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The ESM's Direct Recapitalisation of Banks

Looking Forward in Backstop-Questions

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This paper comes to a balanced judgement:

- We first clear the conditions for the use of the new ESM-instrument before analysing its potential in the short-term (coping with the ECBs stress test results in late 2014).
- We then look into the question how the instrument fits in the banking union's setup (starting 2016).
- We propose to further develop the ESM as a backstop for major recapitalisations in the banking union and set out the necessary conditions for any such assistance. Designed correctly, this can improve the allocation of risks, incentives and burdens between tax payers, Member States and banks.

Content

1. The original aim(s) as times change

At the end of a memorable European Council, on 29 June 2012, commentators saw it as a victory of Italy's Mario Monti and Spain's Mariano Rajoy over Germany's Angela Merkel. In the future, the ESM was to directly recapitalise the Eurozone's ailing Banks, hence adding a sixth instrument to the ESM Toolkit[2]. Taking the loop by transferring ESM-money only to Member States – which increases their public debt – would soon be superfluous. Driven into a corner, Merkel made the direct ESM-assistance conditional upon the establishment of a common bank supervision under the roof of the European Central Bank (ECB).

At that time, many (including the author) criticised the direct recapitalisation instrument as a way to solve legacy problems in southern Europe's bank balance sheets at the cost of northern European taxpayers. Others praised the instrument as well suited to finally separate banking crises from sovereign debt crises.

Since then, a lot has changed. The ECB has issued its OMT-promise and the EU laws on bank resolution (BRRD and SRM have been adopted, setting the stage for the Banking Union to come fully into force by 2016. Almost at the same time and after some Member States (especially Germany) having delayed negotiations on the direct ESM-recapitalisation instrument for over two years, on 10 June 2014, the Eurogroup finally announced a political understanding[3] on the instrument. Some criticise the result as *too little, too late.*[4] Others prophesy enormous costs to tax-payers.[5]

Pending procedures at national parliaments[6], direct bank recapitalisation by the ESM is expected to be possible by November 2014 – just in time to fill some of the gaps the ECBs Assess Quality Review and Stress Test may reveal.

2. ESM-Guidelines: Five Conditions for Direct ESM-Assistance

Seemingly unknown to many, the conditions and procedural modalities for the use of any of the ESM-instruments are set out in the guidelines for the specific instruments.[7,8] These guidelines are more important than they may sound: they find mentioning in the ESM-Treaty and are adopted unanimously by ESM-Governors.[9] Any single decision by the ESM to grant assistance – which as well requires a unanimous decision by the Governors[10] – foots on the relevant guideline.

[2] Existing ESM-instruments include (1) Loans to Member States, (2) Primary Market Support Facility, (3) Secondary Market Support Facility, (4) Precautionary Financial Assistance, (5) Recapitalisation of Financial Institutions (indirectly via Member States).

[3] http://www.eurozone.europa.eu/media/533095/20140610-eurogroup-president-direct-recapitalisation.pdf

[4] See Bruegel's Silvia Merler, Comfortably numb: ESM direct recapitalization - too late to solve the current crisis, too little to deter future crises, June 24th 2014, Available at: http://www.bruegel.org/nc/blog/detail/article/1369-comfortably-numb-esm-direct-recapitalization

[5] See Hans-Werner Sinn, Der Steuerzahler haftet, F.A.Z., July 10th. Available at: http://www.faz.net/aktuell/wirtschaft/eurokrise/standpunkt-der-deutsche-steuerzahler-haftet-13036713.html

[6] As an example, the German Bundestag will have to pass two federal laws enabling the German Finance Minister as representative in the ESM to vote in favor of introducing the new ESM-instrument.

[7] See http://www.esm.europa.eu/about/legal-documents/index.htm for the five guidelines on the ESM's five existing instruments.

[8] Many commentators seem unaware of this, see Franz-Christoph Zeitler, *Bundestag und Bundesrat sind beim Thema Bankenrekapitalisierung gefordert*, Börsenzeitung, 17.07.2014, criticising the alleged lack of any conditionality for the new ESM-instrument, because the ESM-Treaty does not entail such conditionality.

[9] In this sense, the ESM's direct bank recapitalisation is an exception. Hitherto, the guidelines for all ESM-instruments find explicit mentioning in the ESM Treaty. For the new instrument, this is not the case. Neither the new instrument nor the corresponding guidelines will be mentioned in the ESM Treaty, as this treaty will not be formally changed. Rather, the introduction of the new instrument – and the corresponding guidelines – will be footed upon a unanimous decision by the board of ESM Governors according to Art. 19 ESM-Treaty.

