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Medium sized bank resolution: challenges and tools

1. What is at stake

1.1. Europe is still a region with thousands of small banks

This is not only a characteristic of Germany, Italy or Austria but also of the United States: 7000 small US banks and 6300 in Europe (EU 28) at the end of 2017.

There are roughly 3,300 banking groups in the euro area, 119 of which are "significant institutions" directly supervised by the ECB. The ECB supervises in particular the 8 Global Systemically Important Banks (G-SIBs), which are located in the euro area[1]. There is therefore in the Banking Union a dual system, with G-SIBs subject to stricter rules as regards the level of prudential requirements and the resolution regime.

Germany, Austria and Italy are home to four-fifths of all the supposedly "less significant" institutions, whose balance sheet total amounts to 80% of annual economic output in Austria and Germany. And in Germany, it is precisely these institutions that provide funding for small and medium-sized enterprises, which, in turn, form the bedrock of the economy. All in all, the "less significant" institutions in Germany finance 70% of the regional economy[2].

In practice, the bulk of Less Significant Institutions are smaller euro area banks whose assets do not exceed €30 billion. If we look at the overall balance sheet total of the euro area banking system, scarcely 18% can be attributed to the "less significant institutions".

Does this mean that small and medium-sized institutions and their services are completely unimportant and so do not require good supervision? Not at all! "Less significant" institutions can indeed be significant for the stability of the banking system. The Less Significant Institutions (those which are under the 119 threshold) are supervised by their national supervisors, under the oversight of the ECB.

Given the lack of governance of some of those banks, it would be appropriate for the SSM to exercise more often its call-upon power.

1.2. Main features of the current EU crisis management framework

In the Banking Union, unlike in some other jurisdictions, there is a clear distinction between the resolution regime[3] and the insolvency regime. The former is a single EU framework, applying to all banks that are failing or likely to fail and meet public interest criteria. The failing banks that do not meet the public interest assessment are liquidated through the domestic insolvency regimes, which vary substantially across jurisdictions.

EU Resolution is for the few, not the many. Most banks (98%) will continue to fall under normal national insolvency proceedings in the same manner as any other failing business is dealt with. However, for 'systemically important' banks - whose failure would have a ripple effect on the rest of the economy - this new concept of resolution has been introduced. But it is the exception, not the rule.

The European resolution framework[4] introduces some constraints on the management of bank failures. Indeed, it not only substantially constrains any possibility of providing public funds to failing institutions but also imposes a minimum amount of creditors' bail-in (8% of total liabilities) as a precondition for the use of the Single Resolution Fund (SRF). In addition, all entities that could possibly be subject to resolution must issue a sizeable amount of bail-in-able securities (minimum requirement for own funds and eligible liabilities (MREL)).

Moreover, the state aid rules impose some restrictions on the use of Deposit Guarantee Schemes (DGS), especially when the governance of these Schemes is under the control of the public sector.

Unlike the US where TLAC requirements only apply to US G-SIBs, in the EU, the bail-in tool could be applied to any credit institutions[5]. For that purpose, the Bank Recovery and Resolution Directive (BRRD) requires banks to comply with MREL requirements (Minimum requirements for own funds and eligible liabilities) that are determined by resolution authorities on a bank-by-bank basis[6] and may include, for banks that expected to be resolved and not liquidated, where appropriate, a subordination requirement.

The banks that should go to liquidation (98% of them) are subject to an MREL level equal to their capital requirements. But if those banks have losses, someone has to absorb them: the shareholders/creditors (even uncovered depositors) or the national taxpayers (bail out). If the bank goes to liquidation, the national resolution authority is not involved.

In addition, use of public funds is permitted under article 44 of BRRD in exceptional circumstances after the bail-in of 8% of the

[1] BNP Paribas (FR), Deutsche Bank (DE), BPCE (FR), Crédit Agricole (FR), ING (NL), Santander (ES), Société Générale (FR), and Unicredit (IT). Because of the systemic threat they pose to the financial system, G-SIBs should - according to the principles agreed by the G-20/FSB - be submitted to a specific set of rules and enhanced supervision.

[2] S. Lautenschläger, Caught in the middle? Small and medium-sized banks and European banking supervision, 22 February 2016.

[3] The idea of resolution is, put simply, to ensure that a bank that runs into trouble can be dealt with effectively, having the smallest possible impact on the taxpayer - in other words, no more bail-outs - and at the same time, causing the least amount of damage to the wider economy.

[4] The choice of resolution tools depends on the specific circumstances of each case and builds on options laid out in the resolution plan prepared for the bank. The EU Regulation allows the application of four resolution tools They consist of powers to: (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders); (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits; (iii) separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities; and/or (iv) bail in creditors (mechanism to cancel or reduce the liabilities of a failing bank, or to convert debt to equity, as a means of restoring the institution's capital position).

