IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

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Facilitating orderly market exit in the EU crisis management framework

There has been a consensus for some time now at the Member State level that the next practical step towards integration of the European banking market should aim to improve the crisis management framework. At the ECB, we are convinced that useful progress can be made towards making the present European framework more efficient and furthering its basic approach so as to protect public funds without any need for additional contributions from the banking industry. The amounts earmarked for the crisis management framework in Europe are already comparable to those in the United States, so reaping the benefits from increased use of such funds has the potential to reduce crisis costs and, ultimately, the burden for both public and private contributors.

The key will be to focus on measures that make it possible to manage an orderly exit from the market for troubled banks of all sizes through both resolution and liquidation, without economic disruption or indirect forms of bailout by public authorities. By avoiding fire sales of assets, orderly exit reduces the burden that the industry has to bear. It also allows for a healthier banking market; preventing continued activity by "zombie banks" benefits all market participants.

For resolution, this could be done by facilitating access to the Single Resolution Fund (SRF). The ECB supports the IMF recommendation of a possible financial stability exemption. A similar argument can be made for situations where the resolution authority decides that a failed bank needs to exit the market. In such cases, we think consideration should be given to the idea of allowing deposit guarantee scheme (DGS) funding to be used to unlock access to the SRF by helping to finance a possible shortfall below the intervention threshold.

European harmonisation can make the crisis management framework more efficient.

In liquidation too, we favour allowing broader scope for DGS interventions when the objective is to allow an orderly exit from the market. We see strong merit in harmonised European principles allowing DGSs in all Member States to contribute to preventive, alternative and exit measures. For preventive interventions, it will be important to ensure a level playing field between DGS and institutional protection scheme (IPS) interventions, in particular in the way we recognise their contribution to lessening the costs of interventions after the fact. We recommend clarifying and harmonising the least-cost test as a way of promoting alternative exit funding measures once a bank has passed the stage of failing or likely to fail (FOLTF).

We therefore favour a common EU basis for calculating this test, taking into account a broader concept of the costs of a pay-out scenario. We also support limited harmonisation of national creditor hierarchies in liquidation, as these are key to determining the least cost. Instead of a limited DGS super-preference, in our view a more general depositor preference should be introduced. This would support the level playing field across the whole of the European Union and facilitate resolution by reducing the complexity of the "no creditor worse off" test. Both these elements would also enhance DGSs' capacity to contribute to the funding of resolution strategies.

As the rationale of all these proposals is to facilitate exit from the banking market, it is of course essential that the competent authority can ensure exit in all cases. The resolution authority can do this. The supervisor should be able to do so as well, even in situations where the trigger for national insolvency proceedings may not be met. While the role and powers of the supervisor in these situations could also be a field for further harmonisation of national legislation, market exit by a credit institution can be ensured by withdrawing its licence. This is why the ECB very much welcomes the amendment in the Commission's CRD VI proposal allowing the supervisor to withdraw a licence in all cases where banks are FOLTF and encourages legislators to support it.

In the interests of efficiency, the supervisor needs to retain discretion in assessing the timing and conditions of withdrawal, in particular so this can be combined appropriately with possible support measures from the DGS. Automatic withdrawal would make much it more difficult to arrange an orderly exit, as the supervisor would be obliged to take a decision that puts an end to its authority and powers over the institution.

At the ECB, we are convinced that the best way to make practical progress towards the integration of the European banking market is harmonisation which allows a combination of flexibility on means with clarity on the objective of market exit.

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Let's work resolutely on resolution

The adoption of the European resolution framework in 2014 was an essential landmark providing for a unique harmonized crisis management model for the EU banking sector. While resolution authorities are vested with strong powers and multiple tools to address banks' failures, experience from past years also highlighted these powers and tools were not entirely used for some failures in Europe involving mid-sized banks, initially considered as too small for resolution. As a result, these failures have been handled outside the resolution framework, through non-harmonized national paths that proved not always aligned with the resolution core principles, in particular because of the recourse to public funds.

This situation raises important consistency issues: the same banks that did not go into resolution, because of the absence of a "public interest", eventually benefited from external support in national liquidation proceedings, justified by financial stability objectives. These liquidation cases have highlighted different definitions of "public interest" hampering the initial objective of the crisis management framework: to reduce moral hazard by implementing the principle of letting shareholders and creditors absorb losses, and recapitalise when necessary.

Moving forward, there is a need for important adjustments both to the resolution and to the liquidation frameworks.

