

FAQ on the main features of the future ESM direct bank recapitalisation instrument

- 1 – The ESM may already provide financial assistance to euro area Member States for the purpose of bank recapitalisation. Why is it necessary to introduce a new instrument, allowing for direct recapitalisation of financial institutions by the ESM?

For now the ESM can recapitalise banks only indirectly. In this case the ESM provides a loan to the government of a euro area Member State. With these funds the government then recapitalises the banks. This is how the ESM provided assistance in Spain. However, such assistance adds to the beneficiary country's budget deficit and public debt. There is a risk that markets start to doubt whether the country in question will be able to reimburse its debt. This risk increased during the European debt crisis. Governments were forced to support ailing banks, adding to their sovereign debt, and banks usually hold large amounts of public debt. This link between governments and banks (described as a "vicious circle") has been widely regarded as a crucial destabilising factor for the euro area. That is why the leaders of euro area countries decided that an instrument was needed that would allow banks to strengthen their capital position without placing a large burden on the country where the bank is incorporated.

- 2 – Is direct recapitalisation one of the elements of the banking union?

Yes, in December 2012 the European Council (the heads of state or government of EU countries) agreed on the key building blocks of the future banking union. It will consist of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism, and direct recapitalisation of banks by the ESM. At a later stage, a common deposit guarantee mechanism could be added to the framework.

- 3 – Why is the Single Supervisory Mechanism (SSM) a precondition for direct recapitalisation?

Banking supervision in the EU is currently the responsibility of the Member States. However, the recent financial crisis showed that national supervision has not always been effective in spotting problems in banks. Also it showed how quickly problems in the financial sector of one country can spread to another. Therefore, the European Commission has presented a proposal for the establishment of a Single Supervisory Mechanism. According to the proposal the SSM would act as a central authority that oversees the key aspects of the activities of banks in the euro area. This is particularly important in order to ensure an effective overview of banking groups, which often have subsidiaries in many countries. The SSM is the basis for the next steps towards the banking union. This reflects the principle that the ESM will have the possibility to recapitalise banks directly when an effective single supervisory mechanism is established.

- 4 – Will the requesting ESM Member contribute financially to the recapitalisation?

Yes. A burden sharing scheme will determine the contributions of the requesting ESM Member and the ESM. The scheme will comprise two parts:

- (i) If the beneficiary institution has insufficient equity to reach the legal minimum Common Equity Tier 1 of 4.5%¹ (Common Equity Tier 1 is a category of capital consisting of common shares and retained earnings), the requesting ESM Member will be required to

¹ This will take place following a valuation of the bank's assets conducted under the guidance of the ESM in liaison with the ECB and European Commission, and under a sufficiently prudent stress test scenario.



make a capital injection to reach this level. Only then the ESM will participate in the recapitalisation.

- (ii) If the beneficiary institution already meets the capital ratio mentioned above, the requesting ESM Member will be obliged to make a capital contribution alongside the ESM. This contribution will be equivalent to 20% of the total amount of public contribution in the first two years after bank recapitalisation enters into force. Afterwards, the ESM Member's contribution will amount to 10% of the total public contribution.

The ESM Board of Governors will have the right to partially or fully suspend an ESM Member's contribution. This refers to exceptional cases when the ESM Member is not able to contribute up-front due to fiscal reasons.

➤ 5 – Will there be a bail-in or other form of private sector contribution?

Yes. Direct recapitalisation by the ESM will only be considered if private capital resources are engaged first. An appropriate level of bail-in will be applied in line with EU state-aid rules² and applying the principles of the Bank Recovery and Resolution Directive (BRRD) as of the start of the supervision of banks by the SSM. This new supervisory role is foreseen to be taken up by the ECB in the second half of 2014, following a balance sheet assessment of the banks that will be supervised by the SSM.

The key principles of the BRRD were agreed by the ECOFIN Council on 27 June 2013. National resolution authorities will be able to bail in, i.e. write down or convert to equity the claims of the shareholders and creditors of failing banks. Under the new regime, insured deposits (under €100,000) will be fully protected; uninsured deposits (over €100,000) are not protected, but will be given preferential treatment for certain groups of depositors; a bail-in equivalent to at least 8% of a bank's total liabilities and own funds must be imposed before any resolution fund is tapped. In extraordinary circumstances, a national resolution authority may seek funding from alternative financing sources. Member States will be given flexibility to exclude or partially exclude certain types of investors from the bail-in under specified circumstances.³

➤ 6 – Are there any eligibility criteria regarding the requesting ESM Member?

