EU banking crisis management framework: improvement priorities

Having an effective and integrated framework for managing crises is essential for preserving the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability. This session explained why the EU crisis management has not lived up to its initial promise, highlighted the shortcomings of this framework and discussed the way forward for improving the framework for small and mid-sized banks.

1. The EU crisis management framework has not lived up to its initial promise

1.1 The crisis management framework has contributed to maintaining a high level of fragmentation in the banking market

An industry representative highlighted the purpose of the crisis management scheme. It is important to remember the goal when putting this framework in place and assessing if it has proven efficient. This framework should first decouple bank resolution costs from public money. But this has not been the case because public money has been involved and continues to be involved in bank resolution in many cases. As it has failed to be fully implemented and operational for some small & mid-size banks, the EU crisis management framework further contributed to the renationalization of banking sectors across the continent especially thanks to this persistent use of public funds.

The second goal is to improve the competitive landscape and make it sounder. The third goal is to make solving resolution issues possible and predictable. This has not really been the case: banks continue to be sub-efficient while continue to operate and fuel a certain excess of capacity in the European market. This is not positive.

Crédit Agricole S.A. is disappointed that this framework, which has been so costly in terms of contributions and administrative work without generating the expected benefits: a competitive landscape that would be sounder with a progressive exit of the excess capacities seen on the market.

1.2 The inconsistencies between a European resolution and a national liquidation scheme

An industry representative suggested first acknowledging the progress made in the resolution framework that the banks have been working on together with the Single Resolution Board (SRB) in terms of resolvability. This includes improving the loss absorption capacity and the massive minimum requirement for own funds and eligible liabilities (MREL) placing. To an extent, the resilience of the banking sector during the Covid crisis is reassuring.

Recent cases of resolution or liquidation also point to inconsistencies in the framework. Banks with no public interest received public aid, whereas banks that have public interest did not. It might be necessary to be more realistic in the public interest assessment (PIA) and to acknowledge that domestic systematically important banks (D-SIBs) are expected ex ante to have a public interest.

An industry representative observed that consistency is lacking in this process. If an institution proves to be of public interest, all the resolution rules must be applied, and it is necessary to bear the cost and build all the necessary buffers in order to ensure that burdens are shared. But if an institution has not really proven to be of public interest, resolution tools are not there to deal with the situation and liquidation must be applied.

1.3 Any access to external resources must remain conditional on compliance with a stringent burden-sharing requirement

An industry representative added that consistency is lacking in this process. If an institution has not really proven to be of public interest, resolution tools are not there to deal with the situation. Another mechanism is liquidation. If an institution proves to be of public interest, all the rules must be applied, and it is necessary to bear the cost and build all the necessary buffers in order to ensure that burdens are shared.

An industry representative stated that the current rule applicable to access the Single Resolution Fund (SRF) must remain intact and be extended to other possible sources of external funds while ensuring a more balanced allocation of SRF contributions across the banking sector:

- A stringent burden-sharing requirement would ensure that shareholders and creditors of failing banks absorb their fair share of losses and thus minimise the burden on sound banks.
- To comply with such a burden-sharing requirement, small and mid-sized banks should build up an MREL buffer that would enable shareholders and creditors to take a hit before resorting to external resources.
- Burden sharing should also be made consistent between resolution and liquidation under a national insolvency proceeding.

1.4 EDIS: The elephant in the room

An industry representative stated that the discussion is focused on the small and mid-sized banks, but broader issues affect the overall consistency of the framework. The European Deposit Insurance Scheme (EDIS) is the elephant in the room, and not much progress has been made.

This is a matter of consistency. Inconsistencies do not last, not even in Europe. EDIS will happen sooner or later. It will also help to address some of the problems being discussed, like home-host issues.

An industry representative noted that all panellists agree that they want to improve the current resolution framework, make it more efficient and search for the pressing points they have to establish for an effective system. However, they should not make the mistakes of turning the current system 'upside down' without convincing all parties involved or trying to implement EDIS via the back door if normal negotiations are not seen as likely to succeed.

2. Addressing the shortcomings in the current system

2.1 Ensuring that the EU framework allows for a consistent and predictable exit of the market for a failing bank

A policy-maker underlined that the outcome of a resolution procedure is fairly clear and harmonised at EU level, but it might also be necessary to work on the exit strategy in insolvency. Banks that cannot be put in resolution need to be able to quickly exit the market.

A policy-maker reminded the audience that progress has already been achieved with the second EU Bank Recovery and Resolution Directive (BRRD) which states that, in the event of failure with no public interest in resolution, a bank must be wound up under national law. However, there are questions around whether normal insolvency proceedings should apply or if any available national procedure is acceptable. One way to deal with this could be clarifying the procedures around market exit particularly on the exit timeframe, possibly leaving room for the form of exit to be determined at national level. This would further reduce the risk of limbo situations and enhance predictability.

