IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

An effective and integrated framework for managing crises is essential to preserve the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability. The EU bank crisis management framework was established in 2014, after the global financial crisis and in reaction to the EU sovereign debt crisis. It consists of three EU legislative texts, which may be reviewed later this year: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD), which all contain review clauses.

In February 2021, the EU Commission launched a consultation for the review of the bank crisis management and deposit insurance framework to gather stakeholders' experience with the current framework and their views on the revision of the framework, which is part of the debate on the completion of the Banking Union (BU) and can be linked, in particular, to its third and missing pillar, the European Deposit Insurance Scheme (EDIS).

A Central Bank representative (Edouard Fernandez-Bollo) opened the session and noted that there has already been a great deal of discussion about the Banking Union (BU) fragmentation and regulation. There is some scepticism about the possibility of real regulatory change to deepen the BU. The topic of this session is an area where there may be regulatory change. This possibility of regulatory change has been anticipated by the Commission with the large consultation, which raised a lot of interest in the proposals of the Commission.

1. Current thinking of the EU Commission following the review of the Crisis Management and Deposit Insurance (CMDI) framework

1.1 Why the EU Resolution framework is not being used should be questioned

A policy-maker noted that, although the EU Resolution Framework has been operational since 2016, it has only been used in one case. It may be an accident of history that the framework has only been used once, but this is probably not the case, and it is likely that there are some underlying factors. The framework has two basic principles: to preserve financial stability in the event of a failing bank and to protect taxpayers if that bank has to be resolved. Experience of the stresses around the framework indicates that these principles are either not aligned or not perceived to be aligned in all cases. As a result, incentives have been created to encourage the use of alternative routes that avoid using the Resolution Framework.

1.2 Any reform of the EU bank crisis management framework must ensure there is always an alignment between preserving financial stability and ensuring that taxpayers' money is not at risk

A public decision maker outlined issues raised by the Commission's consultation. Early intervention is not always simple, but it can make resolution easier. There is a question of whether the public interest assessment (PIA) should be more flexible, to enhance or widen the scope of banks that might be covered. Access to external funding is another consideration. The policy maker also stated that the upcoming review of the Banking Communication should try to align the principle of preserving financial stability and ensuring taxpayer money.

An official stated that in the current framework there is indeed a perceived difference between financial stability needs and protecting the taxpayer. This should be addressed. An industry representative commented that preserving financial stability and protecting taxpayers' money should be the ultimate goal of the crisis management framework. Its rules should be periodically reviewed. However, there is currently hardly any practical experience with the crisis management framework, and it has to be kept in mind that actual resolution or winding down decisions have to be taken during the crisis event. With this, they will most likely deviate from previously agreed plans.

1.3 A crisis management framework with a continuum of solutions is needed, irrespective of the size, business model and situation of the bank. The FDIC example could inspire changes to the crisis management framework

A policy-maker stated that a situation where some banks are not suitable either for resolution or for judicial liquidation should be avoided. In the context of the framework, systemically relevant banks are no longer deemed to be "too big to fail" and are instead resolved if they are failing or likely to fail. Meanwhile, the failure or likely failure of small banks can be managed via judicial liquidation. In contrast, the management of failures or likely failures among the middle-sized layer of banks can be more problematic within the current crisis management framework. The logic of the Federal Deposit Insurance Corporation (FDIC), which can handle any size of bank, should be imported into the EU. To do so, the Resolution Framework should provide for a continuum of outcomes, with proportionality along the curve of banks. The framework must be capable of managing a very large bank with proportionate bail-in and access to external funding but also managing mid-sized and smaller banks, also with proportionate bail-in and an external funding source.

1.4 Access to external funding in resolution must be improved

A policy-maker stated that, since access to the Single Resolution Fund may not be available for mid-sized banks because of the 8% bail-in requirement, an alternative source of private external funding might be needed if the principle of taxpayer protection is to be respected. The use of national DGS could be such an alternative external funding source, assuming DGS funds could be used for preventive (and not only pay-out) purposes. However, if the national DGS would not have sufficient capacity, the next port of call is the State, which is a problem for taxpayers. In such circumstances, EDIS could act as a backstop to national DGS.

