EU RESOLUTION APPROACH FOR SSM BANKS

The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock. Banking markets are still fissured along national borders. There is little progress in cross-border lending, especially in retail markets, i.e. lending to households and firms. Ring-fencing is still an issue in the BU, although the single supervision authority and single resolution authority unite all of the national competent authorities. Indeed, Member States do not sufficiently trust the institutional set-up of the BU. They believe that capital and liquidity will be trapped in individual Member States if a pan-European banking group fails. It is therefore essential to address host countries' concern over the crisis-management framework.

The Chair invited panellists to discuss forthcoming priorities for progressing with a common, transparent and predictable resolution regime. The second half of the discussion focussed on the European deposit insurance scheme (EDIS). Where does Europe stand? What can EDIS contribute to the completion of the Banking Union (BU)? What are the main stumbling blocks? Why does it seem that progress is stalling?

1. Priorities for progressing with a common, transparent and predictable resolution scheme

Increasing confidence between home and host countries around burden-sharing is urgently required. In this perspective, there are several outstanding issues around resolution to be addressed, such as the need to define a common application of 'public interest criteria', a lack of appropriate mechanisms for resolving mid-sized banks and a need to establish a common banking liquidation framework while maintaining the precautionary recapitalisation instrument.

1.1. Increasing confidence between home and host countries around burden-sharing remains a key priority

1.1.1. It is necessary for parent banks to issue credible cross-border guarantees for their subsidiaries

A regulator noted the difficulties concerned with burden-sharing, expressing his belief that Europe should continue working on guarantees provided by the parent company of transnational groups to their subsidiaries located in the euro-area in order to strengthen trust between home and host countries. Indeed, there must be guarantees and reassurances before the 'fatal weekend' when burden-sharing becomes necessary, which means that these positions must be strengthened ex ante to inspire confidence in burden-sharing and provide Europe with flexibility. Credible cross-border guarantees are suitable for this purpose. These must be based on European law and enforced by European authorities. This will increase confidence between home and host authorities. However, it is difficult to progress in this area because different banking groups want to take different approaches.

1.1.2. MREL is a cornerstone of the EU resolution regime for significant institutions and groups

A Central Bank official felt this issue depends on many of the structures currently being built. For example, large transnational banks are dominant in the Croatian market. When Croatia becomes part of the BU, it will be necessary to have a coherent and consistent framework for these banks to hold a sufficient amount of MREL. There is little alternative to a robust and transparent MREL framework, which is achieved to the largest extent possible in the new Banking Package. By the end of 2024, both the Single Resolution Fund (SRF) and the agreed resolution strategies should become fully credible and operational for all, or the vast majority, of the significant banks and groups in the BU. Second, the SSM and SRB must have a predictable and consistent policy to manage 'failing or likely to fail' banks. If there is a substantial number of exceptions, every bank or national authority will claim a particular specificity, and this will cause multiple fragmentation.

1.2. There is a need to define a common application of the 'public interest criteria'

A common application of the "public interest assessment" by the Single Resolution Board, the European Commission and national resolution authorities would make more predictable the resolvability of failing banks, whatever their size. As evidenced by recent liquidation cases, whether the resolution of a bank deemed failing or likely to fail is in the public interest or whether a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at a national level based on the current legal framework. European resolution decisions are strictly binary: the SRB acts only when banks satisfy a strict European public interest test. All other cases are invariably handled at a national level, enabling divergent courses of action to be pursued along national lines. In recent cases, ailing banks which have been turned down by the SRB were subsequently found to be of public interest by national authorities. Ultimately, the right to decide lies with whoever is prepared to foot the bill.

A regulator observed that the current resolution framework suits large banks well, but there are questions about mid-sized deposit-funded banks. In these cases, there are different definitions of public interest at the European level and the national level. In addition, the differences between different national approaches to public interest cannot be completely explained by the specifics of local markets. This fragmentation undermines the credibility of Europe's resolution framework. Moreover, it is not predictable for external stakeholders. Therefore, Europe should immediately seek a common definition of public interest. As long as EDIS has not been established and is not fully effective, the regulator felt that this topic was essentially a question of burden-sharing. It is essential for national public interests and the European public interest to converge quickly. As an immediate transitional measure until EDIS is fully established, Europe could seek stronger involvement from national resolution authorities in the SRB's decision-making process.