On the one hand, the harmonized resolution mechanism should apply to a larger scope of banks – including smaller ones. Broadening the scope of the public interest assessment might require some targeted adjustments for some specific institutions, such as the ones funded exclusively by deposits. Resolution authorities have indeed logically focussed their initial efforts on resolution planning for larger banks, in particular by developing bail-in strategies. In the light of past crisis cases, "closed bank" transfer strategies should be further operationalized, and the use of DGS in resolution could be expanded to facilitate the funding of such strategies. However it is clear that adequate MREL capacities remain the most efficient way to enhance depositors' protection and a successful market exit in the event of a failure.

On the other hand, crisis management avenues at a national level that rely on national liquidation frameworks need to be further harmonized to ensure more consistency. Also for one reason relevant for resolution: the key principle "No creditor worse off" in resolution is assessed against liquidation rules.

A response to fragmented crisis management: resolution for more banks.

First, national creditor hierarchies could be further aligned, in particular as regards deposits, in order to increase level playing field among deposit-taking banks and to facilitate resolution in a cross-border context. These targeted changes to creditor hierarchies should also allow for a broader use of DGS in resolution, by easing the least-cost test, thus contributing to make resolution work for a wider scope of banks.

Second, it should not be possible to use external funding (DGS alternative measures, State aids) in liquidation to protect creditors who would otherwise have shared the burden in resolution. External funding in liquidation should be circumscribed to the protection of deposits only, with burden sharing requirements similar to the ones in resolution. The revised framework should avoid situations in which failing banks with a negative interest to resolution receive State aid in the context of national insolvency proceedings, based on grounds already assessed during the PIA. A negative PIA for resolution is a strong indicator to limit State aid in liquidation.

Last, it would be good preserve room for an orderly winding-up, taking the form of run-off management, provided that strong safeguards are associated with this process (in particular sufficient burden sharing requirements and an effective market exit), to avoid so called "limbo situations". Such an orderly phase-out proceeding could be included in the resolution toolbox, in line with what the Commission has recently proposed for the resolution of insurance undertakings.

As a consequence, also taking note of the conclusions from the Eurogroup June meeting, one can legitimately wonder if the priority, both at European level and in the context of the UNIDROIT project, is to create new instruments such as administrative liquidation regimes that would unnecessarily duplicate the resolution framework.

Instead, **an immediate step to take is to work on strengthening the only existing common framework, namely the resolution framework, so as to ensure it can be applied consistently to more banks.** The current review process is the perfect occasion to reshape and strengthen some of the building blocks of the CMDI, such as the public interest assessment or the funding arrangements, together with some features of liquidation proceedings, before new steps can be taken in the consolidation of the Banking Union.

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Towards a more efficient and effective crisis management framework in the EU

Ten years after the launch of the Banking Union, its architecture still remains unaccomplished with respect not only to the EU single deposit insurance scheme, but also to some features of the crisis management framework. Despite the progress achieved by the Single Resolution Board (SRB) in enhancing the resolvability of larger banks, some shortcomings hinder both the effectiveness and the efficiency of the framework.

- As to the effectiveness, the main goals of the framework are not fully achieved yet. The objective of ensuring a level playing field is frustrated by the fact that in the euro area a resolution strategy only applies to 200 out of about 3000 banks, the rest being subject to a vast and diverse array of national insolvency procedures. The goal of ensuring a smooth exit from the market may be hampered by the fact that in some jurisdictions failing financial intermediaries are liquidated under the same procedures applicable to non-financial corporations. The goal of avoiding bailouts is contradicted by the frequent use of public resources by Member States that have no viable alternatives to avoid financial turbulence.
- As to the efficiency, the resources collected by the two industry funds established by the EU framework are potentially not trivial[1], but remain idle due to legal constraints embedded in the EU directives that limit their use. The single resolution fund (SRF) may be used only in resolution and provided that at least 8% of liabilities have been bailed-in: the SRF is thus unusable when the prescribed minimum bail-in would trigger contagion effects or exacerbate financial turbulence, like in a system-wide crisis or in case of distressed banks with large deposit base. In most Member States deposit guarantee schemes (DGS) may only be tapped to repay covered depositors during value-destroying piecemeal liquidations, but not to fund the transfer of the failed bank's assets and liabilities to viable third parties. Even in jurisdictions that foresee this possibility, the DGS super-senior ranking in the creditors hierarchy still makes the repayment of covered depositors the less costly – hence, the only viable – option.

Industry funds should play a greater role to support failed banks' smooth exit from the market.

To improve the framework, small and medium sized banks (for which currently resolution is not in the public interest) should be able to exit the market without repercussions on financial stability while preserving their franchise value. To achieve this goal, a greater role should be played by transfer strategies, financially supported by industry funds. In particular, to unlock the resources in national DGSs, the current creditors hierarchy should be amended to introduce a general depositor preference (where all depositors would rank pari passu). This would allow the EU to incorporate some of the key features of the approach successfully applied by the FDIC for almost a century in the USA (and by the domestic DGS in Italy).