Thus, there is an argument for a resolution system that handles both systemically relevant banks under the current arrangements (8% bail-in and access to SRF) and mid-sized banks under similar but more proportionate arrangements (lower bail-in requirement and access to DGS/EDIS). Indeed, the BRRD could be extended to encompass both sets of arrangements. A key difference between the two sets of arrangements would be that under the existing arrangements a failing or likely to fail systemically relevant bank would be resolved and restored to operational capacity, while any any failing or likely to fail mid-sized bank would be liquidated (i.e. exit the market) under the more proportionate arrangements.

A Central Bank representative commented that a continuum that includes bank exit as one of the options for resolution is an interesting idea. DGS may play a role in proposal for resolution.

2. Priorities for improving the EU banking crisis management for small and medium-sized banks

Public Interest Assessment (PIA), level of minimum requirement for own funds and eligible liabilities requirement (MREL) for small and medium-sized banks, and participation of Deposit Guarantee Schemes (DGS) in the financing of preventive measures and in case of resolution were much debated.

2.1 PIA: more banks need to be prepared for resolution, but the main challenge remains a common assessment by resolution authorities

An industry representative noted that there is currently a clear structure in the EU legal framework: crisis management for the larger and more systemic banks and DGS for the smaller banks. It is unclear if the crisis management framework should be applied to medium-sized banks. It would be decisive how these medium sized banks would be defined. By no means small and non-complex institutions should be in the scope of the resolution framework.

An official stated that extending the PIA will not necessarily resolve all issues. In cooperation with NRAs, the SRB had enhanced the PIA framework to capture situations where the rest of the banking sector was affected by an adverse stress test scenario. Reference to these system wide events were introduced as of the resolution planning cycle 2021 and would afterwards work to further underpin analysis of and refine the assessment of critical functions at regional level. This enhancement is expected to lead to more positive PIA, with the consequence that more banks are being prepared for resolution. Operational capabilities and a build up of necessary means – MREL - are needed for the implementing the resolution process. The Single Resolution Board (SRB) and national resolution authorities are considering enhancements, focusing on transfer strategies, tailored MREL calibration and access to funding.

The official further indicated that the SRB operates under the principle of preparing for the worst, so, if in doubt, preparing for resolution. Without preparations for resolution and built up of MREL, options at the point of failing or likely to fail will be limited.

The main challenges faced for a consistent PIA across the EU were: (1) differences between national insolvency proceedings (NIPs), which could lead to different outcomes for PIA, so harmonisation of NIPs or otherwise a common administrative liquidation tool would be very helpful in this regard, and (2) access by the SRB to consistent data at regional level and on DGS capacity. There is currently a good resolution system, with quite tight access to the fund and bail-in, but there is a temptation for national authorities to take the exit point of the 2013 Banking Communication.

An industry representative suggested that with regard to the public interest assessment (PIA) the current EU legal framework does not be changed but the resolution authorities should rather change their restrictive application approach. The current BRRD has a very broad definition of PIA, entailing flexibility for the resolution authorities. It would be a task of the national resolution authorities and the SRB to define a common interpretation of the existing PIA-definition and implement it in a consistent way in all member states.

2.2 MREL needs proper calibration for transfer strategies; a solution to handle banks with a negative PIA exiting the market must also be found

An official stated that there is always the perception that equity-funded medium-sized banks have no access to markets and cannot build up MREL. Therefore, a resolution strategy based on the sale of business or transfers may seem more appropriate than bail-in. However, lack of access to capital markets by these banks is not what we see happening as the market is wide open. Moreover, if banks are predominantly equity funded, a crisis will eat into their capital and at the time they reach the point of failing or likely to fail (FOLTF), there may not be more MREL left. This is the reason why the Financial Stability Board (FSB) did not want equity to feature in TLAC.

2.3 One system across Europe, with the same funding and the same rules applying in all cases

An official stated that the system should not impose a heavy burden on some banks and a lighter one on others. European governance will lead to more transparency and clearer rules. In the spirit of the FDIC, there could be a continuum solution, using one sizeable European Fund.

An industry representative agreed that a single system is crucial. A double system, with an expensive system for large banks and a system at a discount for smaller banks, should be avoided.

