The Steep Road to European Banking Union:

Constructing the Single Resolution Mechanism

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Introduction

The construction of a European 'Banking Union' is one of the most significant developments in European integration since the agreement on the Maastricht Treaty. Banking Union was proposed by the European heads of government and state in June 2012 to: restore confidence in European banking systems weakened by the double whammy of the international financial crisis and the sovereign debt crisis; break the sovereign debt-bank doom loop that plagued the euro area periphery; counter-act the growing fragmentation of European financial markets since the outbreak of the international financial crisis; and – in the words of Council President Herman Von Rompuy (2012) – 'complete' Economic and Monetary Union, thus saving the euro and protecting it better from future shocks (Howarth and Quaglia 2013, see also Donnelly 2013). Banking Union was to be based on five components: a single rulebook on bank capital and liquidity; a single framework for banking supervision; a single framework for the managed resolution of banks and financial institutions; a common deposit guarantee scheme; and a common backstop for temporary financial support (European Council, 2012b&c).

From June 2012, there were negotiations on four of the five elements of a Banking Union and, with the exception of the deposit guarantee scheme, agreements were reached by the spring of 2014. In September 2012, the European Commission proposed a regulation for the establishment of a Single Supervisory Mechanism

(SSM) (European Commission 2012b), which was agreed in amended form by the December 2012 European Council (2012a) and adopted by the European Parliament (EP) and the Council in October 2013. The adoption of European Union (EU) capital requirements legislation in early 2013 reinforced the single rule book – although many lacuna remained. A directive on Bank Recovery and Resolution (BRRD), proposed by the Commission on 6 June 2012 (European Commission 2012a), was agreed by the Council on 27 June 2013, approved in an institutional trialogue (Council, Commission and EP) on 12 December 2013, and finally adopted by the EP in April 2014. The BRRD, which applies to all EU Member States, sets out rules for the 'bail-in' of struggling and failing banks which enable authorities to recapitalise a failing bank by writing-down liabilities and / or converting them to equity with the aim of continuing a bank as a going concern, decreasing financial system instability and giving authorities the opportunity to reorganise the bank or resolve it (European Commission 2014).

In July 2013, the Commission proposed a regulation for the creation of the Single Resolution Mechanism (SRM) (European Commission, 2013) which in a considerably modified form was agreed by government leaders in December 2013 (Council of Ministers, 2013) and then adopted by the Council and the European Parliament in March 2014. The Commission had previously proposed a directive on Deposit Guarantee Schemes (DGS) (European Commission 2010), which was stalled. The European Stability Mechanism (ESM) began operation in September 2012 to replace eventually the temporary European Financial Stability Facility (EFSF) (Hodson 2013). It was envisaged that, subject to certain conditions, the ESM could provide financial support to ailing banks and an amount was allocated specifically to Spanish banks via a national recapitalisation fund (FROB).

However, despite these remarkable achievements, the move to a Banking Union was delayed in 2013 due to differences over the design and operation of the SRM, between the German government and a few northern European Member States, on the one hand, and the EU institutions, France and euro periphery Member States, on the other. While many had previously hoped that the Banking Union would be up and running in 2013, by the end of the year it was clear that the system would not be operational until 2015 and then in a much watered down form from what the Member States had called for in June 2012. Negotiations on the SRM centred around four specific issues: the scope and membership of the SRM, the centralisation of decision-making authority, the sources of funding and the mechanism's legal basis.

The SRM, together with the SSM, was designed to address what we label the 'financial inconsistent quartet', that builds on the 'financial trilemma' outlined by Dirk Schoenmaker (2011, 2013). The trilemma examines the interplay of financial stability, cross-border banking and national financial policies, arguing that any two of the three objectives can be combined but not all three: one has to give way. While Schoenmaker presents an economic analysis to explain the existence of the trilemma, this contribution examines national preference formation with regard to the three objectives of the trilemma and how national preferences shaped one of the main elements of Banking Union: the SRM.

We argue that in the EU there is a fourth element to be considered, namely participation in the single currency. The effective elimination of the 'lender of last resort' function at the national level in EMU and its legal elimination at the supranational level (article 127, TFEU) created greater potential for financial instability, especially in the context of the growth in cross-border banking and the rapid expansion of bank balance sheets during the first seven years of the single currency. Hence, the trilemma became, for euro area Member States, an 'inconsistent quartet'. We also argue that the analytical usefulness of this concept to explain national preferences on the SRM relies upon its nuanced application to individual countries, taking into account national policy-maker concerns regarding moral hazard, with positions determined largely by Member State current account positions and national banking systems (and notably the internationalisation of national banking systems and the increased cross-border activities of banks). This contribution focuses specifically on one element of Banking Union – the SRM – although our argument also applies to the other elements (supervision, common deposit guarantee and the fiscal backstop).

