Improving the EU bank crisis management framework

The discussion showed that using DGSs in resolution or facilitating access to the Single Resolution Fund remains a very controversial issue. Nevertheless, there seems to be consensus on four types of measures to improve the EU crisis management framework. These areas are: defining the public interest criteria in a single way, allowing smaller banks likely to be resolved to have smaller MREL requirements provided some conditions are respected, extending the scope for DGSs interventions to facilitate market exit of failing banks not subject to resolution and supporting limited harmonisation of national creditor hierarchies in liquidation.

1. Using DGSs in resolution or facilitating access to the Single Resolution Fund remains a very controversial issue

The amounts earmarked for the crisis management framework in Europe are already comparable to those in the United States. During this session, several panelists proposed measures to make this money usable for the sales and market exits of medium sized banks. This could be done by facilitating access to the Single Resolution Fund (SRF) and/or using DGSs to fill funding gaps while allowing resolution of medium sized banks. Such an approach would require replacing the existing super-preference of covered deposits by a general deposit preference. Industry representatives explained why they were strongly opposed to these measures.

1.1 Proposals to facilitate access to the SRF and to allow DGSs to support resolution for troubled banks

1.1.1 Make the safety nets money usable

An international official stated that there is a lot of bank backstop money in Europe today. One fundamental challenge is to make the industry monies and fiscal backstops usable. In 2023 around €80 billion will be in the Single Resolution Fund (SRF) and another €55 billion or €60 billion in national deposit guarantee schemes (DGS). If the ESM liquidity backstop is added to that it will total about €200 billion, as well as the very substantial mandatory internal buffers of minimum requirement for own funds and eligible liabilities (MREL). The idea should be to make the backstops usable, with due attention to checks and balances, and with a focus on facilitating a smooth exit of failing banks.

1.1.2 Democratise bank resolution: the EU resolution framework should ideally encompass all banks

An international official added that a second point would be to "democratise" bank resolution. Europe needs a resolution system more on the US model, which is one that spans a much broader set of banks than just the few largest ones. The business of resolution is often about medium and small banks. In order to unlock the door to resolution for small or medium-sized banks Europe should revisit the Public Interest Assessment (PIA). A key difference between Europe and the US is that there is no 8% bail-in threshold in the US, simply a least cost test. This reflects the complex, multi country nature of the construct, and associated issues of trust.

An international official noted that the next question is whether MREL should apply equally to smaller banks. There is an underlying issue of the desirability of business model diversity. Questions can be asked about whether small banks that have never issued subordinated debt or hybrid instruments should be required to do so. MREL requirements for small banks should be proportionately lower than for large banks.

A regulator agreed that there is a need to apply the resolution tools to a larger number of banks, including medium-sized ones. Supervisors need to define what is meant by small and medium sized banks, which is not easy because of the systemic footprint. What is called a small bank in one country can be a big bank in another country, but some harmonisation is needed. Not all banks should be covered by the resolution tools. Another way of exiting these smallest banks is through national insolvency procedures, which should be kept in the landscape. The other idea is the question of accessing the SRF. Supervisors want to avoid free riders, hence the level of MREL and the necessity to define conditions for the intervention of DGSs.

A regulator observed that it is unfortunate that Europe has, in addition to the SRF, more than 21 separate DGS funds in the various Member States, used for different purposes, compared with the same level of safety net in the US, which has one Fund under the Federal Deposit Insurance Corporation (FDIC). There is no legislative reform that can make resolution or insolvency of a bank a 'free lunch'. It will always mean the allocation of losses. It is clear that the first ones to bear losses are shareholders, and then creditors. Europe has made substantial progress for the resolution of significant institutions. The net can be broadened to a second layer, which is mid-sized banks, but if that is done then the same rules have to be applied.

1.1.3 Replacing the existing super-preference of covered deposits with a general deposit preference would allow industry funds to play a greater role to support a failed bank's smooth exit from the market

A supervisor noted that Europe has a situation where it has a significant amount of money that cannot be used, and then Europe does not benefit from a third party entering the market and offering to help banks in trouble. The economics do not work because there is no economic

incentive for using funds or other banks to enter the debate and try to apply the turnaround for a distressed bank, because they know that if things go bad, they will not be treated in the same way as the DGS. There is a huge amount of money that cannot be used at the moment due to legal constraints embedded in the EU directives and this situation should be unlocked. The question is why Europe does not consider treating all depositors the same.

