EU BANK CRISIS MANAGEMENT FRAMEWORK

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Where could we improve the framework for medium-sized banks?

A centralisation of tools and funding at EU level would increase the credibility of the Banking Union.

One of the main goals of the ongoing review of the Crisis Management and Deposit Insurance framework is to enhance how we address the failure of medium-sized banks. The lack of diversification of their liabilities (mainly equity and deposits) potentially puts into question their ability to bear losses in resolution, as own funds may be exhausted at that point, and bailing-in deposits may hamper financial stability.

This might undermine the credibility of their resolution strategies, as resolution is not a free lunch and access to the Single Resolution Fund (SRF) is subject to bail-in of not less than 8% of total liabilities and own funds (TLOF). As for any other bank, it is crucial to address operational resolvability and build up the mandatory minimum requirements for own funds and eligible liabilities (MREL) buffers by 2024. However, some of these banks have not yet been able to tap – or at least historically have not tapped – the markets to build up adequate MREL.

The SRB is working to better adapt its resolution framework to these banks, using the proportionality principle, but without undermining the end goal: resolvability. This work relies on the following three main pillars: transfer strategies, tailored MREL calibration and access to funding. On the first two, the SRB is in the driving seat, but legislative changes are required for the third.

First, transfer strategies seem to be the best tools for medium-sized banks. The SRB is working to enhance its preparation for using these strategies. For instance, in the first half of 2021, the SRB has made substantial progress in making transfer tools fully operational. The SRB will also prepare additional policies and guidance on separability.

Another important missing piece to solve the problem of medium-sized banks is to put in place a European Deposit Insurance Scheme.

Second, MREL needs proper calibration for transfer strategies. In 2022, the SRB will work on MREL policy for the banks that have transfer tools as the preferred resolution strategy. This could, under certain conditions, lower the MREL requirement for banks compared to the status quo. For banks with a credible transfer strategy, there might not be a real need to set MREL at a level that allows the full recapitalisation of the bank. As a result, MREL requirements could be lower, based on the likelihood of transfer strategies being reliably implementable.

Third, access to external funds in resolution, if needed. Currently, banks facing resolution may have access to the SRF and/or the deposit guarantee schemes (DGSs) under certain conditions. However, these conditions severely restrict the use of DGS funds in resolution, potentially jeopardising the success of resolution. This may create incentives for decision-makers to look for ways to circumvent the resolution framework.

Access to the SRF and its combined use with DGS could be further explored, to act as funding to support those resolution tools other than bail-in that ensure the exit of resolved entities from the market through transfer strategies.

To overcome the legal framework's restrictions on the use of DGS in resolution, we recommend replacing DGS-super priority by adopting a general depositor preference. The DGS could then contribute to resolutions in a way comparable to other creditors, in accordance with the creditor hierarchy. While this would likely be a limited contribution, given that the DGS would continue to rank above most creditors, it aligns to the broader responsibilities of the DGS in subrogating to the rights of the covered depositors. This would help to achieve all the resolution objectives; including minimising the use of public funds and avoiding further value destruction.

Notwithstanding the above, given the limited size of national DGSs and the existing uneven playing field, another important missing piece to solve the problem of medium-sized banks is to put in place a European Deposit Insurance Scheme (EDIS). A centralisation of tools and funding at EU level would reduce fragmentation and increase the credibility of the overall Banking Union, thereby further enhancing financial stability.

HELMUT ETTL
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Broader DGS support for failing banks – Yes, but not unconditional!

The current resolution framework is certainly more tailored towards highly concentrated banking sectors with only a few national or even global players than to highly fragmented markets with several hundred banks. The prominent role of MREL in resolution is one indicator in this regard. While for globally active banks with a long track record of bond issuance, issuing MREL eligible debt does certainly not constitute a major obstacle. However, it does so for small, regional banks with either limited or even no capital market access at all. The problems here range from high one-off costs to start an issuance program and the lack of experience in bond issuance to the required minimum ticket size, which smaller bank often fail to reach due to their deposit focused refinancing of their balance sheet.

Of course, there are several other topics in the context of how a failing smaller or medium sized bank can orderly exit the market without any substantial market disruption. These encompass several fundamental aspects, such as whether there is the need for an own regime for small and mid sized banks or not or whether to include those banks in the resolution framework or the national liquidation framework. However, let me return to one of the key elements already mentioned above – loss absorption and financing of the wind-down and exiting process.

