The Bankıng Resolutıon Funds In The European Unıon

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Abstract

The new directive of the European Parliament and the European Council issued in 2014 define unified expectations regarding banking resolution mechanism to be applied in territory of each EU member state. The non-euro zone member states must create national resolution funds while the euro zone member states have to upload the so called Single Resolution Fund. These funds are implemented in order to finance the banking resolution processes. This article introduces the main rules of the unified resolution system as well as deals with its financial background. The European Commission declared in its statement that the target level of the Single Resolution Fund is 55 billion euros. However, this paper provides evidence that this target level is underestimated.

Keywords: Banking Union, resolution, resolution fund

Introduction

In order to stabile the European economic and financial processes, Herman Van Rompuy supposed implementation of an integrated financial system in 2012 which is nowadays called simply as Banking Union (Rompuy, H, 2012). As a realization of the recommendation, the European Parliament and Council approved the proposals of the European Commission concerning European Single Supervisory Mechanism in 2013 and in frame of directives the rules of banking deposit schemes as well as the rules of recovery and resolution of credit institutions were approved in 2014 (European Parliament and the European Council, 2013, 2014a, 2014b). Even more, the Parliament and the Council also issued a regulation that defines uniform rules and uniform procedure for the resolution of credit institutions and certain investment firms in the euro zone (European Parliament and the European Council, 2014c).

The necessity of implementation of the single resolution mechanism ensuring crisis management on Union level appears also in research papers.

Schoenmaker proves that maintaining the financial stability, strengthening the financial integration and enforcing national financial policies are incompatible. Any two of the three could be combined but they make the third impossible. It is the so called financial trilemma which is observable in the practice: the risk of cross-border banking and investment service cannot be managed by national policies either the financial stability or the financial integration hurts (Schoenmaker, 2011). Vítor Constâncio the vice president of the European Central Bank highlighted in his presentation in February 2013 the following: "The recent financial crisis demonstrated how quickly and powerfully problems in the financial sector of one country can spread to another. This is especially the case in a monetary union. As a result, problems in the banking sector might originate at the national level, but are more and more likely to affect other countries of the euro area as well, and may quickly threaten the stability of the entire euro area banking system" (Constâncio, V., 2013). In Claessens, S., Herring R. J., Schoenmaker,D., Summe, K. A. opinion, the national authorities make decision by taking the local interest into account during crisis and they do not deal with the cross-border activity of the institution in trouble. This attitude refers also to one of the ingredients of the financial trilemma (Claessens, S., Herring R. J., Schoenmaker,D., Summe, K. A., 2010). Gros and Schoenmaker recommend implementing a European deposit insurance and resolution authority (Gros and Schoenmaker, 2014). As it will be highlighted afterwards, this proposal is partly realized.

Rules of the resolution mechanism

The directive as well as the regulation of the European Parliament and Council brought significant changings in the process of resolution of the credit institutions being in critical financial situation. The directive is to be used in territory of each EU member state but the regulation must be applied only in the euro zone countries.

Earlier if a government intended to bail-out a financial institution jeopardizing the financial stability of the sovereign, the financial background of the rescue was provided by the tax payers. According to the new rules, applying the bail-in method the owners and the creditors (except for the owners of the covered deposits) become the payers of the resolution. Even more, other tools are also available for the resolution authority.

During the resolution process the sale of the business, usage of bridge institution, asset separation and the bail-in tools are available for the resolution authorities. These tools can be combined or applied separately.

When using the sale of business tool, the resolution authority has right to sell the shares, assets, rights and liabilities of the institution under resolution procedure. The purchaser must be dealt as successor.

The resolution authority entitled to transfer the assets, rights, liabilities of the credit institution under resolution process to a bridge institution without consent of the shareholders. The bridge institution is controlled by the resolution authority. Using this tool, the main goal is to maintain the critical functions of the bank and to sell the institution. When taking and handing over the institution, total amount of the assets has to be higher than the total amount of the liabilities. It can be reached by reducing such liabilities of the credit institution that are not covered. Doing so, the viability of the bridge institution is ensured.

