SESSION SUMMARY - HELSINKI SEPTEMBER 2019

Medium-sized bank resolution

1. Medium-sized bank resolution: what is at stake?

The Chair introduced the topic of medium-sized bank resolution. The Financial Stability Institute has been conducting some work on this matter from both a global and a European perspective. He outlined three relevant singularities or peculiarities of the European Crisis Management Framework. First is the clear distinction between insolvency for less significant institutions, and resolution for significant or systemic institutions. The distinction does not exist in other jurisdictions. Second is the existence of the European Single Resolution Framework, administered or led by the Single Resolution Board (SRB), and the multiplicity of mostly cumbersome and ineffective national insolvency regimes. Third, it is quite a strict resolution framework for significant institutions with explicit minimum bail-in restrictions, and accordingly stringent minimum requirement for own funds and eligible liabilities (MREL) requirements.

Those are three important features to keep in mind. Experience shows that so far, these three important features generate several challenges for the effective operation of the European Crisis Management Framework. The panel will hear about issues concerning the application of the "no creditor worse off" principle in the context in which the loss reference for creditors of banks in resolution is set by the domestic insolvency regime. Other more general issues are related to the consistency between resolution and insolvency, as regards triggers, or the availability of public resources in one regime or another.

Yet the most important challenge has to do with the lack of an effective mechanism to deal with the failure of those banks that could be considered too large to be liquidated according to national insolvency procedures, but at the same time too small or too traditional to satisfy the stringent MREL requirements as requested by the resolution regime. The options for discussion are basically of three types. Firstly, the laissez-faire type of approach, letting banks adjust themselves to the regulatory requirements, the industry adjusting to them, and maybe accepting over time there could be a more concentrated structure of the industry with a smaller number of mid-sized institutions. The second possibility, more or less the approach taken by the European leaders and the Single Resolution Board as well, is to be a bit pragmatic and to adjust the MREL requirements a little downwards for mid-sized institutions, trying to reduce the stress faced by this type of institution to comply with MREL requirements. The third option, which is certainly much more ambitious, is to work in the direction of putting together a more comprehensive crisis management framework in Europe, a European crisis management framework that would be able to deal with crises of different types of banks, following different types of business models.

Options one and two have some relevant drawbacks. The laissez-faire option may imply over time a reduction in the diversity of the European financial industry. More importantly, that would trigger dynamics that could be quite destabilising in the short-term. Option two means to reducing MREL requirements for some institutions, would by definition involve more difficulties in applying the open bank bail-in tool to those institutions. These may generate additional challenges for the resolution of this type of institution. Option three would face plenty of political and technical obstacles but is likely to be the only on that could effectively address all identified challenges.

In that respect, some have supported using the Federal Deposit Insurance Corporation (FDIC) model as a reference for such a reform. This would entail three components. First is the convergence of national insolvency regimes to a common regime, administered by a European authority, typically a Single Resolution Board. The second feature would be that the SRB would have to deal with a crisis of both significant and non-significant institutions but using a different set of tools according to a public interest test, which probably would have to be defined in a more complete way. Third is the creation of a European deposit insurance mechanism. That European deposit insurance scheme or mechanism would actually be tasked not only to pay out cover deposits for failing banks, but also to fund actions taken by the Single Resolution Board to handle, typically through purchasing and assumption transactions, the failure of banks subject to insolvency while satisfying some restrictions in terms of state aid, and the least cost principle. This type of regime would remove the inconsistency between insolvency and resolution and would enlarge the sort of banks that can actually be subject to insolvency. That two-tier regime would help alleviate the middle-class problem.

This type of reform cannot actually be implemented overnight. It will require a smooth transition, probably starting by reforming the national insolvency regimes before these regimes converge in a common one at the European level.

2. Making the EU crisis management framework more flexible

A regulator supported the observation that the current European regime around resolution is very much characterised around a range of rather radical situations: black or white, yes or no, in or out. That is very much the nature of either being systemically relevant (and submitted to the EU resolution framework), or going straight to national insolvency, and so forth. More flexibility would be helpful. The difficulty is what exactly is meant by that. There are two basic principles: first, to technically improve the ability to resolve banks properly, in order not to be exposed to blackmailing situations; and second, to avoid unwanted bailout situations. Those principles have to be held up and should not be ignored. If flexibility means changing those basic principles through a backdoor, it should be opposed. The toolbox at present is too rough-cut in a way and needs to become more flexible. It is interesting as a source of information and inspiration to take a look at the so-called FDIC model. The basic principles must always be remembered.