[5] The main aim of bail-in is to stabilise a failing bank so that its essential services can continue, without the need for bail-out by public funds. The tool enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity so that the bank can continue as a going concern.

[6] For setting the MREL, the 8% is a benchmark, not a floor.

creditors liabilities and the contribution of the Single Resolution Fund for 5% of the total liabilities. MREL is therefore a cornerstone of the EU resolution regime and the solvency support.

1.3. Medium sized banks raise specific resolution challenges in Europe

These banks, and notably those which are considered significant and are therefore in the remit of the SSM and the SRM, are characterized by the low level of junior debt and the difficulty of raising these MREL type securities: indeed, you need a market to raise securities which is not necessarily easy for a bank with little track record in placing listed debt.

As emphasized by the Financial Stability Institute and Mr. Restoy, 70% of significant banks under direct supervision by the SSM are not listed, 60% have never issued convertible instruments. F. Restoy recently explained[7] that those banks are typically too large to be subject to straight liquidation, as they may generate adverse systemic effects, but they might be also too small and too traditional to issue large amount of MREL-eligible liabilities that could facilitate the application of the bail-in tool resolution. Thus, in this view, the depositors of such banks would be inordinately called upon in the case of resolution, which could lead to unacceptable social consequences.

However If depositors in medium-sized banks are exempted from the consequences of resolution, this contradicts the principles of BRRD and would mean that uncovered depositors in medium-sized banks have more rights than taxpayers («bail-out ») or stakeholders of the whole banking system (intervention of the DGS). Taxpayers and the DGS would be subsidizing banks that were unable to issue sufficient MREL.

Therefore, solutions need to be found for the orderly exit of traditional medium (or small) sized deposit-taking banks, notably for the significant banks, without disrupting financial stability.

It would be more intelligent to keep the options open and, like the FDIC, decide, case by case, which is the best solution: liquidation or resolution (merger…). All this seems to justify a two-tier approach (big and systemic banks on the one side and small and medium sized on the other side). The latter could benefit from lower standards in terms of levels of MRELS. But one has to be very cautious on this. It is a fact that those medium sized banks are often riskier and inappropriately managed.

2. Defining a common application of the 'public interest criteria'

If a bank does not qualify for the precautionary recapitalization and is declared by the supervisory/resolution authority to be failing or likely to fail, the choice is between liquidation or resolution. This decision is a prerogative of the Single Resolution Board (SRB) for the banks under its remit, and it hinges on an assessment of the existence of public interest. In other words, European resolution decisions are strictly binary: the SRB acts only when banks satisfy a strict European public interest test. All other cases are invariably handled at the national level, enabling divergent courses of action to be pursued along national lines.

But resolution and liquidation differ substantially when it comes to the scope of legislation that is applicable to the use of public funds. While resolution is governed by the BRRD, liquidation is regulated by national insolvency laws and will be managed by national authorities[8]. While the use of public funds in resolution would be subject to both BRRD scope and State Aid scope – thus requiring a preliminary bail-in up to at least 8% of total liabilities, the use of public funds in liquidation is only subject to State aid burden sharing requirements.

Consequently, since the scope of EU law regulating the use of public money in resolution and liquidation is different, a substantially similar operation conducted under these two different frameworks can lead for similar banks to very different outcomes for (i) the acquiring bank; (ii) the banks' creditors and (iii) the taxpayers. depending on the level of the jurisdiction – (i.e. European, national, regional).

However, these criteria are vaguely defined in European law and there are currently two definitions of "public interest ": one at the EU level, and one by national authorities. Indeed, the question of whether the resolution of a bank deemed failing or likely to fail is in the "public interest" or whether such a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at the national levels. Some ailing banks that have been turned down by the SRB were subsequently found to be of public interest by national authorities.

The Veneto banks[9] cases have made it clear that, depending on national insolvency law, resolution tools may be used at the national level outside the BRRD framework, despite the absence of a 'public interest' determined at the EU level by the SRB. Such actions remain subject to the EU State Aid framework but escape from more restrictive conditions under the BRRD. This is what Andrea Enria, Chair of the European Banking Authority (EBA) called "two different definitions of "public interest" […] one at the EU level and another one by national authorities".

While the definition of critical functions seems clear as regards the SRB's assessment of the existence of public interest, it is not equally clear what role it plays in the EU discipline on liquidation aid, as the 2013 Banking Communication does not include guidelines on how the local effect of liquidation should be evaluated. In the absence of clarity on what constitutes a serious impact on the regional economy, the rules on liquidation State Aid leave room for governments to effectively re-instate at the regional/local level the public interest that the SRB had refused at the national/European level.

One way to overcome this problem, which undermines the credibility of the Europe's resolution framework, could be to ask the SRB to provide an explicit assessment of the impact of failure at the regional/local level, to ensure the assessment is homogeneous.