It seems to be evident that it is not enough to simply impose full MREL-targets and hope for compliance. Some of those banks would not reach these targets at all, some would require years.

These banks would not be resolvable, they would impose a threat to financial market stability and (resolution) authorities would be accountable. In order to address these challenges, loss absorption requirements will need to be more tailored to the actual business model, the riskiness and the financing conditions of the respective banks, or put differently some form of proportionality will need to be implemented for loss absorption requirements.

This leads me directly to the question how costs in resolution could alternatively be born. In this context, a more flexible usage of DGS funds could open up new possibilities. DGS funds instead of MREL funds could, for example, be used to finance a transfer of viable parts of a bank to another bank. Of course this should not mean to altogether abolish burden sharing arrangements and hence loss absorption requirements for small banks. As mentioned above, mid-sized banks required to hold MREL in particular struggle with the issuance of sufficient MREL eligible liabilities.

DGS could play a relevant role in the winding down smaller banks – but not at no cost.

One potential way forward would thus be to oblige those banks to hold an additional standardized calibrated “MREL buffer” beyond regulatory capital requirements in gone-concern-capital instruments, e.g. Tier-2, but in turn to allow for a usage of DGS funds in the resolution of those banks. Of course, such a usage of DGS funds would need to be conditioned upon several things, most prominently upon the loss bearing of shareholders and other holders of regulatory capital and the market exit of the bank.

Another key condition for such an enhanced usage of DGS funds would be a more harmonized and comprehensive definition of the least cost principle in order to ensure a level playing field nationally and across the EU. Currently, this least cost principle is defined by only one sentence in the DGSD, stating that “the costs of the alternative measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS”. How such a specification would look like in more detail remains to be seen, a combination of different cost perspectives and conditions could proof to be a promising way forward.

Furthermore, a least cost principle should not only take into account how much costs arise for the DGS, but also when those costs materialize. Though a DGS might be able to reclaim parts of the paid out covered deposits in the course of the insolvency procedure, these revenues are often realized only many years after the insolvency. Using DGS funds for bridging a liquidity gap in the transfer of business to another bank on the other hand might result in higher one off costs, but those costs might be recovered faster through the sale or transfer of all or parts of the failing bank. Introducing this timing component in the least cost principle can be one potential avenue to improve the measurement of costs in case of an alternative usage of DGS funds.

Summing up, a broader but yet conditional usage of DGS funds can constitute a potential way forward.

At the same time, such an instrument would of course also need to fit within the whole package. This is why I would generally advocate having the discussion on the usage of DGS funds and the least cost test as well as on other specificities only in the context of the whole solution proposed for the revision of the crisis management framework.

EDOUARD FERNANDEZ-BOLLO

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Improving the EU crisis management framework for small and medium-sized banks

The creation of European banking supervision and the Single Resolution Mechanism in the aftermath of the great financial crisis were two crucial milestones on the EU's path to an effective and integrated framework for managing crises. However, in the quest to address too-big-to-fail issues, less attention was paid to managing crises at small and medium-sized banks; it was assumed they would not pose financial stability concerns and could be dealt with under ordinary liquidation procedures at national level.

This assumption has been proven wrong. In some cases, the declaration that a bank was failing or likely to fail at European level did not trigger ordinary insolvency procedures at national level, effectively preventing the authorities from forcing a failed bank to exit the market. Moreover, within the banking union, some Member States rely on administrative bank liquidation regimes with similar instruments to those used in resolution procedures, while others follow the same liquidation procedures that are applied to corporates – often resulting in similar situations being managed differently in different countries depending on the national insolvency procedures. This lack of harmonisation creates an unlevel playing field in the euro area and undermines the potential of the banking union to deliver a truly unified European banking market.

When looking to enhance the consistency and effectiveness of the European crisis management framework, the US model, centred around the Federal Deposit Insurance Corporation, offers valuable insights. Under this model, viable parts of an insolvent bank are matched with a thriving acquirer, often located in another state, thereby allowing small and medium-sized banks to reap the benefits of a large and integrated market while ensuring smooth market exits with minimal impact on depositors.

