Enhancing the EU bank crisis management framework

1. Introduction

The Chair noted that significant events took place in March in the US and Switzerland in the banking sector. The failure of US regional banks and the merger of Credit Suisse and UBS demonstrated the significance of the availability of liquidity in resolution, effective supervisory frameworks as well as the growing influence of digitalisation (mobile apps) and social media in triggering sudden financial outflows. We have seen bank runs that were unprecedented in volumes and speed. EU authorities need to take this into account. Funding can disappear rapidly. Crisis management needs to be flexible enough to tackle all sources of risks.

This banking turmoil is a powerful reminder of the need for effective and agile crisis management frameworks. The European Commission has recently published the crisis management and deposit insurance (CMDI) review proposal.

This session allowed, first of all, to draw lessons from the collapse of the US regional banks and the takeover of Credit Suisse by UBS for the EU crisis management framework. Then the panel focused on how to address the funding gap in resolution notably for small and medium sized banks whether or not they are under the remit of the Single Supervisory Mechanism and the Single Resolution Board. Allowing Deposit Guarantee Schemes (DGS) to address the funding gap in resolution for mid-sized banks remains a controversial issue.

2. Lessons learned from the recent banking turmoil that could improve the CMDI

2.1 Unlike in the US, all European banks apply Basel requirements, notably for the treatment of interest rate risk

An industry representative stated that after years of low interest rates, tighter monetary policy is challenging banks 'effective risk management in securities portfolios and loans exposures. This massive shift in the macro-financial regime after more than a decade of ample liquidity is magnifying the consequences of any mistakes. In the US incidents, mistakes were made in the management of liquidity risks and interest rate risks by banks, but the consequences of those mistakes were magnified. The prudential framework in Europe already prevents most of the consequences of those types of mistakes because of the strength of the regulation and the quality of the supervision. The US example also demonstrates that the consequences of a failure of a so-called medium-sized bank may not be benign. This will likely lead to a sharper assessment of the public interest of many institutions. Indeed, some small, medium sized or regional banks can have a significant public interest.

The takeover of Credit Suisse by UBS marked the first failure of global systemically important bank since the global financial crisis. This crisis management shows that disregarding the hierarchy of creditors and favouring shareholders over bondholders, as was the case in the rescue of Credit Suisse, leads to a lot of turbulence in the markets. In Europe, on the contrary, the hierarchy of claims is clearly defined in the EU crisis management framework, and CET1 capital would always be first to absorb losses and would be fully written down before Additional tier 1 instruments could be written down.

A Central Bank official noted that effective supervision is the first line of defence which reduces the probability of a banking crisis occurring. More uniform implementation of Basel regulation (liquidity, stress testing, and other requirements) provides more effective and equal supervision (both micro and macro) for banking institutions across Europe. This approach can serve as an example to other jurisdictions, such as the US, where a two-tier based supervisory system is applicable, but was proven to be less effective by the recent events.

2.2 The speed of depositor flight in the time of digital banking and social media have highlighted the need to review liquidity ratios

A Central Bank official commented that social media, which can quickly spread financial news and rumours, and digitalisation of finance were important contributors to the speed of recent events. Liquidity buffers were calibrated in a world less influenced by social media and digitalisation and, accordingly, should be rethought.

A policy-maker stated that the question around speed of deposits is not about resolution per se but is instead about whether a failing or likely to fail bank can get to the weekend, at which point the toolbox can be used.

2.3 The key points of the Commission CMDI review proposal

2.3.1 Lessons learned from the recent events in the banking sectors of the United States and Switzerland

A policy-maker stated that the crisis management and deposit insurance (CMDI) revision proposal should be regarded as a continuation of the process that started 10 years ago when banking union began. The CMDI reform is not an urgent response to what happened in the US and Swiss cases. However, there are two lessons learned already from those cases that are relevant for the CMDI negotiations. The first is that it is possible to have an excellent, robust theoretical framework that does not work at all in practice over the "resolution weekend". There must be enough flexibility in the framework to allow it to work in very uncertain and time-constrained circumstances. Excessive rigidity should be avoided. The second lesson is that, although it has been argued that bail-in is more efficient and fairer than bail-out because it prices risk and creates the right incentives, it is not necessarily economically or politically easier than bail-out.

2.3.2 The CMDI extends the existing framework to another set of banks

A policy-maker explained that the CDMI proposal will enhance the existing framework, extending the existing crisis management toolbox to mid-sized banks and the ensure the availability of funding so that these tools can be applied to any bank irrespective of its size and location in the EU. A continuum of responses to bank failures will be created. The proposal aims to replicate options similar to those available to the Federal Deposit Insurance Corporation (FDIC) in the United States.

