Europe Flash

Madrid, June 25th, 2013
Economic Analysis

Europe Unit
Miguel Jiménez González-Anleo
mjimenezg@bbva.com

Financial Scenarios Unit
Sonsoles Castillo
s.castillo@bbva.com

Regulation and Public Policies Unit
Tatiana Alonso
tatiana.alonso@bbva.com

Wojciech Golecki
wojciech.golecki@bbva.com

Eurogroup reaches first agreement on direct bank recapitalisation

Last week the Eurogroup reached a first agreement on details of the direct recapitalisation by the European Stability mechanism (ESM) of ailing banks in stressed countries. A €60bn cap has been imposed over the ESM recapitalization ability. Although this cap can be increased at the discretion of the ESM Board under exceptional circumstances, its relatively low level could limit the effectiveness of the tool in breaking the vicious circle between sovereign and bank risk in the transition to the Single Resolution Mechanism.

- ### Eligibility criteria

  To be applied to systemically relevant institutions in stressed countries that are unable to provide the needed financial assistance to restore the viability of the bank.

- ### Capital shortfall

  To be identified through a stress test under the guidance of the ESM and after applying appropriate bail-in criteria. Under the current legal framework this would involve shareholders and junior debt only, but the door is left open in the proposal for an early application of the bail-in principles contained in the Recovery and Resolution Directive, still under negotiation. This means that senior bondholders could eventually be required to absorb losses immediately after junior debt-holders do so.

- ### Burden sharing

  Two different cases are foreseen.

  - **Case 1:** banks with a capital ratio under 4.5% CET1. Member States to cover all capital needed until 4.5% and the ESM to do the rest until reaching the ECB required ratio (equivalent to current EBA 9%).
  - **Case 2:** banks with a capital ratio at/above 4.5% CET1 but below the ECB required level. Member State to contribute with a 10-20% share and the ESM to cover the rest. Under exceptional circumstances, the ESM Board can decide to suspend the Member State contribution but unanimity is required.
  - **Caveat.** If the amount paid under case 1 (gap until 4.5%) is lower than what the MS would have had to pay under case 2 (i.e, 20% of gap until 9%), the MS would be requested to add the difference (i.,e. for a bank with a 4.4% capital ratio, the MS would not just pay 0.1%, but rather 0.9%).

- ### €60bn cap and limited retroactivity

  The ESM capacity to directly recapitalize banks has been capped at €60bn although the cap can be revised by the ESM Board. Retroactive implementation will be decided on a case-by-case basis (this seems to be a concession to Ireland; Spain has already expressed it unwillingness to ask for ESM assistance). For risk containment purposes, the ESM will set up (fully owned) subsidiary to conduct direct bank recapitalizations.

- ## MoU and conditionality

  The ESM assistance will have to be required by Member States. We understand that the approval of the assistance by the ESM would take place under the same general rules that apply to current ESM sovereign assistance programs (where 85% of votes is requires, which grants Germany a de facto veto power). The associated MoU might include conditionality clauses both for the recapitalized banks and also concerning general economic policies of the Member State. To recapitalize banks, the ESM will set up a fully owned subsidiary with no decision making powers.

- ## Next steps

  The instrument will be finalized in Autumn (once the negotiations on the Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Fund Directive are finalised with the EU Parliament) and is expected to be put in place in Q2 2014, once national parliamentary scrutiny procedures have been finalised (the main obstacle here is Germany, were changes in existing law could be even required) and the Single Supervisory Mechanism is effective. Notwithstanding this, ESM Chairman Regling said in last week press conference that the ESM should be available to provide a public backstop for the EBA stress test exercise (expected for July of 2014). The framework will be revised two years after its entry into force to account for progress in Banking Union, the evolution of legacy assets and other relevant legal developments.

DISCLAIMER