When considering how the US solution could inspire changes to the banking union, two features stand out. The first is a deposit guarantee scheme, which could support the liquidation of a failed bank's assets, ensuring that the failure of medium-sized banks is handled in an orderly and effective manner that guarantees a smooth market exit and only a small impact on local financial stability. This should be done in the most harmonised manner possible in the euro area, with a view to achieving a fully unified model with the implementation of the third pillar of the banking union. The second feature is enhanced predictability of resolution outcomes, which could encourage market participants to engage in cross-border activity and consolidation, and therefore contribute to a more integrated European banking market.

An effective crisis management framework for smaller banks is key for a unified banking market.

But how can we achieve this in practice? First, as a supervisor I would stress that focusing on actions that can prevent a bank's failure, such as improving recovery plans, remains key. In addition, under the Single Resolution Board's revised approach to the public interest assessment (PIA), the resolution framework can be applied more broadly so as to level the playing field for small and medium-sized banks. However, this would mean that smaller banks would need to meet higher minimum requirements for own funds and eligible liabilities (MREL). As these banks rely predominantly on deposits and have limited access to capital markets, their MREL target would likely be met mostly with equity, which could be depleted at the point of failure, requiring a bail-in of uncovered deposits. And even with a broader PIA, resolution would not be available to all banks. Alternative options need to be explored.

One option would be to ensure, through harmonisation at European level, that national resolution authorities have administrative powers to transfer assets and liabilities in liquidation as an alternative, or complementary, measure to an insured depositors' pay-out, with the support of deposit guarantee scheme (DGS) funds. Although discrepancies across Member States could render this solution sub-optimal, allocating administrative liquidation powers and DGS funds to the European level would be more conducive to orderly wind-ups.

However, the absence of a European deposit insurance scheme remains an obstacle, as an exclusive incentives of decision-making power at European level may be misaligned with the use financing tools at national level. A "two-keys" process could be an intermediate solution: the Single Resolution Board would retain the power to trigger liquidation when resolution is not available and check that the transfer of assets and liabilities ensures an exit from the market, while the national authorities would retain the power to decide whether national DGS funds can be used for this transaction.

Although small and medium-sized banks have so far emerged unscathed from this crisis, we should not be complacent. An effective and consistent framework that caters to crises at these banks is crucial to deepen integration, and therefore ensure financial stability, in the European banking market.

JUAN POSWICK
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A way forward in crisis management for small and medium sized banks?

All concerned parties tend to agree that part of the issue stems from the lack of consistency in the implementation of the existing framework and some of its founding principles. Inconsistencies appeared between the European and national levels as well as between different Member States. Besides consistency, at least across the Banking Union, improvements should come in terms of harmonization and predictability.

In this respect, the evolving SRB approach of Public Interest Assessment (PIA) could open an interesting way forward. In our view this could entail that all banks with a minimum balance sheet size, e.g. € 15 to 20 billion, be deemed susceptible of a positive public interest assessment a priori. They should fall under the sole responsibility of the Single Resolution Board (SRB) and not of the National Resolution Authority (NRA) if Failing or Likely to Fail (FOLF).

Accordingly, they would all be subject to MREL requirements, including a recapitalisation amount, and they would all have access to the Single Resolution Fund (SRF) at the same conditions. Similarly, they should fall under the SSM. Consequently, in case of troubles, the possible use of early intervention or preventive measures would be decided at European level in a consistent way, with due coordination between the ECB and the SRB. Although national authorities would remain involved, the decision power for these banks should reside at European level.

The ability of smaller banks in this category to issue Eligible Liabilities in order to meet the MREL targets that belong to the proposed approach is evidenced by empirical analysis of public issuances, which can effectively be complemented by private placement arrangements, available for relatively small tickets. The costs appear quite fair and reasonable compared to that of large banks. Based on the last SRB MREL dashboard, it is worth noting that shortfalls vs. targets concentrate on a limited number of countries, which may be a sign that issuance problems are not linked to size but to local market practices or conditions. We believe that such problems may be overcome by the banks themselves with support from advisers, if necessary, to better represent their strengths and access targeted investor pools.

Besides consistency, improvements should come in terms of harmonization and predictability.

For smaller banks, below the above-mentioned threshold, a way to foster further consistency would be to give the SRB a final say in the PIA. In case of negative PIA, a FOLF situation should entail an effective and rapid exit from the market, a key principle at the basis of the crisis management framework. To that effect, a harmonisation of banking insolvency rules for insolvency triggers following FOLF declaration would help ensuring a level-playing field and avoiding cross-border NCWO issues or limbo situations.

