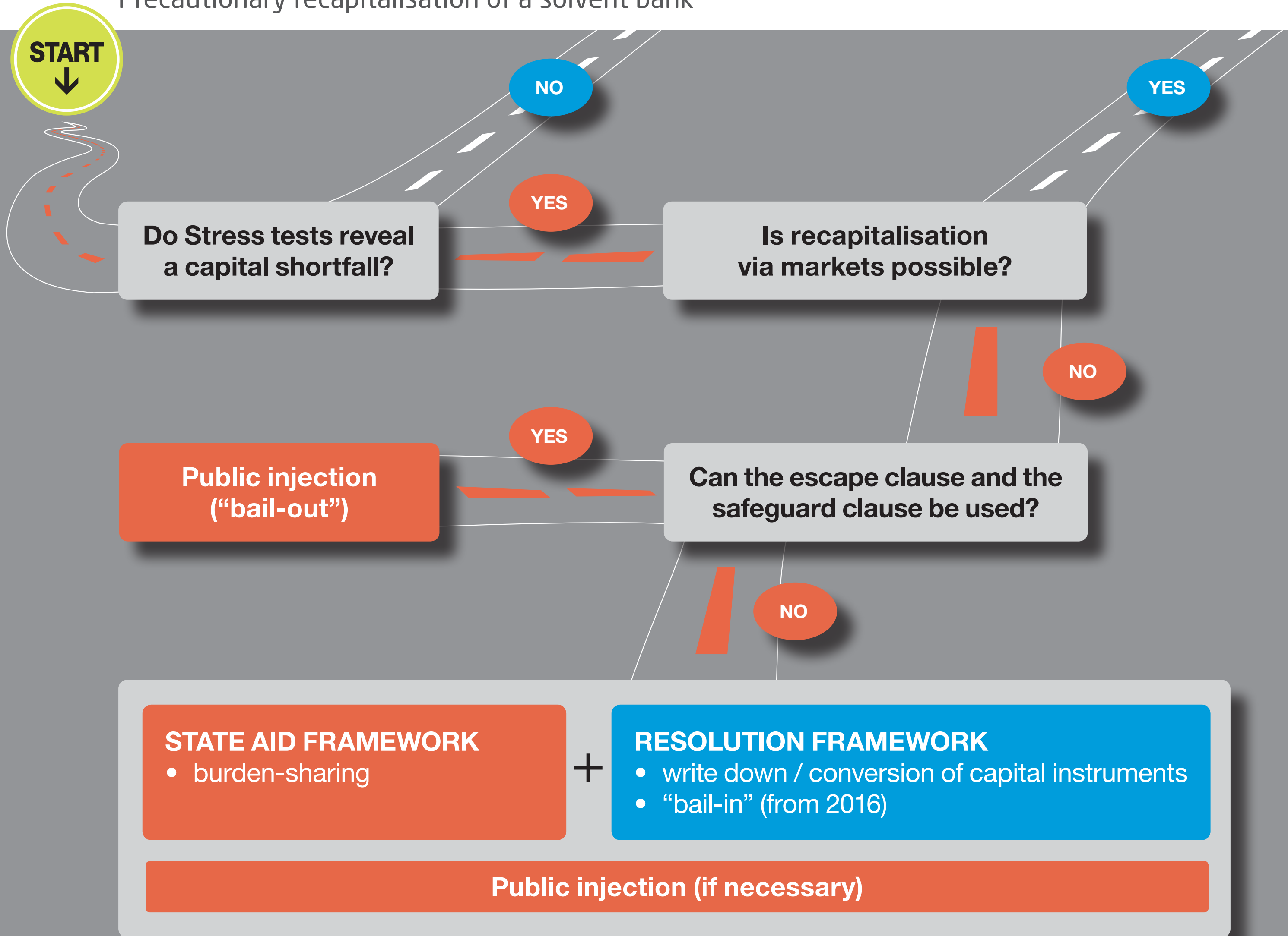
[5] "Normal" insolvency proceeedings are not considered suitable for banks as their application could lead to financial instability, for example through disruptions in the payment systems, loss of market confidence, bank runs etc.

