IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

An official described how the European Commission announced reviews of the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD). There is a new acronym in the world of banking union: CMDI, which stands for Crisis Management and Deposit Insurance. Since the introduction of the Single Resolution Board (SRB) and Single Supervisory Mechanism (SSM), there has only been one resolution case, which raises questions about the effectiveness of the system and the scope for further refinement.

The discussion focused on the resolution framework, the State aid framework, the review of the deposit insurance framework and the potential for a common European Deposit Insurance scheme. It emerged from the discussion that the review of the EU crisis management framework requires a comprehensive approach. Defining and implementing the public interest criteria in a single way, addressing differences in national insolvency laws and aligning state aid rules with the EU crisis management framework will make it more effective. The discussion also highlighted the specific challenges and potential solutions concerning crisis management for small and mid sized banks. The European Deposit Insurance Scheme (EDIS), however, is still a controversial subject.

1. A holistic approach to addressing the weaknesses of the EU crisis management framework

A policy-maker emphasised that Europe has a very sophisticated crisis-management framework that does not seem to be suitable for all types of bank. This creates risks around circumvention, raises level playing field issues, and does not create confidence within the Banking Union. Regulators must take a comprehensive approach and ensure that the 'pieces of the puzzle' are connected. The Commission's analysis includes BRRD and SRMR, but it will also need to consider DGSD, national insolvency rules and coordination with state aid rules. The Commission sees EDIS as central to an optimal outcome, but no decision has been taken on whether or not to table a fresh EDIS proposal. As a concrete priority, the Commission wants to ensure that EU resolution and national insolvency rules apply to the right institutions and form a coherent framework with the right incentives in a level playing field. The industry must develop solutions that allow flexibility in insolvency and determine whether there is a need for more harmonised tools.

An industry representative stated that the crisis management framework has improved and strengthened the resilience of banks. The 'proof of the pudding' is the fact that there have been very few challenges to individual banks. The industry representative stated that it is rare to agree entirely with a legislator, but there was very little to dispute in the policy maker's (Martin Merlin) comments.

1.1 The CDMI review should define clear rules to avoid any increase in the sovereign bank loop

An industry representative described how the crisis management framework has helped reduce the sovereign feedback loop, noting however that there are banks in many member states with considerable levels of public debt. This is aggravated by the fact that in some member states these dependencies have increased as deposit guarantee scheme (DGS) funds have been transferred to national treasuries to lower indebtedness. This is not always a bad investment in terms of credit risk, but it increases the sovereign feedback loop. The review should provide clear rules to avoid this.

1.2 The European banking industry needs evolution, not revolution

A regulator agreed that the resolution framework works, adding that there is nothing, however, that cannot be improved. What is needed is evolution rather than revolution; revolution always ends in chaos. There is a need to have a clear view on the end goal, including EDIS and an update of the Banking Communication in the CMDI review. Then policy makers would agree on a clear and time-bound calendar for the transnational period towards the steady state.

1.3 Taking a step-by-step approach

An industry representative noted that the Banking Communication could be rewritten or at least clarified in terms of how it works with the resolution regime. Indeed, 'the pieces of the puzzle' need to come together, but this is complicated by the fact that the pieces are all moving at the same time. It would be better to take a step by step approach rather than trying to do everything at the same time.

2. Defining and implementing the public interest criteria in a single way

2.1 A European approach to the Public Interest Assessment (PIA)

Banks without a positive PIA should exit the market in the most efficient way possible. An industry representative stated that the resolution process begins with the independent and serious decision of the PIA at the European level. There is a need for a European component to this decision or European supervision of the way the decision is made. This could be handled by the Single Resolution Mechanism (SRM) or the SSM, because they have an opinion on whether a bank is viable or not. Ultimately, that is the relevant question. The national decision is not always as independent and cool headed as it could be.

2.2 Harmonising the rules related to the PIA

An industry representative noted that the landscape is much more diversified for smaller EU banks, which complicates the application of resolution and liquidation rules. Therefore, the SRB's work to further refine the PIA is welcome. The SRB is better placed than member states' competent authorities to apply this test. The BRRD should also be clarified to better define this element.