An official stated that a bank does not need to be resurrected if it fails. A bank that fails is essentially restructured if it is a very large one. If it is a smaller one, an orderly exit of the market is necessary.

2.2 The lack of a funding in resolution mechanism is a major flaw in the Banking Union

An industry representative stated that another missing element is a realistic funding in resolution mechanism. Progress has been made with the European Stability Mechanism (ESM) backstop, but it is insufficient because it is not enough to deal with a systemic liquidity crisis. The eurozone is the only major economy lacking a Lender of Last Resort (LOLR). The authorities need to acknowledge that private insurance mechanisms cannot be a substitute for a proper LOLR.

2.3 Uses of harmonising Deposit Guarantee Schemes (DGS)

An official underlined that a harmonisation of the use of DGS is desirable; this could be part of the CMDI review. It would lead to harmonised and clear routes to what a national DGS could do. It would also harmonise the ideas and align them to the BRRD of state aid rules.

It is also advisable to avoid creating a system in resolution and a myriad of other systems around it. There is one resolution framework, and the alternative to this is a hopefully harmonised insolvency one. DGS need to be part of the system to support and fund within reason.

2.4 The potential for home-host frictions can have adverse impacts on cross-border resolution

An industry representative stated that it is necessary to pay attention to the potential for home-host frictions in a resolution scenario. This is especially relevant to those who operate under a single point of entry (SPE) approach, which requires home-host resolution authorities to rely on each other. The SPE approach is viable, if and only if, (i) the home country resolution authority is authorised, able and willing to assume command of what amounts to a global resolution syndicate, and (ii) the host countries are willing to accept such leadership by the home country resolution authority.

Perhaps rather than having a large subsidiary with about €120 billion of assets that is therefore subject to the decisions of the SRB, there could be a smaller subsidiary that was subject to national rules. Those home-host frictions need to be attended to in order to ensure that the resolution framework is made more robust.

2.5 Other areas of improvement in the EU crisis management framework

An industry representative noted that the state aid rules that belong to a world before the BRRD should be revised. There is a need for harmonisation of insolvency regimes, along with items like creditor hierarchy, the public interest assessment, the state aid and use of DGSs. The remaining differences in the creditor hierarchy across EU countries implies that similar creditors could be treated differently during the resolution or liquidation of an entity. A further harmonisation on the triggers to begin insolvency procedure and the ranking of creditors in insolvency is necessary. The idea for a single administrative liquidation authority is worth exploring but having an EU authority with access to national DGS is another inconsistency.

He added that the resolution framework is too complex in particular regarding MREL definition and calculation. Banks should be able to convey relatively simple and stable resolvability strategies to the markets. It is necessary to streamline some of the processes and to achieve a more pragmatic resolution framework, but it is important to preserve the key role of the bail-in paradigm as a central element of the EU resolution framework.

2.6 A European digital euro could be a useful tool in resolution

An industry representative suggested that there could be a way to harness the concept of a central bank digital currency (CBDC) for the benefit of depositor protection, especially for banks that have a greater reliance on deposits. Depositors would hold funds up to a politically acceptable limit in a separate account, which would be

fully backed by the ECB. Savers would pay into and withdraw from it, subject to the cap, whereas excess balances and funds used for transactional purposes would remain in 'traditional' savings and current accounts, and be subject to national deposit insurance schemes.

3. Improving the framework for small and mid-sized banks

3.1 General issues

3.1.1 Level playing field considerations

An industry representative stated that the resolution of small and mid-sized banks is managed by national authorities, giving rise to level playing field considerations due to the degree of heterogeneity across national approaches to resolution in EU countries. In order to further strengthen the EU crisis management framework, policy-makers should look for ways in which national insolvency procedures can be harmonised for banks that are not considered to be systemically important.

There is also a two-tier system with respect to single supervisory mechanism (SSM) banks and some D-SIBs. On the other hand, the plethora of national approaches to resolution mean that it is not possible to know whether there will be an intervention.

An official offered to 'spoil the party' on mid-sized banks and thanked the other panellists for being honest about trying to scale them. When people speak about mid-sized banks, they are sometimes talking about big banks' competitors. Some banks are repeatedly said to be deposit funded. They are rich in cash, so they do not try to get MREL on board.

An official stated that she likes the idea of a possible continuum. It was proved in 2021 that banks were able to raise capital at competitive prices, mostly because they were looking firmly at their MREL requirements. However, it is not possible to have a very stringent system for the big banks and an easier one for a middle layer of their competitors.

3.1.2 DGSs could act as bridge financing tools

All speakers agreed that the current framework is not entirely fit for purpose. A policy-maker (Alexandra Jour-Schroeder) stated that the reasons for that lie more with the smaller and mid-sized banks. Based on discussions at previous Eurofi meetings, the European Commission has performed outreach and several consultations.