The Chair noted that there has been some evolution in the policy approach. There is the BRRD tool, in which some of the parameters have been somewhat adjusted. Also, the SRB has now been more explicit about the criteria they are using when setting MREL requirements.

2.1. The recent banking package has already introduced some flexibility, but much must be done

A central bank official noted that the new banking package has introduced more flexibility. The big question is to what extent this is enough or not. It is probably not, and this is why rethinking is needed in order to improve the current situation in particular for mid-sized banks. It is very important that the general principles that led to this regulation should be fulfilled. It will avoid a bailout taking place and public money being used when there is

a problem with a bank. Introducing flexibility does not mean that this principle is changed.

2.1.1. A longer period of time to fulfil the MREL requirements

A central bank official noted that the new banking package has introduced some flexibility, which was already in the previous BRRD, but now it has gone a bit deeper. The true dimensions of this flexibility are well-known. First of all is the timeline. Currently there is a longer period to fulfil the MREL requirements, generally 2024 in most circumstances. Small and medium sized banks may need this longer period to build up the required MREL, without threatening their business model and profit generation. This is particularly important for these banks, also because they have never gone to the markets to get this money. They have no experience, and a relatively long period could help.

2.1.2. The level of MREL a bank needs is calibrated depending on the resolution tool to be used

A regulator noted that banks, for which in case of failure no resolution is foreseen, do not have to build up MREL on top of their supervisory capital requirements for a going concern. Hence, those banks do not face further costs apart from the regular costs for supervisory compliance and basic recovery and resolution planning. In contrast, for banks whose preferred strategy is resolution, the SRB's MREL policy and its expectations for resolvability provide for certain adjustments to allow for proportionality as well.

A Central Bank official noted that small and medium sized banks have to exploit, conveniently, the four resolution tools like that in the BRRD (bail-in instrument, sale of business, bridge institution and asset segregation) because depending on the size and the models, different tools can be used to make the resolution feasible. For example, the sale of business tool, which is an instrument which may be particularly useful for mid-sized banks, leads to lower MREL requirements. Again, this flexibility is particularly welcome for these mid-sized banks. Which is the level of MREL needed for a sale of business tool? In such cases, consideration should be given to the fact that the buyer will probably recapitalise the bank and will also provide the liquidity the bank may need when opening after resolution. The MREL requirement should cover the loss absorption amount but it also seems reasonable that the coverage of the recapitalisation amount is partially fulfilled by the buyer. Still, a safe margin for the recapitalisation amount should be covered by each bank with a transfer strategy. As a result, the resolution plan must develop a credible strategy for sale of business.

He added that there is an issue with the mid-sized banks as, because they are basically funded by retail depositors, they do not generally have experience to tap the market. And, even if they have experience, given the limited magnitude of the bonds they have to issue, they generally have to pay a liquidity premium higher than that of other banks. This is a very challenging environment, in particular when confronting these requirements with a low profitability environment. However, this flexibility cannot be done with the MREL requirements. The MREL requirements are there because they are needed, and there are general principles that have to be agreed by everybody. The only way is to have an optimal system of liquidation procedure. This is very difficult to achieve. The main worry is how to make the change in the system compatible with the requirements that are already there. There is a longer period to fulfil the MREL requirements, but it will still be challenging for mid-sized banks.

2.1.3. But the MREL requirements pose challenges for medium-sized banks with a retail business model and almost no practice to tap markets for capital or debt that absorbs losses

An industry representative noted that in Europe there is a very diversified banking landscape. There is quite a large number of small institutions, and more larger institutions that are actually acting cross-border. Anything that has to do with regulation must be structurally neutral, in order to avoid a situation of too high a number of too big to fail banks. That should be a principle in the regulation, but also in resolution.

In that respect, MREL plays a big role, and some flexibility has now been introduced. There is also a widening in the timeframe to find and issue MREL. Nevertheless, as long as the business model needs to build up MREL, or the size of the bank needs more MREL, this has to be done. It is an issue for all the banks to issue MREL in sufficient size. It will become more costly, and there have been many comments on the profitability of European banks. Additional MREL has to be issued, and then there is more capital coming from the implementation of Basel III. There are big numbers around, and that is probably what worries investors. Already, there is discussion about working on a framework that has not even been implemented yet. That does not sound, to investors, like stability. Mid-sized banks have to think about the cost of issuing the MREL, and to think about the type of MREL they want. As such, the SRB has the possibility to not only define the amount of MREL, but also the composition of the MREL. Obviously, it takes much time now to draw up the resolution plans. This is being done, and as such probably a little more time needs to be given, even though times are not easy, instead of doing the next step before the first has been implemented.

