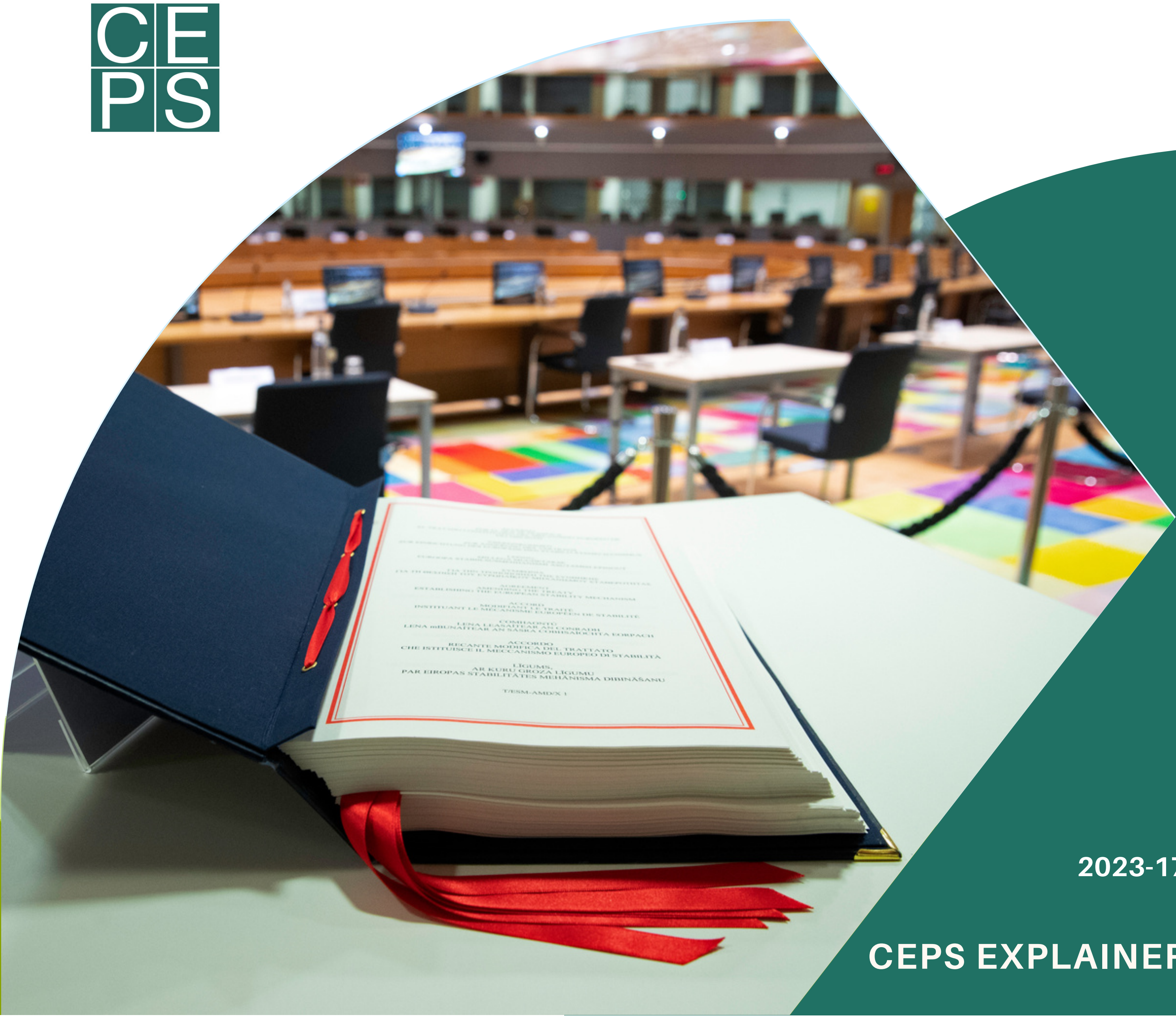

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CEPS EXPLAINER

WHY HOLDING UP THE ESM TREATY'S RATIFICATION IS A MISSED RISK SHARING OPPORTUNITY FOR THE BANKING UNION

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SUMMARY

The ratification of the European Stability Mechanism (ESM) Treaty is currently being blocked by Italy, normally a large pro-risk sharing euro area Member State. This is stopping the early entry into force of the Single Resolution Fund's (SRF) common backstop and defeats all the risk reduction efforts made by Member States and the banking sector up until now. But if the ESM Treaty remains unratified, the SRF will start 2024 without any mutualised public budgetary backing. Luckily, the SRF is currently well capitalised with funds from the banking industry and the EU banking sector appears to be in good shape according to the latest results of EBA's stress tests.

Nevertheless, there doesn't seem to be any good reason for blocking the ESM Treaty's ratification. The Direct Bank Recapitalisation Instrument, which will be replaced by the SRF's common backstop, faces numerous obstacles before it can be activated and thus does not seem to be worth keeping; the combination of risk sharing and risk reduction elements in the ESM Treaty appears to be balanced; blocking the ESM Treaty will not help the one holdout from gaining any leverage on other ongoing discussions; and the stigma that the ESM suffers from will not likely be sorted out in the short term.

Therefore, blocking the ESM Treaty's ratification will not serve any useful purpose for the deepening of the Economic and Monetary Union (EMU). Quite the opposite, it could have a very negative impact.

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A QUICK RECAP: THE ORIGINS AND EVOLUTION OF THE BANKING UNION

By mid-2012, the acute financial situation of several euro area Member States seriously threatened the stability of the single currency, prompting European leaders to launch the Banking Union to sever the vicious circle between sovereigns and banks. Initially, the building blocks of the Banking Union were a Single Supervisory Mechanism (SSM) involving the ECB, to ensure enhanced and homogenous supervision of Europe's banking sector, and a Direct Bank Recapitalisation Instrument (DBRI), an instrument of the European Stability Mechanism (ESM), to directly recapitalise a systemic and viable bank under specific circumstances.