[10] And moreover, requires approval of the German Bundestag.

Although there is political agreement on them, the ESM-Guidelines on the direct recapitalisation of banks cannot be adopted and published before all national parliamentary procedures on the establishment of the instrument are completed.

The following assessment is based on a public document by the Dutch government, informing its Parliament on the precise wording of the guidelines.[11]

According to the guidelines, the ESM may directly assist a bank up to a level to reach the "necessary" capital level set by the ECB, when the following five conditions are fulfilled.

First: The guidelines narrow the scope of banks to which the new instrument may apply. They allow assistance only to banks of systemic relevance or to other banks whose failing seriously threatens the financial stability of the affected Member State or of the Eurozone as a whole. Assistance is limited to banks unable to fulfil the capital requirements set by the ECB.

Second: Member States – not banks – can request ESM direct assistance only if a recapitalisation of the bank by other means (especially – but not only – the hitherto existing ESM recapitalisation instrument via loans to the Member State) would affect in a "very adverse" way the state's own fiscal sustainability or would "endanger continuous market access" of the state.

Third: Given that both the bank and the Member State qualify for direct ESM-support (meaning the first two conditions are fulfilled), the following bail-in must take place before the ESM can assist.

Until 31/12/2015: Contribution of own funds and eligible liabilities of 8 % of total liabilities followed by the use of the national bank resolution fund's means (or the use of any financing arrangements set up according to BRRD) up to the 2015 target level.

Starting 1/1/2016: A bail-in of *at least* 8% of total liabilities, followed by using the resolution fund's (be it national or Eurozone) means for 5% of the bank's liability, followed by writing down/convertion of all unsecured, non-preferred liabilities (excluding eligible deposits).

Fourth: The requesting Member State has to contribute to the ESM-Assistance. It must inject capital as to assure that the bank reaches 4,5 % Tier 1 capital. In any case, the Member State must contribute 20 % of the ESM's contribution (starting end of 2016: 10 %). Exceptions are possible, given unanimity in the ESM's Governors' Board and on the condition of an ESM-Program with macroeconomic elements.

Fifth: ESM, ECB and EU-Commission must agree on a restructuring plan for the Bank. The Commission needs to approve of the plan (given State Aid rules). The Member State requesting assistance must agree on a Memorandum of Understanding (MoU) requiring it to take measures regarding its domestic financial sector and "where appropriate" general economic policy.

3. Short Term: (No) Role

We see a very small possibility only for the new ESM instrument to be used in the short term (up to end 2015). In particular, it is very unlikely that legacy problems or recapitalisation needs occurring upon the publication of the ECBs stress test in October 2014 are dealt with in applying direct ESM-bank-recapitalisation. The main reasons for this assessment are twofold.

First, the guidelines clearly prioritise the existing ESM-instrument for recapitalisation (via loans to the Member State). We find it hard to see a Eurozone Member State credibly claiming that such (or other) ESM-Assistance would very adversely affect its fiscal sustainability or endanger market access. This goes all the more as the ECB (and the EU-Commission) are responsible for this

[11] http://www.rijksoverheid.nl/documenten-en-publicaties/richtlijnen/2014/06/13/ontwerp-esm-richtsnoer-directe-herkapitalisatie.html last checked at July 14th 2014

assessment. Ever since the outbreak of the crisis, the ECB's policy has aimed at gaining time at the advantage of Member States, ensuring there continuing market access at very moderate prices (e.g. OMT). The ECB negatively judging on an ESM-Programme via loans to a Member State is not impossible, but it would equal a dramatic turning away from its existing philosophy.[12]

Secondly, performing an 8%-bail-in in order to receive direct ESM-recapitalisation assistance might be legally challenging in some countries. The European framework for this bail-in (BRRD and SRM) by default takes effect from January 1st 2016 only.[13]

4. As of 2016: Is This the Banking Union's Fiscal Backstop?

Starting 2016, any ESM direct recapitalisation cannot be seen isolated from the then active European regime on banking recovery and resolution, set out by the BRRD and SRM. Complemented by the ESM-Treaty, this regime equals an increasingly complex construct in which different backstops may be of relevance. Below, we identify the most likely backstop mechanisms, of which direct bank recapitalisation by the ESM is likely to be only one (see also the overview at the end of this document).