[6] Between 2008 and 2013 the European Commission adopted seven crisis communications constituting a framework for coordinated action to support the financial sector during the crisis, so as to ensure financial stability while minimising distortions of competition. These special rules are based on Article 107(3)(b) of the Treaty on the functioning of the EU (TFEU) which allows the Commission to approve state support to remedy a serious disturbance in the economy of a Member State. For further information see http://europa.eu/rapid/press-release_MEMO-13-886_en.htm. The 2013 Communication is entitled "Communication from the Commission on the application, from 1 August 2013 , of State Aid rules to support measures in favour of banks in the context of the financial crisis", http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01).

[7] Please note that the ESM's direct bank recapitalisation instrument would trigger bail-in already in 2015 but this instrument cannot be used as a precautionary measure (FAQ on the preliminary agreement on the future ESM direct bank recapitalisation instrument, www.esm.europa.eu/pdf/FAQPreliminaryDRIJune2014.pdf)

[8] As mentioned above, only insured depositors and some specific categories of unsecured creditors are freed from participation in bank recapitalisations. However the resoution authority may exempt further creditors subject to certain conditions.

Precautionary recapitalisation of a solvent bank



Comprehensive assessment and ECB's call for forbearance

The European Central Bank (ECB) is preparing to take on new banking supervision tasks as part of a Single Supervisory Mechanism (SSM). The **comprehensive assessment**, a most important step undertaken by the ECB prior to taking over its supervisory role, is aimed at determining what the financial condition of banks really is and if they are able to survive possible future market turbulence. The comprehensive assessment consists of a backward-looking Asset Quality Review and forward-looking stress-tests, which are conducted simultaneously. The Asset Quality Review should result in banks' assets being valued correctly (adjustments in asset values or collateral values will be reflected in a bank's financial position) while the stress tests should show if a bank is able to withstand external shocks.

Banks have undertaken measures to recapitalise prior to the outcomes of a comprehensive assessment in order to pass this supervisory exercise: according to reports in the Financial Times they have raised

Comprehensive assessment – a supervisory exercise performed by the ECB before taking over its supervisory role in November 2014, comprising two main pillars: asset quality review and stress test. The goals of the comprehensive assessment are threefold: transparency (enhancing the quality of information available about the condition of banks); repair (identifying and implementing any necessary corrective actions); and confidence building (assuring all stakeholders that banks are fundamentally sound and trustworthy).

Asset quality review (AQR) – a review of the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions in order to enhance the transparency of bank exposures.

Stress test – examines the resilience of banks' balance sheets to stress scenarios (hypothetical external shocks).

For further information, see http://www.ecb.europa.eu/ssm/assessment/html/index.en.html?6faf700170bad41e6872ab2ca3a2d6d2

€35.5bn in capital since last July and even the most troubled banks have been able to issue subordinated debt and convertible bonds (CoCos).[9]

Despite this progress, the vice president of the ECB underlined the possible need for the Commission to **show forbearance in the application of safeguard clauses to burden-sharing principles**[10] within the framework in the Commission's 2013 Communication on State Aid. What does this mean in the context of the comprehensive assessment? The answer is not simple because of transitional provisions, the multitude of legal instruments and, last but not least, the fragile situation of the European banking sector.

Forbearance – relaxed application of existing rules.

Safeguard clauses to burden-sharing – burden-sharing might not be applied if the participation of capital holders and junior creditors in the recapitalisation would threaten financial stability or lead to disproportionate results.

Burden-sharing – the idea that a bank, its shareholders and its junior creditors should contribute to recapitalisation as much as possible with their own resources, in order to limit State Aid to the minimum necessary. Limiting State Aid improves competition between banks and across Member States in the single market and helps to address moral hazard. Adequate burden-sharing will normally entail losses being absorbed first by equity holders, then contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent (there is no cap). Such contributions can take the form of either a conversion into Common Equity Tier 1 or a write-down of the principal of the instruments (see European Commission's 2013 Communication on State Aid).