Our analysis proceeds as follows. First, we summarise our understanding of the inconsistent quartet and how different EU Member States relate to this quartet given different positioning on moral hazard issues and very different national banking systems. Second, we seek to explain German reluctance on the SRM which is important because of the significant German government influence in shaping the overall design of Banking Union. Third, we examine the intergovernmental debate on the SRM and the effort of three EU institutions – the European Parliament, the Commission and the European Central Bank – to challenge German efforts to weaken the resolution mechanism and delay its coming into operation.

I. The 'inconsistent quartet' in EMU

In his seminal work, Dirk Schoenmaker's describes and analyses the 'financial trilemma' (2011, 2013) based on the interplay of financial stability, cross-border banking and national financial policies. In the event that national governments want cross-border banking to continue, while maintaining financial stability, the logic runs, they have to accept 'supranational' prudential regulation and supervision. Schoenmaker focuses upon global bank governance but he dedicates a couple of pages in his conclusion to the need for European Banking Union. We argue that for the large majority of EU Member States, there is a fourth element to be considered, namely the single currency. Hence, the trilemma becomes an 'inconsistent quartet'. We borrow from Padoa-Schioppa's (1982) use of the term, applied to the context of European monetary integration, just as Schoenmaker's trilemma borrows from Mundell-Fleming (Fleming 1962; Mundell 1963).

On the one hand, the single currency reinforced financial (including banking) integration in the euro area, with a massive rise in cross-border banking in the euro area from 1999 (see Howarth and Quaglia, 2013). On the other hand, the single currency undermined national financial policies, because the function of lender of last resort – previously performed by the national central bank in providing liquidity – could no longer be performed effectively at either the national level or, legally at least, by the European Central Bank (ECB). Moreover, national resolution powers were constrained by EU / euro area fiscal rules. Consequently, national authorities had fewer tools at their disposal to safeguard financial stability, which encouraged them to look to supranational solutions.

The inconsistent quartet asserts that euro area Member State governments sought but could not obtain all four objectives. We assume that the maintenance of the single currency was a prioritised goal for euro area Member States – although the implications of membership for financial stability and control varied given that Member States were affected differently by lender of last resort concerns. The inconsistent quartet also leads to the hypothesis that in euro area Member States where the banking system was less internationalised and domestic banks were less engaged in cross-border banking activities, interest in the supranationalisation of prudential regulation and supervision was likely to be more limited. Further, EU Member States unlikely to join the single currency in the near future – even those with highly internationalised banking systems and home to banks with an important cross-border presence such as the United Kingdom and Sweden – had less interest in joining Banking Union, in part because lender of last resort functions remained intact.

The inter-related global financial crisis that erupted in 2007 and the sovereign debt crisis that broke out in 2010, highlighted the difficulties arising from the inconsistent quartet within EMU – even if the ECB mitigated financial instability by providing liquidity and governments were, temporarily, permitted to break EU fiscal policy rules and bailed out a range of banks. The crisis was also necessary to overcome the entrenched opposition in a range of euro area Member States reluctant to transfer prudential supervision and bank resolution functions from the national to the supranational level. Prior to 2012, home country control of supervision dominated and financial support for failing banks came almost entirely from national fiscal authorities according to national priorities – proving Mervyn King's adage that banks are 'international in life but national in death'.[1] The collapse or threatened collapse of a range of cross-border European banks in the context of the two crises and threat to other banking systems reinforced the logic of moving beyond unilateral or ad hoc arrangements. The sovereign debt-bank doom loop in the euro area periphery Member States further undermined the ability of their governments to rescue or resolve failing banks (for further details, see Howarth and Quaglia, 2013).

For these reasons, euro area Member States decided (with reluctance in several cases) to explore the move to a Banking Union, thus replacing the third objective of

[1] See Turner Review (2009) p. 36.

Schoenmaker's trilemma, namely the maintenance of what he refers to as 'national financial policies'. National financial policies in the context of the euro area include regulation, which even prior to Banking Union was in part set at the EU level; supervision, which for large systemically important banks was to be undertaken by the ECB through its new Supervisory Board in the SSM; resolution, which was to be performed by the SRM; a deposit guarantee scheme to be replaced by some kind of common European scheme; and even the lender of last resort function becoming – in addition to de facto ECB support – a European fiscal backstop for struggling and failing banks. Some argued that all of these elements were necessary in order to make Banking Union work (Gros and Schoenmaker 2014). However, euro area Member State governments facing the inconsistent quartet had different preferences on the various elements of a Banking Union, depending on the concern of national policy makers for moral hazard created by BU-level financial support for banks and sovereigns and the configuration of their national banking system. Preoccupation with moral hazard depended on whether a Member State was more or less likely to be a net contributor to the proposed single resolution fund and the ability of national authorities to resolve banks headquartered in the Member State. While our inconsistent quartet allows us to predict interest in a Banking Union throughout the euro area, it also helps us to explain German reluctance which stems, we argue, from moral hazard concerns but also the specific features of the German banking system, notably its limited internationalisation.