Still, shortly afterwards, in December 2012, the Four Presidents' Report added a new building block to the Banking Union, namely a Single Resolution Mechanism (SRM), to protect financial stability and the taxpayer by planning for and managing bank failures. The final block, a European Deposit Insurance Mechanism, that in its final phase would provide for unified insurance for Banking Union banks, was mentioned in the November 2015 Five Presidents' Report.

The SSM started functioning in November 2014 and is currently deemed to be the best working element of the Banking Union. The ESM's DBRI was adopted by its Board of Governors back in December 2014, has never been used and, as will be explained below, is expected to be discontinued once the Single Resolution Fund's (SRF) common backstop enters into force. The SRM became operational in January 2016. As for the European Deposit Insurance Scheme (EDIS), it's one of the main missing elements for completing the Banking Union, with the European Commission's 2015 legislative proposal still languishing on Member States' table.

The SRM is made up of the Single Resolution Board and the National Resolution Authorities in euro area countries (and Bulgaria). It's complemented by the SRF, an emergency fund that would ensure the efficient application of resolution tools for failing banks after other options – such as the bail-in tool – have been exhausted.

The SRF is funded by the banking industry, with all banks across the 21 Banking Union countries paying annual contributions by law to the SRF. The SRF has been built up over a period of eight years (2016-2023), reaching 1% of the amount of credit institutions' covered deposits in all 21 Banking Union countries.

WHY WE NEED A PUBLIC BACKSTOP TO THE SRF

In December 2013, Member States acknowledged that the available funds in the SRF during the transition period – but also in its 'steady state' – would not be sufficient. That is why an agreement was reached to put a bridge financing mechanism in place during the transition period, to be used as a last resort, and a common backstop for the SRF's steady state.

Following prolonged technical and political discussions, Member States in December 2015 agreed to implement national individual credit lines as of 2016 to reinforce their respective national compartment in the SRF. This was clearly not a satisfactory outcome for Member States that favoured a swifter deepening of the Economic and Monetary Union (EMU), but it was finally accepted due to it being perceived as a transitory arrangement.

