SESSION SUMMARY - VIENNA SEPTEMBER 2018

Resolution of banking groups at the EU Level

1. A new resolution framework is starting to work but is the hardest "nut to crack"

The chair outlined how resolution and rebuilding trust is at the core of many regulatory issues facing the EU in the financial area. Rewinding to the toughest moment of the crisis, trust between authorities was shattered. There were crises in groups that were solved by splitting them along national lines to make them manageable with national crisis management tools, financial support by governments accompanied by the repatriation of business and a refocusing on domestic markets. Looking at data on the de globalisation process he highlighted the reduction in cross border banking. Considering the breakdown by area, almost all of the reduction is explained by intra EU business, which has collapsed since the crisis. An industry representative noted that bank resolution and capital mobility are deeply intertwined. Mobility in good times and bank resolution in bad times are 'part and parcel' of the same issue.

However, trust died 10 years ago. The reflex among regulators was not to trust each other. The chair noted that there has been a huge effort at the global and European levels to re establish this trust by changing the institutional set up and the legal setting. The key ingredients in this area are the recovery and resolution framework, bail ins, which requires banks shareholders and creditors to bear the cost when a bank fails, crisis management preparedness (e.g. living wills) and cooperation within colleges. Another regulator stressed that there is a substantial amount of work ahead to foster confidence among Member States and stakeholders in the resolution regime. In the future, resolution authorities must become a reliable and predictable part of the regulatory environment for all stakeholders, markets and Member States. While a substantial amount of progress has been made, this progress was mainly achieved internally in silos and not by cooperation between stakeholders. The Single Resolution Mechanism (SRM) worked internally on its own establishment as an organisation and on several policies and resolution plans. At the same time, certain non Banking Union resolution authorities did the same for themselves. The banking union should not lead to a rift between ins and outs, but facilitate cooperation throughout the EU.

An industry representative felt the function of a ratings agency was not to survey the industry's progress and offer congratulations. Rather, ratings agencies must take account of what is happening and listen to what the official sector is saying about progress and what remains outstanding. Of course, the BRRD has been a 'game changer' for banks and the investor community, and is therefore a game changer for rating agencies. When BRRD was enacted, they had to take a view on many different aspects of the legislation. The first one of those was government support. The replacement of bail outs with bail ins has implications for ratings, because many banks had government uplift in their rating. One consequence of BRRD, in his view, is that government support is unlikely for small and average sized banks.

A regulator noted that they regularly hear in meetings that the process is going too slowly for some people and too fast for others. The process is probably somewhere in the middle, because everyone is somewhat unhappy. Another regulator feels the tool of EU law could be very powerful here, because it overrides national law. On the institutional side, the industry must trust the Single Resolution Board (SRB) and other authorities to develop a step by step approach to develop trusted relationships with people inside and outside the Banking Union. A regulator outlined how a very large number of people at resolution authorities and supervisory authorities have been devoting their time to crisis preparedness. The system is starting to work, but the area is probably the hardest 'nut to crack' in this package of measures.

Many reasons explain the lack of confidence of Member States vis à vis the EU resolution framework and their current ring fencing policies. But realistic solutions exist to solve these issues.

2. Many factors explain the lack of confidence of Member States vis à vis the EU resolution framework and their current ring fencing policies (capital, liquidity, leverage, bail in able instruments)

The preference for decentralized buffers reflects an awareness that most of the costs of prudent bank risk taking and banking failure remains national. Three main concerns of host countries were expressed: the treatment of bank failures at the EU level is not sufficiently predictable; the availability of group financial support to a failing subsidiary is not guaranteed in case of bank failure; and the issue of liquidity in resolution is not yet clarified.

2.1. The treatment of bank failures at the EU level is not sufficiently predictable.

An industry representative suggested that uncertainty was the principal driver of risk and fear during the financial crisis. The situation was defined not only by where losses were situated, but also by the fact that the rules of the game were changing constantly. Considering the approach to resolution since the crisis, this ad hoc approach has unfortunately continued. Taking the examples of SNS REAAL, Co operative Bank, Banco Espírito Santo, Cyprus, the Slovenian banks, Hypo Alpe, Banco Popular or any of the various Italian situations, it is very hard to find consistency among them. "There has been a substantial move towards private sector loss absorption, but consistency is hard to find", he said.

