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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The ESM Treaty and the Single Resolution Fund: The Unfinished Reform

by **Andrea Miglionico**

Abstract: *The establishment of banking union with a centralised structure of supervision and enforcement has recently raised criticisms on the long-waited reform of third pillar, namely the Single Resolution Fund. Notwithstanding the successful progress of supervisory mechanism for dealing with failing banks, the deposit insurance scheme remains controversial. In this context, the revision of the European Stability Mechanism (ESM) Treaty has been questioned with respect to negotiation and monitoring of conditionality in financial assistance programmes. This article argues that the policymakers should move towards completing the banking union by introducing a deposit insurance system and a form of risk sharing on the government debt issued by countries in the Eurozone. The pandemic crisis has inflamed the debate on the ability of the ESM to deal with euro area countries with non-sustainable government debt. The task of the ESM to provide financial assistance, subject to strict conditionality to Eurozone countries, has irritated some Member States, i.e. Italy which claimed that the debt restructuring should not be imposed from political desire but designed and implemented based on Italian initiatives. This article also suggests that the approach taken on the revision of the ESM should be reconsidered. With its focus on possible debt restructuring for countries receiving stability support it has led to further political tensions between Italy and the European institutions, thereby making a deal between them less likely.*

Summary: 1. Introduction: the ESM governance system. – 2. The controversial reform of the ESM. – 3. The question on collective action clauses: the position of Italy. – 4. The Deposit Guarantee Scheme and the quest for a common backstop to the Single Resolution Fund. – 5. The role of the ESM at times of Covid-19 pandemic crisis. – 6. Conclusion.

1. In 2011 the European Council adopted a comprehensive package of measures to respond to the ongoing crisis at the time, as well as to guard against such crises materialising in the future [1]. The main features of this package relate to the strengthening of the preventive and corrective mechanisms to address internal and external imbalances, particularly fiscal imbalances, and competitiveness problems of individual Member States. In this context, the Council set up a permanent crisis resolution mechanism, namely the European Stability Mechanism (ESM). This includes the establishment of a

regulatory tool as an ultima ratio safeguard against imbalances in individual countries [2]. The ESM is an intergovernmental institution designed under public international law through a Treaty signed by the euro area countries and based in Luxembourg [3]. It has been established to provide financial assistance, subject to strict conditionality, to Euro countries experiencing severe financing difficulties [4]. Specifically, the ESM grants assistance in the form of loan disbursements; precautionary facilities; facilities to finance the recapitalisation of financial institutions in an Euro Area Member States (EAMS) through loans including non-programme countries; and facilities for the purchase of bonds in the primary and secondary markets [5]. The ESM may also exceptionally intervene in the debt primary market under the same conditionality. The main rationale is to ensure financial stability in Europe by supporting EAMS. It has indefinite duration and, in terms of ranking, preferred creditor status: it enjoys preferred creditor status in a similar fashion to the IMF, while accepting the preferred creditor status of the IMF above the ESM.

The active participation of the IMF (in all circumstances) is sought on a technical and financial level. The debt sustainability analysis is jointly conducted by the Commission and the IMF in liaison with the European Central Bank (ECB). In parallel, the policy conditions attached to a joint ESM and IMF assistance are negotiated by the Commission and the IMF in liaison with the ECB. EAMS may participate on an ad hoc basis alongside the ESM in financial assistance operations for EAMS. This means that the ESM would not require the credit enhancements of the EFSF to secure a Triple-A rating. In this context, Article 136 of the of the TFEU provides that “the Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality” [6]. The financial assistance programmes operate as follows: the ESM Stability Support (ESS) request from an EAMS; the EU Commission together with the IMF and, in liaison with the ECB, assess the actual financing needs of the EAMS; the Commission, the IMF and ECB negotiate a macroeconomic adjustment programme with the EAMS in an MoU; the EU Council endorses the macro-economic adjustment programme and the Commission signs the MoU on behalf of the EAMS; the ESM’s Board of Directors then approves the financial assistance agreement containing the technical aspects of the assistance; and the Commission, the IMF and ECB are responsible for monitoring compliance with the policy conditionality.

