The European financial landscape is about to undergo a total facelift. On 15 April 2014 – just in time ahead of the European elections at the end of May – the European Parliament finalized the rules governing the second pillar of banking union, the so-called single resolution mechanism. The findings from banks’ comprehensive assessment – consisting of an asset quality review (AQR) and stress tests – that are scheduled for publication in October, are now being eagerly awaited. They will mark the start of the first pillar, the single supervisory mechanism under the auspices of the European Central Bank (ECB). Time to take a closer look.

The aim of the banking union is to enhance financial stability in the Eurozone. Partly by breaking the vicious circle between banks and national finances, which in the past has only served to exacerbate crisis situations. And partly by supporting a return to stronger financial market integration in the Eurozone. In the wake of the debt and confidence crisis, the fragmentation among interest rates and credit markets had risen to heights similar to those last witnessed prior to the introduction of the Euro, and had made it harder for the ECB to implement a single monetary policy.

A “complete” banking union would be based on three supporting pillars:

- a single supervisory mechanism,
- a single resolution mechanism, and
- a single deposit guarantee scheme.

(The latter is, however, not planned.)

Nor does the banking union exist in a vacuum. It will be embedded in a new single set of rules governing the financial sector throughout all EU member states. The European Commission has been working on this so-called “Single Rule Book” since 2010. Many of the some 30 new rules governing the European financial sector will come into force this year, or next year at the latest. The rules address issues such as how much capital banks must keep as a security buffer (Basel III), how to deal with banks in distress (“Bank Recovery and Resolution Directive”) and how to handle deposit guarantees (“Deposit Guarantee Scheme Directive”). The banking union will implement these rules for all Eurozone member states. EU countries outside the EMU can join the banking union voluntarily (“Opt-in”).

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Understand. Act.
European banking union in a nutshell

Rationale 1: Breaking the vicious circle between banks and national finances

Rationale 2: Supporting the implementation of single monetary policy via higher financial integration

fully-fledged banking union

<table>
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<th>Single Supervisory Mechanism (SSM)</th>
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- Set up to ensure homogeneous supervisory standards across the euro area.
- ECB to directly supervise 128 significant banks, representing 83% of total euro area banking assets.
- Fully operational on November 4, 2014.
- Beforehand: Comprehensive assessment (AOR and stress tests) based on a capital benchmark of 8% Common Equity Tier 1.
- Will enter into force on January 1st, 2015
- Single Resolution Board to be single authority responsible for resolution of euro area banks.
- Resolution to be financed by bank’s shareholders and creditors (bail-in equal to at least 8% of total liabilities, pre-defined cascade of liability) and backed by Single Resolution Fund (5% of total liabilities max).
- Bail-in and resolution functions to apply from January 1st, 2016.
- Fund financed by bank levies raised at national level as of 2016 and gradually materialized in the course of 8 years. Volume: EUR 55bn by 2024. Fund could borrow from the market.
- Not envisaged at this stage.
- EU savers are guaranteed that their deposits up to EUR 100,000 (per depositor / per bank) are protected at all times and everywhere in the EU.
- Financing requirements for DGS: target level for ex-ante funds of 0.8% of covered deposits to be collected from banks over a 10 year period.

Banks will no longer be “European in life but national in death.” Bail-in should become the rule, bail-outs the exception.

First pillar: Single Supervisory Mechanism

When the ECB first takes on responsibility for banking supervisory tasks on 4 November 2014, a new financial supervision system will emerge in the Eurozone. In spite of its comprehensive responsibility, however, the ECB will not perform all banking supervision tasks itself; instead it will join forces with the national supervisory authorities to form the “Single Supervisory Mechanism” (SSM).

The implementation of a single set of supervisory standards aims at lowering the risk of future banking crises. It will permit the exchange of cross-border information and the performance of cross comparisons to identify any risks that jeopardize or originate from the banking system in good time. At the same time, “Europeanizing” the supervisory mechanism should reduce the incentive to protect banks out of national considerations and thus burden other member states.

How will the SSM work?

