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On the EU Bank Resolution Agreement

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EU ministers reach agreement on bank resolution. And yes, Cyprus was a template.

Late last night EU finance ministers meeting at the Ecofin council agreed terms for banking resolution in Europe. Significantly, the bail-in proposals are very close to the template that was so controversially outlined by eurogroup head Jeroen Dijesselbloem after the Cyprus bank crisis -- the template that he vehemently denied was a template (see "Dubious Timing, Obvious Truth" March 28, 2013).

- Deposits up to €100,000 are to be protected -- as current Ecofin president, Michael Noonan said, "They are sacrosanct."
- For deposits above €100,000, those of natural persons and small and medium enterprises (SME) would have preference over those of large corporations.
- There is a minimum bail-in threshold of 8% of total liabilities that has to be reached before bank resolution funds can be used.
- Significantly, liabilities to the European Investment Bank (EIB) are also protected. This reduces the risk the EIB would take through its ordinary operations, where it lends to banks for onward lending to industry.
- Also, if -- as planned -- the EIB increases its exposure to European banks as part of a SME credit securitization plan (see "The EIB, Not the ECB" April 12, 2013), the EIB would not be increasing risk through greater direct exposure to banks.

Much of the agreement is looking to prevent the need for bail-ins at all, through prevention and early intervention.

- Banks will be required to draft recovery plans -- and update them annually -- to be implemented in the event of a deterioration of their financial situation -- not unlike the "living wills" US banks have drawn up. Regulators will draw up their own resolution plans -- death warrants in advance -- for each institution, as well.
- National authorities will have the power to set "minimum requirements for own funds and eligible liabilities" (MREL) on an institution by institution basis, depending on the business model, size and risk of the institution. This seems to be a major departure from the one-size-fits-all Basel capital requirements currently used as a benchmark for bank health.

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE FINANCIAL STOCKS: The Cyprus template is the template for bank resolution in Europe. The agreement reached by European finance ministers means that bank creditors will be bailed in during a bank resolution before any public funds are used. This is good news for peripheral sovereigns -- particularly Spain -- who will have that contingent liability reduced. The risk is to credit growth, as banks may now be even more risk averse. The EIB -- protected under this agreement -- now seems like the only solution to that problem.

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- As yet though, it is unclear when the MREL requirements will come into force, and if the requirements for each institution will be published.
- A resolution fund will be funded over the next ten years by contributions from banks based on their liabilities adjusted for risk.
- Until the resolution fund is up and running, the European Stability Mechanism (ESM) will provide the necessary funds -- once the bail-in threshold has been reached.

The plan agreed by EU finance ministers has to be agreed by the European Parliament before it comes into force, and the ministers are hoping that agreement can be reached before the end of this year.

We see this agreement -- overall -- as a good compromise. The main opportunities it presents are in peripheral sovereign bonds.

- The hierarchy of creditors to be bailed in *before* public or ESM funds can be used reduces the contingent liability on peripheral sovereigns from their banking systems.
- The Irish "no bond-holder left behind" model has been replaced by the Cypriot "bail-in" model.
- This goes a long way towards removing the risk premium in peripheral sovereign debt where countries have large banking systems -- the clear example here is Spain.
- Further, the MREL proposal, under which banks are assessed individually on their risk profile, will likely make banks even more risk averse, and thus more likely to hold low-risk sovereign bonds over riskier credits, which, again, should free through to bond prices.

Overall, good for sovereigns, and clarity for bank creditors, which itself may increase funding pressure on banks. A likely unintended consequence will be continued risk aversion by the banking sector, which will mean no easing of access to loans to the SME sector. Again, it seems that the EIB -- shielded in this agreement -- is the only hope for movement there.

Bottom line

The Cyprus template is the template for bank resolution in Europe. The agreement reached by European finance ministers means that bank creditors will be bailed in during a bank resolution before any public funds are used. This is good news for peripheral sovereigns -- particularly Spain -- who will have that contingent liability reduced. The risk is to credit growth, as banks may now be even more risk averse. The EIB -- protected under this agreement -- now seems like the only solution to that problem.

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