II. Explaining German Reluctance: Moral Hazard, Legal Challenge and the Sparkassen

Germany – as the euro area Member State with the largest economy and one of the largest banking system measured in total assets, the largest current account surplus and one of the more stable economic, financial and fiscal positions – would almost inevitably make net contributions through the support and resolution mechanisms of Banking Union. Enjoying a kind of veto power – although one constrained by the threat of sovereign debt default in the euro periphery, contagion and euro area disintegration – Germany had more influence on the design of Banking Union than other euro area Member States. The German government's position thus merits further consideration and, specifically, the German concern for moral hazard, the potential of legal challenge and the pre-occupation with the impact of Banking Union on public sector savings banks (Sparkassen).

From November 2011, Finance Minister, Wolfgang Schäuble directly linked the use of European Stability Mechanism (ESM) funds to help banks to the creation of the SSM in order to limit the effects of moral hazard, demanding that strong conditions be imposed on both sovereigns (supervisors) and banks that receive ESM funds (Boone and Johnson 2011).[2] For sovereigns (supervisors), the potential availability of EU-level financial support for banks might effectively encourage them to loosen national regulation and/or supervision, allowing potentially riskier activities which in turn undermines the pursuit of Member State governments to discourage these activities given that national tax payers and/or depositors will be less expected to pick up the tab for saving banks (Micossi *et al.*, 2011). To obtain ESM funds (potentially), according to this logic, Member State governments had to accept further constraints on their autonomy in financial regulation and supervision, and banks had to accept a potentially reinforced regulatory and supervisory framework.

[2] *New York Times*, 18 November 2011 ; *European Voice*, 16 February 2012.

The agreement to allocate ESM financial support to save struggling banks also created a moral hazard for banks – already a concern at the national level in the context of widespread bail-outs in the aftermath of the international financial crisis. The standard argument runs that banks are more likely to engage in riskier activities in the knowledge that they will be bailed out in the context of crisis. German preoccupation with the moral hazard created by EU-level support was demonstrated clearly in the intergovernmental debates over the Cyprus bail-out in March 2013 and in the German insistence on the significant bail-in of uninsured depositors (Pisani-Ferry 2013).

The creation of an SRM with a single resolution fund also created moral hazard for both sovereigns and banks. The German government had already implemented its own bank restructuring and resolution mechanisms and urged other Member States to do so. German policy here contradicted the longstanding position of several other Member States, including France, the governments of which were previously hostile to national resolution mechanisms precisely on moral hazard grounds (Hardie and Howarth, 2009). With the SRM, the German government (amongst others) were principally concerned that the creation of a large EU resolution mechanism could create perverse incentives for other Member State governments to be more lenient in the regulation and supervision of banks: at the end of the day, EU funds could be drawn upon to resolve the bank[3]. The funds would come from all EU banks (or at least those of a certain size), not from governments. So the pressure on government resources (and national tax payers) would be limited – especially following the creation of a single European fund. Thus, to limit this moral hazard, the German government insisted on the precondition of direct ECB supervision for

[3] *Financial Times*, 29 April 2013.

systemically important banks, EU rules on 'bail-in' (that is, initial losses imposed on both private sector bond and shareholders – BRRD Art. 37.51-52), with EU level support only at the end of a relatively long process/and difficult voting system. But these conditions and complexity led many observers to question the credibility of the mechanism and the likelihood of EU-level support, which created additional concerns about the resolution of banks and potentially undermined investor / international confidence in the long term stability of euro area periphery financial systems.

German policy-makers were also preoccupied with the compatibility of the SRM with the German Basic Law. Here, the German concern, as with the establishment of the ESM and the proposed Common Deposit Guarantee Scheme, was that German taxpayers would be required to step in to support the SRM without constitutionally required parliamentary approval. In particular, German policy makers were concerned with the transition period when national resolution funds would exist, prior to the mutualisation of these funds into a single EU fund. In particular, the German federal government favoured a two-step approach to the creation of the SRM, starting with a network of national authorities and creating a centralized authority in the future and only once EU treaties had been changed and appropriate measures enacted to protect national taxpayers.[4]

The BRRD and the SRM were to apply all EU-headquartered banks. The directive was to enforce losses upon share- and bondholders of all EU-headquartered banks prior to a taxpayer funded bail-out or resolution. However, it was highly unlikely that SRM funds would be needed to cover the resolution of smaller banks. The ECB was unlikely to be in a position to force resolution upon smaller German

[4] *Wall Street Journal,* 10 July 2013.

banks (notably the German Cooperative Banks or the publicly owned *Sparkassen*), except in the very unlikely circumstance that the Supervisory Board of the SSM sought to extend direct control over the supervision of these institutions – a possibility created in the SSM regulation in the event that the Board deemed (by a majority of its members) necessary to ensure the consistent application of 'high' supervisory standards. Member State finance ministers could also initiate the resolution through the SRM of any EU-headquartered bank but it was highly unlikely that this would involve smaller German institutions.