2.3.3 Removing the super preference of DGS for allowing them to step in, in lieu of deposits to manage the failures of medium-sized banks

A policy-maker commented that the incentives to use resolution tools have become distorted, mainly around the treatment of depositors. In the EU context, we are speaking of deposits of small and medium-sized enterprises(SMES) and not the much larger deposits which characterised the balance sheet of SVB in the United States. Experience suggests that EU policymakers have chosen to bail out SME depositors using public funds rather than bail them in. That is because bailing in these SME depositors was seen as creating a financial stability risk through possible contagion or as inflicting excessive economic damage on the local economy.

The CMDI proposal addresses the question of whether the taxpayer or the banking-sector safety net should bear the cost of a bank failure in circumstances where the bail-in of SME depositors is excluded for reasons of financial stability/economic damage. In line with the fundamental principles of the EU resolution framework, the proposal provides for an extended use of the safety net so as to protect the taxpayer. The CMDI reform will start by extending resolution tools to medium sized banks but, to do that, funding possibilities must be improved, Banks' shareholders and creditors must always be the first to bear losses. However, external funding possibilities must also be expanded, which means using the deposit guarantee schemes (DGSs) more proactively. To accommodate that more proactive use, the creditor hierarchy must be changed, creating a single tier preference for deposits and the super preference of DGS must be removed. The proactive use of DGS, as opposed to the standard paybox function, will be governed by a harmonised least-cost test. All the elements in the CMDI proposal are interdependent. It is not possible to pick and choose between them. If the creditor hierarchy and super-preference of DGS cannot be changed, the DGS cannot be used proactively either. Only when you have the funding in place does it make sense to extend the use of resolution tools.

2.3.4 EDIS is still missing

A policy-maker noted that a European deposit insurance scheme (EDIS) would further enhance a reformed crisis management framework, by supporting the national DGS in a situation where it was not sufficient to meet the funding needs of a failing bank. In such circumstances today, the national DGS would turn to the state. As a basic principle under the Bank Recovery and Resolution Directive (BRRD) is that the state should only be involved as the absolute last resort, EDIS would therefore strengthen the crisis management framework.

An industry representative noted that EDIS is no longer being pursued.

2.3.5 When an IPS functions as a DGS, it must observe the rules of DGS

A policy-maker stated that the Commission must find an appropriate balance between the level playing field with recognising the specificities of national banking sectors including a functioning framework for the IPS. This balance was reflected in the Eurogroup statement of June 2022. The Commission believes that it has found that balance in the CMDI proposal, whereby an IPS must observe EU DGS rules, when it is recognised as a DGS and functions as a DGS. Otherwise, the IPS is still able to perform other non-DGS-related functions.

2.3.6 A more proportionate approach to Minimum Requirement for own funds and Eligible Liabilities (MREL) for medium sized banks

A policy-maker stated that it may not be possible to have equal treatment for MREL between very large and smaller/mid-sized banks. More proportionate MREL treatment for medium sized banks is proposed in the CMDI proposal. Unlike two years ago where interest rates were persistently low, the issuance of subordinated debt has become more costly, and some banks may struggle with this in their existing business model. MREL treatment should be equivalent between banks, although he accepted that equivalent treatment is more difficult to measure. The proposal is for a proportionate approach to MREL for medium sized banks. If the 8% bail-in threshold for accessing the Single Resolution Fund (SRF) cannot be met, it would be possible – in very specific circumstances – to use the DGS as a bridge to achieve access to the SRF so long as all shareholders and eligible creditors have already been bailed in. However, the quid pro co for this is that entities will be liquidated, i.e. exit the market fully, thus addressing the risk of moral hazard. All banks contribute to the SRF, so there is no philosophical reason why the SRF cannot be applied to all banks, but MREL will be the first line of defence. And all banks should pay for stability of the banking system as a whole.

An official commented that the European banking sector is indeed very diverse. This may hinder finding a solution over the weekend in a crisis. Instead of finding second best solutions to this problem, banks should compete for funding and allow the investors to assess the risk of different business models. The best tool for this is to require all banks to have the 8% MREL.

2.3.7 Resolution starts with MREL

The Chair commented that resolvability does not stop with MREL. It starts with MREL. Entities must be ready to withstand a resolution decision. If CMDI is adopted, the first thing that the Single Resolution Board (SRB) will do as a resolution authority is to request that these banks targeted for resolution respect not only MREL but also resolvability. The proposal is not a 'free lunch for dying quietly'.