2.4 Giving the final say to EU institutions in the PIA in the way the least cost test is implemented would foster consistency of the EU banking crisis management framework and improve its predictability

An industry representative stated that consistency in the implementation of the framework has been an issue. Consistency can be ensured if European institutions have the final say on a number of issues, such as the PIA and the use of preventive or alternative measures funded by mutualised or public resources. If applied consistently across the Banking Union, positive PIA could be extended to smaller banks important for a regional economic system. However, the basic principle that banks with no specific impact on national or regional economic systems- should exit the market when failing should apply and that could be achieved with the help of DGSs, without necessarily going into liquidation as long as a strict and consistent least cost test is satisfied.

In addition, it should be stressed that the MREL market is wide open for small and medium-sized banks. Many of them with much less than 100 billion in total balance sheet are issuing senior preferred debt or subordinated debt at cost close to that of large banks. This means that they can effectively build a good level of MREL too.

Another key principle of the BRRD and the existing framework is indeed that there should be burden-sharing by shareholders and by the creditors of the failing bank first, before any recourse to mutualised or public resources and a proper level MREL should ensure that for smaller banks too. Attention should obviously be paid to retail depositors, though they are already protected, and MREL would further shield them.

Finally, it should be reminded that the Banking Union means a single market for banking. The main objective is to have a single functioning market within which several types of business model prosper. Larger banks should not be overburdened in comparison to smaller ones or to their international competitors.

An industry representative replied that one also has to take into account that small and medium-sized banks contribute to the SRF funding process, although they will never benefit from it.

2.5 The bail-in tool should apply to retail investors

An industry representative commented that the bail-in framework should be applied in a consistent manner. The reluctant application of the bail-in tool by resolution authorities with regard to retail investors is problematic in this vein as this differentiated application is creating conflicts with fundamental rights. The review of the crisis management therefore has to safeguard that the bail-in tool has to be applied to all categories of creditors without exceptions for private retail investors.

3. Diverging views about EDIS

3.1 EDIS is an essential piece of the Banking Union

An industry representative stated that their organisation is a cross-border bank, so everything that happens at a European level is welcomed. It is better that banks are supervised by the European Central Bank (ECB), the SRB and any authority that considers banks across the space. If small banks in some member states do not understand why they have to contribute to Europe, they should ask themselves why they are in Europe in the first place. EDIS is a necessary pillar of the BU. Using DGS funds for resolution of local and smaller banks is not a very good idea. If it is necessary, it should be organised at a European level. The public interest test should be administered by the SRB at a European level.

3.2 Three elements should be considered in the review of the DGSD

An industry representative suggested that three elements should be considered in the review of the DGSD. The first element is the target size such deposit funds. It is different in many member states and the directive states 0.8%. In Belgium there is no target size because it is a quasi tax paid directly to the treasury. The same is true, indirectly, in the Netherlands, where the bank deposit fund is absorbed by the Dutch Treasury as a means to lower the European and Monetary Union (EMU) debt level. This is counter effective to breaking the vicious circle between banks and governments. A fixed target size should be promoted in the directive for all member states. Secondly, financing is different in all member states. Pan European banks do not benefit from this and a harmonised approach is preferred. Lastly, when a bank wants to switch between EU DGS, for example because of a changing corporate structure or a merger, the DGS Directive determines that only the contributions paid in the previous 12 months can be transferred to the new DGS. All other funds paid into the DGS cannot be transferred. This means that the bank moving to another DGS will be asked to build up years of DGS financing as fast as possible, as competent authorities will rightly want to enlarge their DGS to cover for an increase in covered deposits. This means a bank will finance the guarantee for its depositors twice. This provision strongly disincentivises cross border consolidation as well as branchification strategies.

3.3 Ringfencing measures may be triggered and the branchification trend undermines DGS

A regulator commented that the daily supervision in the Single Supervisory Mechanism (SSM) is difficult without EDIS. Andrea Enria earlier noted that the liquidity waiver can cause an issue if there are no European DGSs. It is very difficult for national competent authorities (NCAs) to accept cross-border liquidity waivers within a group. In addition, after 2008, people wish to protect their own national deposit insurance system. This may cause some sort of ring fencing. EDIS is necessary to fully explore all the advantages of the BU. Digitalisation enables market participants to do banking business in the whole European area via normal passporting. The branchification trend will undermine the existing system of national DGSs. If a substantial part of European banks' branchification is going into the market via digital instruments, there will be an imbalance between DGSs.