The third tool that could be applied by resolution authority is the asset separation tool where the authority has right to hand over the assets, rights and liabilities of the credit institution under resolution procedure or to hand over the bridge institution to an asset management vehicle. While keeping the critical function of the credit institution is the main goal of the bridge institution, the price maximising is the goal of usage the asset separation tool.

By virtue of the new directive, the owners and the creditors are the primer payers of the resolution cost of the credit institutions. This rule is realized by deleting or dilution of the shares or uncovered liabilities.

In order to have enough own fund and liability (eligible liability), the credit institution should meet the minimum criteria as follows:

$$IM < \frac{own\ fund + eligible\ liabilities}{own\ fund + liabilities} \qquad (1)$$

where IM is the institute-specific minimal requirement. The IM has no predefined value. It is determined by the resolution authority and depends on numerous factors. When applying write down or conversion of capital instruments and liabilities the following sequence must be kept by the resolution authority:

common equity Tier 1 items,
additional Tier 1 items,
Tier 2 instruments,
subordinated debts,
rest of eligible liabilities.

Suppose the resolution authority decides writing down 1135 units. The remaining values of the liabilities are the followings:

Table 1 The sequence of the write down of liabilities (fictive data)

Liability	The value of the liability before using the bail-in tool (unit)	Write down (unit)	Compound write down (unit)	The value of the liability after using the bail-in tool (unit)
Common equity Tier 1 items	465	465	465	0
Additional Tier 1 items	204	204	669	0
Tier 2 instruments	239	239	908	0
Subordinated debts	351	227	1135	124
Rest of eligible liabilities	6201	0	1135	6201

Source: Fictive data

An instrument could be reduced if the liabilities being on higher rank in the abovementioned hierarchy have already been reduced to zero. Therefore, the cost of the resolution is primarily paid by the owners and such creditors who have receivables related to eligible liabilities of the bank under resolution procedure.

The target level of the funds is 1 % of the covered deposits that must be reached by the member states by the end of 2024. Member states have to ensure that the institutions pay contribution in order to fulfil the target level. The contribution is proportional. It means that the contribution of an institution has to be paid based on the amount of the uncovered liabilities in the bank compared with the uncovered liability portfolio in the member state in question. The highest level of uncovered liabilities the highest level of contribution.

Resolution funds must be created by non-euro zone member states separately and the Single Resolution Fund must be implemented by the euro zone member states.

The European Commission declared in its statement the target level of the Single Resolution Fund which is 55 billion euro (European Commission, 2014). However, this paper proves that this level is underestimated. The calculation is partly based on the survey made by the European Commission in 2013. Data disclosed by the Commission were provided by bank deposit guarantee schemes of the member states. Since the survey made by the Commission is related to the covered deposits and contribution to the resolution fund depends on their level (1 %) the wealth of the funds (in case of euro zone member states – Single Resolution Fund and in case of non-euro zone member states – national resolution funds) can be forecasted.

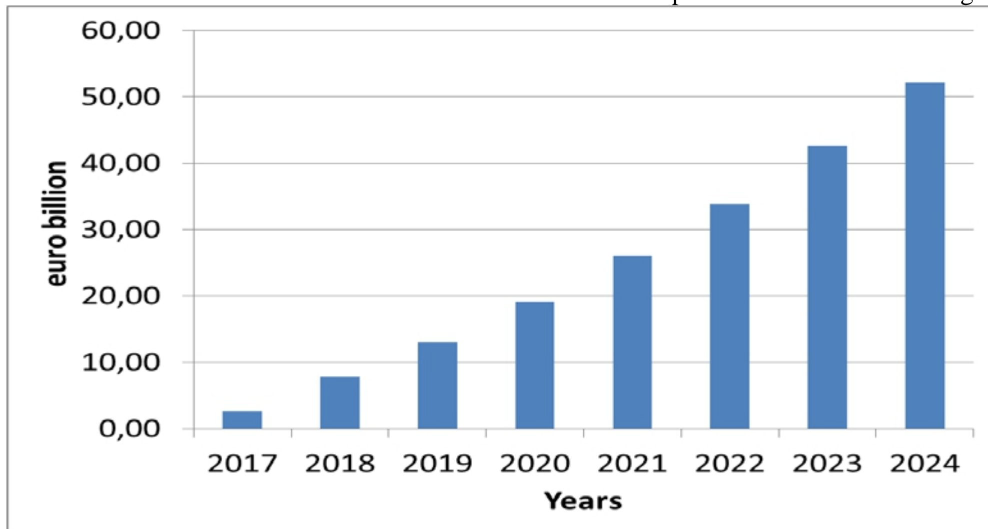
The uploading process of the Single Resolution Fund is not determined in the regulation but it is defined in an intergovernmental agreement. According to this, in the first year 40 % of the available financial