In other words, the banks' funds (MREL) should and will remain the first to shoulder losses in resolution, but it is key to have -after MREL- credible access to the safety nets built by the industry (DGS and SRF), without gaps. This will enhance the ability of the resolution toolkit to meet its objectives, including the minimisation of use of public funds.

3. Should DGSs be allowed to address the funding gap in resolution for mid-sized banks?

The debate on this subject is controversial. The main arguments for and against this legislative proposal have been expressed.

3.1 On resolution, there is much for Europeans to learn from the US

A Central Bank official noted that the US has more powerful and flexible instruments in place to resolve a failing bank. In case of Europe, capacity and flexibility will increase once DGS systems are in place and ready to participate in resolution more actively. This could enable the controlled market exit of banks while minimising market panic and preserving the value of the bank under resolution. However, to have equally powerful and flexible resolution tools in Europe as in the US, the banking union would have to be fully finalised, including an agreement on EDIS.

To enable better resolution functioning from the practical perspective, there is a need to unify principles of the least cost test, which is important for more cost-efficient interventions by the DGSs. While this test is to be applied in case of the DGS interventions other than the payout of covered deposits, there may be some differences in how it is implemented in practice because the designated authorities have some room for discretion.

3.2 Constrained flexibility is needed to secure financial stability in banking crises

An official stated that the regulatory and supervisory reforms enacted in Europe in the last 10 or 15 years mean that Europe is in a safe place. The recent events in the US and Switzerland demonstrate that trust can be endangered by a medium-sized bank. Resolution is about preserving trust while curbing moral hazard. In order to do that, a large toolkit and constrained flexibility is needed, meaning a clear framework is required, with legal rules and a safety valve. As happened with the systemic risk exemption in the US, unknown unknowns must be taken into account. The Commission proposal goes in the right direction but is unsatisfactory in parts. For example, on the precautionary capitalisation, it adds constraints that are not fully justified. So far, the precautionary capitalisation has been used in a way that wiped out shareholders and subordinated instruments, so moral hazard was addressed.

Regarding uncovered deposits, recent events vindicated what was stated in Europe after enactment of the BRRD in 2011 and 2012. The Italian authorities argued that depositors should not be bailed in due to the risk of contagion effects. In the case of SVB, 90% were uncovered depositors, but the US authorities stepped in very quickly to protect them in order to preserve trust. This should encourage consideration of what is in the European crisis management framework. The 8% rule was applied with certain technicalities about whether the impairment should be factored in. Recent events have proved that flexibility is needed.

3.3 Increasing the possibility of using DGS and the Single Resolution Fund to manage bank failures

An official stated that the banking ecosystem in Europe is made up of very different banks and should be preserved. MREL is a crucial part of ensuring resolvability. However, some business models cannot issue MREL instruments or cannot issue up to the point that would be required if the rules were applied in the same way to all different business models. Level playing field does not mean applying the same rules in different situations. Around €35 billion is sitting idle in DGS. There is €80 billion in the SRF. As stated by the European Central Bank (ECB), this should be used when it is the least-cost solution. An element of the proposal that needs fine-tuning is the governance of when to use these mutualised funds as the preventative measures. When measuring least cost, not only direct but also indirect cost should be considered.

A Central Bank official commented that the role of resolution is to help banks with failing business models to orderly exit the market. An effective system is needed to ensure that the banking sector is vibrant, viable and moving forward. As a country with many fintech companies, Lithuania has a positive attitude toward the proposal because if the e-money institution is keeping funds in the bank, the DGS could treat funds on a granular (person) level. This provides more favourable environment for banking as a service business model.

3.4 Moving to the FDIC model remains challenging. Too much focus on the deposit transfer tool may prevent consideration of the big picture. The DGS super preference should be maintained

An official commented that the same rules apply across small, medium and large banks on liquidity and capital purpose. This is correct and appropriate.

Crises come in waves and complacency must be avoided. The quickness of the digital deposit run was shocking and has interesting implications for the growth companies and founders. The FDIC tool relied on the transfer of deposits, which was not possible to achieve within a weekend. Speed is very important here, not only in how quickly the market reacts but also in how quickly officials react. Whether the proposed changes in the CMDI would achieve the necessary speed should be considered. The EU crisis management framework should be formulated ex ante. Before the crisis, as complete a toolkit as possible should be built. The ex-ante toolkit will signal that there is a level playing field between the different sized banks.