2.3 Clarifying the existing legal provisions concerning the PIA

A regulator agreed on the need to clarify the legal provisions concerning the PIA, though this speaker is cautious regarding the legal amendments, as the SRB is already carrying out policy work in this regard. The SRB is in the process of expanding the PIA to an assessment of how to manage a system-wide stress scenario. The scope of this should be broadened for a positive result. The logical consequence of a positive PIA is that banks need to be resolvable. These banks need some Minimum Requirement for own funds and Eligible Liabilities (MREL) and they need to be operationally resolvable. The legal framework is adequate, but there is work to be done.

2.4 Ensuring a smooth exit for banks that do not pass the PIA

A regulator described how there is both one European resolution regime and 21 plus insolvency regimes within the Banking Union. If the industry seeks a more European approach, national procedures must be harmonised. Banks without a positive PIA must exit the market in the most efficient way possible. An industry representative noted that the Banking Union is not complete, because the market is not sufficiently integrated. Resolution procedures at the national level are producing 'zombie banks', which increase national fragmentation, are bad for domestic consolidation – and therefore profitability – and make the European banking market less attractive to investors.

2.5 A wider approach to the PIA

A policy maker considered that a wider approach to the PIA will ensure that resolution is applied in all cases where insolvency under national law is not appropriate. The more that can be done through EU wide harmonised rules, the easier it will be to achieve a level playing field and to enhance confidence. However, expanding the application of the PIA is not sufficient. Having more banks in resolution means that resolution must be a credible and feasible strategy. If a bank is put in resolution and requires funding from the Single Resolution Fund (SRF) or a DGS, the conditions of that funding should not be an insurmountable obstacle. While there should be strict conditions attached to funding, those conditions must be realistic.

3. Challenges and possible solutions for medium-sized banks

3.1 To be resolvable, banks need to have enough loss absorption capacity (MREL)

An industry representative suggested that, following a PIA, if a bank is in scope of resolution, the bank should need some MREL. Business model, size, country, local market and rating must be taken into account. If flexibility is applied, it should happen at EU level. National competent authorities (NCAs) must apply the rules if they wish for financial institutions to be covered by the BRRD.

3.2 A way forward for medium-sized banks

A regulator explained that mid sized banks are generally equity and deposit funded. There cannot be a group of banks for whom resolution is too cumbersome and insolvency also does not work. To solve this problem, these banks should be made resolvable. It is useful to consider the best use of a DGS in this process. When seeking to resolve a bank, there will either be a transfer strategy, which is a resolution strategy, or a plan for the bank to exit the market, in which case the DGS safeguards depositors. If the bank must be sold, it is important to consider the franchise being sold. It is not a good idea to bail in the customers who want to sell. This raises questions about whether the transfer should be supported. Transfer tools are not a 'free lunch'; they have a cost. In the current system of super priority, the DGS will not experience many losses. If Europe wants to move to a US style system, it should reassess depositor preference to ensure we make the best possible use of DGS funds.

3.3 The importance of the funding side to support early intervention

A policy maker highlighted the importance of funding. The Commission considers that EDIS would make the industry more effective. EDIS is a natural complement to the crisis management framework. The liquidity support in a 'hybrid EDIS' could minimise the risk of shortfalls and an overreliance on taxpayers' money. A hybrid EDIS providing liquidity to support DGSs could use some of the tools in the current framework, including DGSs in resolution and well-framed preventative measures and alternative measures. The industry must consider the synergies that could be created between a sufficiently ambitious EDIS and the SRF; the smart use of these instruments could lead to flexible and balanced funding solutions.

Broader use of DGS resources in liquidation and resolution would facilitate the use of transfer tools but this proposal is not consensual.

3.3.1 Apart from resolution, deposit guarantee schemes should not be used for purposes other than guaranteeing deposits

An industry representative cautioned that Europe should be very careful about deposit guarantee schemes to be used for purposes other than guaranteeing deposits following negative PIA. The industry must 'go back to basics'. In the case of resolution, the question is whether this is being handled properly at the national level. Another industry representative agreed that it is not a good idea to use a DGS for preventative measures. A DGS is for liquidation. Other measures exist for this purpose; they are clear, and they have been applied in the past.