Outcomes of the comprehensive assessment versus state-aid rules

There are several possible outcomes for the comprehensive assessment, an exercise that should bring transparency to the situation of banks in Europe. As a starting point there are minimum capital requirements as forseen by CRD IV/CRR, calculated on the basis of a bank's financial position before the asset quality review (AQR).[11] The assesment is made by applying stress test scenarios (a baseline scenario and a more severe adverse scenario) to banks' regulatory capital, and then simultanously the results of AQR are integrated. Different capital ratios are set for the comprehensive assessment, depending on the scenario used.[12]

Various combinations of outcomes are possible but the most likely are that a bank either survives both scenarios, fails both scenarios, or survives the baseline scenario but fails the adverse scenario.

When a bank meets the CRD IV/ CRR capital requirements but is required to **raise additional capital** as a result of the comprehensive assessment, this should be done primarily via **market funding** (or other private solutions to generate capital such as retention of earnings). The assumption is that a bank in this situation should still be able to find investors. But if the institution is not able to find funds on the market for precautionary recapitalisation ('precautionary' since the bank's own funds meet the minimum capital requirements) or if there are too many banks or institutions requiring capital injections compared to the supply of funds, then the responsibility for any recapitalisation after the comprehensive assessment bounces back to **Member States**. In between those two solutions (capital raising via the market or public injections) there is a third possibility of contribution to the recapitalisation, namely the **contribution of equity holders and junior creditors**.

As already mentioned, the idea of equity holders' and junior creditors' contribution is well established in State Aid rules. The State Aid rules demand that the shareholders, hybrid capital instruments holders and junior creditors cover any capital shortfall to the maximum extent before any injection of public funds into the bank can be made.[13] It assures that the holders of capital and junior creditors bear responsibility for their investment decision and therefore reduces moral hazard. The participation

[9] Please note however that CoCo's can under strict conditions count as AT1 and T2 instruments under the CRR/CRD IV regime but can never constitute the highest quality capital, CET1.

[10] Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the OeNB Economics Conference, Vienna, 12 May 2014: http://www.bis.org/review/r140512b.htm

[11] The ratios applicable in 2014 and 2015 (without buffers) were: Common Equity Tier 1 (2014: 4.0 %; 2015: 4.5 %), Tier 1 (6%), Total capital ratio (8%) – Article 92 of CRR

[12] The ratios for the comprehensive assesment are 8 % CET 1 in the AQR and baseline scenario, and 5.5 % CET 1 in the adverse scenario

[13] The principles of burden-sharing (where holders of a bank's capital and subordinated debt instruments participate in the bank's recapitalisation) differentiate between a bank being above the EU regulatory minimum of capital requirements and a bank being under the regulatory minimum at the point when an injection of public funds is needed. In the first case hybrid capital instruments and subordinated debt (AT1, T2 and subordinated debt outside T2) must be converted into equity (CET 1) before State Aid is granted and therefore shareholders contribute through dilution (via related lower dividend and possible equity price decline). See Par. 43 and 44 of the European Commission's 2013 Communication on State Aid.

can have the form of a write-off or conversion of capital instruments and/or debt instruments.[14]

A so-called '**safeguard clause**' in paragraph 45 of the 2013 Communication on State Aid allows however for exceptions to the burden-sharing rules, meaning that shareholders, hybrid capital instrument holders and junior creditors will be freed from participation in cases where implementing those measures "*would endanger financial stability or lead to disproportionate results*". Theoretically it should be difficult to prove that without the precautionary public recapitalisation of a particular bank, overall financial stability would be endangered. But given the size, interconnectedness and contagion effects, it might not be so difficult to demonstrate. In practice it might be fairly easy for a competent authority/Member State to gather arguments in favour of using safeguard clause and hence to provide aid to its national banks with taxpayer money without involving shareholders and junior creditors.[15]

Financial stability – a definition used by the ECB describes financial stability as a condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

What will change after 2014?

The very same concept of participation of owners and creditors in bank recapitalisation is a foundation of the BRRD/SRM regime. Actions taken under the BRRD/SRM might be even more severe since a broader spectrum of bank creditors will suffer appropriate losses and bear an appropriate part of the costs arising from its recapitalisation, especially when the bail-in tool is used.