Different levels of subordination and seniority protect themselves. A bank that only had deposits, corporate deposits and retail deposits, would run very easily. From the financial stability point of view, a full spectrum is needed. That is achieved by designing the right incentives for the banks and investors through regulation. There is currently too much focus on the deposit transfer tool. The wider implications of focusing only on this should be carefully considered. The shareholders and creditors should pay first. The hierarchy should be in place. Diversity is valuable, but it is not the only thing that should be optimised. The banking sector's role is to be extremely efficient at pricing risk correctly, so that the system works as smoothly as possible. From that perspective, the present model is very effective.

The general depositor preference is a concern. If the deposit transfer is indicated to be the preferred tool through the design of the least cost test and DGSs end up being used in all various crisis events, there is a danger that the money will run out. This is a clear risk in Europe with the very diverse banking sector with various business models. If it is indeed the case that banks cannot access markets to reach the 8% requirement of MREL then it is likely that over the weekend solution in a crisis would mean a huge haircut on bank assets in a transfer situation. Replenishing DGSs ex ante could be too expensive from the industry point of view. If everything is covered, it is unlikely that the private sector could pay and still be competitive. Then there is a risk that it would fall to the taxpayer again. There are also moral hazard consequences. If it is stated ex ante that there is a possibility of transferring all of the deposits i.e. none of them are used in bail-in, it is a huge investor protection scheme.

A policy-maker acknowledged that the CMDI proposal focuses primarily on the transfer of deposits, but the use of the transfer tool, other tools or the use of DGS in a paybox function only would be at the discretion of the national resolution authority. These would be no obligations to use any specific tool. Also, under the CMDI proposal, the existing crisis management framework is being extended. More fundamental changes in the approach to EU crisis management would have to be in the context of the overall framework including for "too-big-to-fail" banks.

3.5 Not respecting the creditor hierarchy and eliminating the DGS super priority would lead to a great deal of turmoil in the markets

An industry representative commented that the CMDI framework must respect the fact that a level playing field across Europe is essential. No public or mutualised money should be used to maintain so-called zombie banks on the market. The least-cost test and public aid rules must be more widely applied and harmonised across Europe. That means that all the European authorities in charge of overseeing this scheme must address a larger number of institutions than was initially envisaged.

The question of whether the taxpayer or the industry should pay was raised previously. In the first place, shareholders and creditors should pay. No bank should be entitled to escape from the common rules, in terms of having sufficient buffers of different categories of liabilities and protecting the deposits. There should be technicalities that allow all sizes of banks to access these types of liabilities and to issue different types of securities in order to build up those stacks. DGSs should not be used to address funding gaps in resolution and facilitate the access to the SRF for medium sized banks. Access to the SRF must be reserved for banks that have built the level of (MREL) and remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF). Reviewing the deposits or the DGS positioning in creditor hierarchies would present bank liquidity issues, increase volatility of bank deposit financing and introduce moral hazard.

The Chair noted that all banks contribute to the SRF, although not in the same amounts.

3.6 The CMDI review puts thousands of small and medium-sized banks at risk

An industry representative stated that the CMDI review puts thousands of small and medium-sized banks at risk for two main reasons. First, resolution for all means a combination of the authorities stepping in very early, a least-cost test and preferences for resolution. That would replace the decision-making process within an IPS and make an IPS obsolete. Secondly, the proposed Deposit Guarantee Schemes Directive (DGSD) changes would make IPS measures close to impossible for the DGS IPS[1]. Flexibility, trust and speed are very important. The EU IPS released a joint declaration on 26 April. There are wo calls for action. First, IPS measures must come before resolution actions. Second, the new DGSD should distinguish between the paybook schemes and schemes that are also legally recognised as IPS.

Conclusions drawn from the US are not necessarily the right conclusions for EU banks. The European Banking Authority (EBA), the SSM and the SRB are doing an excellent job so far. Policy-makers should actively embrace the diversity of the financial sector. The German banking sector is a good example of the benefits of diversity. Diversity of a banking sector can be considered in the context of future risks. The existing banking union already provides a solid foundation for banking stability.

The Chair commented that a new source of funding must be identified to address the funding gap in resolution for medium-sized banks. This raises a number of questions around DGS super preference, least-cost test and articulation between least-cost test and no creditor worse off. The role of the DGS is one of the most important changes in the CMDI proposals.

1. DGS-IPS refers to all IPSs that are recognized as DGS.