German reluctance on the SRM can thus be seen as stemming from the structural reality that very few of its banks would be covered. Approximately, twenty-five German banks were to be subject to direct ECB supervision: a range of commercial banks and all the remaining public sector Landesbanken. The percentage of total bank assets covered by direct ECB supervision was the lowest of any euro area (Banking Union) Member State given that the German banking system was the least concentrated in Europe.[5] Almost one-third of the euro area's banks were German, including slightly more than 420 Sparkassen (publicly owned savings banks) and 1200 Cooperative banks (2011 figures), none of which would be covered by direct ECB supervision.

Applying the 'inconsistent quartet' to Germany, we would expect less interest in Banking Union generally and, more specifically, in the creation of the SRM –

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[5] According the Herfindahl index, Germany is consistently the least concentrated banking system in the European Union and has an index approximately one-fifth that of the euro area average (ECB 2013; ECB Statistical Warehouse). The five largest credit institutions consistently have the lowest percentage of total bank assets of any national banking system in the EU (ECB Statistical Warehouse).

despite German participation in the single currency – because the German banking system was one of the least internationalised in the euro area both in terms of foreign bank penetration and the international presence of national banks.[6] The bulk of bank assets were nationally held with the exception of the biggest two and a small number of other much smaller commercial banks.[7] Although Germany was home to one very big, highly internationalised, commercial bank – Deutsche Bank – and a second very big commercial bank with a significant European presence – Commerzbank – almost all the other banks were nationally focused, with operations in nearly all cases limited to a small area in Germany. Negligible German interest in European-level funds stemmed from the fact that Germany as a comparatively large, rich and solvent Member State was unlikely to have financial difficulty bailing-out or resolving any of its banks – including the two largest commercial banks. The bank assets to GDP ratio in Germany in 2013 was at 300 per cent of GDP, below the EU average of 349 per cent, just above the EU median and far lower than the ratios in the Netherlands (397),

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[6] Foreign bank penetration (the branches and subsidiaries of foreign headquartered banks) in Germany is at 12.2 per cent of total assets versus the euro area average of 17.8 per cent (ECB statistical warehouse, 2012 figures). The international presence of German headquartered banks reached 28 per cent of total bank assets (2007-2011 average). When the largest three banks are excluded, only 16 per cent of German bank assets were held outside the country. The assets of German banks held outside the euro area reached 14.6 and 5.5 per cent respectively. Figures for British banks were 40 and 25.6 per cent respectively. Figures for French banks were 25.2 and and 12.6 per cent respectively. These figures are based on authors' calculations, using data from national central banks.

[7] See the previous footnote.

France (423) and the UK (495).[8]

Systemic features of German bank liabilities also resulted in less pre-occupation for lender of last resort type concerns. Notably, a possible collapse in bank liquidity – for example, through a freezing of interbank wholesale markets – was of marginal concern in Germany. Only 0.6 per cent of total bank funding was short-term wholesale market funding (less than two years) (3.9 per cent of total debt funding) (Bundesbank statistics, end 2012). The comparison with French banks is revealing: 10.8 per cent of French bank funding was short-term wholesale market funding – eighteen times the German level (Bank of France Statistics, end 2012). German public sector banks relied overwhelmingly on stable long-term wholesale market funding (*Pfandbriefe*) – nearly all of which was domestically held – and government held long-term debt ('silent participations'), while the more traditional Cooperative banks relied largely on deposits to fund bank lending. The bulk of German Sparkassen enjoyed a lower cost of capital compared to their commercial rivals because they relied disproportionately on high levels of funding through 'silent participations' and were under no obligation to make pay-outs to their local municipality investors.

German government concerns over the fate of the Sparkassen determined the contours of the Banking Union agreed between December 2012 and March 2014 and dictated the reach of ECB direct supervision, which ended up covering only one of the more than 420 savings banks. The Sparkassen banks were local or regionally based public sector banks with a vested interest in the local economy and a strong presence in local community life. They provided the bulk of external finance to the Mittelstand (small and medium sized nonfinancial companies), the backbone of the German economy. In late 2012, the largest savings bank had a balance sheet of approximately

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8 *The Banker* Database, http://www.thebankerdatabase.com.