If the comprehensive assessment reveals **capital shortfalls, banks will be expected to cover them within six to nine months** after the disclosure of the results of the comprehensive assessment. Banks that do not raise funds in 2014, which is quite probable given that the supervisory exercise ends in October 2014, will be recapitalising with the resolution regime in force.[16] If public funds are to be used, the Commission must ensure that the burden-sharing principles were applied in conformity with State Aid rules and the related provisions of BRRD/SRM before it can authorise such aid.[17]

Two systems should be better than one and certainly better than none. But as we highlight in this policy note in some cases the newly established BRRD/SRM tools may and will be out of the question. And **threats to financial stability may also disable burden-sharing under state-aid**. As a result, there is a risk that taxpayers alone might be burdened with a bank's capital shortfall.

In the case of precautionary recapitalisation with public funds, which would theoretically only occur if a bank cannot find enough capital in the market and the burden-sharing applied is still insufficient, the BRRD/SRM contains an '**escape clause**' (in Articles 32 and 59 of BRRD) that can bypass the application of resolution tools and the writing off or conversion of relevant capital instruments. Thanks to the escape clause, a precautionary recapitalisation with public funds might fall outside the BRRD/SRM regime and be subject only to State Aid rules. That means that the status quo of rules regarding such recapitalisation will be maintained.

[14] It should be noted however that the burden-sharing principles should be implemented in national legislation and some Member States have adopted provisions that allow burden-sharing in all scenarios, whether a bank remains above or below the minimum regulatory capital requirements. Some Member States have provisions in place allowing them to undertake burden-sharing in resolution scenarios only when a bank is below the minimum regulatory capital requirements. In the latter case the Member States decided ex ante that precautionary recapitalisation cannot be made with public funds at all.

[15] It is however the European Commission that has 'the last say', as it assesses the compatibility of a precautionary recapitalization with the State Aid Framework as well as its compatibility with primary and secondary EU law. It is also worth noting that the European Commission has not used the safeguard clause yet, even when burden-sharing was applied in Spain or Slovenia.

[16] But until 2016 without the bail-in tool in force, with write down or conversion of relevant capital instruments (Article 59 of BRRD).

[17] See "Terms of Reference Applicable rules on addressing capital shortfalls and burden-sharing in the context of the Asset Quality Reviews and Stress Tests" agreed in the margins of the Ecofin Council meeting 8 July 2014, http://italia2014.eu/media/1327/ecofin-asset-quality-reviews-and-stress-test.pdf

Central to this issue is Article 32 of BRRD[18] (mirrored by Article 16 of SRM) which normally considers a bank that requires "*extraordinary public financial support*" to be failing and therefore subject to BRRD resolution rules, including the potential write-down or conversion of relevant capital instruments. But if public money is used to help a solvent bank to fill a capital shortfall revealed by the ECB's stress test or equivalent exercise (for example to preserve financial stability), then an exemption applies.

The cumulative conditions for the use of escape clause are as follows: a) the bank is solvent, b) the injection of funds shall be of precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and preserve financial stability, c) it shall not be used to offset losses that the institution has incurred or is likely to incur in the near future and d) last but not least the transaction is approved under the union State Aid framework (so after application of burden-sharing).

This escape clause is available in the current and any future supervisory exercises. While we understand the rationale and the supervisor's need to preserve market confidence and stability, the clause might have the opposite effect given the wide **room for interpretation** described below.

The way the BRRD/SRM escape clause will be interpreted will have an impact on the applicable regime in 2015 and later. Especially the condition that the injection shall **not be used to offset losses that the institution has incurred or is likely to incur in the near future** leaves some room for manoeuvre/interpretation. And it may be read that the escape clause is only applicable to a shortfall revealed in the adverse stress scenario. The room for interpretation does not go along with restoring trust in markets.

Moreover, preserving financial stability is a necessary condition for the use of the escape clause within the resolution framework, and one of two conditions needed for the use of the safeguard clause within the State Aid rules. Under the resolution regime it is the competent authority (the ECB for banks subject to the Banking Union) that confirms whether the conditions for precautionary recapitalization have been met. But under the State Aid rules, it is the European Commission that confirms whether burden-sharing was applied correctly or whether the safeguard clause could be used before approving a precautionary recapitalization. **The two institutions might have different opinions on whether a threat to financial stability exists**.[19]

If the precautionary public recapitalisation falls outside the BRRD/SRM, the entering into force of bail-in in 2016 will actually make no difference – only hybrid capital instruments and subordinated debt holders will still be (potentially) included in the circle of investors contributing to recapitalisation when burden-sharing is applied.