Yes. The requesting ESM Member would have to be unable to provide financial assistance to the beneficiary bank without very serious effects on its own fiscal sustainability. The use of the direct recapitalisation could also be considered if other solutions could endanger the continuous access to markets of the requesting ESM Member. This could in turn force the country to seek financial assistance from the ESM.

In addition, ESM financial assistance would have to be considered indispensable to safeguard the financial stability of the euro area as a whole or of its Member States.

➤ 7 – What are the eligibility criteria with respect to the bank requiring recapitalisation?

The bank would have to currently be (or likely to be in the near future) unable to meet the capital requirements established by the ECB in its capacity as supervisor. It would also have to be unable to obtain sufficient capital from private sources. The bank in question must also be of systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of its Member States.

² According to EU state aid rules, losses would be possible for shareholders and junior bondholders

³ For more information on the ECOFIN decision, please consult

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf



- 8 – What kind of conditionality will apply for the ESM Member requesting the use of direct recapitalisation and for the beneficiary institution?

There would be conditions applying to the recapitalised institution, established under EU state aid rules. In addition, the ESM, in liaison with the Commission and the ECB, can establish additional institution-specific conditions. These can include rules on the remuneration of management and bonuses. Other policy conditions may be related to the general economic policies of the ESM Member concerned. They will be included in the Memorandum of Understanding (MoU) attached to the financial assistance.

- 9 – Will the ESM become a shareholder in the beneficiary institution?

Yes. As a general rule, the ESM will acquire common equity shares in the beneficiary institution.

- 10 – Will the ESM establish a subsidiary through which it would conduct direct recapitalisation operations?

Yes, the ESM will establish a subsidiary in order to ensure greater transparency and flexibility in the recapitalisation operations. The use of a subsidiary structure will not affect the decision-making powers of the ESM governing bodies. Thus, the ESM Board of Governors and Board of Directors will continue to take key decisions even if the funds for recapitalisation are provided by a subsidiary of the ESM.

The ESM may establish further subsidiary structures under the subsidiary to facilitate external investors' participation and enable risk-taking on a country- or individual-institution basis.

- 11 – Will the ESM be able to influence the business model and governance of the beneficiary institution?

The degree of involvement of the ESM in approving the strategy, business model, and appointing senior management of the beneficiary institution will be considered on a case-by-case basis. The general approach is to ensure a careful balance between influence by the ESM and the maintenance of independent commercial business practices by the recapitalised bank's management. Therefore, the ESM will not be involved in the day-to-day-management of the beneficiary bank.

- 12 – Will there be a cap on the amount of resources available for use under the direct recapitalisation instrument?

Yes, in order to preserve the ESM's lending capacity for other instruments, there will be a limit on the total amount of ESM resources available for direct recapitalisation of banks. This will also provide transparency for investors and help preserve the high creditworthiness of the ESM. The limit will be set at €60 billion, and the ESM Board of Governors will be able to change the amount in the future, if necessary.

- 13 – How will direct bank recapitalisation impact the ESM's lending capacity?

Should the ESM use its direct bank recapitalisation instrument it would acquire common equity shares in the beneficiary institution. As acquiring a stake in a bank is considered to be more risky than granting a loan to a country the impact on the ESM's capital and creditworthiness is higher in the case of direct bank recapitalisation than for granting loans. Because of the different risk profile €1 for ESM direct bank recapitalisation would reduce the ESM's lending capacity by more than €1 in order to maintain ESM's high creditworthiness which is crucial for its overall operation in capital markets and market access.



However, the maximum lending capacity will only be adjusted when ESM actually enters into direct bank recapitalisation programmes. The ESM has a maximum lending capacity of €500 billion. So far the ESM has disbursed €41.3 billion to Spain in the context of an assistance programme for the financial sector (indirect bank recapitalisation). Furthermore the ESM has committed €9 billion to Cyprus of which €3 billion has been disbursed.

- 14 – Can direct recapitalisation be applied retroactively, so that the ESM would directly recapitalise troubled banks in countries currently receiving financial assistance from the EFSF and ESM?

The potential retroactive application of the instrument will be decided on a case-by-case basis and by mutual agreement of ESM Members.

- 15 – What are the next steps that need to be taken for the direct recapitalisation instrument to come into effect?

The operational details of the ESM direct recapitalisation instrument will be finalised as soon as the legislative proposals for the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive have been agreed with the European Parliament.