In any case, the identification and the publication by the Single Resolution Board of the list of significant banks of public interest would make more predictable the resolvability of failing banks.

3. Lessons to be drawn from the US FDIC experience

It would be appropriate to be inspired by the remarkable experience of the FDIC. Why is the FDIC system more efficient[10]? This superiority comes from:

- The fact that the FDIC is a national organization (not 19 Jurisdictions).
- The plurality of options: no hard-wired obligations (8%- 5%) but a pragmatic, flexible, least cost principle base[11]. Thus, the FDIC takes on the risks of some losses in relation to transferred assets rather than requiring creditors to absorb minimum losses in relation to their claims.
- The FDIC has the capacity to select healthy banks in order to purchase some of the assets of the failing banks.
- The FDIC usually agrees to absorb a significant portion of future losses on assets because this method produces a better net recovery than an immediate liquidation.
- Operations of the FDIC are backed by the unlimited credit line from the Treasury which allows the FDIC to gain time and not be threatened by purchasers which are eager to buy the assets at the lowest possible price.

The experience of the FDIC shows abundantly that size is not the major criteria for resolution. What is important is to get the best solution/deal out of an ailing bank. This requires experience, intimate knowledge of the banking system, the capability of negotiating with other banks without being paralyzed by some mechanistic prescriptions.

In a way, the US gives us a lesson: the 15 systemic banks have the necessary capital requirements (including TLACs, stress tests, etc.…) and the other medium and smaller ones have, de facto, a level playing field which is shaped by the FDIC. FDIC is guided by common sense principles: it is free to choose the best solution, case by case.

The FDIC model seems an appropriate way to wind up medium-sized and small banks while protecting insured depositors.

4. What could be done?

It is essential to improve the EU crisis management model for medium sized banks in order to safeguard financial stability. This is also a condition for the Banking Union to achieve its main objectives.

Defining precisely the public interest criteria in a single way, identifying the banks which are meeting those criteria and publishing the list of these banks would make more predictable the resolvability of failing banks.

In addition, during the next five years, EU Institutions should specifically work on the treatment of the failure of medium sized banks, which are significant (under the remit of the SSM and the SRB) but who do not meet the public interest criteria by:

- Pursuing the harmonisation of specific aspects of the national frameworks including creditor hierarchies and insolvency tests. This would facilitate the application of the NCWO principle under which creditors should not bear losses above those they would suffer under liquidation in accordance with national insolvency procedures. This would also ensure that the resolution framework and the insolvency regime are consistent.
- Introducing some public risk sharing in the crisis management framework as in the US or the UK. Indeed, If the credit line provided by the European Stability Mechanism (ESM) to the Single Resolution Fund (SRF) is used[12], it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended by up to another two years. Consequently, it will be fiscally neutral over the medium term. If no agreement can be achieved to progress to some limited public risk sharing in the Banking Union (e.g. public guarantee to refinance the backstop in case the SRF has not been able to pay back the ESM), it seems difficult to make the EU crisis management framework evolve towards the US FDIC model.
- Achieving an agreement on EDIS and entrusting the Single Resolution Board (SRB) with administrative liquidation powers, along the lines of the FDIC to deal with failing significant banks that do not meet the public interest test. As a manager of EDIS, the SRB would be empowered to decide on the transfer of insured deposits of failing non-systemic bank to an acquirer, or the creation of a bridge bank, with the possibility of granting some support subject to constraints. In this perspective, the insolvency procedures for non-systemic banks would include a depositor protection objective and EDIS funds could be used in managing bank failures - e.g. for early intervention purposes or to finance resolution (i.e. a transfer from the failing institution to an acquiring bank)-. The EU regime would therefore evolve into a fully-fledged European FDIC model.

If there is no political will to move towards a European FDIC, then Europe should move towards a two-Tier system:

On the one hand, banks that are equipped with the proper buffers, MREL toolbox and that could have access to the Single Resolution Fund: the EU G-SIBs and the Significant Institutions with public criteria.

On the other hand, banks that are exempted from having the full range of instruments, in return for which they are liquidated immediately in the event of a problem.

Regarding the Significant Institutions (under the remit of the SSM and the SRM) without public interest, they could be submitted to a lower level of MRELS in order to absorb possible losses exceeding own funds. However, it must be clear that these banks have to be liquidated if they are likely to fail. Indeed, it would be desirable to avoid “free-riders” sailing between these two positions, claiming not to have the means to raise MREL, but claiming to be too important locally/nationally to be liquidated.

These financial institutions affect the profitability of the entire EU banking system: not only can they sell their financial products and services at a lower price because they do not have to charge MREL, but they can also force other banks to contribute more to the SRF to pay for their potential failure. These banks must either reduce their size or merge together to form larger groups capable of raising MREL and becoming “resolvable”. ●