€40bn about one-fiftieth that of Deutsche Bank and more than 100 had less than a billion euros in assets.[9]

However, the Sparkassen also benefited from being part of a large closely linked network and collectively could be considered to be one of the largest financial groups in the world with more assets (€1tn) than Deutsche bank, a collective 38 per cent share of German bank lending and almost 37 per cent deposits (Bundesbank, end 2012 figures). Furthermore, the Sparkassen (and Landesbanken) benefited from the German regulatory practice that considered loans between these banks as risk-free – which meant that no capital had to be held against such exposures. The Sparkassen were not required to file combined accounts as a single financial group and accounts were first overseen by auditors from within the saving bank group, not external auditors. The Sparkassen also benefited from a joint liability scheme (*Haftungsverbund*) which was to provide both bail-out funds and emergency liquidity for member banks (Simpson 2013) – although such a scheme in place for the Landesbanken did not save German taxpayers from bail-outs and some Sparkassen did not contribute the level of aid that corresponded to their ownership stakes. Pointing to this joint liability scheme and competent management, the Sparkassen representative association, the VOB, vigorously denied the relevance of the Spanish *caja* precedent.[10] Sparkassen directors also appeared to be unanimous in their view that home regulators better understood their characteristics and way of doing business (Simpson 2013).[11] Transferring control over their supervision and resolution to the supranational level was unacceptable.

[9] *Financial Times*, 2 December 2012.

[10] *Financial Times*, 20 June 2013.

[11] *Financial Times*, 2 December 2012.

III. The Negotiations on the SRM

In July 2013, the Commission issued a draft regulation to establish the SRM (European Commission 2013a), designed to complement the SSM. The Commission envisaged the establishment of a Single Resolution Board (SRB), consisting of representatives from the European Central Bank (ECB), the European Commission and the national resolution authorities of the Member States where banks had their headquarters as well as their branches and/or subsidiaries. According to the initial proposal, the ECB, in its role in the SSM, would signal when a bank headquartered in a Banking Union Member State was in 'severe financial difficulties' and needed 'to be resolved' (European Commission 2013a). The SRB would be 'responsible for the key decisions on how a bank would be resolved', with national resolution authorities 'closely involved in this work'. The Commission would then decide whether to enter a bank into resolution. The Commission, which drafted the proposal, argued that this decision could not rest with the SRB 'for legal reasons', namely according to the Treaty, only an EU institution could take such a decision at the European level, precluding an agency (such as the European Banking Authority (EBA)) from fulfilling this role (European Commission 2014).

National resolution authorities would retain responsibility for executing the resolution actions, with the SRB having an oversight role, monitoring implementation by national authorities. If the national authorities did not comply with SRB decisions, the SRB would have the power to 'directly address executive orders to the troubled banks' (European Commission 2013a). A Single Bank Resolution Fund would be set up under the control of the SRB to provide financial support during the restructuring process (European Commission 2013b). It was envisaged that this fund would be created from contributions from the banking sector, through the pooling of the resources of national funds of participating Member States. While these funds were being built up, however, the Commission proposed that the SRB should be able to borrow from the markets (European Commission, 2013a).

The draft legislation on the SRM was criticised from both sides. For some, it did not go far enough in that it failed to propose the establishment of a true Single Resolution Authority, which would have required Treaty revision. Hence, responsibilities were split between several layers of decision-making (Deloitte 2013). The Commission was assigned the ultimate decision-making power on whether or not to initiate a resolution. The SRB was tasked with planning resolutions, whereas national authorities were in charge of executing resolutions under national law. The actions of the SRB were contingent on the decision of the ECB / SSM to signal that a bank was in difficulty. Hence, the SSM's internal decision-making structure and its interaction with national authorities would form a further layer within the SRM (Deloitte 2013). Numerous observers, the ECB and the Commission itself had argued with great regularity that during crisis, clarity and speed in decision-making were crucial for bank crisis management. Nonetheless, the Commission proposed a multi-layered SRM with many veto points.

For other critics, the draft legislation gave too much power to the Commission, which would decide whether and when to place a bank into resolution. The head of a Bavarian banking association went so far as to liken the Commission's proposals to 'enabling acts', the laws that the Nazis used to seize power.[12] The German government challenged the Commission's draft on legal grounds, arguing that the Commission had overstepped its authority and that a treaty change was required for

[12] *Financial Times*, 11 July 2013.

such a far-reaching reform.[13] German policy-makers feared that their country would be the main contributor to the resolution fund and that the Commission would take decisions that could have fiscal implications for the Member States. Should the Single Resolution fund not have enough financial resources to intervene, national governments (and ultimately taxpayers) would have to step in.

More specifically, German policy-makers demanded that resolution decisions should be taken by the European Council,[14] which operates by unanimity allowing each member state to retain its veto. German policy makers also wanted to reduce the scope of the SRM: with their own Sparkassen (savings banks) in mind, they sought to exclude smaller banks from SRM coverage.[15] In this respect, Germany favoured a compromise that would mirror the deal reached with reference to the direct supervision of banks by the ECB in the SSM which deprived the ECB of involvement in the direct supervision of all but 130 banks – although the ECB retained the power to intervene in any bank if necessary subject to a majority vote in the SSM's supervisory board.