A supervisor stated that the first point would be to try to remove the super priority in order to create the economic incentive for other financial institutions to intervene together with the DGS. This would reduce the probability of contributing banks to lose, because there could be a preservation of the economic value in the system. The current creditors hierarchy should be amended to introduce a general deposit preference where all depositors would rank pari passu.

A regulator noted that if a super-priority in the creditors' hierarchy of DGS funds was removed and a general depositor preference was introduced, then the DGS could still be protected by their position in the hierarchy. However, they would also be able to step in in lieu of deposits and to support market exits when this is less costly and more efficient than a pay-out.

An international official observed that there is a need to revisit the super seniority for DGS money and to replace the DGS super preference by a single deposit preference, as it would make the use of DGS resources more efficient. The current system makes it impossible to use DGS resources for anything other than payouts. The focus should be on making this money usable, not just for deposit payouts: DGS resources should be available to support purchase and assumption transactions.

1.1.4 Allowing DGS to try to facilitate the market exit and to devise a least cost test that creates and preserves economic value for banks that have to get out

A regulator said that there are two avenues the EU needs to look at. If a bank has a systemic footprint systemic footprint that has a financial stability impact, then resolution is the best strategy. There are different tools, but resolution does not mean resurrection. Following that, there are a large number of banks for whom there is not a major financial stability concern. The EU framework has not always helped those banks smoothly exit the market. Harmonising insolvency procedures does not mean immediately going to an FDIC model but harmonising some parts of the framework so that DGS can support the exit.

A regulator added that not every bank that gets into trouble needs to go into an insolvency procedure. DGS funds would be used in resolution only when it costs the DGS less than their pay-out to depositors. If a solvent wind-down is the best solution, then that might also be an option. In many cases, purchase and assumption transactions and/or transfer tools might be the better option. It will be important to harmonise the least cost test to make clear what the role of the DGS can and cannot be, and to include the question of what the position of the DGS is in the creditor hierarchy. In any case, the goal must be market exit of a failing bank.

The Chair stated that from a supervisor point of view there is already a consensus to have a framework where supervisors withdraw the authorisation to ensure that there is an exit from the market when it is used. The Chair asked a supervisor if a European harmonisation to ensure that there is a link between use of the funds of the DGS and a soft exit of the banking market can add value.

A supervisor stated that he supports the objective, provided that we ensure that the exit from the banking mark remains a soft one. This is the key issue to tackle. Otherwise, if central banks cannot rely on an efficient and consistent use of DGSs, then state aid should still be available.

The Chair noted that in June there had been a consensus at the Eurogroup that the EU needs to facilitate the market exit of small banks. There is an issue that the EU still has too many banks that are not getting out, and the ways to get out were using public money when they got out. Europe has to facilitate an orderly exit for troubled banks of all sizes through both resolution and liquidation, without economic disruption or indirect forms of bailout by public authorities. On these issues, the idea is to do so at the least cost by increasing the efficiency of the use of the money. If the EU admits that avoiding a formal insolvency procedure preserves value, then it needs to find ways to do that in a European harmonised way.

1.2 Objections to extended use of DGS for banks in resolution and easier access to SRF for medium-sized banks in resolution: same business, same risk, same rules

An industry representative stated that the bail-in of 8% of total liabilities and own funds (TLOF) being a requirement before having access to the Single Resolution Fund (SRF) is the existing rule. While banks are not necessarily attached to that level, banks are attached to one thing, which is having the same rule for all. There should not be a different rule for smaller banks and larger banks. Using the safety nets money is a false good idea. The contributions to the SRF and the DGS is costing the banking sector a great deal of money, at more than €14 billion per year currently. Investors are expecting this level of contribution to come to an end once these funds are funded at their target level as it significantly impacts the profitability of EU cross-border banking groups.