From November onwards, the ECB will supervise “significant” banks directly. A bank is classified as significant if its net assets amount to more than EUR 30 billion or 20% of national economic output (minimum total net assets: EUR 5 billion). The three largest banks in each member state must be monitored in any case. In addition, the ECB will be authorized to directly supervise all banks that request or receive aid from the European Stability Mechanism (ESM), the Eurozone’s bailout fund. 128 of the banks in the Eurozone, equivalent to about 85% of total banking assets, meet these requirements (“SSM banks”). The remaining banks will be subject to “indirect” supervision: they will continue to be mainly inspected by the national authorities, however, these will be subject to the general conditions specified by the ECB.
A "Chinese wall" between monetary policy and banking supervision
Banking supervision and monetary policy under the same roof? In order to avert any conflicts of aims
and interests, an organizational "Chinese wall" will be set up between the divisions responsible within
the ECB, for example by installing separate reporting procedures and chains of command. Institutional
separation of the two policy areas at the level of the decision-making bodies is, however, not planned.
The ECB Council has the final say, not the new Supervisory Board.2

Financial sector "health check"

Before the ECB assumes its new role as the supreme supervisory body, systemically important banks
will be subjected to a comprehensive assessment. The health check—consisting of an asset quality review (AQR) and, based on the results, stress tests throughout the EU—aims to uncover potential threats and capital gaps in balance sheets and to test the ability of the European banking sector to stand firm in the face of risk. The findings from this comprehensive assessment are scheduled for publication later this year, in October.

From May 2014 onwards, the 124 largest banking groups in the EU, including most of the 128 SSM
banks, will undergo EU-wide stress tests. Working in collaboration with the national supervisors and
the ECB, the European Banking Authority (EBA) will examine how the capital buffers for 2014–2016
cope under more severe market conditions. Passing the test requires a common equity tier 1 capital ratio
of at least 5.5% (risk scenario) or 8% (baseline scenario).

The risk scenario assumes a bandwidth of risks (credit, market, country, securitization risks and risks
associated with rising financing costs) coupled with recession and rising unemployment. The main risks
assumed for the European banking sector are as follows:

1. an increase in global bond yields triggered by US yields increasing by up to 250 basis points;
2. a further deterioration of credit quality in countries that are already teetering economically;
3. a flagging reform zeal jeopardizing confidence in the sustainability of public finances; and
4. the lack of sufficient progress with cleaning up bank balance sheets to maintain affordable
market funding.5

The stress test takes into account the paradigm shift that even government bonds are exposed
to risk. This is because, unlike the stress test performed by the EBA in 2011, this time the banks
have to simulate significant losses from government bonds as well. Losses suffered during the test relate
not just to the government bonds in the trading book, but also to those classified as available for sale
in the banking book. Between 20% and 60% of the simulated losses on government bonds in the latter
must be included in the equation.6

1 For example, a hike in interest rates that seems expedient in the light of price developments may be postponed or even tabled if there were a risk of supervisory banks running into difficulties as a result. See Deutsche Bundesbank, "Fragen und Antworten zur europäischen Bankenaufsicht", http://www.bundesbank.de/
Redaktion/DE/FAQ Listen/themen_europaeische_banken aufsicht.html; Node-ID=1520208/120268.

2 A special procedure for the decision-making processes has been developed to circumvent this dilemma: The Supervisory Board drafts proposals for resolution that it then submits to the ECB Council for approval. If the latter raises no objections, the draft is deemed to be accepted. If objections are raised by the ECB Council, an Arbitration Board comprising the member states is convened. The Arbitration Board cannot, however, bind the ECB Council, because the latter ultimately bears final responsibility. Ibidem.

3 All 128 of the banks to be supervised directly by the ECB in future will be included in the AQR, whereas the stress test will also include banks from other EU member states, such as Sweden. Banks taking part in the stress test must be consolidated at EU level and—measured in terms of total assets—account for at least 50% of the national banking sectors in the EU. These criteria relate to 124 banks
at EU level.


scenario_-_specification_and_results_final_version.pdf.

Any resulting capital shortfalls must be closed by the banks by summer 2015. Capital shortfalls that have already been discovered during the AQR or in the stress test baseline scenario must be covered with tier 1 equity no later than six months after publication of the findings. Capital deficits emerging in the risk scenario must be resolved within nine months.

To start with, the banks must try and cover their capital shortfalls on the financial market or through private sources (owners, bond holders or, ultimately, depositors), or they must further reduce their risk assets. If that proves insufficient, national rescue solutions come into play (public funding from the home country in line with state aid rules, public bailout funds if necessary) and, as the last resort, instruments at the European level, such as the ESM.

What can investors expect in future?
The single banking supervisory mechanism is likely to strengthen confidence in the European banking sector. Financial market players should, however, expect volatility in the near term until autumn 2014 as doubts about the solidity of the European banking sector and national finances could re-emerge in the wake of the AQR and stress tests. Not least, information might be informally leaked before the findings are officially published. The flow of information could become quite dynamic between now and the conclusion of the audit and official publication of the findings.

Second pillar: Single Resolution Mechanism

The Single Resolution Mechanism (SRM) is the second pillar supporting the banking union. It forms the necessary counterpart to the first pillar. So, when the ECB supervises European banks, a further European body will oversee their resolution, specifically from 2015 onwards.

