Medium-sized bank resolution

Pablo Hernández de Cos

Governor, Banco de España

Resolution of mid-sized European banks

The global financial crisis required significant public-sector intervention to bail out banks in order to prevent financial instability and the subsequent deep and negative impact on the real economy. After the crisis, the authorities, through the work of the Financial Stability Board, reviewed the resolution framework and shifted the paradigm, moving from bail-out to bail-in. Additionally, for global systemically important banks (GSIBs) it was agreed to ask for minimum total loss absorption capital (TLAC) that should cover both potential losses and the funds needed to recapitalise the bank.

Europe has also developed a new resolution framework with three particular features. First of all, the creation of the Single Resolution Board (SRB) as a key pillar of the Banking Union. Secondly, the adoption of the new paradigm centred on the bail-in, but also including other resolution tools (sale of business, bridge institution and asset segregation). Thirdly, the new resolution framework and the accompanying MREL (minimum requirements of own funds and eligible liabilities) requirements apply to all banks, not only to GSIBs. This may pose some challenges for mid-sized European banks with a retail business model and almost no tradition or practice to tap wholesale markets for capital or debt that absorbs losses.

> *"The build-up of MREL in mid-sized banks should insulate tax-payers from rescuing failing banks."*
>
> \- PABLO HERNÁNDEZ DE COS

The BRRD clearly states which are the objectives to be protected in resolution: continuity of critical functions, financial stability, minimising the use of public funds, protecting the guaranteed depositors and the assets and funds of bank customers. The authorities, in cooperation with banks, develop a resolution plan that also includes a minimum MREL requirement, precisely to protect those objectives and minimise the use of tax-payers money. Therefore, if a bank of any size performs critical functions and its liquidation may threaten financial stability, it needs to have enough MREL for its orderly resolution.

The level of MREL a bank needs is calibrated depending on the resolution tool to be used. The resolution tool needs to be credible and feasible. As such, only

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>>> bail-in seems credible and feasible for large and complex banks since it appears to be almost impossible to find a buyer for a large and complex bank when resolving it. The past crisis provides support for this hypothesis. However, for mid-sized and small banks, sale of business and the bridge bank seem reasonably credible and feasible resolution tools. The successful resolution of a Spanish bank two years ago by the SRB is an example of how a domestically systemic bank with 150 billion euros of total assets can find a buyer in resolution.

Which is the level of MREL needed for a sale of business tool? In this case, it should be taken into account that the buyer will probably recapitalise the bank, as it will also provide the liquidity the bank may need when opening after resolution. The MREL requirement should cover the loss absorption amount but it also seems reasonable for coverage of the recapitalisation amount to be partially fulfilled by the buyer.

However, as it is not fully certain that a buyer will appear in resolution, a safe margin for the recapitalisation amount should be covered by each bank with a transfer strategy. In any case, the resolution plan must develop a credible strategy for sale of business, in particular, the creation of vendor data rooms that would allow a third party to run an efficient due diligence process in the event of resolution.

Last but not least, the BRRD2 will allow for a longer period to fulfill the MREL requirements (1st January 2024 in most circumstances). Small and medium-sized banks may need this longer period of time to build up the required MREL, without threatening their business model and profit generation. Given their smaller size, MREL issuance liquidity might also be a matter of concern. In any case, there are windows of opportunity for these banks to start to tap wholesale markets. It will be challenging but not impossible.

The combination of a longer period of time and the use of the whole array of tools provided by the resolution framework in Europe should allow mid-sized banks, with critical functions to protect and with a potential impact on financial stability in case of liquidation, to build the needed MREL that will insulate tax-payers from jumping in again to rescue failing banks. ●

Fernando Restoy

Chairman, Financial Stability Institute, Bank for International Settlements (BIS)

A European FDIC?

The Single Resolution Mechanism (SRM) represents a crucial step in the development of the banking union. Yet the common regime for the resolution of systemic banks must coexist with a wide variety of – typically inefficient – national insolvency regimes for non-systemic institutions, creating significant obstacles for the management of banking crises in the euro zone. In particular, the current regime fails to provide robust procedures for handling the failure of mid-sized institutions. It also falls short of fully breaking the link between banks and sovereigns.

Thus, the current crisis management framework needs further development, if it is to help maintain financial stability more effectively and make the banking union work as intended. This requires a regime that can deal effectively with all types of crisis-hit institution. The unavoidable (if counterintuitive) insight is that the resolution regime for non-systemic institutions may need to be more flexible than the current one for systemic banks.

"Ideal option for the full development of the Banking Union is a FDIC-like formula, managed by SRB."