2.2. An assessment on the level of MREL

An industry representative noted that the quantity of MREL is a big piece of what is being discussed. Only around 20 banks of the five countries that received ESM support and were on an ESM programme receive any kind of support. Putting the numbers in terms of how much bail-in plus bailout they have received, it is something like 10% till off. For a 40% risk weighted asset density, this would come out with around 25% till off. Taking into account the 8% maximum that in theory can be done until the single resolution fund can get in, then there would be 20% MREL, which is a diplomatic way of saying that it is lower than the current numbers around. It is a relevant number also because the situation is not the same as previously in the crisis. There are already a Single Resolution Fund up which is being set up, and much time has been dedicated to the macroprudential policies that, in principle, should support the overall capacity of the system to cope and anticipate, and manage the crisis. On relative costs, there is clarity in terms of the direct relation between size and cost of MREL funding or issuance. This is observable for anyone in the markets. In this context, one can say again that there is a framework, in this case the resolution framework, which in a way is driving into the ecosystem of big banks, as they are the ones more able to cope with it, or at least cope more easily with it. There are also fixed costs which are very relevant in this equation. There is, therefore, a need to reflect on the implications which this ecosystem brings in terms of financial stability and competition in the system, and reasonably priced and diversified financial products.

3. A set of common standards, practices and harmonised rules for the liquidation of banks would considerably facilitate resolution planning, increase predictability and prevent diverging outcomes in different member states. Needless to say that administrative procedures might be preferable to judicial procedures

3.1. Operational challenges raised by the diversity of insolvency regimes

A regulator noted that in different member states they have different criteria to open the insolvency proceedings. They have different tools to tackle insolvency. They have different roles for administrative authorities in different member states. In some countries they can use state aid for liquidation, and in others they cannot. In the case, for example, of ABLV, the ECB triggered the Failing Or Likely To Fail of the parent company in Latvia and its

subsidiary in Luxembourg. In Latvia the court decided to liquidate the bank and in Luxembourg the court did not. They thought that it did not comply with the accounting insolvency requirement so, as the bank was not insolvent, they did not open the proceeding for insolvency. Another example relates to the use of state aid with the Failing Or Likely To Fail of two mid-size Italian banks, and the SRB decided that there was no public interest in the resolution of these banks, and they went into liquidation. Finally, in this liquidation, there was state aid authorised by the Commission. Comparing the situation for creditors in a country with this possibility to a country without this possibility, it is very easy to understand the consequences. If it had been decided that these two banks could go to resolution, in that case the resolution framework is applied and all kinds of liabilities can be written down, including uncovered deposits, depositors, and senior bond holders.

A regulator noted that after a Failing Or Likely To Fail, the resolution authority has to decide if the bank has to go into resolution or liquidation according to the public interest assessment, determining if the preservation of a bank's critical functions is required to maintain financial stability. One key element of public interest is the analysis of the credibility of the insolvency proceedings in that country. It is quite challenging to compare 19 insolvency regimes with one single resolution framework. Imagining, for example, a cross-border institution, there is also the no creditor worse off principle. This element tries to make consistent the resolution framework and the liquidation framework, because one creditor cannot be worse off in resolution. This comparison is also quite challenging with a wide variety of insolvency frameworks.

3.2. Designing a package which is politically doable, sufficiently ambitious, and technically valid

A regulator noted that MREL is another motivation that was pointed to, with respect to medium-sized banks. It started with defining what exactly is considered to be a 'medium-sized' bank. Some of the challenges around providing enough MREL for smaller banks have been addressed already in the BRRD currently. It comes back to a huge project of harmonisation of insolvency rules. At the end of the day, a good package must be designed, which is politically doable. In theory, everyone would want a harmonised insolvency regime in the EU by next week, but it will not happen. That is, in itself, a 15-year project. Financial regulators are well-trained in acting within highly Europeanised environments. On the judicial side, and the judiciary ministries, it can be sensed very quickly that they are much less trained. A path should be taken which is politically more doable, and slightly less ambitious, but still makes a lot of mileage.