4.1 Direct bank recapitalisation by the ESM: A relevant backstop for major recapitalisations (only)

The SRM-Regulation explicitly states the possibility for the European resolution fund to seek "alternative funding means" be it from "financial institutions", "institutions" or "other third parties".[14] Also, "public financial arrangements" providing financial means to the fund are a possibility.[15] Admittedly, it remains unclear today which of these bodies (if any) would be willing to provide such financial means to the resolution fund in extraordinary circumstances. We here consider two likely sponsors to the resolution fund: the ESM and (one or more) Member States. Both may act as a sponsor in different ways, as the overview below demonstrates.

[12] Assessing the likelihood of such decision to be very small, the author would actually welcome such decision. It would dismiss the ECB from its role as being a fiscal backstop for the Euro-states and pass on that role to the Member States. In a imperfect world, this is an improvement.

[13] Member states of course can transpose the BRRD-Directive in a manner enabling bail-in at an earlier stage. The German government's proposal for transposition of the directive into German law foresees a bail-in starting 2015.

[14] Art. 73 SRM-Regulation

[15] Art. 74 SRM-Regulation

Most likely backstops within the banking union framework

Note: The options in **bold** are already in force or are forthcoming.

1. Recapitalisation financed by an ESM-loan to a Member State (Art. 15 ESM-Treaty)

2. Bridge Bank or Bad Banks financed by a guarantee, credit or similar to the Resolution Fund(s) (Art. 73, 74 SRM-Regulation) by

 2.1 the ESM or by

 2.2 Member State(s)

3. Recapitalisation of max. 5 % financed by a guarantee, credit or similar to the Resolution Fund(s) (Art. 27 para. 8 in conjunction with Art. 73, 74 SRM-Regulation) by

 3.1 the ESM or by

 3.2 Member State(s)

4. Recapitalisation over and above 5 % financed by a guarantee, credit or similar by Member State(s) to the Resolution Fund(s) (Art. 27 para. 9 in conjunction with Art. 73, 74 SRM-Regulation)

5. Recapitalisation over and above 5 % financed by a guarantee, credit or similar by

 5.1 the ESM to the Resolution Fund(s) (Art. 27 para. 9 in conjunction with Art. 73, 74 SRM-Regulation)

 5.2 direct ESM-recapitalisation of the bank (new ESM-instrument to be adopted, Art. 19 ESM-Treaty).

The ESM-guidelines and this overview of possibilities suggests that from 2016 on, the direct ESM-bank recapitalisation is likely to become an instrument for major recapitalisations only and may add to a number of other elements of assistance. If at all, ESM direct assistance will hence become relevant only after those other elements of assistance have taken effect.

Putting direct ESM-recapitalisation at the end of any lines of defense is sensible. The same goes for it being relevant for major recapitalisations only and having seen extensive bail-in and write-downs. The national contribution of 10 % is a necessary and acceptable means of ensuring an adequate national back-stop (given it being a precondition that ESM-loans to the Member State are not feasible).

4.2 Further Developing the ESM as a Backstop for the Resolution Fund

The banking union's resolution fund is to collect 55 billion € by 2026. Criticism as to the limited size of the fund is extensive and often goes hand in hand with the "logical" deduction by some that the ESM will be forced to serve as a backstop for the resolution fund.

Obviously, whether or not the resolution fund will need "extraordinary financial assistance" to cover any resolution or recapitalisation costs by/in the run up to 2026, will heavily depend both upon the size of any future bail-in as well as upon the size of any assistance by affected Member States (be it to banks or to the resolution fund). Both variables are subject to moral hazardous behaviour but as of today, they remain unknown, making it impossible to reasonably deliver a judgement on the adequacy of the fund's financial capability.

Nevertheless, we argue that there are good arguments for allowing the ESM *(given some conditions, see below)* to offer assistance to the resolution fund for bank recapitalisations (our overview shows such a role in mechanisms 2.1; 3.1 and 5.1.) Any ESM-assistance to the resolution fund is possible only given a change of the ESM-Treaty or – more likely – given the introduction of a new ESM-instrument.[16] Following Article 19 ESM-Treaty, ESM-Governors could allow for the ESM financing the resolution mechanism. Such decision requires unanimity and the consent of some national parliaments (as is the case in Germany).