An industry representative added that the money being a safety net was mentioned in the statement of the Eurogroup. It is a safety net, which means it should only be used in exceptional circumstances. Reviewing the deposits or the DGS positioning in creditor hierarchies means changing the rules of the game in the middle of the game itself. Using DGSs and the SRF intensively means that the banks will have to replenish them, at the cost of investors but also of the customers. It will indeed increase the cost of the banking services for us all, i.e the European taxpayers. In times of high inflation that may not be welcome from a political viewpoint. The banks that are already barely profitable in Europe will become even less profitable.

An industry representative noted that when examining who is contributing to these funds, it is the largest and the soundest banks in the system, be it the national system for the DGS or the European system for the SRF.

That is an issue, because by doing so and by using those funds on a regular basis this would constitute a burden for the sound part of the banking sector. In the end, this would not only raise serious questions of a level playing field but could also threaten financial stability.

An international official suggested that, when a small bank is resolved using a purchase and assumption transaction, any backstop monies deployed usually form a sweetener for the acquirer, and the acquirer is typically a larger bank. So, when one speaks of making DGS and/or SRF resources available to support the resolution of small and mid-sized banks, typically the industry money will flow to larger banks. And, because the transaction is at lower cost than a straight deposit payout, everyone benefits.

An industry representative maintained that changing the creditor hierarchy to ease the least cost test (LCT) and extend the potential use of DGS for resolution would be a step in the wrong direction. A least cost test easier to pass would lead to repeated DGS interventions and increasing costs for the sound part of the banking industry. This would force healthy banks to 'bail out' failing banks and replenish DGSs much more often. Raising all deposits to the same level in creditor hierarchies would also reduce the 'bail-inable' instrument base, with potential negative consequence on the ratings of other debts and on liquidity.

1.3 Financial stability should be the underlying rationale of the CMDI review

An industry representative stated that he would not join all the complaints about the status of the Banking Union (BU). It is important to look at what has happened since 2014 when the Deposit Guarantee Scheme Directive (DGSD) was introduced, and since February 2015 when the Bank Recovery and Resolution Directive (BRRD) was introduced, and the Single Resolution Board (SRB) came into place. Since then, the national deposit guarantee schemes have worked quite well, and the SRF has never been used. Europe does not need to contemplate a fundamental change. When reviewing the crisis management and deposit insurance (CMDI) framework, the ultimate objective should be enhancing financial stability. A second objective is to maintain the trust of depositors. These objectives are particularly important when it comes to the scope of the resolution framework. A resolution is appropriate for failing institutions that pose a threat to financial stability. All other failing institutions should go into national insolvency. There is no need for a fundamental overhaul of the CMDI framework and there are no merits in blurring the lines between resolution and deposit protection.

An industry representative noted Europe has collected approximately €64 billion, which would otherwise be in the core tier 1 accounts of the European banks. It is unclear what contributes more to the banking sector's safety, either storing these contributions or applying them in the current situation, particularly for strengthening the banks themselves.

A regulator agreed that the funds should not just be used because they are there. It is important to be careful, as that money is the safety net. It is important to think about the mid-sized banks and say that the DGS can play a role to protect depositors and support market exits.

2. Four areas of consensus to improve the EU crisis management framework provided some conditions are respected

Panellists agreed that the four areas of improvement are: defining the public interest criteria in a single way, letting smaller banks having smaller MREL requirements provided some conditions are respected, using DGSs in resolution to facilitate market exit of failing banks with complete sale of business as resolution strategy subject to least cost test, and supporting limited harmonisation of national creditor hierarchies in liquidation.

2.1 Defining the public interest criteria in a single way in Europe

A regulator stated that the PIA should be revisited, but that also means that if Europe decides to implement a resolution decision that means there is a positive PIA. If there is no resolution decision it means that there is no PIA positively assessed for the liquidation processes.

An industry representative agreed that there are two layers in the financial institutions: large, pan European ones, and the small and medium-sized banks. That is where proportionality occurs. Clarity on whether a failing bank is undergoing resolution or being sent into national insolvency is essential. This dual framework should be strengthened by clearly defining PIA at EU level.

An international official noted that the EU resolution framework should encompass a broader set than it currently does. Unlocking the door to resolution of medium sized banks can be done by reinterpreting the public interest assessment or rewriting the EU legal texts.