3.2.1. Defining the endgame scenario is not so complicated…

A regulator had less trouble in looking at the endgame scenario, which should be indeed a fully harmonised insolvency environment, and should be an integrated competency in a European setup, possibly comparable to the SSM logic, specifically the integrated approach of a European level and branches, or something like that on a national level. The combination of bail-in, and at least for bridge purposes access to public funding, are the key building blocks. That is plausible as an endgame scenario.

3.2.2. …But the roadmap to achieve it is more challenging

A regulator noted that the part that is more of a struggle is the timing and how to get there. There is a very delicate question of what would be a prudent first, second or third step for the next two years, five years and so forth. Everyone is agreed that the basic principles set out when the whole journey started a couple of years ago should not be forgotten. Technically, there was just one bank that was resolved in the sense of BRRD, but in a broader world and in a non-technical sense many more banks have been resolved, and the real challenge is how to cope with banks in trouble. On the timing question, focus should probably be on best practices, as regards insolvency procedures and requirements, and trying to establish a European code and superimpose it on existing insolvency regimes. Second, a way has to be found to calibrate staying faithful to the no-bailout principle on the one hand and give access to some public money. It is being mobilised anyway if millions of voters in a particular country or region are under threat. Structures should be found to do that. EDIS would not be the right tool, because its purpose is as a guarantee system, which is very different to mobilising money for bridging purposes.

3.3. Making national insolvency regimes more efficient

A central bank official felt that the most interesting avenue is the possibility of reforming insolvency regimes to make them more efficient. If there were an efficient liquidation regime, then more medium and small banks could be incorporated into the strategy, and this would immediately diminish the umbrella requirements. Fixing what is meant by an efficient liquidation regime has a few elements which are particularly relevant. The first is the need for liquidation regimes that are bank specific. Some elements in the banking industry, in particular the loss value of the assets and the fact that the loss rate is very quick, make very clear the case for having a liquidation regime specifically for banks. Second, in those jurisdictions where this is the case, there is a need to move from court-based to administrative regimes for liquidating banks. Third, many of the tools currently in the resolution regime need to be incorporated into the liquidation regime, which is not currently the case in many of the European countries. Given the aim for a level playing field, it is important to have a homogenous liquidation regime for all jurisdictions. Given all these elements it is natural that there should be one administrative institution, and the SRB is the natural one to take this responsibility.

3.4. Defining a common application of the "public interest criteria" and designing a better proportionate resolution framework

An industry representative noted that the SRB has published a paper presenting the methodology and how the SRB assesses the criteria set out by EU law. There is more to be done on that, but it is a good basis for everyone to re-read again what the principles are and how public interest assessments should work.

An industry representative noted that, from a general perspective, there is a need for better alignment between the resolvability of banks and MREL requirements. There is also a need for better alignment with the fact that banks with fewer and lesser systemic critical functions are more resolvable, and then this should have implications in terms of requirements, and better alignment also between MREL requirements and size.

3.5. There is no true Banking Union without EDIS

An industry representative noted that on EDIS one cannot lose ground in terms of how relevant it is to close the overall project of the banking union. There is not really a Banking Union. There is a banking friendship, but not a Banking Union. This will not be the case until one euro here is the same as one euro there; that is critical. If one looks at what happened in the worst financial crisis, with the MREL requirements plus all new requirements, EDIS is very cheap in terms of what it delivers in terms of financial integration, confidence with citizens, and at the same time is at the end in terms of the probability of being used, precisely because everything else is already in place. The establishment of EDIS that can provide the insurance of all covered deposits irrespective of location is a critical part of this resolution in this context.

3.6. Not to be too ambitious on EDIS

An industry representative noted that EDIS is not necessary for achieving a Banking Union. Much time has been lost because EDIS was overambitious when it was put on the table. The same things have been discussed for the last four years, and a restart is needed

to find a way to embed all of this in a reasonable way that permits different sizes of banks to fulfil their tasks for the economy and for the scope of the clients that they see. Crisis management is always a very individual exercise. With all the rulebooks and all the principles being drawn up, there will always be the odd case that does not fit into it. A crisis is also something that cannot be treated with handbooks alone, but principle-guided treatment of crises of individual banks will be at hand.