1.3. The EU must determine the appropriate mechanisms for resolving mid-sized banks

1.3.1. The BRRD's approach to resolution does not take account of a bank's size or business case

An official disagreed with the remarks made by the regulator, highlighting that liquidation is the default option in the regulation. If Europe wants to have different resolution approaches for large, medium-sized and small banks, the regulation must be changed because the current EU framework, respecting the principle of proportionality, is applicable to all kind of banks. Second, the Single Resolution Board (SRB) has a single policy for assessing the public interest, so for banks under the remit of the SRB only one resolution

policy is applied. The only two Institutions that can challenge its decision are the European Commission and the European Council, not a national resolution authority. Third, the governance of the SRM is completely different from that of the Single Supervisory Mechanism (SSM). Decisions on resolution or on approving resolution plans lie with the executive section (if a national authority participates and the members do not reach a consensus, only the permanent board members vote). An industry representative stressed the importance of taking into account the reality of the relationship between the SRB and national resolution authorities. With regards to the two failed Venetian banks in 2017, the SRB assessed that they banks were neither systemically relevant nor providers of critical functions, so they concluded that there was not public interest in their resolution.

1.3.2. The BRRD rules seem inadequate for mid-sized banks in the EU

A Central Bank official reiterated the importance of trusting and valuing the work that is already complete. If the system is not working, Europe must conduct some fine-tuning. One of the primary objectives of BU is to provide visibility and financial stability. The current system does not guarantee financial stability from the point of view of different member states. Banks still 'die nationally'. If this principle is applied to a medium-sized bank which does not comply with the European interpretation of public interest, an insolvency process will be required. However, this will be completely chaotic, because Europe has not created instruments for insolvency within the BU and the common legislative framework. In other words, this means that, while supervisory and resolution decisions are mostly taken at the European level, the ensuing consequences still lie with taxpayers at the national level, with potentially serious impacts on national budgets. As the ultimate guarantor of financial stability remains national, but with limited tools to act, this 'accountability conundrum' needs to be solved.

Solutions need to be found for the orderly exit of traditional medium-sized deposit-taking banks without disrupting financial stability. Whereas MREL and bail-in requirements form a cornerstone of the common EU resolution regime for larger banks, the 8% bail-in within the BRRD is absolutely inadequate for medium-sized banks whose business model relies on retail and SME clients. Thus, there is a systemic dimension to these non-systemic or non-relevant banks at an European level. Additionally, the role of national DGSs must be clarified. A Central Bank official considered it essential to determine the correct solution for deposit-taking banks before considering harmonisation. Additionally, financial stability is a key objective. Otherwise citizens will not recognise the BU as anything but an instrument for the consolidation of banks. It is prudent to refrain from supporting greater harmonisation of insolvency regimes until Europe understands what it is trying to do. The Central Bank official clarified that their main objection is not with the concept of a bail-in but rather with the 8% BRRD bail-in, which demands an excessive amount of MREL. In addition recent calls to form a sort of European FDIC, merging the Single Resolution Fund and EDIS into one single entity, merit our attention in this regard in the medium-term, provided that the legal framework is fixed and that financial stability – both at the European as well as at the national level – is enshrined as the first and fundamental objective of any intervention.

1.4. Europe must establish a banking liquidation framework

1.4.1. Making the liquidation regimes across the Union more consistent and predictable

There is still considerable fragmentation between national regimes, which means there is a need for greater harmonisation. A regulator suggested that it would be useful to reform the liquidation framework for banks. Liquidation regimes across the Union are not sufficiently consistent and predictable. This framework will need to hold during the 'fatal weekend'. This process involves the reaction function, commitment and engagement and it must have a sound basis in European legislation. The early intervention of the authorities should create confidence and the process should be enforceable, whether in resolution or liquidation. Liquidation will be essential here, because resolution will need to be built on the 'no creditor worse off' basis.