2. The revised text of the Treaty establishing the ESM has been agreed by the Eurogroup on 4 December 2019 although the final version is still under discussion for legal obstacles advanced by some Member States [7]. The revisions of the ESM Treaty focus on the following areas: activities of the ESM, including clarifying and expanding the ESM mandate on economic governance; ESM governance issues; the precautionary financial assistance instruments; and the establishment of the ESM as a backstop to the Single Resolution Fund (SRF) [8]. Specifically, the revised text should expand the ESM mandate on economic governance, particularly vis-a-vis the Commission. This new role is reflected in Article 3 (“Purposes”), which allows the ESM to “follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt and carry out analysis of relevant information and data”. The ESM will have a stronger voice in the design, negotiation and monitoring of conditionality in future financial assistance schemes. For instance, when an ESM Member requests support, the Commission in liaison with the ECB will work closely together to prepare the assessments

supporting the decision to grant a loan. The ESM will perform its analysis and assessment from the perspective of a lender. Further, the ESM will be involved in the design of policy conditionality and any future Memorandum of Understanding (MoU) detailing the conditionality attached to the financial assistance facility will be signed by both the Commission and the ESM Managing Director. In terms of debt sustainability, the revised text will also require the confirmation of a country's repayment capacity. The assessments on debt sustainability and repayment capacity will be conducted by the European Commission, in liaison with the ECB, and the ESM, on a transparent and predictable basis, while allowing at the same time a sufficient margin of judgement.

The revised Treaty establishes ESM Managing Director (and staff) independence and reinforces submission to EU law. That could help in providing a clearer separation between the ESM managing Director and staff and the ESM Member States. The revisions include amendments to the precautionary financial instruments. The new features aim at enhancing the precautionary financial instruments effectiveness while ensuring the appropriate level of conditionality. The revised eligibility criteria are stricter than in the current precautionary instruments. Firstly, according to the current ESM Treaty, Member States under a procedure for excessive imbalances could still be eligible for precautionary assistance. That element is absent in the revised text. Secondly, the revisions require compliance with the eligibility criteria for the two years preceding the request for financial assistance; currently this is not required, at least explicitly. It remains unclear whether a precautionary credit line would qualify for access to the ECB outright monetary transactions programme (OMT), which might be one of the reasons why a Member State could consider a precautionary financial assistance. The current wording of the ESM and the ECB technical explanatory note on OMT do not clarify this either.

The reform of the ESM Treaty will come into force once it has been ratified by all ESM Member States. This involves approval in all national parliaments: the ratification process will start following the signature of the agreement amending the Treaty. However, Italy opposed the draft text claiming that the 'done-and-dusted ESM revision will force the country to default on its debt to small savers' [9]. Italy has not agreed on the proposed revision, partly on the grounds that conditionality would be imposed from the political pressure of some Member States. Most importantly, the reform does not address the question on what happens in financial markets on the occasion when a country's debt level is declared non-sustainable. There would be an immediate and possibly large increase in the interest rate resulting in an immediate crisis that would make the need for rescue funds immediate and possibly much larger. In other words, if the country has not already implemented credible structural reforms and fiscal adjustment, it would be too late to avert a crisis at the time the debt burden is deemed non-sustainable.

3. The reform of the ESM has posed serious questions on the willingness of Member States to adopt the strict conditionality imposed by the bailout fund. Specifically, the issue is the proposed inclusion of text in an annex to the Treaty that would require Euro area governments to include collective action clauses (CACs) in future bond issues [10]. These would make it easier to secure agreement among creditors to a debt restructuring. The idea of annexing the CACs to the Treaty raised the challenge of debt sustainability that is a highly charged in Italy since it has the highest public debt burden in the bloc after Greece. CACs allow modifying the terms of sovereign bonds [11]: with the revision of the ESM Treaty, this would be possible with a simple rather than a double majority, making it easier to carry out debt

restructuring. Italy, with a debt rate of 138% GDP, considers this would jeopardise its position in the financial markets [12]. As mentioned, there is still a controversial debate and the revised text has not been fully agreed. Specifically, the reform of the ESM Treaty is being held up because of the Italian opposition. Italy insists that the new ESM Treaty will impose losses on retail investors who put their savings in government bonds [13].