With reference to the Resolution Fund, German Finance Minister Wolfgang Schäuble opposed a pure model for a single European bank rescue fund financed by levies on banks. This model was supported by the Commission, the ECB (as discussed below), the French government and southern euro area Member State governments. German policy-makers favoured a network of national funds in the medium term and argued that the setting up of a common fund required treaty

[13] *Financial Times*, 6 December 2013.

[14] *Financial Times*, 6 December 2013.

[15] *Financial Times*, 6 December 2013; *European Voice,* 19 September 2013.

change.[16] According to the Commission's proposal, contributions to the fund would be lower for banks funded mainly through deposits and undertaking lower risk activities. However, the German position on fund contributions was more cautious than the French and southern European position – despite the large number of small banks engaged in 'traditional' banking activities in Germany. The two largest German commercial banks, Deutsche Bank and Commerzbank, fought a rear guard battle against the proposed funding scheme which would hit them on both fronts (deposits and risk activities).[17] Germany also insisted on bringing forward rules to impose losses on senior creditors in banks to 2015. These bail-in measures, which were included in the BRRD, had been resisted by France, Italy and Spain.[18]

In the run up to the decisive Ecofin meeting in December 2013, Dutch policy makers floated the idea of splitting the SRM proposal into two parts, to be discussed in parallel negotiations. One part concerned the scope and decision-making mechanism of the SRM, the other part concerned the Single Resolution Fund.[19] With reference to the Fund, a compromise solution proposed by Dutch policy makers was a system whereby the resolution fund of the bank's home state would be used before other Member States' funds were utilised. The *Financial Times* also reported a possible compromise on the banks covered by the system, leaving national authorities in the lead in resolving smaller banks, as favoured by German policy makers.[20]

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[16] *Financial Times*, 6 December 2013.

[17] *Wall Street Journal,* 10 July 2013.

[18] *Financial Times*, 6 December 2013.

[19] *Bloomberg*, 10 December 2013.

[20] *Financial Times*, 6 December 2013.

Another contentious issue in the negotiations on the SRM was how to proceed if national resolution funds were insufficient to deal with a big bank's failure. German government officials argued that if the resolution funds were insufficient to resolve an ailing bank, the national authorities (and in the end, the taxpayers) of the home country should cover the costs. France and some Southern European countries called for the use of the ESM as a common backstop. For example, French Finance Minister Pierre Moscovici reiterated his support for a Single Resolution Fund with a 'unique backstop' to cover shortfalls while the fund was filled with levies on the banking industry.[21]

On 18 December 2013, an agreement was reached in the Council of Ministers on the draft regulation on the SRM (Council 2013). In addition, a decision was adopted by euro area Member States that committed them to negotiate an intergovernmental agreement on the functioning of the Single Resolution Fund by March 2014. The draft regulation agreed by the Council established that 'upon notification by the European Central Bank that a bank was failing or likely to fail, or on its own initiative, the SRB would adopt a resolution scheme placing a bank into resolution'. It would decide on the application of resolution tools and the use of the single resolution fund. 'Decisions by the Board would enter into force within 24 hours of their adoption, unless the Council, acting by simple majority on a proposal by the Commission, objected or called for changes' (Council 2013). This was an important change, advocated first and foremost by Germany, compared to the original Commission draft, which gave the Commission the power to decide on the resolution of a bank. It was agreed that the SRB would consist of an executive director, four full-time appointed members and the representatives of the national resolution authorities

[21] *Bloomberg*, 10 December 2013.

of all the participating countries. The Commission and ECB would only have observer status. Any decisions with significant financial implications for the fund would be taken by a two-thirds majority of the board members representing at least 50 per cent of contributions. According to the version of the regulation agreed in December 2013, a decision to close down a bank would need the approval of a large number of actors including: the European Commission; the Council of Ministers; the supervisory board of the Single Supervisory Mechanism (the ECB); as well as the executive board of the Single Resolution Mechanism, and its plenary council.

The SRM was to cover all banks in the participating Member States. However, the Germans succeeded in getting adopted their position that the Board would be responsible for the resolution only of those banks directly supervised by the ECB. National resolution authorities would be responsible for the resolution of all other banks, except if a bank required access to the Single Resolution Fund, which in the case of Germany was unlikely. National authorities would also be responsible for executing bank resolution plans under the control of the single resolution board (Council 2013). In order to guarantee Member State budgetary sovereignty, the SRM could not require governments to provide extraordinary public support to any bank under resolution (Commission 2013c).