2.2 Smaller banks can have smaller MREL requirements provided some key conditions are respected

A supervisor noted that the previous day's panel on business models touched on the principle of proportionality. Europe needs to ensure biodiversity of business models in the EU on a going concern basis, but on a gone concern basis people then claim that central banks should apply the same rule across all different business models. A question is why central banks cannot apply the proportionality principle in the gone concern aspect. MREL should be there, but it could be lower. Small banks cannot issue MREL instruments in the same way as larger banks, and if they did, it would be much more difficult and costly.

A supervisor added that the client base is not as advanced as it might be in other cases, but the EU should consider the biodiversity of the EU banking system on the resolution side. If MREL can be reduced then the resolution tools can be applied to a greater extent without creating a contagious effect or a disruptive impact in the

market, because then banks might still try to reduce the impact on the deposit base.

An industry representative observed that this biodiversity should be filled with life. Proportionality, subsidiarity and diversity are just words used at the beginning of speeches by regulators, central bankers and politicians. A Central Bank official has given some hints on how to properly take into account the diversity of the EU's banking system.

An industry representative stated that resolution must be primarily funded though MREL. It is the duty of resolution authorities to set appropriate MREL targets for all the banks potentially subject to resolution. The level of MREL should be proportionate to two things: the riskiness of the bank itself, and the type of resolution strategy that would apply to them if they failed. Access to the SRF should remain subject to prior bail-in of at least 8% of TLOFs, and DGS should not be used to finance a possible shortfall below that intervention threshold. Proportionality already exists today in the regulation, so it just needs to be applied.

A regulator noted that MREL has been discussed. Proportionality already exists. Adequate MREL capacities remain the most efficient way to enhance depositors' protection and a successful market exit in the event of a failure. Europe cannot escape the right level of MREL for all banks covered by resolution tools, and with the possibility to access the SRF. Proportionality already exists, so supervisors need to be able to use it more smoothly while taking into account that the right tool to use for medium sized banks is the transfer strategy. A credible transfer strategy should embed a lower level of MREL.

2.3 Using DGS interventions to facilitate market exit of failing banks not subject to resolution is logical, providing some key conditions are respected

2.3.1 Establishing a link between the use of the funds of the DGSs and a soft exit from the banking market

An industry representative agreed that there is room for consensus on many points in this area. There can be a way to use the DGSs, but there are some key conditions that should be respected. The use of the backstops should facilitate the market exit, and that market exit should be swift. The use should be to shield the depositors, not the shareholders or the other creditors, and it should remain subject to the Least Cost Test. The term 'unification' could also be used, because leaving all these rules at the national level is a recipe for divergence and a messy outcome. If Europe wants something that works, then all these rules should be made applicable at European level and made applicable by European authorities. Preventive measures should be reserved to a viable institution and should not be compared with anything like resolution.

A regulator explained that external funding in liquidation should only be circumscribed to the protection of deposits, 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.

2.3.2 The DGSD already provides for the flexible use of DGSs

An industry representative stated that a failing institution that does not pass the PIA should go into national insolvency. He added that Articles 11.3 and the 11.6 of the DGSD provide for the possibility for DGSs to apply preventive and alternative measures. So, the DGSD already allows for the flexible use of DGSs. Article 11.6 might offer a way out for mid size banks not going into resolution, because these alternative measures provide the possibility to make use of the DGS funds to support a failing institution. It would be applicable within the framework of the PIA, the least cost test, state aid rules and everything else.

2.3.3 Alternative measures should be part of a harmonised rule book

A regulator observed that alternative measures should be part of a harmonised rule book. Alternative measures are currently an option that is not implemented in all many Member States. The Chair noted that Europe can ensure the exit of the institution if it is linked to withdrawal of authorisation whenever the conditions are met, but the harmonisation needs to be pushed forward, as Article 11.6 is currently 'a complete mess' in Europe. Convergence is fine if preventive measures are linked when using DGS funds to exit the market. It would be a preventive measure as it avoids payout in insolvency. It is not preventive in the sense that it aims at making a viable institution that continues its activities. The real issue is to link it with market exit. Whenever the name Deposit Guarantee Fund is mentioned, it should be to get out of the banking market, not to stay in.