3.3.2 DGSs could support the wind down of non-systemic banks, given the prior establishment of strict least cost tests and adequate loss sharing

A regulator highlighted the issue concerning failing small and mid sized deposit funded banks which do not pass the PIA. Reformed DGSs could form one important part of a possible solution, but the Banking Union should strive for EDIS as a European solution. It is important to be realistic: neither the European nor the banking Union are clearly at this point yet, which is why it is essential to address the issue within the current framework. However, allowing member states to implement diverging setups for DGSs would be a step towards fragmentation. The banks being discussed almost entirely fall under the competence of national resolution authorities and not the SRB. DGSs are national financial instruments. In any near term solution, resolution will have to occur on a national level or be embedded in a harmonised European framework. Currently, a DGS mostly has a paybox function in a bank's insolvency: it pays out covered deposits and then seeks to recover funds as a super senior creditor. This approach is not always the most cost efficient or the cheapest, however. There could be cases where a more flexible usage of a DGS could be beneficial. Contributing to a standardised P&A tool could be more efficient and less costly than paying out covered deposits and then recovering funds. Moreover, continued access to accounts and deposits could positively contribute to financial market stability.

The regulator suggested that, if DGS funds were also used for such transfer operations, the same strict conditions for accessing the SRF should hold true for the use of DGS funds. Furthermore, a comprehensive implementation of a least cost principle should be a key element of any DGS intervention. The criteria for this test must be harmonised within the EU. Any DGS contribution must be conditional on the market exit of the bank. In order to prevent moral hazard and excessive losses for the DGS, additional safeguards for DGSs will be required. A dedicated mandatory layer of gone concern instruments above the regulatory capital requirements could be one way forward. A side effect of this would be an increased level playing field between these resolution banks and liquidation banks. A maximum threshold introduced to limit the financing of a transfer tool via DGS funds is another feature which should be evaluated.

Two regulators mentioned the need to set down adequate rules for access to funding in resolution. This would require revisiting the conditions that limit the uses of DGS in resolution, especially the current super priority of covered deposits.

4. Aligning State aid rules with the EU crisis management framework

4.1 Reviewing the state aid rules for banks in the context of the broader CMDI review

A policy maker considered that any reform should include a consideration of state aid rules, particularly the use of liquidation aid. There is a need for a careful evaluation of the requirements to access funding under the resolution and state aid frameworks in order to assess whether further alignment and coordination is appropriate. The Commission's current plan is to present a proposal concerning the resolution and the deposit insurance framework at the end of the year. First, the Commission will draw out lessons from the ongoing consultation and political discussions between member states. There is also a commitment in the Eurogroup to come forward with a work plan for a Banking Union by June, the content of which will have to be taken into consideration before a proposal can be tabled.

A regulator noted the importance of addressing the Banking Communication. It is a difficult proposition to have a clear framework for burden sharing and creditor hierarchy while creditors are still able to get a better result from the insolvency process if they are convincing. It is vital to eliminate the existing loopholes in the framework and ensure that the Banking Communication is aligned. An industry representative highlighted the tiny number of resolution cases. The Banca Tercas case shattered the industry's ideas about the process. In that case, judges said private money is not public money. On the other hand, the money from the DGS comes from the compulsory contributions of banks and is then passed to customers to serve the public interest, which is not very different from a tax.

4.2 A holistic review of State aid rules and the crisis management framework will ensure a coherent set of rules for both frameworks in the future

A policy maker explained that state aid control comes directly from the Treaty. Its function is to assess injections of public money to private entities. The 2008 Banking Communication – as expanded in 2013 – specified the minimum requirements for aid to banks to be compatible with the internal market: aid to banks must remedy a serious disturbance in member states' economies and prevent distortions of competition. The Banking Communication was a realisation of the State aid regime as it exists in the Treaty.

The policy maker stated that the Commission is evaluating, among many other issues, the suggestions of perceived inconsistencies around the burden sharing requirement. The Commission has also noticed the suggestions of inconsistencies between the PIA and the concept of serious disturbance. However, the PIA comes from the BRRD and is a relative test; it assesses whether the resolution objectives would be better achieved in resolution rather than liquidation and insolvency proceedings. The serious disturbance test, however, is an absolute test in the EU Treaty, which assesses whether such aid could remedy a serious disturbance or not. The European Commission regularly evaluates and reviews State aid rules in the light of new market and regulatory developments. European policy makers are reconsidering its regulatory framework in the context of the COVID crisis and the potential effects of this crisis on the real economy. The European Commission will review the Banking Communication at some point, but reviews and evaluations should be carried out consistently – and in a holistic fashion together with the BRRD and the entire crisis management framework. For instance, the bail in rules in the BRRD came after the bail in rules in the Banking Communication. The Commission considers it essential to take a holistic approach on these issues. The policy maker explained that, while the outcome of the Banca Tercas case does not seem to please many stakeholders, the solution could not consist in simply qualifying these situations as incompatible aid: consistency with previous case law needs to be ensured. Moreover, contrary to banking legislation, state aid principles apply to all sectors of the economy, hence cross sectoral consistency needs to be ensured when exercising state aid control. For the time being, since the EU legislator has chosen to respect national specificities in the design and functioning of national DGS the the Commission will carry out case by case assessments to assess whether an operation by a DGS is imputable to the state or not. If all DGSs were subject to the same rules, the Commission could judge whether there is imputability to a public budget. As long as there is a choice between a private or public DGS, the Commission will have to proceed with this case-by-case assessment.