The version of the regulation agreed by Member States in December 2013 created a Single Resolution Fund that would be financed by bank levies raised at the national level. It would initially consist of national compartments that would be gradually merged over 10 years. During this period, mutualisation between national compartments would progressively increase (Council 2013). So while during the first year the cost of resolving banks (after bail-in) would mainly come from the compartments of the Member States where the banks are located, this share would gradually decrease and the contribution from other participating countries' compartments would increase. The December version of the regulation also endorsed the bail-in rules set by the BRRD as applicable to the use of the Single Resolution Fund. The SRM would gradually merge national resolution funds into a single European one over a decade, with the target funding level of €55bn by 2026 or about one per cent of all insured deposits.[22] In the end, it was decided that during the building up of resolution funds, national governments would collectively have to provide the extra funding to resolve national ailing banks, if necessary by requesting a loan from the ESM. A fully shared backstop would be available only once national resolution funds reached their target level and were fully merged.[23] From this point on the SRM could no longer borrow from the ESM.

The German government refused to include in the regulation the most sensitive elements of the SRM package, notably specific provisions on the transfer and pooling of Member State funded compartments into a single mutualised fund. These were placed in an intergovernmental side agreement. The Germans insisted upon subsequent intergovernmental agreements among participating Member States to permit the transfer of national funds towards the Single Resolution Fund and the activation of the mutualisation of the national compartments. The Germans sought an intergovernmental agreement in order to eliminate European Parliament involvement on these matters and minimise the Commission’s role.[24] Moreover, the December compromise ensured that the SRM regulation was not to apply before the intergovernmental agreement entered into force – which was to take place following

[22] *The Guardian*, 19 December 2013.

[23] *Wall Street Journal,* 18 December 2013; *The Guardian,* 19 December 2013.

[24] *European Voice*, 12 December 2013.

ratification by participating Member States representing 80 per cent of contributions to the Single Resolution Fund.

The EU institutions battle for the SRM

The European Parliament, the European Central Bank and the Commission joined forces in challenging elements of the regulation / intergovernmental agreement compromise of the December European Council. The EP questioned the need for an intergovernmental agreement to formulate the details on the functioning of the Single Resolution Fund to be used in bank resolution (European Parliament 2014a). In a letter sent to the EU's rotating presidency of the Council, the EP argued that the 'intergovernmental agreement on Single Resolution Fund is illegal because it bypasses the established legislative processes of the Union'.[25] The Parliament did not even formally recognise the Council text of the side agreement – regarding which it had no formal role. However, the EP retained some leverage on the side agreement, because of its co-decision power on the SRM regulation.

To further complicate negotiations, the version of the regulation adopted by the EP in January 2014 was significantly different from that agreed by the Council. MEPs restated the requests that 'all banks must be treated equally, irrespective of which country they are established in, and that the system must be credible and efficient' (European Parliament 2014a). They called for a simplification of the resolution decision-making process by creating a stronger, more centralised authority, with the Supervisory Board of the SSM possessing the final say over bank resolution without political interference. They also wanted to remove Germany's safeguards so that the Single Resolution Fund would be available sooner, with access to a

[25] *Financial Times,* 16 January 2014.

centralised / common credit line. A further EP demand was to accelerate the mutualisation of the Fund so as to complete it by 2018 rather than 2026. Informal 'trialogue' negotiations between the European Parliament and the Council, assisted by the Commission, began in early 2014 with a view to reaching a first reading agreement on the proposal before EP elections in May 2014.[26]

Over a period of a fortnight in April 2013, all six of the ECB Executive Board members came out publicly in favour of a rapid move to a SRM even though this was clearly at odds with the German government's more gradualist version (see, for example, Mersch 2013).[27] In November 2013, the ECB issued a 32-page opinion signed by Mario Draghi that the SRB should be, from the start, a single 'strong and independent' body, thus directly challenging the German position that the SRM should begin as a network of national authorities.[28] The ECB argued that 'co-ordination between national resolution systems has not proved sufficient to achieve the most timely and cost-effective resolution decisions, particularly in a cross-border context'.[29] The ECB also insisted that treaty change was unnecessary to create the new body.[30]

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[26] *Febelfin*, 20 December 2013, available at http://www.febelfin.be/en/eu-flash-single-resolution-mechanism-bank-recovery-and-resolution-brrd-deposit-guarantee-scheme-bank

[27] *Financial Times*, 29 April 2013.

[28] *Financial Times*, 8 November 2013.

[29] *Financial Times*, 8 November 2013.

[30] Bloomberg, 17 December 2013, available at http://www.bloomberg.com/news/2013-12-16/draghi-says-european-bank-resolution-plan-may-be-too-cumbersome.html.