A regulator stated that one of the key psychological obstacles to trust is that at some point the host resolution authorities will let a subsidiary go to insolvency and not embark on resolution. At least psychologically, this is one of the key drivers of mistrust between the authorities. The regulator reiterated what had been said about predictability, noting that predictability between authorities is very important. It is needed in resolution and, before that, it is needed as a part of supervision when the first intervention measures are taken. Europe must be sure about what the sequence of resolution will be. An industry representative suggested that it is very difficult for ratings agencies to make assessments on banks which are 'too big to fail'. It is not possible to say that for these banks there will never be any government support again. It could be in particular difficult to manage bail-ins during periods of systemic crisis, despite the existence of the MREL buffer.

Another industry representative felt the real question in the debate concerns which system will replace the current one. The simpler strategy is to subsidiarise, ring fence and build a national sandbox. It is simple and it puts things into states' control, but it is dangerous. If all of the capital is pushed to national subsidiaries, the bank will be more likely to fail; it will be much less resilient, given a set of assets and capital, between five and 15 times less resilient. In other words, ring fencing policies are dangerous for financial stability.

2.2. The availability of group financial support to a failing subsidiary is not guaranteed in case of bank failure

In general, the root cause of domestic ring fencing practices emerges from the concern that, should a banking group face difficulties, the parent company will repatriate liquidity and capital to the detriment of subsidiaries in other jurisdictions. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises. The perception of this problem is particularly acute in countries which are strongly dependent on foreign banks for the financing of their economies.

An industry representative raised the question of guarantees and support agreements between the parent company and the subsidiaries of EU transnational banking groups. The problem that is always raised is that host countries want collateral for that guarantee, and preferably in cash. A regulator advised that one piece of legislation that would be helpful to authorities' work on developing trust is the strengthening of group support. If the scope of group support is predefined, Europe can begin building predictability. Another industry representative stressed that Europe must build economic incentives to induce and compel group support. This question is a game theory problem. If a neighbouring country is ring fenced, it is also advisable to ring fence, because it is dangerous to be the one 'no fencer' in a ring fenced world. The industry representative noted that Credit Suisse published a paper on this subject, which concludes that there should be modest replacement, a large pool of group capital that can be moved to where trouble is, and groups should have skin in the game and legal incentives that force them to support hosts.

2.3. The issue of liquidity in resolution is not yet clarified

An industry representative stressed that behind this call for cash and collateral, there is an elephant in the room, which is the missing factor for the creation of trust in Europe. This is the subject of liquidity in resolution. This is not about whether the Single Resolution Fund is liquid or whether it has a backup in case it is called upon faster or quicker than expected; this is about the day to day liquidity of the bank in resolution, or the role of the lender of last resort. The United States and the United Kingdom have both explained to the world how they will institute a lender of last resort. This is a missing piece in Europe. Additionally, European authorities have the power to put this in place rapidly. The fact of its existence would remove the pressure on collateral and cash guarantees that comes from host countries. Fundamentally, this emerges from the fear of a lack of liquidity. If host countries know a newly re solvent bank has access to liquidity from a lender of last resort, the stresses, tensions and fears would be far less acute.

A regulator agrees that the liquidity or funding in resolution is an elephant in the room. Funding in resolution is something that happens in resolution, which means we deal with a resolved entity. To be in resolution means the capital position has been restored and a viable banking business has been created. But according to this official, the trust issue comes before that, because when a group goes into resolution people will believe they can ignore the subsidiaries.

An industry representative agreed, suggesting that the role of the lender of last resort is to be the lender of last resort to a solvent institution, which means it has been bailed in and reconstructed. Adjustments to the resolution and crisis management framework are therefore needed to achieve a unified, transparent and predictable resolution regime.