1.4.2. EU legislators should create a single insolvency regime instead of harmonising incrementally

An industry representative emphasised the importance of learning lessons from recent cases of resolution, even if Europe's system was fully aligned with international principles on the subject. Ultimately, national insolvency regimes should be harmonised. Europe must have a single resolution framework, but it is important not to discuss harmonisation for decades and achieve nothing. A common insolvency regime would provide clarity for investors, customers and the public regarding how bank failures will be treated. The ideas floated by the SRB and the Commission indicate the right direction. There should be a single insolvency regime for banks with a single administrative authority. Arguably, the SRB is the ideal institution for this role. This will require the involvement of judiciary authorities, because it is a deeply legal issue. There will need to be a set of liquidation powers, a resolution toolkit and a bridge bank. There will also need to be clear and consistent creditor hierarchies in order to ensure that the resolution framework and insolvency regime are consistent. Finally, Europe should define common triggers for the activation of insolvency. The Commission has called for a study about this issue, which will feed into a legislative proposal.

1.4.3. There is potentially added value in using a 28th regime for Europe's liquidation framework

The Chair described how, in a previous panel, a panellist had proposed involving justice ministries in this process. However, each justice ministry believes that its version of insolvency law is better than the 26 others in the Union. The Chair wondered whether Europe could consider a 28th regime where issuance is possible. A Central Bank official agreed that this is possible, adding that harmonising insolvency regimes is something for the very long-term. If a big bank operates in multiple regimes inside the BU with a clear regime and a responsibility for covering deposits, all of its stakeholders should have the same level of guarantee. The Central Bank official felt that harmonising the different insolvency regimes of member states cannot work. This is the reason why a 28th regime seems a viable option. In addition, Europe must undertake further work in relation to the medium-sized deposit-taking banks notably because the existing regulations around the BRRD and state aid create a nightmare. An official disagreed, noting that the issues raised by the Central Bank official were about the application of burden-sharing. The Central Bank official emphasised that he had not asked for state intervention. The official considered that this was behind the desire for a different approach from the BRRD. The Central Bank official clarified that the problem is not the bail-in but rather the rigid bail-in rules of 8% and 5%.

1.5. It is necessary to maintain a precautionary recapitalisation instrument

In relation to divergence in national liquidation procedure, the Chair noted that a member of the audience had suggested that the simplest way to solve divergence in liquidation practices is for the European Commission to announce the withdrawal of approval of precautionary recapitalisation. An official answered that without precautionary recapitalisation

a bank will be forced into resolution or liquidation and the lack of harmonisation of the insolvency laws will not be solved. In liquidation without the state aid allowed by DG Competition, the shareholders and creators of a bank should bear the losses of the liquidation. This question comes back to market discipline, but such a withdrawal of the precautionary recapitalisation instrument will not solve the lack of harmonisation in insolvency proceedings. This type of measure could be possible if flexibility is added to a different part of the EU resolution framework, for instance a flexible liquidation regime for handling medium-sized banks. However, Europe must seek a compromise to secure additional flexibility. It cannot be withdrawn without compensation.

2. Still many stumbling blocks to achieving an agreement on EDIS

While views on EDIS still diverge considerably, a possible way forward to accommodate the differing opinions appears achievable. Without EDIS, the credibility of the SSM and SRM is at stake, but EDIS will not 'miraculously' solve the issues within the BU and it has the potential to threaten the existence of member states' institutional protection schemes (IPS). However, EDIS should not be considered as a novelty since a political commitment was achieved as early as 2012, inspired by the US system. Ultimately, Europe should progress gradually and cautiously towards EDIS.

2.1. Without EDIS, the credibility of the SSM and SRM is at stake

A Central Bank official considered that not creating EDIS could create morally hazardous incentives for national authorities. National regulators may be incentivised to use tools designed for systemic institutions to handle less systemic institutions in order to protect their own DGSs. There are also other moral hazards and possible arbitrage around EDIS. For example, Croatian banks could offer German savers a slightly higher interest rate while guaranteeing deposits up to €100,000. If savers know they are insured and that the DGS is well funded, this kind of arbitrage becomes possible.

Additionally, EDIS will solve the problems concerning liquidity and capital ring-fencing issues in transnational banks. In many cases, EDIS will lead to the branchification of larger transnational banking groups, because it is unnecessary to have a subsidiary if it is possible to have a branch. In the absence of EDIS, full responsibility for depositor and client protection, as well as protection of public funds in thousands of small and medium-sized banks, will remain at the national level while key decisions on issues such as licence withdrawal and public interest are made at the EU level. However, the Central Bank official highlighted the importance of ensuring that legacy issues are not mutualised, stressing that this would have to be solved before EDIS is possible. The SSM and the SRB should create an environment in which all countries agree that it is now time for EDIS. Before this, the banking market should be cleaned up. The Central Bank official expressed frustration that the people advocating EDIS are also attempting to make the SSM less efficient. There must be the will on all sides to do this. Everything will be much easier with a good insurance system and properly capitalised banks. The Central Bank official noted that Croatia closed 42 out of 62 banks over 16 years and experienced no banking crisis because there was enough capital and enough money in the deposit-guarantee-scheme. It is possible to clean up the market gradually with the right expertise.