Following the December European Council compromise, Vitor Constâncio, a member of the ECB's executive board, expressed the ECB's fear that the markets would find the proposed resolution process insufficiently credible because it was too complex and involved too many policy makers to work with the necessary speed in crisis situations (ECB 2012). Constâncio also warned that to be credible, the national bank-resolution funds needed to have access to outside financing, especially in the period when national resolution funds were being built up.[31] He criticised the December agreement because it did not allow the resolution funds to borrow on the financial markets to raise extra funding: 'We are talking here not about a final backstop, we are talking here about a credit line, which is a system that exists for instance in the US…. You should flesh out the possibility of the fund borrowing in the markets to have bridge financing to complete the resolution process'.[32]

Michel Barnier, the EU Commissioner responsible for financial services, remained concerned about the ability of the SRM to take difficult decisions to close a bank quickly or secretly enough. He argued that 'decision-making within the SRM [was] still too complex with a consultation system which [slowed] down the process unnecessarily. What we are building is a single system and not a multi-storey intergovernmental network'.[33] Concerns similar to those expressed by the ECB and the Commission were also aired by policy makers outside the EU. Jack Lew, the US Treasury secretary stated: 'We don't think it's big enough. We don't think it's fast enough'.[34]

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[31] *Wall Street Journal*, 18 December 2013; *The Guardian,* 19 December 2013.

[32] *The Telegraph,* 18 December 2013.

[33] *The Telegraph,* 18 December 2013.

[34] *Financial Times,* 16 January 2014.

Conclusion

In 2013, most of the policy discussions on Banking Union focused on the issue of bank resolution, with the agreements on the BRRD in June and December and the publication of the Commission's draft SRM proposal in the summer of 2013. Two different amended versions of the regulation were adopted by the Council and the EP in December 2013 and January 2014 respectively. Afterwards, the main difficulty consisted of reconciling the two texts, with a view to adopting the new rules before the EP elections in May 2014. The text approved by the Council also envisaged an intergovernmental agreement to be reached by March 2014. The EP strongly opposed this side agreement, arguing that all the new rules concerning the SRM should be part of ordinary EU law and co-decided by the Council and Parliament.

The EP unsuccessfully attempted to bring the elements of the December intergovernmental side agreement into the regulation, winning only limited concessions in the 20 March 2014 compromise with the Council: a decreased period of eight years during which the national compartments would merge; an increased proportion of the Fund shared at an earlier stage; and a marginally increased role performed by the Commission in the Single Resolution Board – allowing the Council to reject resolution proposals only under certain conditions.[35] Although the Commission was to have a limited role in the SRM, Member State governments retained their vetoes on mutualisation and an important say on the use of resolution funds. A messy compromise was reached on triggering the resolution process. It was agreed that the ECB (the SSM's supervisory board) would hold the trigger, being responsible for deciding whether or not a bank should be resolved. The Single

[35] *Financial Times*, 20 March 2014.

Resolution Board would ask the ECB take such a decision and if the ECB declined to do so, then the Board itself would take the decision. The ECB was therefore to be the main 'triggering' authority but the Board might also play a role if the ECB was reluctant or hesitated to act (European Parliament 2014b).

The main issues in the negotiations on the SRM concerned the centralisation of decision-making power, the scope of the SRM, the sources of funding and the legal basis of the new mechanism. German opposition to the Commission's draft directive on the SRM stemmed from concerns over moral hazard both for banks and for sovereigns, legal difficulties and the structure of the Germany banking system. More crudely put, the German government disliked both having to pay for the closure of foreign banks and empowering foreigners to close German banks. The Commission proposal envisaged that decision-making power would be assigned to the Commission itself. Some Member States, first and foremost Germany, argued that decision-making power should rest with national resolution authorities individually and then collectively in the EU Council of Ministers. The Commission pushed for SRM coverage of all EU banks, whereas the Germans insisted upon coverage of only the largest systemically important cross-border banks. As for funding the new mechanism, the Commission proposed the creation of a Common Resolution Fund, funded by industry, but some Member States, particularly Germany, opposed this idea. The fourth issue concerned the legal basis of the SRM, in particular whether it required treaty revision, as requested by German policy-makers, or not, as argued by the Commission, the ECB, France, Italy and Spain, which were keen to speed up the establishment of the SRM.

By March 2014, Banking Union Member States had agreed a complicated set of bank resolution procedures. In the space of less than two years, all the main elements of Banking Union – except the Common Deposit Guarantee System – had been agreed. Yet most observers were highly sceptical of the institutional design of the nascent Banking Union – and in particular the Single Resolution Mechanism – and its potential contribution to banking and financial system stability (see, for example, Münchau 2014). For the euro area periphery, the delayed and complex SRM agreed failed to provide the clear backstop that they sought to prevent doubts about the solvency of national governments from undermining confidence in their domestic banks. In other words, it remained unlikely that the institutions and procedures agreed would significantly undermine the sovereign debt-bank doom loop. The process of 'squaring' the inconsistent quartet was and would continue to be highly contentious and complicated. Future institutional and procedural modifications were almost inevitable and the road to an effective Banking Union remained a steep ascent.

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