Write down or conversion of relevant capital instruments (Common Equity Tier 1, Additional Tier 1 or Tier 2) – a tool which under BRRD/SRM might be exercised independently of the resolution action or together with a resolution action. When a bank is failing or likely to fail, a write-down or conversion of relevant capital instruments should be exercised before any resolution action is taken since share-holders, hybrid capital instruments holders should contribute first.

Resolution action – a decision of a resolution authority to place a bank under resolution if it is falling or likely to fail, accompanied by the application of a resolution tool (exercising the power to sell or merge the business with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones and to convert to shares or write down the liabilities of failing banks) and/or exercise of the resolution powers foreseen by BRRD/SRM, which are necessary to apply resolution tools described above (e.g. the transfer of shares).

[18] Article 32 (4) (d) of BRRD states that an institution shall be deemed to be failing or likely to fail if "*extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms:*

i) a State guarantee to back liquidity facilities provided by central banks according to the central banks' conditions;

ii) a State guarantee of newly issued liabilities; or

iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution, where neither the circumstances referred to in point (a), (b) or (c) of this paragraph nor the circumstances referred to in Article 59(3) are present at the time the public support is granted.

In each of the cases mentioned in points (d)(i), (ii) and (iii), the guarantee or equivalent measures shall be confined to solvent institutions and shall be conditional on final approval under the Union State Aid framework. Those measures shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the institution has incurred or is likely to incur in the near future.

Support measures under point (d)(iii) shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, EBA or national authorities, where applicable, confirmed by the competent authority."

[19] The Commission has to assess the compatibility of measures undertaken with the State Aid Framework as well as their compatibility with primary and secondary EU law. It may also question the competent authority's assessment regarding all of the conditions set in BRRD/SRM (incl. its general assessment of whether the bank is failing or likely to fail or not).

Interconnectedness of banks

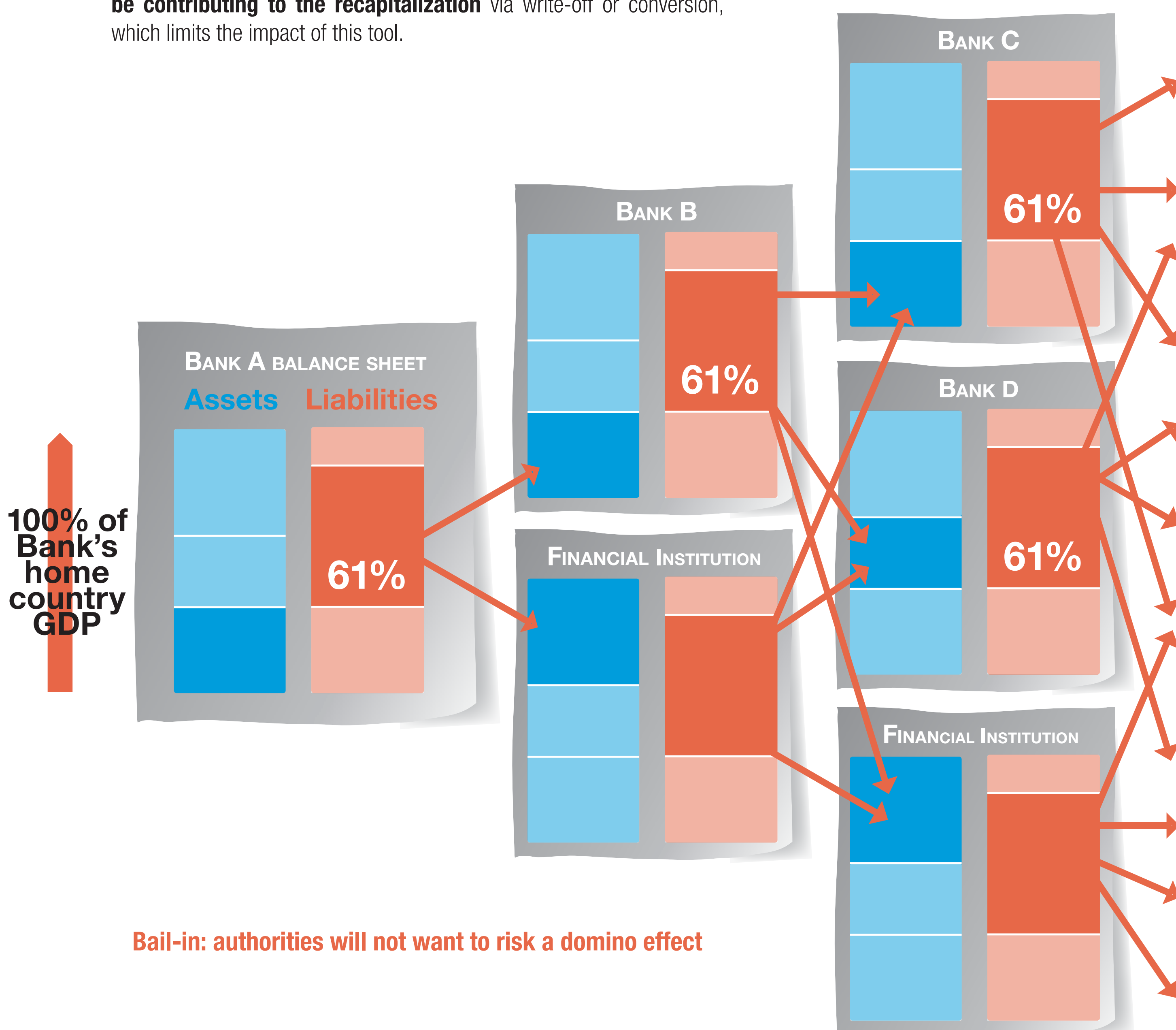
Several measures show that bank interconnectedness remains high. The European Commission's April 2014 European Financial Stability and Integration Report flagged a **high level of bank equity cross-holdings**:

"Between 2008 and June 2013, out of the €630 bn of capital increase in aggregate terms, €400bn correspond to increases in interbank positions and only €230bn represent fresh capital injected from outside the banking system." (European Commission 2014)

In other words, while banks have increased their overall levels of equity, the rise in loss-absorbing capacity of the industry as a whole has increased rather less. The same report shows a **high degree of interconnectedness** resulting from other asset classes:

"Interconnectedness through other instruments (bonds and loans) has declined after it peaked in 2009. Nevertheless, overall interconnectedness remains high: the counterparty for 24 percent of Euro area banking assets (or €7,400bn) is another Euro area bank (December 2013)."

Moreover the International Monetary Fund highlighted extremely high interconnectedness stemming from European banks' **high reliance on wholesale funding**, in average amounting to 61% of liabilities (IMF 2012). Institutional wholesale funding is provided by financial institutions, such as banks, securities firms, insurance companies, asset management companies, and money market funds. If it is **secured funding it won't be contributing to the recapitalization** via write-off or conversion, which limits the impact of this tool.



Bail-in: authorities will not want to risk a domino effect

Of the 40 global banks with liabilities greater than 50% of domestic GDP, 29 are in the EU. Seven EU banks have liabilities greater than 100% of domestic GDP (ESRB 2014).

These figures may explain the ECB's reluctance, as macro and micro single supervisor, to transfer losses into another part of the financial system via burden-sharing or bail-in tools. If the capital instruments or liabilities are written off or converted it means that the investor is suffering losses. It is again a question of who will suffer and to what extent. Or, putting it in other words: there is a difficult balancing act to be undertaken when imposing losses. We believe that is why the ECB is underlining the importance of safeguard clauses. It is not a surprise given the aim of preserving financial stability and restoring market confidence.