One of the most debated question is whether small and medium sized banks should be subject to a fully-fledged MREL requirement, along the lines of large institutions, and have adequate internal loss-absorbing capacity to be resolved without external support. In the USA, the answer is a clear-cut "no": as flatly put by a FDIC senior manager, "the Deposit Insurance Fund has been our MREL"[2]. Indeed, requiring these banks to build up MREL buffers would put their business model at danger, as they are typically funded by retail clients and depositors: therefore, a proportionate approach would be key to preserve some bio-diversity in the EU banking system.

Moreover, the lack of a (or a reduced) MREL requirement for small and mid-sized banks would not necessarily foster moral hazard, since their creditors are usually unsophisticated agents that are not in the position to effectively monitor their bank counterparty. Moral hazard concerns could be efficiently addressed by a risk-based contribution system, whereby each intermediary would contribute to industry funds in function of the probability that it may need their support.

The envisaged approach would add one critical instrument to the toolkit already available to both the SRB and national authorities without amending their competence at this stage. In the longer run this approach could also pave the way to EDIS, the ultimate goal of the Banking Union, possibly merging with the SRF. Indeed, implementing a framework that can successfully deal with the crises of all types of banks might reassure all Member States that mutualized resources are used in the most effective and efficient way.

[1] The SRF and national DGSs collect an amount equal to 1,8% of the covered deposits (euro 144 billion by the end of 2023).

[2] Arthur J. Murton, "The FDIC approach over time to the crisis management of small and medium-sized banks" in "The crisis management framework for banks in the EU. How can we deal with the crisis of small and medium-sized banks?", workshop organized by Banca d'Italia on 15 January 2021 (available at www.bancaditalia.it).

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Towards a more harmonized bank crisis management framework?

A truly harmonised and integrated framework for managing bank crises is essential for preserving trust and financial stability. Over time, it would also help reducing the excessive fragmentation of the banking sector in the EU.

The broad principles agreed by the Eurogroup in June 2022 are generally welcome. It should however be underlined that a true harmonisation of key principles such as Public Interest Assessment (PIA) or Least Cost Test (LCT) will only be achieved if their implementation stands under the direct responsibility of EU authorities. Leaving it at national level can only lead to diverging courses.

The opening of resolution to viable medium size banks with a positive PIA assessed at EU level makes sense too. Immediately thereafter though comes the question of how to fund that resolution for medium size bank and the idea that DGSs might play a role in it. The question is a bit surprising and the proposed solution even more.

As recently reminded by Mrs König at the joint ECB-SRB conference of end June, resolution must be funded through MREL. There is no reason to depart from that basic principle and it is the duty of resolution authorities to set appropriate MREL targets to all the banks potentially subject to resolution. It has been empirically demonstrated that even very small banks were able to issue Eligible Liabilities (EL). So why would medium size banks not be able to do the same?

It is understood that some banks are well capitalised essentially with CET1 instruments. If that is sufficient to meet MREL requirements, why adding further constraints? They should only be bound to keep their CET1 at the required MREL level or, were it to decline, to replace it with newly issued CET1 or EL. In the case of decline below the required MREL level without replacement, the M-MDA mechanism should apply first. If the situation deteriorated further there should be a mechanism allowing authorities to trigger recovery actions or to declare the bank in question Failing or Likely to Fail, even if the CET1 level is still well above the minimum prudential requirement of 4.5% of RWAs. In other words, banks potentially subject to resolution that stick to CET1 only for their MREL requirements must accept higher than standard CET1 requirements. In this way, an other key principle underlined by Mrs König, Same Business - Same Risk - Same Rule, would be respected.

Resolution must be funded through MREL. There is no reason to depart from that basic principle.

As several medium sized EU banks that would potentially be subject to resolution have apparently not yet built up appropriate MREL levels or have not even been notified MREL targets commensurate to resolution requirements, a transition period of a few years should be foreseen.

Using DGSs to fill funding gaps and allow resolution of medium sized banks goes against their very purpose. These are schemes primarily conceived as safety nets for covered deposits. They are also funded by the industry, i.e. mainly by the largest and soundest banks in a given country. Consequently, any relatively intensive use of them in resolution would constitute a burden for the sound part of the sector to resolve failing competitors that would not have built up sufficient MREL. In fact, that would be a form of bail-out by the sector. This would not only raise serious questions of level playing field but could also threaten financial stability. In that sense, mutualised resources should be managed as parsimoniously as taxpayer money and LCT should strictly and consistently apply.

The idea that DGSs might be used to fill the gap and reach the minimum burden-sharing of 8% of Total Laibilities and Own Funds necessary to access the SRF would double up the issues, bringing them at Banking Union level in addition to national one.