A regulator said that policymakers have to be precise on what they want to do when it comes to preventative measures. They are not used to prevent something that will obviously happen, but to make sure that there can perhaps be an earlier exit of the market at a better price. The panel has not discussed the elephant in the room, which is the 2013 Banking Communication. Europe still has inconsistent rules about what is burden sharing, and different ideas on how to potentially resolve the situation. Harmonising the rules there is urgent, otherwise there will always be the element of having an exit that is not insolvency or resolution but paid for by the taxpayer.

An industry representative reminded the panel and the audience that Articles 11.3 and 11.6 of the DGSD are applied as part of the existing legal framework with DG COMP monitoring that no competition laws are affected. Preventive measures apply before a failing or likely to fail (FOLTF) situation arises.

The Chair clarified that the discussion had centred around the idea that Europe will prevent the use of DGS funds to maintain unviable banks: these funds should not be used to keep banks alive, but on the opposite to prevent hat they continue their operations.

An industry representative stressed the need for enhanced legal certainty around these measures, including alternative measures. The Banca Tercas ruling

by the European Court of Justice had confirmed that alternative measures do not constitute state aid. Although Banca Tercas had been dealt with in another way in the end, but the court looked back in history stating that it could have been compliant.

2.4 A support for limited harmonisation of national creditors hierarchies in liquidation

2.4.1 A fully harmonised European insolvency framework seems out of reach

A regulator explained that a global harmonisation of the banking insolvency proceedings is too complex because it involves the Ministries of Justice. The first low hanging fruit suggestion is to harmonise the creditors' hierarchy. The second is to define common objectives for a liquidation regime at the European level.

An international official noted that it has traditionally been said that harmonising corporate insolvency across the EU is a 'bridge too far'. It is an area that sits with Ministries of Justice, not Ministries of Finance, is deeply entrenched in national legal tradition, and is essentially impossible to do. The BRRD shows, however, that it is possible to create a carve-out for banks across Europe. Regarding the national insolvency route, there are a lot of differences out there. The national insolvency regimes for banks in some countries look more like resolution frameworks. Others are essentially identical to non financial corporate treatment. Full harmonisation is a taller order than broadening the scope of the BRRD and the authority and reach of the SRB.

A regulator did not think Europe will get to a fully harmonised European insolvency framework in the short term, but harmonising "special" insolvency procedures through BRRD and SRMR worked well, so there is hope in the long run.

2.4.2 The least cost test should be harmonised at the EU level and national creditor hierarchies should also be further aligned in order to level the playing field among deposit-taking banks and to facilitate resolution in a cross-border context

A regulator noted that crisis management avenues at a national level that rely on national liquidation frameworks need to be further harmonised to ensure more consistency. The BRRD sets a common set of rules, and then supervisors need to respect two key principles. The first underpins the suggestion to align the creditors' hierarchy, which is the 'no creditor worse off', principle. No creditor should be worse off in resolution than in a normal insolvency procedure. The EU needs to find a way of harmonising the test about comparing the resolution implementation decision versus a normal insolvency procedure, which can currently be different in 21 countries. When there is a cross-border group with a subsidiary in one country and a subsidiary in another country then the resolution authority needs to twice compare the 'no creditor worse off' principle. It is important to harmonise the creditors' hierarchy for the banking institution.

A regulator explained that the second key principle is the least cost test. The discussion has shown that panellists consider in reality that at the centre of the crisis management there is resolution, and then for resolution a harmonised tool kit with common rules should be defined, with the same rule for different ways of dealing with bank failures. The least cost test should be assessed in different ways for DGSs to be able to be involved in the process. France has a DGS that can act preventively. What matters is that the preventive actions respect the same set of rules that have to be respected under resolution. The key principle is to be sure that there is a continuum and no risk of someone saying that an entity would have been better off if it had used something different.

A regulator added that the need to revisit state aid rules is on the agenda of the European Commission. The state aid rules coming from 2013 which was a time when the BRRD had not yet been adopted, need to be realigned.