At the end of the transition period on 31 December 2023, the SRF should be totally mutualised (national compartments would thus cease to exist) and a fully mutualised SRF common backstop would replace national credit lines, further contributing to the dilution of the vicious circle feedback loop between sovereigns and banks.

REFORMING THE ESM

In December 2018, the Eurogroup in inclusive format finalised a report to EU leaders on the prospects for further EMU deepening, including the terms of reference for the SRF's common backstop and a term sheet on reforming the ESM . It was decided then that the ESM would provide the SRF's common backstop for euro area Member States. It was also indicated that the common backstop, originally planned to be introduced by 1 January 2024, could enter into force earlier, but only if sufficient progress had been made in reducing risk in the banking sector, based on an assessment to be produced by 2020.

It was also decided that the common backstop would replace the DBRI. Overall, this looked like a balanced package between risk sharing (a mutualised common backstop, possibly introduced earlier) and risk reduction measures (the DBRI's replacement and sufficient progress in reducing banking sector risk, thus allowing for the earlier introduction of the common backstop).

The ESM reform agreement went further than simply delivering on the SRF's common backstop. To start with, the eligibility criteria of one of the two precautionary instruments, the Precautionary Conditioned Credit Line (PCCL), were clarified and made more transparent. This replaced the need for a Memorandum of Understanding between the

European institutions and a beneficiary Member State, where the latter would commit to adhering to predetermined eligibility criteria. The other precautionary instrument is the Enhanced Conditions Credit Line, intended for ESM members that aren't eligible for a PCCL but whose general economic and financial situation remain sound, would remain available as is foreseen in the current guidelines.

Second, a commitment was reached to replace the so-called double limb Collective Action Clauses (CACs) in sovereign bonds by single limb ones, assuming that the problem of holdout investors in debt restructuring processes is addressed. Indeed, under a single limb system, a qualified majority of debt holders would suffice for restructuring all the debt, whereas double limb CACs requires an overall majority as well as majorities at the level of every individual issuance.

Finally, the ESM would have a stronger role in the design, negotiation, and monitoring of conditionality in future financial assistance programmes. This package of ESM reform beyond the common backstop also contained risk sharing (the reform of the PCCL instrument) and risk reduction elements (single limb CACs and a stronger role for the ESM).

THE DECISION TO FRONTLOAD THE INTRODUCTION OF THE SRF'S COMMON BACKSTOP

At its meeting on 30 November 2020, the Eurogroup in inclusive format decided to introduce the backstop at the beginning of 2022. This was deemed possible because EU financial institutions had confirmed that sufficient progress had been made in reducing risk in the banking sector, particularly regarding the build-up of the minimum requirement for own funds and eligible liabilities (MREL), as well as the diminishing trend in Non-Performing Loans (NPLs). Member States committed to sign the revised ESM Treaty in January 2021 and then launch the formal ratification process, in time for a mutualised common backstop to become operational by the start of 2022.

DESPITE THE POLITICAL AGREEMENT, THE ESM REFORM HAS NOT YET BEEN COMPLETED BECAUSE ITALY IS REFUSING TO RATIFY THE ESM TREATY.

Despite the political agreement, the ESM reform has not yet been completed because Italy is refusing to ratify the ESM Treaty. And yet Italy has always traditionally been in favour of deepening both the EMU and risk sharing measures.

So then one begs the question – why would a big pro-risk sharing Member State want to jeopardise a mutualised SRF common backstop? It's time to try to unpack this…

THERE IS NO GOOD REASON *NOT* TO RATIFY THE ESM TREATY

One possible answer to the question posed above is that they would rather keep the DBRI rather than see it replaced by the SRF's common backstop. But the truth is that the conditions necessary for applying the DBRI are way too restrictive, which greatly reduces the chances of it being used.