If any, possible flexibility to use DGSs in resolution should be limited to the above-mentioned transition period of a few years (e.g. 4 years maximum) and only for banks that would not have been notified MREL targets before the change in policy. The maximum relative intervention per concerned bank should gradually decrease to the end of the transition period. There should also be a limit per DGS relative to its size.

On the other hand, the use of DGS to facilitate market exit of failing banks not subject to resolution is a logical one. It should well remain subject to LCT while market exit should clearly entail a true reduction of offer (branch closures, brand disappearance, ...), not the extension of the offer of an acquirer.

Finally, changing the creditor hierarchy to ease the LCT and extend the potential use of DGS would be a step in the wrong direction. Besides already mentioned issues, it would entail moral hazard for creditors, potential liquidity risks through increased volatility for banks and open the door to further deviations from the basic principles of the SRM.

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IPS provide financial stability to the Banking Union

Being small or medium-sized less significant institutions (LSIs) in their vast majority, over 99% of the German Sparkassen do not qualify for resolution. It is also highly unlikely that one of them becomes insolvent – not the least because of the well functioning institutional protection scheme (IPS) they adhere to. Its support measures work in a preventive manner before any of its member institutions are declared failing or likely to fail (FOLTF). While the IPS falls under the regulations of the DGSD it could provide depositor compensation, but this is merely a formal last resort.

Consequently, we very much welcome the Eurogroup Statement dd 16 June as it recognises the stabilising role of IPSs. More precisely, it captures their specific relation to the CMDI Framework by stating that its review needs to preserve "a functioning framework for IPS to implement preventive measures".

In addition, Europe's Finance Ministers used the statement to provide further meaningful guidance on how to advance on the Review of the CMDI framework, a topic with high potential for controversy. Now, it will be on the European Commission to come forward with a suitable and balanced proposal. For this, it can build on prior work undertaken in the last two years. However, in the light of the Eurogroup Statement, a careful re-evaluation of that work will be essential. The Commission will have to proceed with prudence, as only a balanced proposal will be able to enable a consensus on the review by the end of this legislature. Far-reaching changes to the framework will be detrimental to that task.

The question of expanding the scope of the resolution regime to mid-sized banks is one of the crucial issues. Clarity on whether a failing institution is undergoing resolution or being sent into national insolvency is paramount. Increased transparency on the criteria for the Public Interest Assessment would be welcome in that regard.

The crisis management framework benefits from taking into account EU's banking sector's diversity.

However, with a larger scope, the question of the necessary funding of resolution cases is on the table. Medium-sized banks that are mainly deposit-funded might face a disadvantage compared to capital market-funded banks when holding sufficient MREL. As this is linked to the possibility to access the Single Resolution Fund, there are considerations for using deposit guarantee schemes (DGSs) to finance the resolution of mid-sized banks instead. However, there are certain risks involved:

- The Eurogroup clearly decided against pursuing a European deposit insurance scheme (EDIS). It is clear that concentrating competencies on deposit insurance at European level would not be in accordance with this decision. Therefore, if a national DGS is to be used to fund a mid-sized bank in resolution, then it needs to be one of its member institutions and the framework for this intervention will have to be carefully calibrated.
- The DGSD already provides for the flexible use of DGSs. With Alternative measures and the possibility of preventive measures as used by IPSs, DGSs can be used for measures other than the pay-out of secured deposits. These measures have proven their value as they help to ensure the continuation of a bank's business relations to its customers. Against this background, we do not see merits in or the feasibility of a harmonised least cost-test, which would just hamper their functioning.
- Further widening the access to and the use of DGS funds for resolution comes with the high risk of undermining depositors' trust – even more so, if unwarranted changes to the creditor hierarchy increase the likeliness of such events.

It is high time that the European Commission puts forward less controversial issues than EDIS that are more important for financial and capital markets integration and promise faster results. Considering how contentious the discussions on the Banking Union are, the European Commission would be well advised with regard to the CMDI review to properly take into account the diversity of the EU's banking system. For LSIs, the upcoming review could look at ways for a targeted harmonisation of national insolvency rules for banks. Additionally, the review should ensure that the existing flexibility of the framework is maintained and encourage the national DGSs and IPSs to make use of these measures. In this context, the warranted recalibration of state aid rules could ensure that measures in accordance with the DGSD are not limited or prohibited. Finally, there are many technical issues to be addressed based on the lessons learned in the last years, for example on triggering FOLTF or the use of early intervention measures.

The review should be used to find ways to further improve the functioning of the resolution and deposit protection systems. This has to happen in an evolutionary way that is not hampering the functioning of existing structures. The underlying rationale must be to ensure that the Banking Union can further increase the stability of our financial system.