If done so, the ESM might be involved in the financing of recapitalisations in one the following three mechanisms:

(1) ESM-financial assistance to the resolution fund, which in turn recapitalises the bank (here: 5.1) or

(2) direct recapitalisation of the bank (here: 5.2) or

(3) ESM-financial assistance to a Member State by an ESM-loan to recapitalise the bank (here: 1)

ESM-financial assistance to the resolution fund for recapitalisation purpose should be possible only given the following conditions being fulfilled simultaneously:

The Discussion on German Tax Payers' Risks

Undoubtedly, direct ESM-assistance causes risks for (German) taxpayers. The accusation that these risks are taken without democratic control and are unlimited in their height is dishonest.

The introduction of the new ESM direct assistance instruments according to Art. 19 ESM-Treaty requires the consent of the German Bundestag in plenary. On July 9th, the German government has made legislative proposals aiming at this. A vote is expected to take place in autumn. Moreover, any single use of this ESM-instrument requires consent by the Bundestag. The guidelines on the new instrument (and any change thereof) need approval of the Bundestag Budget Committee.

Following a political agreement by the Eurogroup, the ESM will limit the total of any direct assistance to 60 billion €. Besides risk-minimisation, this move is to ensure the ESM's AAA-Rating. The ESM board of governors is to adopt a formal decision setting this ceiling. Any future change of this ceiling will only be possible given the consent of the German Bundestag.[1] Given a German capital key to the ESM of 27 %, this comes down to a maximum default risk to the German budget of 16,2 billion €.

[1] See new §4 para. 1 Sentence 2 Nr. 4 of the proposed changed ESM-Finanzierungsgesetz; July 9th 2014, available at: http://www.bundesfinanzministerium.de/Content/DE/Downloads/Abt_7/2014-07-09-Bankenunion-ESM.pdf?__blob=publicationFile&v=2

- it applies only to major recapitalisations above 5 % of the bank's liabilities (which means that an 8% bail-in and a full writing down of eligible liabilities has taken place) and
- the affected Member State(s) has/have already participated in the financial burdens (e.g. by financing the recapitalisation share below 5% or by an input to bridge banks).

Given these conditions, the advantage of the ESM serving as a backstop for the resolution fund are:

1. **It diminishes risks to tax-payers** (as compared to a direct ESM-recapitalisation, mechanism 5.2). Given that the fund is backed by a large number of banks, the ESM (i.e. the tax payer) faces less risk when assisting the fund instead of directly financing the ailing bank.

2. **It does not increase public debt** (as compared to an ESM-loan to a Member State, mechanism 1), which might be a relevant issue given major recapitalisations.

3. It **copes with moral hazard problems** (in a similar way a direct ESM-recapitalisation but better than ESM-loans to a Member State). It is important that the ESM should not be the first recourse in case the resolution fund encounters any financial problems. In our opinion, an ESM backstop for the resolution fund might make sense for major recapitalisations (above 5 %) – but only after affected Member States have taken on the role as backstop themselves. This is justified given that – despite the single banking supervision by the ECB – Member States still dispose of many possibilities (and hence responsibilities) to foster or discipline their national banking sector.

[16] Currently, the ESM-Treaty allows only for loans being awarded to ESM-Members. The discussed new direct recapitalisation instrument would change this and would allow direct capital injections at the benefit of private banks. A similar change is necessary in order to allow the ESM to assist the resolution fund.

Affected Member States should hence be expected to support the resolution fund if it needs assistance, up to the 5% recapitalisation margin. For the same reason, ESM-loans to Member States for recapitalising up to the 5 % margin should be seen very sceptical.

4. It may be **necessary to close a financing gap**. ESM-loans to Member States may overburden those Member States. Direct ESM-recapitalisation is limited to 60 billion € and national back-stops have their limitations as well.

However, the ESM serving as a backstop to the resolution fund is not a panacea. How the advantages and disadvantage compare depends on the alternatives available and will remain a case-by-case decision. We distinguish two scenarios.

Scenario 1: The conditions for direct recapitalisation by ESM are not fulfilled. The remaining options are: ESM-loans to the Member State for recapitalisation or ESM-assistance to the fund. ESM-assistance to the fund will better activate national backstops and will increase national responsibility (coping better with moral hazard), but goes at the cost of a higher default risk for the ESM (and hence for the tax-payer). As a solution for the latter problem, the volume made available for this instrument might be confined.[17]

Scenario 2: ESM-loans to the Member State for recapitalisation overburden the Member State. The remaining options are: direct recapitalisation by ESM or ESM-assistance to the fund. ESM-assistance to the fund means less default risk for the ESM (and hence for the tax-payer) but may overburden the EU's banking sector, as all banks would be at risk of having to post-finance an ESM-credit to the fund.

