Improving the EU bank crisis management framework

1. Enhancing the EU's crisis management toolkit

On 18 April 2023 the European Commission published its legislative proposal concerning the review of the BRRD, SRMR, DGSD and Daisy Chain Directive, which is currently debated by the European Institutions. The Chair observed that the ECB views progress on the crisis management and deposit insurance (CMDI) framework as essential to European integration. If there is no progress on this topic, the prospects for progress on banking union look very dire.

1.1 The current framework is 'handcuffed' by contradictions, but the CMDI proposal seeks to provide the beginning of a solution

A resolution authority official stated that the expansion of Public Interest Assessment (PIA) should come with funding solutions for those banks that will become resolution entities. An expanded PIA without additional funding would be suboptimal with respect to the status quo. Indeed, switching new banks from liquidation to resolution without adequate funding options may be detrimental to the credibility of the system. The CMDI proposal provides us with a valid toolkit to deal with the banks that would enter in the resolution sphere.

The Chair noted that the ECB is extremely supportive of the discussion. Widening the scope of the European harmonised resolution framework is the most cost efficient way to facilitate an orderly market exit for banks that meet the test of failing or likely to fail (FOLTF). The proposed amendments would also minimise struggling banks' net asset losses, contribute to stabilising deposits in the system and require less funding to be mobilised than is necessary with depositor pay outs. The ECB is also happy to engage on the important issue of cost. It will be important to find an arrangement that reassures the industry that the benefits are greater than the costs.

1.2 The scope of resolution can be enlarged if the rules ensure financial stability

An official considered that there are three key elements to the proposals. First, the question of resolution versus national insolvency should not be an ideological debate. The default should be national insolvency. The key factor should be whether resolution delivers better results on financial stability. The scope of resolution can be enlarged if the rules guarantee financial stability. Secondly, some constraint is important to curb the moral hazard, but there is also a requirement for flexibility in order to address exceptional cases. Deposit guarantee schemes (DGSs) should be used in exceptional cases where funding resolution would endanger financial stability. Finally, Minimum Requirement for Own Funds and Eligible Liabilities (MREL) is not the only means to achieve resolvability. Technology and preparation are also important contributing factors. MREL should not be the same for all banks: proportionality is key. For a resolution strategy involving full recapitalisation, MREL could easily reach 16% or 18% of risk weighted assets or being even higher. If small banks are asked to set aside this amount, it will drive them out of the market.

An industry speaker reacted to the idea that enhancing financial stability should reduce the funding gap for small and mid sized banks: this can be true only if two conditions are met. First, MREL requirements have to be imposed on much more small & mid-sized banks, and second the authorities have to intervene early much more often. On the first point, some say that medium sized bank cannot issue MREL instruments: this is not true, as there are other solutions such as longer transitional periods, relying on a higher share of retained earnings or the creation of an escrow account to access in resolution. On the second point, in its current form, the CMDI reform could reinforce the other preventive actions that exist: this is a key issue to foster consolidation of the banking sector in Europe.

1.3 A public liquidity in resolution backstop is essential for successful crisis management

The banking turmoil earlier this year has highlighted the importance of being able to access funded public backstop facilities in resolution; they are essential to restore confidence. This is still an open issue in the current EU framework.

1.3.1 Liquidity in resolution: a missing piece in the EU framework

An official stated that liquidity is not a topic that should be addressed through the CMDI review; rather, it should be addressed through the completion of the banking union. Liquidity is key for the maintenance of financial stability in the event of resolution. There will be a liquidity problem in a bank resolution, no matter what the cause of the crisis. If the bank has met the FOLTF test, there will be a liquidity stress. Even though the bank has been resolved and recapitalised, the market will need reassurance. There will always be a need for bridge financing while the markets are being reassured.

Therefore, there must be a credible and transparent liquidity backstop which is easily understood by market participants and depositors. This mechanism should be subject to strict conditionalities, such as the existence of a viable business plan. The related legal regime should also be transparent and clarify – for instance – how to recover any losses. The European Stability Mechanism (ESM) backstop is a move in the right direction, but the resolution of a very significant bank (like a G-SIB) or the

unfold of a systemic crisis will likely require hundreds of billions of euros. In such a case, where the mutualized funds are not enough, there is ground for the public authorities to intervene and provide the resources. Any resolved bank that has been fully recapitalised should be able to access a public backstop. This could be similar to emergency liquidity assistance (ELA), appropriately amended and translated for the resolution framework.