The main argument of some opponents of the ESM reform is that these CACs (single limb CACs) [14], by making it easier for the sovereign to conduct a debt restructuring, will send a signal to the market that the sovereign is more likely to restructure. This means yields to rise and end up causing the very crisis that the clauses are intended to protect against [15]. As has been argued, 'the small and uncertain benefits of a debt restructuring mechanism must be weighed against the huge risk that the mere announcement of its introduction may trigger a perverse spiral of expectations of default, which may prove to be self-fulfilling' [16]. In the revised Treaty, ESM Members will commit to introducing single-limb CACs [17] into new euro area sovereign bonds issued starting from 1 January 2022. However, in absence of an agreed text, if a country accesses the ESM for emergency loans there will be an automatic bail-in of existing private investors along with the CACs on new government debt issued [18]. Another issue regards the ESM's undemocratic governance system, with only Germany, France and Italy given a veto; unbalanced capital composition (only 11 per cent of the subscribed capital is already paid in, the remainder takes the form of callable shares); and a sort of self-financing paradox which sees countries applying for stability support not being exempt from capital contributions [19].

The idea of offering EU's financial support to a member country conditional on its implementing structural reforms has been suggested as a way out in several occasions. However, a reform plan that appears dictated from outside the country can be politically ineffective as the reform plan should be prepared and presented by Italy. It can be immediately matched by some important financial help, for instance with well targeted EU financed investments. However, after this first exchange the Eurozone should come up with a deep reform plan to complete the banking union and to help the solution of the doom-loop problem also with the creation of a risk-free asset. Once pre-emptive action has been taken to make Italian debt levels sustainable and the threat to the Euro averted, the EU can turn its attention to risk-sharing for the future to mitigate the risk for future crises as a result of the "doom-loop" between sovereign debt and banking crises. The first step would be to implement a European deposit insurance system for the Eurozone as suggested in the banking union.

4. The lack of international convergence of deposit insurance schemes raised concerns among bank regulators and policymakers, particularly after the failure of cross-border banks which highlighted the domestic prerogative of protection systems [20]. In response to this regulatory loophole, the EU legislature introduced the Deposit Guarantee Scheme Directive (DGSD) that set a comprehensive legal framework on depositor protection [21]. The directive provided for substantial harmonisation of deposit insurance policies and enhanced the integration of retail banking [22]. The EU regulators amended the directive in 2009 abolishing co-insurance and introducing a coverage level set at Euro 100,000 [23].

The amending directive of 2009 addresses cross-border issues providing that home state schemes cover deposits taken in any branch anywhere in the EU; host state schemes manage payments, but home state

schemes must reimburse; and non-EU branches may accept deposits covered by their home schemes if those schemes are equivalent – otherwise they must join the host scheme [24]. It can be argued that these regulatory measures reflect the existing voluntary lending and borrowing mechanisms between EU Deposit Guarantee Schemes (DGSs), particularly once extraordinary contributions have been raised and in an amount not exceeding 0.5% of covered deposits of the borrowing DGS [25].

In November 2015, the Commission published a Communication setting out the European deposit insurance scheme (EDIS) for bank deposits [26], accompanied by a Proposal for a Regulation [27] that marked a notable step towards the creation of a third pillar of the Banking Union, namely the Single Deposit Guarantee Scheme [28]. The intervention of the EU legislature culminated with the adoption of the Deposit Guarantee Scheme Directive of 2014 (DGSD 2014) that introduces minimum standards for bank DGSs [29]. The main objectives of the DGSD 2014 are: (1) to ensure financial stability in the banking sector after the global financial crisis; and (2) to recover deposits by mandatory bank contributions [30]. Although the political agreement among Member States for the establishment of the EDIS is still far from an overall consensus, the rationale of designing a common deposit protection scheme falls under the prudential supervision of credit institutions [31]. Specifically, the common deposit guarantee system aims to achieve uniform administrative practice resolution financing; to establish the reimbursement of a limited amount of deposits to depositors whose bank has failed; and to prevent depositors from making panic-driven withdrawals.

The EDIS should reduce the moral hazard effects of banks' misbehaviours as well as pooling the risk of unexpected failures, however different views in the Eurozone and wide discretion of domestic authorities create serious obstacles in the achievement of an effective DGS [32]. In academic terms, it has been proposed to establish a European deposit insurance and resolution authority (EDIRA) "financed by a fund fed through regular risk-based deposit insurance premiums from the banks, whose customers benefit from its protection" [33]. This proposal aims to incentivise the private sector to cover solutions to resolve banking failures and contain moral hazard. Private funds should be available for resolution based on the principle of (self-)insurance by the banking sector.