In the future, the ESM should be allowed to financially assist the resolution fund – and not just banks directly. This is not a panacea, but – depending on the situation – the additional option offers the ESM more possibilities to accurately allocate risks, incentives and burdens between tax payers, Member States and banks. In any case, ESM-assistance to the resolution fund should be possible for major recapitalisations only and only following national backstops having been activated. An upper ceiling for this instrument may be installed.

[17] Similar to the limit of 60 billion Euro for direct recapitalisation this would prevent a rating downgrade.

5. Summing Up: Recapitalisation Backstops' Conditionality Should Not Distort Competition

Having added the possibility for the ESM to assist the resolution, the picture results in a four-instrument-backstop for major recapitalisations.

1. Recapitalisation by an ESM-Loan to a Member State (Mechanism 1)
2. ESM-Assistance to the resolution fund (Mechanism 5.1)
3. Direct ESM-Assistance (Mechanism 5.2)
4. Member state's assistance to the resolution fund (Mechanism 4)

It is important that the conditions associated with these different options do not distort competition. This requires some changes, especially given the instruments of ESM-loans to Member States.

At the moment, banks from Member States with sound financing can assume mechanism 1 to be the most relevant mechanism for them in case of any major recapitalisation needs. Any ESM-credit would increase national debt, but not so to a level beyond sustainability. Banks in weaker Member States would reasonably expect direct ESM-assistance or ESM-assistance to the fund. However, for ESM-loans, bail-in and write-down conditions are weaker than for both other instruments. This would unduly privilege banks form solid Member State through a cheaper refinancing.

Note that these changes are easily reachable. In its role as state-aid watchdog, the EU-Commission can put them into practice.

The following shows an overview of existing conditions as well as *necessary adjustments*.

ESM-Loan to Member State **(Mechanism 1)**	**ESM-Assistance to the resolution fund** **(Mechanism 5.1)**	**Direct ESM-Assistance** **(Mechanism 5.2)**	**Member state's assistance to major recapitalisation by resolution fund (Mechanism 4)**
Only for recapitalisations endangering fiscal sustainability	Only for major recapitalisations (> 5 %)	Only for major recapitalisations (> 5 %)	Only for major recapitalisations (> 5 %)
8 % Bail-in (clarification as to the volume is necessary)	8 % Bail-in	8 % Bail-in	8 % Bail-in
Full write down of unsecured liabilities (for major recapitalisations only)	Full write down of unsecured liabilities	Full write down of unsecured liabilities	Full write down of unsecured liabilities
	National contribution must have taken place (by mechanisms 2.2 and 3.2)	National contribution of 10 %	
☒	☒	☑	☑

6. Conclusion

Given the conditions in the ESM-Guidelines, it is very unlikely that direct ESM-assistance to banks will be used to deal with legacy problems in the EU-banking sector. We do not except any recapitalisation needs occurring upon the publication of the ECBs stress test in October 2014 to be dealt with direct ESM-recapitalisation.

Upon full activation of the banking union (2016 onwards), direct ESM-assistance will serve as backstop for major recapitalisations only and makes extensive bail-ins and write-downs necessary. Its design is convincing. The national contribution of 10 % is a necessary and acceptable means of ensuring an adequate national back-stop (given it being a precondition that ESM-loans to the Member State are not feasible). Every single activation of the instrument as well as any extension of its scope of 60 bio. € require the approval of the German Bundestag. Risk to German taxpayers is not insignificant, but it is limited.

We favour introducing a new ESM-instrument, allowing it to offer financial assistance to the resolution fund and not only to banks directly. This instrument should be relevant for major recapitalisations (above 5 % of the bank's liabilities) only and given that a national backstop has been activated. This new instrument is not a panacea. However, depending on the scenario, this additional option offers the ESM more possibilities to accurately allocate risks, incentives and burdens between tax payers, Member States and banks.

In order to avoid distortions to competition, we propose changes to the conditionality of the instrument of ESM-loans to Member States for recapitalisation of banks. The changes entail a consistent bail-in and write-down by the EU-Commission in its role as state-aid watchdog.