1.3.2 Prerequisites for an operational liquidity in resolution tool

An industry representative emphasised that the most important task is to ensure that the framework works when needed. A liquidity in resolution tool will be required to resolve medium sized banks. It will also be necessary in the event of a liquidity constraint across multiple banks. However, it should be a contingent liquidity in resolution tool. The ECB is the natural candidate to create this tool, given its experience in providing collateralised funding to the market. However, there will be a need for a public guarantee, which will require the involvement of the member states. The experience in the US provides some insight into how to structure the tool. In the US, the Federal Reserve granted loans to bridge banks and loaned money to banks with beneficial collateral treatment. These are the types of ideas that should be explored.

1.3.3 The SRB's resolution toolkit is strong, but it must have effective liquidity provisions

A resolution authority official explained that CMDI caters for mid sized or regional banks that could also present a systemic risk. On liquidity, it is key to recall that there are over 75 billion in the Single Resolution Fund (SRF) – plenty of resources. However, we should find a solution for the tail-risk cases. For the bigger banks, it is currently not easy to find enough money at the right time. The question of liquidity in resolution is always discussed in terms of finding a lender of last resort. However, being the lender of last resort does not automatically mean losing money. In the case of Credit Suisse, the Swiss government provided a guarantee of 100 billion Swiss francs to the liquidity line provided by the central bank. This line was certainly not drawn up and, in any case, everything was fully reimbursed with interest in a few weeks and provided a lot of stability to the transaction. Nor the central bank nor the government lost any money in the credit line transaction.

The Chair agreed that the recent cases of resolution all involve the sale of the bank. In the case of Switzerland, the sale was a resolution in all but name. The CMDI reforms are aimed at reducing the cost of managing failing banks. The aim is not to make the process more costly for the good banks; it is about trying to find the least costly way to deal with mid sized banks. Ultimately, it will be important to reassure DGSs that this will diminish their burden rather than increasing it.

1.4 Strengthening contingent liability will improve the sale of business resolution tool

An industry representative suggested that the best way to minimise cost is to avoid disruption and contagion. So far, contagion and disruption have been largely avoided by using a sale of business strategy. The effectiveness of this strategy could be enhanced by providing acquirers with better protection against contingent and hidden liabilities. Contingent liability is a calculation of potential losses that are unlikely to materialise in the future or losses that cannot easily be estimated. This is a cost for an acquiring bank. Under the existing framework, the acquirer of a failing bank is exposed to a broad range of contingent and hidden liabilities. The proposal makes some progress in this regard. At the moment of resolution, an independent valuer will consider the contingent liability. This is a step forward, but there are some concrete ideas that could further strengthen it.

1.5 Preventing the so called 'limbo effect' and reforming insolvency law

A regulator queried whether future regulations should address the so called 'limbo' effect, which relates to entities that meet the FOLTF test but do not meet the insolvency or resolution criteria. Supervisors, as well as resolution authorities, find these entities difficult to deal with. When some banks in Poland went through resolution, the discussion revolved around the philosophical question of whether insolvency should be the default solution. Different countries have very diverse legal regimes for the insolvency of banks. The traditional understanding is that insolvency is the standard solution and resolution is an exception. The experience in Poland suggested that it might be preferable for resolution to be the default procedure. At some point in time, there could also be a harmonised pan European legal regime for the insolvency of banks, which would harmonise the law for entities that have no ability to access the SRF.

2. Should DGSs address the funding gap in the resolution of mid sized banks?

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

2.1 It may be beneficial to use DGS funds to bridge the gap required to meet the 8% total liabilities and own funds (TLOF) threshold, especially in case of small or medium sized entities

A resolution authority official explained that the proposed intervention on DGSs has a key aim: to protect financial stability without using taxpayers' money. The possibility of using DGS resources (industry funds) in resolution should reduce the need to use them in liquidation. For customers, resolution is always a preferable option as it avoids the interruption of functions. However, resolution in some cases, even if preferable, is hard to execute because of a funding gap.