3. Solutions to address home/host issues and restore trust vis à vis the EU crisis management framework exist and need to be implemented

3.1. Optional group support from EU parent banks to their subsidiaries based on EU law is needed for going concerns and not only during resolution

A regulator felt it is essential to ensure the validity of group support once Europe has agreed on the quantum of scope necessary to build trust in the system. At present, validity is provided by company law; there must be a European law to ensure group support. It is also important not only to ensure validity but also validation. An industry representative also stressed the importance of creating a system which incentivises group support both legally and financially. Another industry representative noted that Moody's often examine internal support within groups. Notwithstanding concerns around harmonisation or fragmentation, Moody's takes the view that for some banks the commitment to supporting a subsidiary is very strong and for others it is less strong, and this is reflected in their rating. Secondly, given the existence of the fragmentation of banking markets in Europe and the national and solo approach, which maintains a domestic focus in the way prudential requirements are imposed on banking subsidiaries across the EU Moody's considers that a resolution scenario for a very large group would be highly problematic.

The first industry representative agreed that improving the legal structure to improve trust with hosts is very important. The industry representative reiterated their view that a mix of financial support with some pre placement could put enough 'skin in the game' to demonstrate to a host supervisor that the host subsidiary is in a better position than any comparative local bank. Groups can show host authorities they have made the subsidiary of an international bank a safer place to conduct financial transactions in that country than an equivalent local bank. Europe can build a much safer system for the host with that mix of moderate pre placed finance, although not full ring fencing, and legal support.

An official clarified that their comments about group support had not been meant in respect of an obligation. This is a tool for institutions to use if they think it better for them; it should be optional and be achieved through a contractual agreement which is fitted at different levels. At present, there is no complete support, or agreement, because these are branches and hence part of a group. With this type of agreement, support can be modulated to a group's risk appetite, which can be useful.

3.1.1. Would such guarantees lead to adverse effects?

A regulator disagreed with the remarks made by the previous panellists, expressing their view that Europe does not need stronger intra group guarantees. The obligation to create trust exists more on the side of the authorities and not on the side of the industry. The regulator explained how the subsidiaries of Austrian banks in the CESEE region have not been abandoned by their parent banks. Rather, the banks demonstrate full commitment to these local markets without any strong intra group guarantees. Such guarantees will in fact lead to adverse effects by removing intra group risk diversification and increasing moral hazard at the subsidiary level. In conclusion, the regulator expressed his conviction that such intra group guarantees will ultimately lead to a branchification process to allow groups to steer subsidiaries and reflect the risk bearing structure of their groups. However, failing a common deposit insurance scheme, such branchification would shift the groups' entire risk to the home deposit insurance system, which would increase risks in these countries unduly. Lastly, these guarantees would substantially damage the development of local financial systems, including regional capital markets.

3.1.2. The two resolution strategies – Single Point of Entry (SPE) and Multiple Point of Entry (MPE) can perfectly coexist very well

An industry representative felt that the regulator had cogently explained the differences between the two types of resolution strategy. The industry representative noted that the regulator had described the multiple point of entry strategy (MEP), which works perfectly. However, there is also a single point of entry strategy (SPE), which could serve the way a group is organised. The two models can coexist perfectly well, and Europe should not oppose the existence of both of them.

An audience participant wondered whether a single system of entry or multiple points of entry should prevail over the other, given that Europe is seeking an integrated financial market. An industry representative felt that the most important issue is to know which kind of strategy is being implemented. A regulator suggested that this issue is a question of how groups at the European level are organised. They can be organised in compartments which function relatively independently or they can be aligned to the centre. The regulator expressed his conviction that nearly all groups are both of these things in various markets. These two structures are not two separate systems, and one system is not better than the other. The SRB has always expressed the view that this is not about groups choosing how they would like to optimise their MREL. The solution should be derived from how a group is organised and run.

3.2. Fostering cooperation between supervisors and resolution authorities and enhancing the transparency of the resolution strategy for external stakeholders

A regulator felt that Europe must break up its silo mentality and acknowledge that the European Union is far more than the Banking Union. After three years in which the focus of the work has been internal, it is important to refocus attention towards non Banking Union EU countries. There should be common policies which are applicable to all Member States. A common understanding should be developed, along with a unique basis for resolution plans, especially for cross border banking groups. This common understanding should lead to joint decisions within the resolution colleges. These colleges should be the forum where the resolution authorities discuss their strategies with full transparency, common understanding and agreements on resolution plans. Second, there should be close cooperation between supervisors and resolution authorities, between the SSM and the SRM. There is definitely room for improvement even within the existing framework. The regulator considered it inexplicable why it is so difficult to share information and cooperate very closely in ordinary business as well as crisis situations. Lastly, transparency is not only key within the regulatory world; transparency is also key for external stakeholders. Therefore, resolution authorities should create clarity through structured communication.