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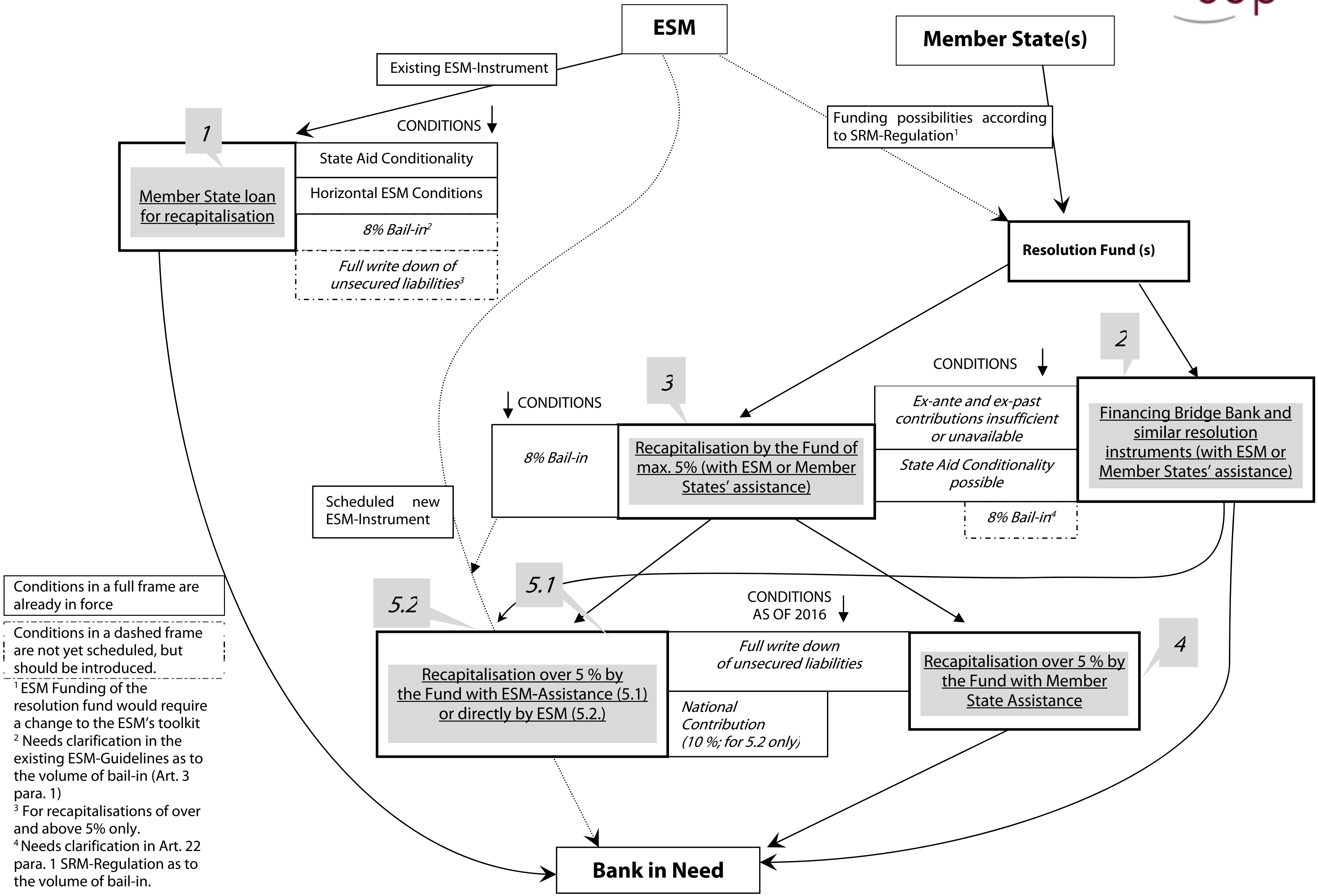
SCENARIOS FOR THE BANKING UNION'S BACKSTOPS



Conditions in a full frame are already in force

Conditions in a dashed frame are not yet scheduled, but should be introduced.

[1] ESM Funding of the resolution fund would require a change to the ESM's toolkit
[2] Needs clarification in the existing ESM-Guidelines as to the volume of bail-in (Art. 3 para. 1)
[3] For recapitalisations of over and above 5% only.
[4] Needs clarification in Art. 22 para. 1 SRM-Regulation as to the volume of bail-in.