For small and medium sized banks, this gap may be due to two practical reasons. First, it will take a significant amount of time and effort for the "CMDI switching banks" to transition to MREL compliance. EU biggest banks have

had an eight year transition period to reach MREL compliance. Second, a crisis may be more severe than expected. If the losses that the bank took are very large, it may be necessary to bail in deposits. A deposit bail in is politically very difficult. DGSs should intervene to fill these kind of financing gaps. Since the DGS intervention is only up to the level of the 8% TLOF and since MREL remains the first line of defence, according to our estimations, the amounts being targeted will not be significant. Needless to say that the banks that are targeted for resolution have to be resolvable.

It should be clear. To be resolvable, means more than waiting for interventions from a DGS or the SRF. All the work that the SRM and the banks have been doing in the past years is a testament to this fact. When the national resolution authorities and the SRB earmark a bank for resolution, the bank needs to work to become resolvable. This requires issuing MREL, putting in place IT systems capable of delivering the right information the right time, a bail in playbook, valuation capabilities and so on. CMDI is just a practical solution. It is key to recall that the CMDI proposal, besides the DGS bridge and expanding the scope of PIA, will simplify and clarify several parts of the framework (e.g. the withdrawal of the licence for the failing bank and the daisy chain requirements). These improvements should not be lost.

A regulator noted that Poland has an institutional structure where the resolution authority is also the deposit guarantor. This means the resolution fund and the DGS fund exist 'under one roof'. The advantages and disadvantages of this structure should be discussed more widely. In the panellist view, it may be beneficial to use DGS funds to bridge the gap required to meet the 8% threshold, especially in case of small or medium sized entities. Indeed, there is a requirement for pragmatic and practical cooperation between DGSs and resolution authorities. In cases where these funds are managed separately, there are benefits to involving the DGS at an early stage of the process.

2.2 Eliminating the DGS super priority could lead to turmoil in the markets

2.2.1 Strict burden sharing must remain the cornerstone of resolution, excluding a DGS bridge

An industry speaker emphasised that the recent US crisis has shown that the failure of small and mid sized banks can trigger widespread contagion. The reform of the EU crisis management framework should first seek to enlarge the Public Interest Assessment (PIA). Ultimately, the same risk should be governed by the same rules. Safeguards to ensure the harmonised application of the revised PIA should be put in place. The application of the PIA by national authorities could be made more consistent by disclosing a summary of any PIA outcome that concludes in favour of liquidation. This would foster transparency and enlarge the scope of resolution. Nevertheless, the enlargement of resolution must not distort healthy competition or maintain excess capacity in the European market.

2.2.2 The 8% TLOF requirement should remain intact

An industry speaker considered that the MREL buffer, which is necessary to reach the 8% TLOF bail in requirement, should be used to access the Single Resolution Fund (SRF). This is consistent with the post crisis principle that shareholders and creditors should pay more of the costs of resolution. It is not correct that small and mid sized banks cannot issue MREL. These institutions can and do issue MREL, especially when ordered to do so by resolution authorities. If these banks cannot shoulder the cost, they should exit the market. Finally, supervisors should act early enough to handle bank distress without undue cost. This is allowed by article 27 of the BRRD. To reinforce these powers, there should be inducements for the authorities to act in a timely manner. If the reform is in line with these principles, it would foster the necessary consolidation of the banking sector in the EU and reduce overcapacity.

2.2.3 The protection offered by DGSs would be negatively impacted by a requirement to finance the resolution of small and mid sized banks

An industry speaker stated that deposit insurance is a core element of the entire CMDI framework. Deposit insurance offers one product: protection. From that perspective, the key question is how to protect the protectors. The benchmark for the framework will be whether it improves upon the high level of confidence in the current system. The CMDI proposal can be divided into two different parts. The first part aims to improve the existing framework and is based on several European Banking Authority (EBA) opinions on the variation in depositor protection, which suggest further harmonisation as a way to ensure equal protection for all depositors in the event of insolvency. This suggestion is a positive step forward. However, the second part of the proposal is a fundamental shift towards resolution as the standard procedure. This protection for the protectors would come at a steep price. To make resolution available to most banks, the current protection offered by DGSs would be reduced.