3.4 The establishment of EDIS is not required

An industry representative commented that there are European solutions for larger, systemic, cross-border banks, for example the Single Resolution Fund (SRF). Small cooperative banks with balance sheets lower than €5 billion do not understand the relevance of EDIS to their position as they have no cross-border business. So if EDIS would be discussed more seriously only larger systemic cross-border banks should be in the scope of such a system. The principle of proportionality is vital in Europe. It is important to have diversity of banking models and banking size in Europe. Care must be also taken that an EDIS is not implemented via a back door, for example if the DGS fund is used in a broad way to finance resolution actions. For resolution actions such as the transfer of assets only the single resolution fund should be used but not the DGS fund. The differentiation between Crisis management for the systemic important banks and DGS for the smaller and less complex institutions should not be therefore maintained.

A Central Bank official stated that there is no intention to use DGS to recapitalise and continue a bank. DGS will be used in a bank exit, very near liquidation. Under current European law, DGS is only mandatory for liquidation.

An industry representative did not agree that the current system is more expensive for larger banks than for smaller banks. The current system reflects only the different risks of large cross-border and small and non-complex institutions.

3.5 EDIS as a test balloon for newly licensed banks and EDIS as a cross-currency scheme represent two possible options for making progress

A regulator commented that a European FDIC would be a perfect solution. This would save time and there would not be two funds, DGS and a resolution fund, and a need to discuss actions on the national and European level. As this is not possible at the moment, there are two other potential options.

The first option is EDIS as a test balloon for newly licensed banks only. Whenever a bank is licensed, supervisors undertake a prudent assessment of the bank in question. This would fulfil the requirement of only mutualising those assets that have been subject to risk assessment at European level. This pilot sample of banks could be used as a test case for a European deposit guarantee scheme. In order to ensure sufficient funding, national DGSs could serve as a backstop. The second proposal is EDIS as a cross-guarantee scheme. Austria has some experience with this system. In the near future, Austria will have three guarantee schemes. This would avoid an ex-ante funded EDIS since the European cross-guarantee scheme would be a backstop for a national DGS. If the responsible national DGS has to intervene, and only if the financial means of the responsible DGS are not sufficient, then the other DGS – EDIS - have to intervene as well. Such a system would need a solid contractual framework.

A regulator advised that reviews of current legislation need to be completed swiftly, most importantly the CMDI review. Most probably, DGSs will stay national for the time being. It is therefore clear that national resolution authorities have to have the decisive role in case of the use of DGS funds. The ECB, SRB and the European Systemic Risk Board (ESRB) could coordinate a more harmonised application of the CMDI. This could start with an assessment of the application of PIA within the Union. In the past PIA for banks with a balance sheet of €100 million have been positive. This is evidence that a more harmonised approach is needed.

3.6 A fully fledged EDIS only for cross-border groups was also proposed

An industry representative commented that flexibility is lacking in the CMDI review. It is important that a flexible use of DGSs for preventive or alternative measures is maintained.

After six years, EDIS is just one of several proposals under discussion. Others include the De Lange proposal in the ECON Committee (European Parliament), the European Deposit Re-Insurance Scheme (EDRIS) of the French banks and the hybrid model of the Austrians. However, the Commission has not yet withdrawn its initial proposal so an open discussion on EDIS is not possible.

An industry representative noted that UBS Chairman Axel Weber has proposed a fully-fledged EU banking framework for cross-border banking groups. These cross-border banking groups could become part of a mutual deposit insurance system. The smaller banks could remain national, be it in their DGS or in their Institutional Protection Schemes (IPSs) as used by the cooperatives and the savings banks in Germany. Smaller banks would also continue to face national insolvency in case of failure. This clear distinction between a cross-border banking regime and a national regime for small and medium banks would be a very simple but cost-effective solution that should be further elaborated upon.