The SRM "Europeanizes" the application of the Bank Recovery and Resolution Directive (BRRD) in the Eurozone. Its aim is to ensure the future application of uniform rules throughout the Eurozone for banks in distress. Centralized resolution decisions will aim to prevent distortions of competition in future. In short, banks will no longer be "European in life but national in death".

Being "European in life but national in death" will no longer apply for banks.

(European Commission)

In future, creditors must bear the cost of restructuring banks in distress rather than this being a burden (solely) for national budgets (breaking the sovereign-banking-nexus). This means that primarily investors will bear the risk associated with their investment decisions instead of the state. And: Banks will be subject to the same market discipline in future as all other sectors.

Stronger market discipline: Bail-in will become the rule, bailout the exception

If a bank fails, a strict cascade of liability will apply, based around the "bail-in mechanism" requiring contributions from private creditors, which will come into force from 2016 onwards. This means that if a bank fails, it is primarily the shareholders and creditors who will be called upon to cover the losses. Together, they must cover 8% of the total liabilities. If that is not enough, the banking sector will contribute up to 5% of the total liabilities in a second step (via resolution fund), before resorting to external funding.

How will the SRM work?
The single resolution mechanism is comprised of two elements. The Single Resolution Board (SRB), based in Brussels, constitutes the institutional framework for the SRM. In future, it will directly make resolution decisions relating to banks under ECB supervision or banks with cross-border operations. In the case of all other banks, the Board monitors their compliance with the rules, while responsibility for their resolution remains with the national authorities. The Single Resolution Fund (SRF), constitutes the financial backbone of the SRM.


* Unless the private bail-in exceeds 8% of the losses, the SRF is limited to 5% of the total liabilities. See Federal Ministry of Finance: "Fragen und Antworten zum einheitlichen europäischen Bankenaufbaufonds-Mechanismus", 17 April 2014, http://www.bundesfinanzministerium.de/Content/DE/FAQ/2014-01-22-srmfaq.html. By implication, there is no limit to the amount of bailout by the SRF, in principle. If the fund is drawn upon, the outflows will be replenished from bank levies raised at national level.
Triggering bank resolution in practice
The decision-making processes as to whether and how to wind down a bank remain complex—and yet these decisions are supposedly going to be possible within the space of a weekend. The determination that a bank is failing or likely to fail is made by the ECB as the supreme bank supervisor (first step). In a second step, the Single Resolution Board (SRB) assesses the presence of systemic risk (i.e., that threats the public interest) and the availability of alternative private solutions. In the absence of the latter, the Board then draws up a specific resolution scheme in a third step, which it submits to the European Commission. Since legal constraints forbid the Board from making any final decisions at its own discretion, the Commission—in step 4—must formally confirm its resolution decisions. The Commission therefore has a sort of “veto right” as it can either agree or object to the concept in matters of discretion (e.g., if common market principles are violated). By contrast, the EU Council of Ministers has the final say in two specific cases: Thus, the Finance Ministers can firstly reject the resolution concept in the absence of any public interest, and they must secondly agree to it if the Commission has raised objections on the grounds that 5% or more of the fund would be drawn down. If neither the Commission nor the Council of Finance Ministers objects, the resolution concept comes into force in the fifth and final step within 24 hours. The question is: How will the players involved actually handle a possible future precedent case? This remains difficult to predict at this stage.

How is the resolution fund going to be funded?
From 2016 onwards, the SRF will be funded through levies from all banks domiciled in a country that has joined the SRM. In 2024, the fund’s volume is likely to amount to EUR 50 billion (1% of guaranteed deposits). The amount contributed by each bank will be measured on the basis of its total liabilities and risk profile—although the exact definition still has to be finalized.

Since current European law does not provide for a European bank levy, the fund will initially be based on a system comprising national compartments to which the national bank contributions will be transferred from 2016 onwards. As such, during the build-up phase, resolutions will initially be funded primarily from the contributions raised by the relevant national banking sector, although voluntary loans between the national departments

**Note:** When deciding whether to close a bank, the Single Resolution Board only comes into play if it has informed the ECB but received no response within three days.

Single Resolution: Players and decision-making structures

Sources: Allianz GIC Global Capital Markets & Thematic Research, European Commission, as of May 2014.
will be possible. The **gradual mutualization**, i.e., bundling of these monies in a European resolution fund that no longer differentiates between countries, is planned over the course of eight years, based on an intergovernmental treaty. 40% of the fund will supposedly be available in the first year, and a further 20% in the second year, for European assumption of liability.