5. EDIS remains a contentious issue

5.1 EDIS is what is missing from the EU crisis management toolbox

A regulator suggested EDIS is a necessary third pillar of the Banking Union to ensure financial stability and to overcome the sovereign bank loop. However, there have been innumerable attempts to create a roadmap for EDIS. Europe must 'hit the road' at some point. There will need to be interim steps on this journey, but these steps should contain a clear idea of the ultimate destination. While the SRB is committed to making banks resolvable and to broadening the PIA, the industry must work to achieve resolvability. There is a need to align the insolvency framework and ensure there is room to manoeuvre for the use of DGS funds, but ultimately EDIS is the best option.

5.2 Clinging to the idea of EDIS is an impediment to reaching an optimal European solution

An industry representative stressed that, outside the virtual debate on the 'acronyms invented in Brussels', banks are coping with the fallout from the COVID crisis. In all likelihood, the industry will have to overcome an increase in non performing loans (NPLs). It is therefore a particularly bad time to consider replacing the EU's well-functioning Banking Union and harmonised deposit guarantee scheme with EDIS. It is not a sound argument simply to repeat the mantra that the third pillar of the Banking Union must be EDIS. The industry could address some of the real shortcomings here without the introduction of EDIS. On the home host issue, a less restrictive allocation of liquidity within a banking group could be reached without endangering the deposit insurance system in the host country. Responsibility for deposit insurance should lie with the parent company's deposit guarantee scheme. Second, to foster cross border consolidation, the industry needs a system of adequate premium refunds when an institution leaves as a result of a merger. Ultimately, the inflexible focus on the EDIS model is causing the deadlock. Principally, the Commission is not open to the idea of changing or withdrawing its EDIS proposal. The so called hybrid model is not fundamentally new; a fundamentally different proposal would ensure the continuation of well functioning Institutional Protection Schemes (IPSs). EDIS would prohibit the use of funds for preventative measures, which would eliminate this effective toolbox.

The Commission should build on the subsidiarity inherent to the CMDI framework: a clear distinction between systemically important banks under the direct responsibility of EU institutions and non-systemically important banks under national responsibility. Changing this foundation cannot be justified economically or politically. It would contradict the idea of a diverse Europe and undermine local responsibility. The European Court of Justice's recent ruling in the Banca Tercas case highlighted the validity and importance of using preventative and alternative measures to support troubled members of a guarantee scheme from within their respective peer group. By definition, these measures must be economically more advantageous than mere reimbursement of depositors in the event of liquidation. Following the reasoning confirmed by the Union's highest court, the CMDI review should seek to strengthen the role of existing DGSs and IPSs within crisis management by committing to preventive and alternative measures. In addition, national authorities should be provided with additional tools to deal with banks going into insolvency. This would improve the proper functioning of the banking union and maintain the diversity of the EU banking system at the same time.

5.3 Making full use of the Banking Union as a single jurisdiction could break the current deadlock

An industry representative stressed that there are still issues to address concerning capital movements, liquidity and the cross border elements for cross-border banking groups. Considering that from a supervision perspective the Banking Union is a single jurisdiction, such obstacles are not justifiable. This underlying flaw of the banking union's first pillar (supervision) also undermines the functioning of the second pillar (resolution). This issue should be addressed as the policy makers and the industry should consider the move to EDIS. These two pillars must be very stable. The current dynamics in Pillars 1 and 2 undermine the acceptability of any EDIS-like structure as a Pillar 3. As long as the Banking Union is not a single jurisdiction, solutions – i.e. the sale of a business – will be found at the national level. This holds back future integration, risks amplifying domestic issues and hinders any way forward on EDIS.