- FERNANDO RESTOY

What looks to be the ideal option for the full development of >>>

>>> the banking union is an FDIC-like formula, managed by the Single Resolution Board (SRB). This approach, which calls for a unified bank-specific insolvency regime, would help authorities manage a crisis affecting non-systemic banks by ensuring that their value is more effectively preserved.

It would also help the SRM work more smoothly for systemic banks by underpinning the no-creditor-worse-off assessment. Further, by streamlining insolvency procedures, it could widen the range of entities that it could safely apply to, reducing the scope for instability arising from the failure of mid-sized banks. Finally, by combining a new-minted European Deposit Insurance Scheme (EDIS) with an integrated crisis management framework for all types of bank, this option would make a further advance towards breaking the bank-sovereign link.

Certainly, this approach would meet with challenges. In particular, the necessary transfer of insolvency responsibilities would touch on highly sensitive areas of national legal systems, including employee protections as well as the treatment of contractual and property rights. And this is to say nothing of the economic, political and logistical implications involved in making the SRB responsible for all the euro zone's 4,000 and more credit institutions. Most challenging of all – given the difficulties of setting up an EDIS, even with a pure paybox function – would be to reach an agreement to establish an empowered EDIS within the SRB, with additional quasi-resolution functions for non-systemic banks.

Against that background, a less ambitious phased-in approach might be considered. This would aim at eventually converging on something close to a European FDIC but based initially on a partly harmonised yet still decentralised insolvency framework with an enhanced role for domestic deposit guarantee schemes. ●

Karl-Peter Schackmann-Fallis

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

Making a clear cut: proportionality in the resolution regime

There is no doubt, that the past years have seen valuable efforts to make even large financial institutions resolvable, creating a more resilient financial system and better avoiding taxpayer bail-outs. To put it into practice is requiring continued efforts by everyone involved, including small and larger financial institutions. For the way forward, we see room for a fine-tuning of requirements to eliminate unnecessary burden.

For banks falling under the resolution regime, a more tailored calibration of their MREL-requirements will be crucial. The SRB increasingly addresses questions of quantity and quality of MREL also by taking into account the resolution strategy of an institution. However, it will also be key to consider further bank specific factors including size, business and funding model, risk profile, SREP and stress test results as well as the degree of systemic relevance. Also, specifics like the legal form of an institution should be taken into account.

> *"There is no need to require MREL for institutions that do not fall under the resolution regime."*
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> - KARL-PETER SCHACKMANN-FALLIS

The vast majority of the German Savings Banks are considered not to fall under the current resolution regime. As they do not perform any critical functions and neither pose a threat to financial stability, their resolution plans foresee that national insolvency proceedings are applied, if bad comes to worse. Nonetheless, the BRRD still fully includes less significant institutions in its scope triggering a number of burdensome work-arounds. Hence, resolution authorities are obliged to set MREL requirements, which they fulfil by equalling them to an institution's own funds requirements. In a second, somewhat makeshift step, these institutions are exempted from reporting and disclosure requirements for MREL. Further work-arounds are in turn triggered when looking at the national level, where yet another exemption has to be granted regarding the permission regimes for eligible liabilities. All this creates unnecessary administrative burden and uncertainties for resolution authorities and financial institutions concerned alike.

The inclusion of the German Savings Banks in the resolution planning process is all the more superfluous when considering that not one of them has gone into insolvency since they founded their Institutional Protection Scheme (IPS) in the 1970s.

The main aim of an IPS is to provide support to prevent an insolvency from happening and it has successfully done so since the beginning with the result that no customer has lost deposits or had to be compensated.

With the European banking market's so far only limited experience in resolving failing institutions, the years to come will have to prove the functioning of the comparatively young resolution regime, probably triggering certain learning and adjustment processes. This should allow for a better differentiation of what is warranted and proportionate, lead to a reduction of complexity and lastly ease the burden for all actors involved where possible. ●

David Vegara

Executive Board Member,
Chief Risk Officer, Banco Sabadell

A proportionate resolution framework

The post-financial crisis regulatory reforms included not only a wide range of prudential and governance requirements intended to reduce the likelihood of the failure of financial institutions, but also measures to enable failing institutions to be 'resolved' in an orderly manner and without cost to taxpayers. More recently, updates to the resolution framework pave the way for a more stable and predictable framework.

Crucially, the MREL requirements and its demanding implementation schedule will add to the current highly challenging environment for banks and their business models, particularly for small banks.