A regulator stressed the importance of cooperation. When tackling a problem like this one, it is important to start with the headquarters of banks and not the subsidiaries. This method may have given some non euro area members of the EU the feeling they were being excluded. In respect of predictability, it is also important to be sufficiently clear that resolution is a dedicated special insolvency system; it is the insolvency procedure for highly complex cases.

The most important part is to make banks resolvable, which is what resolution planning is about. It also means defining critical functions, particularly in respect of critical financial market infrastructures and how to unwind portfolios in a structured way. There is a great deal of work to be done, but European authorities should get some credit for the work they have already completed. Resolution is being worked on, and the Single Resolution Board (SRB) is trying to expand to other authorities step by step. Within Europe it is probably still necessary to convince the last few countries who are concerned with safeguarding their institutions. It is important for all players to understand that this cannot be the solution. However, saying this can be done from a single jurisdiction alone is also not the correct approach.

3.3. Moving towards a common liquidation regime for transnational EU banks

Europe must develop an approach to the liquidation of transnational banking groups in case of this happening to a large group. Indeed, despite the fact that these transnational banking groups are supervised at the EU level and that this liquidation would impact the whole euro area, liquidation is still managed at the national level on an entity by entity basis. This can require public money from the Member State where the entity is located. In addition, recent cases have shown that idiosyncrasies in national liquidation rules give rise to unforeseen impacts on resolution execution. The scope and variety of these differences create unwelcome uncertainty. A common liquidation regime for these banking groups should ensure an equal treatment of creditors of the same rank within the group and should address the possible costs at the EU level.

3.3.1. Completing the insolvency hierarchy related to loss-absorbing liabilities

An industry representative explained that it is unnecessary to create a perfect insolvency hierarchy; it is only necessary to perfect the parts containing loss absorbing liabilities. It is essential to consider capital instruments through to senior non preferred debt. Europe did something extraordinary with the change to article 108 of BRRD. In less than one year a legislative proposal went through the European Parliament and the European Commission, and was introduced. This part of the hierarchy is now harmonised across Europe. Completing this work can be done. Europe should address this in BRRD 2, before the end of the current Parliament. Europe needs a harmonised banking insolvency hierarchy for the layers down to senior non preferred debt, i.e. the layers that matter in relation to bail ins. If Europe develops the essentials of individual bank insolvency regimes in the right way, it will be able to build more quickly an insolvency regime for banking groups that will be common across the desired perimeter, whether that is the Banking Union or the European Union. This ambitious, but it will take Europe to where it could go by using branch structures and bring an entire banking group under a single insolvency regime.

4. Conclusion

The chair emphasised the considerable amount of work being done by the Single Resolution Board (SRB) and resolution authorities to make this topic progress. At the same time, there is a perception, certainly on the industry side, that if Europe waits until everything is finalised to let cross border business flourish again, it might be too late. There is a clear sense of urgency here. Importantly, Europe must ascertain whether further legal fixes are needed, because these will take a considerable time. The regulator summarised the discussion, noting the following key messages. First, the issue of group support is not an obligation for all groups but an additional tool with a stronger legal basis. The issue of pre positioning is mainly an issue for discussion in resolution colleges. This is not a question of whether Europe will have it or not; it is an issue of quantum. If pre positioning is high it could reinforce balkanisation; if it is low, there could be a problem of trust. Europe must find the right balance; this is a task for resolution colleges and joint decisions. The balance between ins and outs, especially in the single market, will be a very important element.

Second, liquidation was clearly highlighted. There are situations in which the bar of the public interest test is set relatively high and then there is liquidation at the national level. There are cases like in Denmark where liquidation would go into normal corporate insolvency without the possibility of deploying an administrative tool. This means the Danish authorities have concluded that all banks must pass the public interest test and will need to be put into resolution. In the single market, this is one implication on the funding costs of different banks. Europe must address this issue somehow.

Third, harmonising insolvency laws will always be challenging, but there are areas where this is possible. Finally, the completion of the safety net via the European deposit guarantee scheme will reinforce trust from host authorities.