**Third element: Harmonized deposit guarantee scheme**

A supranational, harmonized deposit guarantee scheme is not planned at present. Unlike the supervisory and resolution mechanisms, these schemes will remain at national level even in the Eurozone, but will be harmonized through the EU Deposit Guarantee Scheme Directive (from 2015 onwards).

As before, savings of up to EUR 100,000 per depositor and bank will be protected – everywhere in the EU. What is new is that all EU member states will have to set up **deposit guarantee funds** which must be funded ex ante by the banks within ten years to a level equivalent to 0.8% of covered deposits. If this ex ante funding proves to be insufficient, the deposit guarantee scheme will be increased through direct ex post contributions from the banking sector. In addition, voluntary loans between the deposit guarantee schemes of different EU member states will be possible. Moreover, the maximum deadline for compensating savers will be gradually reduced to seven working days (from 2024 onwards).

**Challenges during the transition phase**

The transition phase en route to single supervisory and resolution mechanisms in the Eurozone may arouse uncertainty among investors to a certain extent. For example, what is going to happen if capital shortfalls occur during the coming months, before the Bank Resolution and Recovery Directive comes into force across the EU in January 2015? And what will happen if there is not yet enough money in the resolution fund?

What happens if capital shortfalls are identified during the coming months?

If the capital requirements cannot be fully covered on the capital market or through private sources, public funding will be engaged at national level – in line with state aid rules – and, if necessary, through the provision of a public backstop. National support mechanisms should be activated in the first instance. If the national rescue schemes are not sufficient, then EU instruments, including the ESM, can be drawn upon in the second instance.

This procedure is, however, subject to the constraint that the ESM may only recapitalize banks directly, i.e., without recourse to national budgets, and only to the tune of EUR 60 billion maximum, once the SMAs have been put in place. In addition, this ESM “backstop” is to date only based on a declaration of intent from the Eurogroup. Before then, financial aid from the ESM will only be granted on request by a member state and subject to strict-conditionality – as in the case of the bailout of the Spanish banks in 2012.

What if the SRF is not yet sufficiently funded by the banking sector?

If financing gaps need filling while the resolution fund is still in its eight-year transition phase and has not yet reached its target volume, a member state will have to pay some of the resolution cost. This “bridge financing” will then supposedly be covered (ex post) by (additional) bank levies. The fund may also secure borrowing facilities. (Indirect) financial aid from the ESM will only be granted at the last resort (see above). The national compartments will, however, be permitted to lend each other money.

**Common backstop – a grey area**

During the transitional period, a common backstop will be developed for the period thereafter, although the details of this have not yet been finalized. The basic idea focuses on providing the resolution fund with a safety net allowing it to borrow from the market and subsequently claim reimbursement of the costs from the banks.12

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Understand, Act.

- In the wake of the financial and economic crisis, the Eurozone member states launched a fundamental reform of the European financial landscape—the banking union. It encompasses a single banking supervisory mechanism, a single resolution mechanism, and a harmonized deposit guarantee scheme.
- In future, banking supervision and resolution actions will be handled at European level. This will not only establish a new level of integration at institutional level; it will also accelerate the return to financial market integration in the Eurozone.
- By “Europeanizing” supervision standards under the roof of the ECB (SSM), the risk of future banking crises should decrease—and confidence in the European banking sector should increase.
- Before the ECB assumes its new role as the supreme banking supervisor, systemically important banks will be subjected to comprehensive assessment. This health check—comprising asset quality review (AQR) and stress tests—aims to create transparency with regard to banks’ risk exposure.
- The stress test takes into account the paradigm shift that even government bonds are exposed to risk. Unlike the test performed by the EBA in 2011, this time the banks have to simulate significant losses from government bonds as well.
- The single resolution mechanism (SRM) will ensure that the same rules are applied throughout the Eurozone for banks in distress. Being “European in life but national in death” will no longer apply for banks.
- From 2016 onwards, the costs of bank failures will primarily be borne by the investors. “Bail-in” will become the rule, “bailout” the exception. This means that primarily investors will bear the risks associated with their investment decisions—and banks will be subject to the same market discipline as all other sectors.
- The decision-making processes as to whether and how to wind down a bank remain complex—and yet these decisions are supposedly going to be possible in the space of a weekend.
- In the near term, the flow of information relating to AQR and stress tests, as well as the challenges surrounding the backstop mechanism, could cause volatility on financial markets.
- In the long run, the banking union should make the European banking sector more stable.

Imprint

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Data origin – if not otherwise noted:
Thomson Financial Datastream.

Calendar date of data – if not otherwise noted:
May 2014

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