It is also important to address the sometimes controversial use of preventive or alternative measures funded by mutualised or public resources. Here again, we would see benefits in giving a final say to European authorities for the sake of consistency, among other in the way the least cost test is applied and in the logic behind the recommended use of such measures in relation to the PIA. If such measures were to be used for banks with a negative PIA, they might delay but should not prevent an effective market exit. They should neither limit nor eliminate due burden sharing by shareholders and subordinated creditors.

More generally, access to the public or mutualised funds should indeed always remain subordinated to that key condition. To reduce the burden on other banks, minimise moral hazard and avoid competition distortions, adequate burden sharing must be imposed on any failing bank's shareholders and creditors, e.g. through write-down of equity and bail-in of subordinated debts, whenever an authority or a DGS deploys preventive or alternative measures. This should hold whether utilising public funds subject to state aid restrictions, or privately mutualised funds. In addition, each such measure should be subject to the least cost test.

This key principle of burden sharing must also apply to FOLF depositor-funded banks whatever their size. Equity and debt holders of such banks must be clearly informed about the risks attached to their investments, in line with MIFID, and protective rules for retail investors should be reinforced as appropriate, e.g. through relative limits for such investments, in order to prevent socio-political issues upon FOLF event.

Without fundamentally changing the existing framework and by consistently applying key principles initially set by the EU lawmakers we believe that some serious steps forward could be achieved.

JOHANNES REHULKA
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Do not to throw the baby out with the bathwater

Necessary amendments

When we start to think about improving the CMDI framework we have to keep in mind the current regulatory framework. After long and intensive negotiations, the legislative bodies came to the political decisions to establish a regulatory framework for systemic relevant institutions (BRRD and SRMR) and a regulatory framework for non-systemic institutions (DGSD). These political decisions laid the foundation for the current legal framework in 2014.

We should support all technical necessary improvements of the existing BRRD and the DGSD (see the EBA proposals to improve DGSD) while at the same time we should avoid fundamental structural changes like the establishment of EDIS, higher contributions of the national DGS to the resolution funds or a shift of competences from the national to the European level. Such far reaching changes would rather have a negative impact on the confidence of citizens and market participants in the functioning of the systems.

Also the arguments raised for an implementation of EDIS are still not convincing. For insolvencies of large banks with cross-border implications a resolution mechanism and a highly monetarily endowed resolution funds has been implemented on the basis of the BRRD and SRMR. However we do not believe that such a kind of risk and fund transfer is appropriate in any manner especially for regional active banks, which would be the main target of such an EDIS system. These regional banks (most of them are part of an institutional protections schemes) would never benefit of such a European centralized system but would always be obliged to finance such kind of scheme.

Application framework by authorities

Since 2015 the European resolution authorities have at their disposal far reaching instruments for winding up credit institutions that fulfill the “public interest assessment test”. So far some authorities have not applied the resolution framework although the current legislative framework leave the them far reaching discretion (to be clear: the Austrian authority has applied the framework in the past). The current legal framework does not have to be changed in this point rather the resolution authorities would have to change their restrictive application approach.

The same counts for the application of the bail-in tool. In theory the application of the bail-in tool could lead to a higher part of loss absorbency for shareholders and subscribers of bail-in able instruments. The reluctant application of the bail-in tool by resolution authorities with regard to retail investors is problematic in this vein. An exclusion of retail investors by resolution authorities, who were informed in detail about the risks of the bail-in able instruments, does not fulfil the original objective of BRRD.

A big bang with the establishment of EDIS is not required. Necessary Improvements should be adopted.

Small and non-complex institutions

We have to be very cautions to understand and maintain a diversity of different banking models and banking sizes in Europe. As a matter of fact, the vast majority of small and non-complex banks (e.g. cooperative banks) with a traditional business model does not have capital market access and is therefore unable to take up instruments for MREL purposes. In line with the recent adopted exemptions in BRRD II they should be out of scope of the MREL requirements due to their size (balance sheet up to EUR 5 bn) and noncomplex business models. Most of them are operating on a national regional level only and are also part of an institutional protection scheme. A resolution of these banks is not very likely and even in the case a resolution of these institutions would not be of public interest.