A policy-maker stated that specific features of the current framework might affect how authorities handle the failure of small and mid-sized banks, in particular for business models funded primarily by deposits and equity. In addition, other private collective sources of funding – such as DGS – might be out of reach in resolution.

Reviewing the EU's framework will put it in a stronger position to manage bank crises. The European Commission needs to ensure that banks' internal loss absorption continues to be the first line of defence. Industry-funded safety nets must also be accessible for all banks, subject to proportionate access conditions. DGSs could act as bridge financing tools.

A policy-maker stated that other changes to the crisis management and deposit insurance framework are required to unlock the full potential of the deposit guarantee schemes and enhance the level playing field. This includes changes to the least cost test and the hierarchy of deposit guarantee schemes claims in national insolvency rankings. In cases where this source of funding might come up short, a hybrid European deposit insurance scheme mechanism would be key, providing liquidity support and ensuring the robustness of the framework. Only changing pieces of the CMDI framework will not work because every aspect that it modifies might have far-reaching consequences on other parts of the crisis management and deposit insurance framework. It is also necessary to work on the definition of 'public interest assessment' but only broadening the scope of resolution, without addressing the issues faced when managing the failure of small and mid-sized banks.

3.2 How to interpret the Public Interest Assessment criteria

An industry representative emphasized that the resolution framework has a very broad definition of 'public interest assessment' that is appropriate for the resolution authorities. Limiting the definition is not advisable because the resolution authority needs the discretion in case of a resolution, and it has to decide over a weekend if an institution falls within the resolution framework. This is not a question of a new regulation or directive. Rather, it is a question of how the resolution authorities interpret the very broad definition. The resolution authorities should change their restrictive application approach in certain cases instead of demanding changes in the general resolution framework.

He advised asking how to handle an institution that would overwhelm the national DGS in a crisis. If a single institution in a crisis would overstress the national DGS, it should also be in the scope of the resolution framework because this would be a classic case of a public interest assessment.

3.3 Small and non-complex institutions should be out of the scope of the EU resolution framework

An industry representative highlighted an issue with mid-sized banks. There are some banks for which it is not possible to be sure if they fulfil the public interest assessment. It is also difficult for the resolution authorities to define which institutions will fall into the scope of the resolution.

Mid-sized banks with balance sheets between 25 or 30 billion are a grey area. On the other hand, a resolution framework for systemic, important banks has been established as a consequence of the financial crisis. Because these systemic, relevant institutions might be a threat to the financial stability in the eurozone, the special resolution framework for small and non-

complex institutions has been established. Small and non-complex institutions with a balance sheet below 5 billion would not make any sense to include in the resolution framework because it was only established for real, systemic, important banks. There are different national insolvency procedures and harmonising them is a considerable task.

3.4 The MREL regime

3.4.1 The MREL regime requires careful consideration by the resolution authorities with respect to small and mid-sized banks

An industry representative observed that there is a public interest in promoting the financial resilience of mid-sized banks, but there is also a risk that the imposition of MREL requirements that are too high could have a negative impact on the real economy. Furthermore, the fact that the MREL calibration for small and mid-sized banks is typically decided by national resolution authorities can give rise to further level playing field issues.

There might be a way to grade in an MREL requirement by size so that it is similar to the global systemically important bank (G-SIB) buckets, where someone is looking at a greater proportion of regulatory capital based on the complexity and interconnectedness. It could be possible to apply a similar principle to smaller banks of different progressive sizes. This would notably alleviate the Tercas type situation. There could be a bail-in that could then result in a smaller amount of bail-out money being required.

3.4.2 MREL is a real impediment for banks that have irregular access to the capital market

An official stated that two main problems are rooted in the design and application of the regime. The framework is not appropriate for all banks – it is rather tailored for systemically important banks, and MREL is in some cases a real impediment for banks, especially if they have limited access to the capital market and costs that rise fairly high. There is also a lack of proportionality in the system. The EBA's Advisory Committee on Proportionality (ACP) has chosen recovery and resolution as one of the committee's main topics in the work programme for 2023

3.4.3 The introduction of some sort of proportionality in the current system is necessary

An official noted that the current framework has already reached a sufficient level of complexity. Moreover, it might come at the cost of resolvability because it is very difficult to implement proportionality regarding resolvability. Cutting the current framework into pieces does not seem the correct approach. The introduction of proportionality in the current system is nevertheless necessary.

It might be necessary to go through the process. The Austrian Financial Market Authority probably benefited from favourable market conditions, but the first expected recovery of Heta in 2015 was 46%. In December 2021, the Austrian Financial Market Authority released Heta into liquidation with a recovery rate of 86%. A consequent and coherent application in all Economic and Monetary Union (EMU) Member States would greatly improve the credibility of the system and prove that it could work.

An official fully agreed that a consistent framework is necessary. It has been proven that the winding down of this portfolio is feasible. It should be possible to do something within resolution.