An industry representative agreed with the Central Bank official's remarks, noting that the issue of EDIS is about consistency, credibility, and the logic of the BU. If BU is about ensuring the fungibility of money, EDIS is necessary because one euro should be equally protected regardless of where it is located. As a compromise, there could be different speeds of implementation, but there is no intermediate solution which can break the 'doom loop' between sovereigns and banks. The industry representative stressed the importance of having the same rules with centralised supervision and resolution. If the costs of EDIS are borne locally, decisions taken at the European level could create serious political issues. The absence of EDIS generates doubts about European states' ability to compromise on the BU and hampers the development of cross-border deposit markets. EDIS would support the single market, enhance financial stability and enable more lending in the economy, because more deposits would flow. However, a badly designed EDIS would be a 'nightmare'. Europe needs solidarity, and there is no solidarity implied within EDIS. EDIS must be designed so there is no systematic and consistent flow from the north to the south or from the east to the west, which could be avoided by adjusting contributions using risk parameters.

2.2. EDIS will not 'miraculously' solve the issues with the BU and could threaten IPS regimes

An industry representative questioned two of the main arguments for EDIS: It supposedly breaks the sovereign-bank loop and its absence causes restrictions on the free flow of capital and liquidity. EDIS will not miraculously eliminate these problems. Additionally, the industry representative brought forward several arguments against EDIS. First, alternative measures such as those being applied in Italy would no longer be possible. Second, the target volume of 0.5% for concentrated markets like France would be lost. Third, 50% of all credit institutions in the EU are part of an IPS, the existence of which would be threatened under EDIS. Bearing all this in mind, the industry representative stressed the need for Europe to explore alternative solutions. If the industry sets aside the Commission's 'dogmatic' proposal for a fully mutualised EDIS, there are several alternatives allowing for the retention of national DGSs as a first line of defence, while also making possible the creation of an additional European layer. Regarding resolution and EDIS, the industry representative questioned that there are direct links. After bailing-in the debt of the institutions that need to be resolved, will Europe reach a level where deposits also need to be bailed in? The industry representative doubts this, suggesting that the conservative MREL and TLAC requirements in place will be sufficient. A regulator agreed that an evolutionary approach could be a solution, expressing doubt that EDIS would threaten IPS regimes.

2.3. EDIS should not be considered as a novelty since political agreement was achieved in 2012

A Central Bank official considered that not implementing EDIS is problematic because it is a compromise package and not something envisaged to be dependent on NPLs, sovereign exposures and insolvency harmonisation. EDIS was a package agreed when Europe was in a serious crisis (2012) and inspired by the FDIC. Europe must think back to this time and not consider EDIS as a novelty. The reason for the discussions on waivers and alternative measures is because the progress being made on the BU has stopped.

2.4. Europe should progress gradually and cautiously towards EDIS

A regulator considered that every member state has carried out risk reduction, which means that Europe should progress gradually and cautiously towards EDIS. Domestic exposure to sovereign-bonds is an important problem to address, and this will require 'creative' solutions. It is not sufficient to discuss solutions exclusively in terms of prohibitions or disincentives for investment on sovereign-bonds. On the contrary, Europe should consider the incentives for buying sovereign-

bonds carefully, because to some extent all banks will hold sovereign exposures. Europe should not penalise sovereign-bond holdings per se; rather, Europe should create positive incentives for well diversified sovereign-bond portfolios.

The Chair noted that the debate between risk reduction and risk-sharing had been raised and queried whether this is a false dichotomy. An industry representative suggested that Europe could be halfway to EDIS if attitudes toward risk reduction and risk-sharing were different. If further risk reduction is impossible, there is always the possibility of changing the risk premiums in EDIS. The industry representative agreed that diversification could be achieved through a safe asset or synthetic risk-weighting. It is healthy for banks not to be excessively concentrated on one sovereign, but they do need some sovereign exposure.