In parallel, deposit guarantee schemes are regulated by the Bank Recovery and Resolution Directive (BRRD) which provides a system through domestic DGS to cover deposits up to Euro 100,000. All member States must set up national resolution funds with resources which after ten years must amount to one percent of insured deposits [34]. According to Article 31(2) of the BRRD, where resolution has the effect of protecting depositors, a relevant EU DGS is liable for the amount by which covered deposits would have been written down had they been written down to the same extent as other creditors of equal priority [35]. However, the DGS liability shall not be greater than the amount which it would have had to pay out in a conventional insolvency, or 50% of its target pre-funding level. In case the DGS exposure turns out to be in breach of the "No Creditor Worse Off than in Liquidation" (NCWOL) principle, the BRRD provides a mechanism for compensation [36].

The Single Resolution Fund (SRF) operates as a back-up option when additional capital is needed, e.g., for the purposes of providing guarantees, making loans, purchasing assets, providing compensation to shareholders or creditors, providing capital to a bridge bank [37]. Further, SRF is not to be used directly

to absorb losses of a failing institution or for direct recapitalisation. It can be noted that the DGS is relevant to bank resolution because credit institutions are funded primarily by deposits than are financed primarily by wholesale markets. As most retail deposits are insured, the strength of the DGS is ultimately based on its recourse to financing from the sponsor national government [38]. The use of deposit guarantee schemes in resolution involves liability to contribute up to the amount of losses that the schemes would have had to bear if the relevant institution had been wound up [39].

A major change of the ESM reform concerns the establishment of the "common backstop" (set with a nominal cap of 68 billion euro) that will be used only as a last resort, in the situation that the SRF is diminished, and the Single Resolution Board (SRB) is not able to raise sufficient contributions or borrow funds from other sources at acceptable rates [40]. In case the SRF is reduced, the ESM can act as a backstop and lend the necessary funds to the SRF to finance a resolution. The common backstop is covered by the banking sector and should not involve costs for non-Banking Union Member States [41]. Decisions on loans and disbursements will be taken by the ESM Board of Directors (consisting of high-level officials from the Euro area finance ministries) by mutual agreement and on a case-by-case basis, guided by certain criteria. Such decisions should be taken within 12 hours of the SRB's request, but in the case of a particularly complex resolution operation, the ESM Managing Director may agree to lengthen the deadline to up to 24 hours.

5. The Covid-19 crisis has ignited the debate on how to secure the stability of the Eurozone and how to reinforce the solidarity of members [42]. During the lock-down the pandemic has tested the resilience of EU institutions that intervened with controversial regulatory responses, determining unprecedented suspensions of current legal framework (e.g. capital buffers, payment holidays, mortgage and loans relief) [43]. However, the emergency situation has showed unexpected reluctance among Member States to adopt harmonised measures for containing the outbreak: it is instructive the ongoing divergence between some countries in the agreement reached for some economic instruments namely the Recovery Fund [44] and the ESM [45]. The opposite views on various mechanisms in support of sovereigns severely impacted by the coronavirus have resuscitated a sentiment of Euroscepticism that characterises the ideology of populist movements. Indeed, the economic policy response against Covid-19 has struggled the euro area countries in the implementation of the ESM measures particularly in negotiating certain conditions to funding schemes. Specifically, the Pandemic Crisis Support is based on the existing Enhanced Conditions Credit Line and subject to 'standardised terms agreed in advance by the ESM governing bodies, reflecting the current challenges, on the basis of preliminary assessments by the European institutions' [46]. Such assessment of the EU institutions represents the "Gordian knot" of the debate that left on the spot several Member States (i.e. France, Italy, Spain, Austria and the Netherlands) apparently unwilling to agree a common position [47].

Few commentators point that since the ESM is a natural disaster, this could attach very light conditions to the loans, e.g. to some IMF facilities designed for this type of events [48]. Similar debate around EU countries raised on the use of Eurobonds: despite they are not the only instrument of sharing the financial burden of the pandemic, they have been advocated as the best way to express solidarity (the ill-named corona-bonds) [49]. Some in Germany after opposing the issuance of common bonds as a way of condoning some European countries' lack of budgetary discipline, with the onset of the Covid-19, have

started to support such joint ‘European Crisis bonds’ to help the sovereigns worst affected by coronavirus [50]. To add oil to an already inflamed debate, the ECB policies have recently been contested in the German Constitutional Court’s decision that denied the European Court of Justice (ECJ) jurisdiction on the ECB’s Public Sector Asset Purchase Programme (PSPP) [51]. The ruling raises concerns on the limits of ECJ power: the German court noted that the ECJ had only conducted a limited review of the effects of the PSPP programme and could not assess if the ECB had breached the principle of proportionality, under which the content and form of any EU action must be limited to what is necessary to achieve the pursued aim [52]. The German judges’ decision poses the problem whether the hierarchy of EU law is clearly demarcated as it seems the ECJ judgment being ultra vires in Germany [53]. The current discussion over the ESM and Recovery Fund is a stark reminder of the dangers posed to economic and financial stability by Covid-19 crisis. The pandemic situation facing Europe today reveals the difficulties to achieve political consensus on emergency economic measures which, on the contrary, should consolidate the spirit of cohesion and unity among Member States.