First, the instrument will apply only to banks that are considered systemically important or may pose a clear threat to the euro area's financial stability. Secondly, this is an instrument of last resort, which means that before it can be used, both the private and the national public sectors must have fulfilled their part in attempting to rescue the bank. On the private side, there must have been a bail-in of at least 8% of the bank's total liabilities, a contribution from the SRF of at least 5% of these liabilities and the conversion or write-off of all unsecured debts. On the public side, it must be verified whether the Member State where the troubled bank is based is able or not to provide public financial support without jeopardising its own fiscal sustainability.

In any case, the Member State, together with the ESM, will have to recapitalise the credit institution in question. Indeed, if Common Equity Tier 1 (CET 1) is below 4.5%, the Member State should replenish the institution's capital to this level. Once this level has been reached, the Member State should then contribute at least 20% of the institution's capital. In an ideal world, the conditions for activating the DBRI would be made more flexible and an SRF common backstop would be in place. But being realistic, this is totally out of the question and has never been part of any serious political discussions.

Another possible explanation for the lack of will to ratify the treaty is an unbalanced combination of risk reduction and risk sharing elements in the ESM package reform. This doesn't seem to be a good reason either. Some of the risk reduction efforts have already been wasted because the SRF's common backstop could have entered into force two years earlier than initially expected. All the other reduction elements in the package (single limb CACs and a reinforced role for the ESM) don't seem relevant enough for a large pro-risk sharing Member State to block a previously agreed institutional reform.

A third possible reason for the blockage is to gain leverage in other ongoing discussions, such as the reform of the fiscal rules. This also seems odd – once it's acknowledged that the chances of using the DBRI are very low, the ESM reform basically entails a risk sharing element in the form of the SRF's common backstop. So why would a Member State that favours risk reduction reduce its negotiating ambitions in the fiscal rules files under the threat the SRF common backstop will not come into force?

Another reason behind the current impasse in ratifying the ESM Treaty could be linked to the stigma effect that the Luxembourg-based institution has been suffering from since the end of the euro crisis. Possible proof of this is the failure of the ESM Pandemic Crisis Support Mechanism, designed to support ESM members in financing pandemic-related healthcare costs with concessional loans.

This is in stark contrast with the Commission's European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE), which equally offered Member States concessional loans, in this case to address sudden increases in public expenditure to bolster employment. Out of the EUR 100 billion made available under SURE, more than EUR 98 billion was disbursed.

Despite this stigma effect, the truth is that euro area Member States have EUR 80 billion of paid-in capital in the ESM, giving it an arsenal of available firepower above EUR 400 billion. Several ideas could be brought to the table to reinvigorate the ESM, such as converting it into a permanent fiscal capacity mechanism or a 'European Monetary Fund' that would operate under the Commission, as suggested by the never-discussed 2018 legislative proposal. Unfortunately, the current political mood in some Member States makes it highly unlikely that such plans could ever come to fruition.

But even the stigma effect and frustrated ideas to reform the ESM still don't appear to be behind the delay in ratifying the ESM Treaty. After all this, it rather seems to be related to a misguided political narrative installed within national politics about the ESM's real intentions and purpose. And that's why there's really no real pressing reason not to ratify the treaty.

CONCLUSIONS

Though things could have always been done better and proper conditionality embedded through Memoranda of Understanding has now been replaced by other national ownership mechanisms (such as the one used for NextGenerationEU), it would be unfair not to acknowledge the crucial role the ESM has played in safeguarding the euro area's financial stability.

Thus, blocking the ESM Treaty's ratification will not serve any useful purpose when it comes to deepening the EMU. Quite the contrary, we risk starting 2024 without any mutualised backing for the SRF. Luckily, the SRF is now well capitalised with funds from the EU banking industry, which itself seems to be in good shape according to the latest results of EBA's stress tests.

Nevertheless, we cannot afford to get bogged down when it comes to making steady progress with the Banking Union. Yet how can we insist on making progress if one of the largest euro area Member States is blocking the SRF common backstop?

We've already wasted a golden opportunity to introduce the common backstop early. At least, let's try not to be even more delayed – there is still time to reach an agreement. Now it's time for policymakers (especially those from our one Member State holdout) to put their heads together and find a credible way forward.

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