The interconnectedness of European megabanks might be directly attributed to their business models and the resulting composition of their balance sheets. Bank balance sheets grew especially due to market activities (trading, market making, underwriting etc.). As a consequence of this shift in business model megabanks hold large trading inventories on the asset side and rely on wholesale funding on the liabilities side.[20] This balance sheet size and composition makes banks too interconnected to deal with losses resulting from the application of the burden-sharing mechanism if they are another bank's creditor. It hampers the credibility of the bail-in tool and of the resolution regime as a whole since public authorities will not risk a domino effect. On the other hand, if the funding provided by other financial institutions is secured it remains out of the scope of bail-in, limiting the options for recapitalization. **A strong separation of banking activities, which is recommended in the next section**, is one of the main measures, which could address this problem effectively – after separation there would be a safer, less interconnected, more resilient deposit taking bank and legally separated investment entity, which would not be too interconnected too fail. For a more detailed explanation of this, please see "Europe's banking trilemma" (Finance Watch 2013).

Interconnectedness – inter-linkages between banks and between banks and non-banks on (1) the liabilities side (e.g. funding via repo and short-term debt) as well on (2) the asset side (holdings of financial assets issued by other banks and non-banks) and (3) off-balance sheet positions (guarantees etc.). Banks can also be interconnected if they hold similar asset portfolios as each other, since unfavourable market movements will affect them at the same time.

Interconnectedness risk materializes when illiquidity and losses in one institution translate to illiquidity and losses in others. The speed and extent of this process is of major importance. Inter-linkages have been central to megabanks' focus on wholesale funding, securities financing transactions and derivatives.

A more broad and universal concept of financial interconnection, referring also to countries' interconnectedness, was developed by the IMF ("Understanding Financial Interconnectedness", 4 October 2010, http://www.imf.org/external/np/pp/eng/2010/100410.pdf)

[20] In contrast to traditional bank business models where the assets are mainly loans and the liabilites are funded to a much greater extent with deposits.

Conclusion

The comprehensive assessment of banks might reveal capital shortfalls even when banks are otherwise solvent. What will happen if a bank that needs to raise capital after the assessment cannot do so in private markets?

The current rules (State Aid) and the new rules (BRRD/ SRM) require existing investors to contribute to a bank's recapitalisation before any public funds can be injected. However, a series of safeguards and escape clauses allow public authorities to let these private investors 'off the hook' especially if financial stability is at risk, in which case public money can be used to recapitalise the bank instead.

Safeguard or escape clauses are needed to protect financial stability and to add flexibility to the framework. However, the room for interpretation on the use of the BRRD/SRM's escape clause undermines market confidence and the level playing field. It might also worsen moral hazard given the sector's fragile situation and interconnectedness, especially if those clauses are used extensively.

In our view the competent authorities/ Member States will only be confident enough to use the BRRD/SRM/burden-sharing tools if the current levels of complexity and interconnectedness in the EU banking sector are significantly reduced; authorities will not want to risk a domino effect. Dealing with those issues should make the system of protection against bail-outs more effective and the tools, which are finally in place, credible.

In other words, there is a fundamental need to address the source of the threats to financial stability.

An effective separation of EU banking activities is one of the main measures needed to restore credibility to this system of protection against bail-outs. After separation there would be a safer, less interconnected, more resilient deposit taking bank and legally separated, smaller investment banking entity. Separation of trading activities would stop the rapid growth of bank balance sheets and excessive risk taking and would limit the system's interconnectedness resulting from overreliance on wholesale funding (see OECD 2013). Without those steps even a 'precautionary' recapitalisation might involve taxpayers, never mind the public involvement that would be needed in a genuine systemic crisis. The 29 January 2014 proposal by the Commission on banking structural reform, which sets the right ambition and strikes the right balance, should thus be supported and reinforced by the Parliament.

Further reading:

Finance Watch – "**Europe's Banking Trilemma – Why banking reform is essential for a successful Banking Union**", September 2013
http://www.finance-watch.org/our-work/publications/687-europe-banking-trilemma

Finance Watch – "**Structural reform to refocus banks on the real economy**", August 2014
http://www.finance-watch.org/our-work/publications/898-fw-policy-brief-august-2014

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BRRD – Directive (EU) No 2014/59 of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 [online available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0008&from=EN].

Commission's 2013 Communication on State Aid – Communication from the Commission on the application, from 1 August 2013, of State Aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') [online available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01)].

CRD IV – Directive (EU) No 2013/36 of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [online available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2013.176.01.0338.01.ENG].

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SRM – Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council [online available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0806].

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