assets paid by the banks for resolution are to be transferred to the mutual resolution fund by the counterparties. In other words, 40 % of the contribution paid by the banks operating in the territory of a euro zone member state could be used for mutual resolution of an institution operating in other country of the euro zone. In the second year additional 20 % of the available sources must be transferred and after that this portion will be increased by 6 2/3 %. As a result of it 8 years is needed to upload the Single Resolution Fund.

Taking the result of the abovementioned survey into consideration, according to which the amount of the covered deposit portfolio was 5 212 705 euro million in the euro zone at the end of 2012 and supposing that this amount is unchanged as well as supposing that the Single Resolution Fund will be uploaded by equal amounts, the following levels of the Fund will be available for mutual resolution in the euro zone in the transitional period.

Chart 1

Forecasted amount of mutual fund available for resolution of euro zone institution if the value of the covered deposits is unchanged



Source: European Commission, own calculation

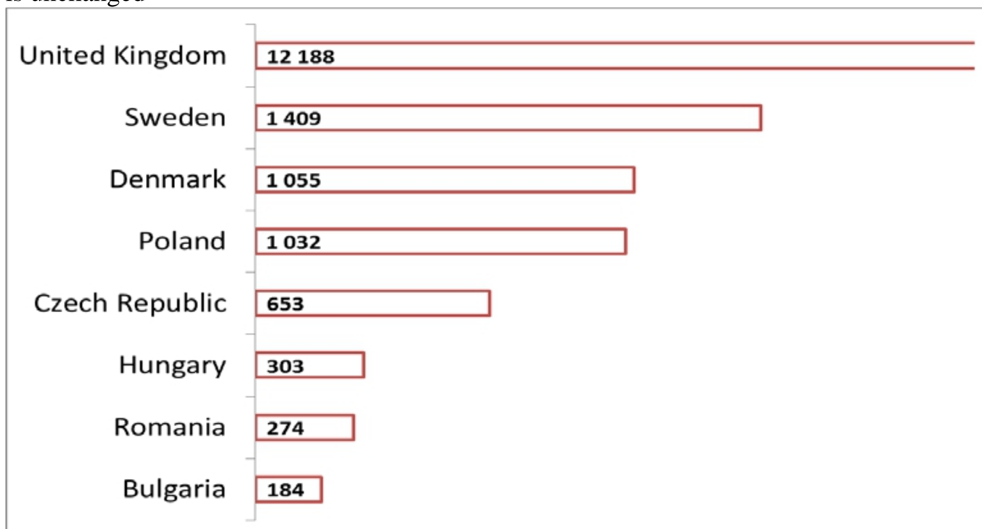
According to the chart above, uploading of the mutual fund will be even. If the level of the covered deposit in the euro zone did not change, the expected value of the total assets would be 52127 euro million by the end of 2024 (1 % of the covered deposits). This amount would serve the operation of resolution mechanism.

In case of member states outside the euro zone, the following forecasted levels of national resolution funds are forecasted by the end of the

year 2024 if the values of the covered deposits are unchanged (data regarding Croatia are not available):

Chart 2

Forecasted amount of national resolution funds if the value of the covered deposits is unchanged