Highest ranking for covered deposits

The current priority system according to which deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency have the highest ranking must be preserved as this provision ensures the functioning of DGS-payouts. It is important that deposit guarantee schemes that pay out depositors the full protected amounts shall primarily be reimbursed from the insolvency assets. Otherwise, the consequence would be an unjustified severe disadvantage for DGS and the member-banks financing the DGS.

Preventive measures

Preventive measures of DGS are inherent to banking sectors which are organized in an institutional protection scheme. These IPS have implemented early intervention systems which avoid bank failures at an early stage. Therefore these preventive measures have not only contributed effectively to the avoid bank failures with regard to the DGS-Directive but also do so since decades on a voluntary basis. Therefore they should be maintained under the current conditions.

KARL-PETER SCHACKMANN-FALLIS

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Improving and not uprooting proven crisis management mechanisms

A key lesson from the Global Financial Crisis was that public authorities must be enabled to resolve financial institutions whose failure could be systemic. With the EU's resolution framework, this premise was translated into practice to limit the overall impact of bank failures on economic activity and to avoid exposing public funds to loss.

In 2021, the European Commission is reviewing this framework, but while emphasising that it will proceed with prudence, far-reaching changes are to be expected.

Of all credit institutions, the review might particularly affect savings banks and cooperative banks in a negative manner. This is despite them not having caused the financial crisis and not having been the target of subsequent reforms on resolution or their underlying reasoning. To be clear, in their vast majority these are small or medium-sized less-significant institutions (LSIs) that do not qualify for resolution.

Looking at the debates accompanying the European Commission's review to date, it becomes clear that there are considerations for a global overhaul of the framework that fail to adequately meet the needs of the EU's diversified banking sector. Particularly problematic in that regard is the intention to closely entangle the review of the resolution framework with the deposit insurance framework. This risks muddling national and European responsibilities as well as the distinction between systemically important banks qualifying for resolution and non-systemically important banks going into national insolvency.

One example are deliberations on further centralisation at EU level and the resulting administrative and financial implications. Neither in terms of proportionality nor from the perspective of financial stability would it be necessary to expand the competence of the Single Resolution Board (SRB) for the use of Deposit Guarantee Schemes (DGSs) or to widen the resolution mechanism beyond those credit institutions of systemic relevance. For the overwhelming majority of small or medium-sized institutions, a regular insolvency proceeding in combination with the responsible national deposit insurance framework has proven to be an adequate solution. These cases display low complexity and entanglement in the financial market as well as a client base that is limited to a region.

EDIS threatens to block any meaningful progress in the Banking Union.

Further complicating the picture, the Commission continues to hold on to its proposal for a European Deposit Insurance Scheme (EDIS). By making it an integral part of the review of the crisis management framework, there is a risk of inhibiting any progress at all. Discussions on EDIS have been in limbo for almost six years. A breakthrough has become even less likely against the background of an ongoing global health crisis whose effects on the real economy have not yet fully materialised. Ongoing increases in public debt and heightened credit risk further complicate the picture, as witnessed at the last Euro Summit.

On top, EDIS would risk undermining financial stability by weakening tried-and-tested institutional protection schemes (IPSs) or even rendering their continued existence economically non-viable. This concerns a significant amount of covered deposits in the Banking Union where currently well over 20% are protected via IPSs.

To overcome the current deadlock, the Commission should consider withdrawing the EDIS proposal. Furthermore, the stabilizing role of IPSs recognized as Deposit Guarantee Schemes (DGSs) must be taken into account and explicitly reflected in future legal texts. A feasible way to do so would be their structural exemption from a centralised deposit protection system. This could avoid that IPSs are limited in their functioning to pure depositor compensation, which they provide merely as a formal last resort.

If the review of the crisis management framework shall advance and bring tangible improvements, it will be crucial that the diversity of the EU banking system is taken into account. For LSIs, the upcoming review could look at ways for a targeted harmonisation of national insolvency rules for banks. Furthermore, a strengthening of the national DGSs and IPSs would allow for improvements, for example by maintaining and encouraging their ability to engage in preventive measures. In this context, the warranted recalibration of state aid rules could ensure that measures in accordance with the Deposit Guarantee Scheme Directive (DGSD) are not limited or prohibited.

The coming months should be used to find ways to increase the efficacy and efficiency of the resolution and deposit protection systems in an evolutionary way, that is, without hampering the functioning of existing structures.

The underlying rationale must be to ensure that the Banking Union can foster the stability of the financial system.