4. Can the European system be inspired by the example of the FDIC?

4.1. Resolution under the Federal Deposit Insurance Act

An official noted that for the FDIC's Global Systemically Important Banks (G-SIBs), the very largest banks that are part of the Systemically Important Financial Institutions (SIFIs), the strategy worked on since the last crisis and the passage of Dodd-Frank is the single point of entry. A key feature is the requirement to have Total Loss-Absorbing Capacity (TLAC) to take on the losses so that other creditors and depositors do not have to, and operating subsidiaries can be kept going. That is for the very largest banks.

For the smallest, the community banks, approximately 500 of them failed in the last crisis. They are largely funded by insured deposits and, as a result, when they have problems there is more time to deal with them. They do not face the same liquidity pressures, so there is time to work with the supervisors for corrective actions, and if the situation worsens there is typically time to market the bank to other potential acquirers. Typically, this takes place over a few months or a few weeks, then the resolution weekend, where the bank is closed on a Friday, and an acquirer is usually found to take on the business of the bank, including in most cases all deposits, not just insured deposits. This is possible under the least cost test, because essentially the acquirer decides to bear the costs of covering the small amount of uninsured. Then the bank opens on Monday morning to depositors, and it is business as usual. 95% of those banks that failed in the last crisis were handled through a purchase and assumption (P&A) transaction with all deposits being transferred to the acquiring institution.

The medium-sized banks pose different challenges. Compared to the very largest banks, they do not have the single point of entry resolution strategy and they do not have the TLAC requirement, so there is not the same loss-absorbing resource. They rely much more on uninsured deposits for funding, and sometimes market sources of funding. They are larger and more complex, and the consequences are that when they face problems, there may be more liquidity pressures so there may not be as much time to act. Due to their size, it may be that there are fewer potential acquirers. It may be less likely that a purchase assumption can be done, so a bridge bank may be required, which poses operational challenges. The large amount of uninsured deposits makes it much less likely that a transaction can be done where uninsured depositors are covered, meaning two challenges are created. The first is operational. It is very difficult to sort over a weekend the insured from the uninsured deposits. The bank's systems are not built for that. Second, the disruption that would come from haircutting and imposing losses on large uninsured depositors in such a resolution has not really been faced to such a great extent, but many of these are corporate customers. In such circumstances, the FDIC would be tasked with continuing the failed bank's operations to avoid disruptions to depositors and to maximize value in the ultimate disposition of the bridge bank.

Those are some of the challenges. In terms of actual experience in the last crisis, there are two examples that bookend it. There was IndyMac, which was a $30 billion institution that failed quickly and had to be bridged. Then at the larger end there was WaMu, which was a $300 billion institution, which was able to be sold to JP Morgan Chase. It was interesting that a $30 billion bank was the most expensive bank failure ever, and cost approximately $12 billion. WaMu, the $300 billion bank, cost the deposit insurance fund zero. Finally, in the crisis in the 1980s, some medium-sized banks failed in Texas and New England, and that pushed pressure to have interstate acquisitions, so geographic diversification was a result.

4.2. Lessons to be drawn from the FDIC experience

A regulator noted that there was a lot of talk about flexibility, which can refer to tools and the absorption of losses. The key issue is the absorption of losses. If a model like the FDIC is imported, someone has to cover and absorb the losses. The liquidation of Vicenza and Veneto was reported in a Spanish newspaper as 'Spain 0, Italy 3'. This was wrong, because the taxpayer had paid the bill. In the current framework there is no flexibility. Creditors need to be used in the framework of resolution, the single resolution fund, and alternative financing arrangements can be made after the use of the Fund.

An industry representative noted that the FDIC model in Europe has been accepted as best practice. The problem consists of different insolvency laws in the different member states, and therefore the US model (there is a single liquidation in the US) cannot work in Europe. Also, liquidity support has not been touched upon, and the backup of the Treasury that exists in the US for FDIC. The next point that should be worked on is a liquidity backstop for the SRF. Most of the institutions that got into trouble in the last crisis died of liquidity, not necessarily of capital. The next point is access to some public money: not an excessive amount, and not the typical bailout and things like that, but reasonable ways to use state aid to prevent worse situations.

An official noted that before the FDIC was created there were dozens of legislative proposals for a federal deposit insurance system, and they failed until the great depression. Even after that, state deposit insurance schemes coexisted alongside the federal system. Those schemes did not survive the 1980s crisis. Having one insolvency regime for insured banks, administered solely by the FDIC, is quite helpful, as is having an ex ante deposit insurance fund that is there to allow losses to be borne and liquidity provided. ●