6. The Banking Union represents a welcome approach to avoid the involvement of depositors into the rescue programmes and to contain the disruption of collapses. The DGS and the SRF establish innovative tools to provide financial assistance to fragile economies in the Eurozone. However, EU regulators leave wide discretion to national governments to adopt domestic depositor protection schemes which is a legacy of the past to protect deposits and national financial stability under the public interest. State level deposit insurers are not viable inside a monetary union because even the liquidation of several small banks could overwhelm the capacity of national deposit insurance. Mutualisation of deposit insurance requires full harmonisation of insolvency laws because the effectiveness of the bank liquidation process will have an impact on the financial situation of the deposit insurance over which insured depositors have a legal claim [54].

The Covid-19 crisis has raised criticisms about the use of the ESM to support euro area countries with non-sustainable government debt. What makes the debt problem for Italy especially urgent from the perspective of the Eurozone is the size of the country and its debt. Italy can be considered “too big to fail” since a substantial haircut on its debt could threaten the solvency of Italian banks in particular, but also financial institutions elsewhere and, not least, taxpayers would have to accept large losses at the ECB with its large holdings of Italian government bonds [55]. Italy with its national debt may also be deemed “too big to save” since the amounts that other countries would have to contribute would be so large that political resistance may prevent a rescue. Political risk should not be underestimated: such risk may originate in an increase of populism or increased divisions between richer “frugal” Member States and the likely biggest recipients of EU pandemic emergency funds [56]. Further, political risk may result in higher default risk and higher spreads in sovereign debt. The most dangerous situation is when high public debt correlates with political risk and unwillingness to take the necessary economic reforms, limiting support from other Eurozone members.

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[14] If a country decides to proceed with a debt restructuring, a single vote by government security holders would be sufficient to amend the terms and conditions of all the bonds instead of dual votes (one for each issuance and one for the bonds as a whole).

[15] Theresa Arnold, Ugo Panizza and Mitu Gulati, 'The Ridiculous Drama in Rome Over Proposals to Reform the ESM Treaty', Oxford Business Law Blog, 10 December 2019, available at https://www.law.ox.ac.uk/business-law-blog/blog/2019/12/ridiculous-drama-rome-over-proposals-reform-esm-treaty. The authors observe that that over 99% of Italy's sovereign debt is governed by local Italian law. That means that any Italian government that wishes to restructure its debt has a wide variety of options it can turn to. And most, if not all, of these options are a lot easier to implement for a government that affirmatively wishes to force a restructuring on its creditors than CACs (enhanced or not).
[16] Ignazio Visco, 'The Economic and Monetary Union: Time to Break the Deadlock', keynote address at the OMFIF-Banca d'Italia Seminar 'Future of the Euro area', Rome, 15 November 2019.
[17] Sovereign state's bonds are typically divided into multiple different issuances, or "series" (with different maturities, interest amounts, etc.). Single-limb CACs allow the majority vote to take place at the level of all these "series" combined, without the need for a majority at the level of the holders of each individual "series". This reduces "holdout" risk, i.e., that a small group of bondholders decides not to take part in the restructuring, forming a minority to block it, in the hope of getting a better deal for themselves. These "holdouts" can result in delays in resolving a debt crisis.
[18] Access to ESM credit facilities currently requires an assessment of public debt sustainability. If debt restructuring is deemed appropriate, the disbursements of any ESM funds will become conditional on creditors and debtors reaching agreement on a standstill. In practice, this means that a qualified majority of creditors consent to extend eligible debt maturities for the duration of the ESM programme. See Jochen Andritzky, Désirée I. Christofzik, Lars P. Feld and Uwe Scheuering, 'A mechanism to regulate sovereign debt restructuring in the euro area' (2019) 22 International Finance 1, 25.
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