Indeed, the shift to resolution is based on the idea that DGSs should finance resolution tools. This would require DGSs to lose their super preference in insolvency proceedings. The super preference gives the DGS a preferred position in the creditor hierarchy. In a depositor pay out, a DGS will usually be entirely reimbursed. Removing the super preference will significantly increase a DGS's losses and reduce its financial firepower, its capability to safeguard deposits and consequently its capability to ensure trust in the system. Using DGS to finance resolution would make it more difficult to recover funds paid for depositor compensation and would indirectly result in further financial burdens for credit institutions. The use of DGS funds for resolution combined with the loss of the super-preference would lead to frequent additional funding obligations. During a crisis, these obligations could result in a domino effect.

Furthermore, the role of DGSs and Institutional Protection Schemes (IPSs) would also be reduced to mere payboxes instead of risk minimisers. As stated in their joint declaration and call to action, the preventive measures of IPSs will be made more difficult or even impossible by the new extensive requirements, which are not in line with the obligations on IPSs pursuant to

article 113(7) of the Capital Requirements Regulation (CRR). Take the example of someone buying a new car. A potential buyer might be happy to learn that a car is equipped with a state of the art AI autopilot system, but, if the choice is between an AI autopilot system that works in most cases and an airbag that is proven to work in all cases, the decision for the buyer is clear. Nobody would choose a new IT system if it meant not having an airbag. Customers want to rely on the most basic safety feature that offers reliable protection. The discussions over the last years have been around the credibility and financial firepower of DGSs, yet the Commission is proposing to take away the core element of that credibility.

2.3 DGS funds can play a key role in resolution under a robust and harmonised Least Cost Test (LCT)

An industry speaker stated that the key question is about the least cost solution. The current proposal makes the solution impressively expensive for DGSs. Indeed, there is no contradiction between protecting the protectors and protecting financial stability. Deposit insurance schemes play a significant role in financial stability. The idea of protecting customers should not mean that all customers are protected in all cases. Currently, deposit insurance schemes strike the right balance between providing protection for those who need it and a 100% guarantee for all customers. The latter would cause significant moral hazard, facilitate less market discipline and make the scheme much more costly.

A regulator observed that the least cost test can only be properly performed with the involvement of the national resolution authority and the DGS. The determination of cost has to be holistic. The resolution authority and the DGS should come to a joint determination. Additionally, there is question about the competition consequences of smaller or medium sized institutions being unable to meet the criteria yet nonetheless receiving the benefit of the DGS. Ultimately, the goal is to protect financial stability. It may be necessary to balance competition and financial stability.

Indeed, it is important to consider the interaction between the protection of financial stability and the protection of competition. The smaller banks will receive the benefit of resolvability at a lower cost than the larger banks, which have been paying this higher cost for the last eight years. In this regard, the least cost test could even become the leading test perhaps at the cost of the PIA. Harmonisation will be a challenge, especially for non eurozone resolution authorities. There should be further discussion of enhancing the transparency of the PIA, which could involve the publication of PIA outcomes.

An official explained that to allow for a wider recourse to industry funded safety nets to manage crises and foster value preserving transfer strategies, two adjustments are imperative: the elimination of the DGS super priority and the inclusion of indirect costs in the least cost test. DGSs should be unleashed to serve a public purpose. Cost is the most relevant factor in this discussion. The opposing argument is that the removal of super priority would mean that DGSs would pay much more in piecemeal liquidation scenarios. However, it is the intention of the proposal to try to avoid piecemeal liquidation scenarios. By allowing authorities to pursue the least costly solution (through DGS preventive and alternative measures, as well as DGS intervention in resolution), DGSs are used preventatively and the likelihood of these very costly and impactful situations occurring will be close to zero. It is important to protect DGSs, but it is possible to do that while serving the higher purpose of financial stability. Furthermore, including indirect costs in the LCT would allow a proper identification of the real costs borne by the DGS and the whole financial system and unleash the effective deployment of efficient and value preserving bank crisis management tools.