Source: European Commission, own calculation

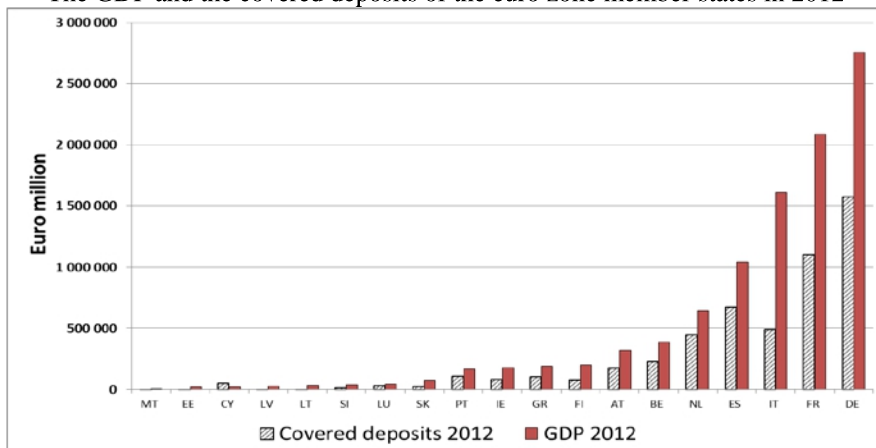
When compiling the two charts above, it was assumed that data given for 2012 remains unchanged. However, depending on numerous factors the portfolio of covered deposits is continuously changing.

The size of the population, the level of the national GDP, the unemployment rate, the abroad activity of the credit institutions could have effect on the level of covered deposits belonging to one member state.

By separating the member states of the European Union as per euro zone member states and non-euro zone member states, strong correlation could be revealed between data of national GDPs and the covered deposits in both cases in year 2012. The correlation ratio is very high in the euro area, its value is 0.9728 (the minimal value of the ratio is zero and the maximum is 1). The situation is the same in case of non-euro zone member states. The value of the correlation ratio is 0.9940.

The following chart illustrates the relationship between national GDPs and covered deposits belonging to the member state in question in case of euro area.

Chart 3
The GDP and the covered deposits of the euro zone member states in 2012



Source: European Commission, Eurostat, own calculation

The tight connection between national GDP and the level of the coverage deposits makes possible analysis of this relationship by using linear regression model. In both cases (euro and non-euro zone member states) the covered deposits are the dependent and the national GDPs are the predictor variables. The equilibrium of the linear regression line is

$$\hat{y} = 3470.742 + 0.5233x \qquad (2)$$

in case of euro zone member states, and

$$\hat{y} = -57832.4 + 0.6112x \qquad (3)$$

in case of non-euro zone member states.

The interpretation of (2) and (3) is the following: if the national GDP grows by 1 million euro, the covered deposit grows by 0.5233 million euros in case of euro zone member states and by 0.6112 million euros in case of non-euro zone member states. Therefore, if the values of GDPs are known, the covered deposit level could be determined by using the abovementioned linear regression models. Since 1 % of the covered deposit is the target level of the resolution fund the expected value of total assets of the funds could be forecasted. However the values of GDPs are not known for period 2015-2024. In order to forecast them, in both cases (euro zone member states and non-euro zone member states) four scenarios were calculated as follows:

Name of the scenario	average GDP growth supposed
Scenario 1	0 %
Scenario 2	1 %
Scenario 3	2 %
Scenario 4	3 %

The following table shows the result of the calculation.

Table 2
The forecasted values of covered deposits, and forecasted total assets of resolution funds as for year 2024

Data in million euro	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Covered deposit in euro zone member states	5293186	5846608	6451605	7112406
Covered deposits in non-euro zone member states	2269977	2513518	2779755	3070549
Total assets of the Single Resolution Fund (euro zone member states)	52932	58466	64516	71124
Aggregated total assets of the national resolution funds (non-euro zone member states)	22700	25135	27798	30705

Source: own calculation

Conclusion

Since the target level is determined as 1 % of the covered deposits in the resolution regulation and directive, data given in the above table show practically the forecasted level of the Single Resolution Fund and the forecasted cumulative level of the national resolution funds.

It is observable that the level expected by the Commission (55 billion euros) will be reached by a very slight growth of GDPs (in case of euro zone member states). However, its value will likely be significantly higher. In other words, the 1 % proportion of the covered deposits defined in the abovementioned regulations ensures significantly higher level of the Single Resolution Fund comparing with the expected EUR 55 billion.

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