In addition to issues related to market access and funding costs, the resolution framework imposes other requirements that will be a challenge for banks of all sizes. It is important to note that, given the fixed costs and reliance on external providers that are part of these requirements, the costs of compliance are inversely proportional to the size of the bank. These recurrent costs are mostly related to:

- Financial costs. MREL funding, contributions to the Single Resolution Fund and Deposit Guarantee Fund.
- Operating costs. Potentially higher than financial cost, such as the development of management information systems capabilities for resolution.
- Operational continuity. Expanding the scope of the business continuity arrangements introducing, for example, resolution proof clauses within its critical providers or developing specific contingency plans for accessing Financial Market Infrastructures under a resolution scenario. The bargaining power of mid-sized banks with key providers is lower than that of its larger competitors.
- Governance arrangements. The entities must develop solid crisis management procedures to prepare for a potential entry into a pre-resolution or resolution scenario.
- Regulatory uncertainty and architecture costs. Uncertainty regarding the impact of future requirements is one of the various factors weighting on the valuation of European banks.

In summary, the current resolution framework separates entities into different tiers, comprised broadly of:

- Systemic financial institutions with active participation in capital markets that are subject to the resolution procedures and have the scale to cope with the recurrent regulatory costs.
- Mid-sized institutions, for which resolution could be considered in the public interest, have access to the capital markets, but whose business models could be affected by stringent MREL and operational requirements.
- Non systemic institutions that are subject to national insolvency procedures, have limited access to the capital markets and are struggling to cope with the regulatory costs.

"The resolution framework should be adapted to ensure that the principle of proportionality is respected in its application."

\- DAVID VEGARA

In this context, the main features of the resolution framework need to be completed, including the key issue of liquidity in resolution. Additionally, the resolution framework should be adapted to ensure that the principle of proportionality is respected in its application.

Finally, in order to give credibility and predictability to the resolution framework, the European Deposit Insurance Scheme (EDIS) needs to be implemented and a harmonized insolvency law for banks agreed upon. There is no true banking union without EDIS.

Elke König

Chair, Single Resolution Board (SRB)

A common set of rules for liquidation for small and medium-sized banks

The definition of a bank's size as small, medium or big is relative. The Banking Union (BU) established a definition for significant institutions and a dedicated framework. However, there are many other institutions as well as significant institutions, which are not small but for which resolution will not be the option in case of failure. The EU framework makes clear and we have repeatedly stressed that resolution is for the few, not the many.

The decision to put a failing institute into resolution depends on the outcome of a "public interest assessment" (PIA), determining if the preservation of a bank's critical functions is required to maintain financial stability. If the PIA's outcome is negative, a failing bank will be sent into national insolvency. In order to increase transparency the SRB recently published a paper on PIA presenting >>>

>>> the methodology and how the SRB assesses the criteria set out by EU law.

In due consideration of proportionality in resolution planning, the loss absorption requirements for each institution are carefully adjusted to the choice of resolution tools. Banks, for which in case of failure no resolution is foreseen, do not have to build up Minimum Requirement for own funds and Eligible Liabilities (MREL) on top of their supervisory capital requirements for going concern. Hence, those banks do not face further costs apart from the regular costs for supervisory compliance and basic recovery and resolution planning. In contrast, for banks, whose preferred strategy is resolution, the SRB's MREL policy and its expectations for resolvability provide for certain adjustments to allow for proportionality as well.

The SRB can also grant transitional periods for banks, based on features such as market conditions or a bank's liability structure or market access, in order to allow for a gradual build-up of MREL requirements. However, the rules require, that before using the SRF significant losses must be absorbed by the bank's equity- and bondholders. And it is undisputed that sufficient MREL is needed to implement any resolution strategy. In this regard the SRB must strike a careful balance between feasibility of the build-up of MREL and the credibility of the resolution strategy.

Building up the capital buffers may be challenging for smaller fully deposit funded banks. For this reason, a common set of rules for winding down such banks could be beneficial - for some SRB banks and all less significant banks. While we have one common European resolution scheme, in the BU we are faced with 19 different national insolvency laws when winding-down a (cross-border) bank. A set of common standards, practices and harmonised rules for the liquidation of banks would considerably facilitate resolution planning, increase predictability and prevent diverging outcomes in different member states. Needless to say that administrative procedures might be preferable to judicial procedures. At the end of this process might stand the creation of a European bank liquidation regime - a European FDIC. Not only would this ensure centralised decision-making, but also the application of a harmonized and effective toolbox supported by a European deposit insurance.

With this being a long decision-making process, legislators should wait no longer. ●

Arthur J. Murton

Deputy to the Chairman for Policy, Federal Deposit Insurance Corporation (FDIC)

Resolutions under the Federal Deposit Insurance Act

The FDIC is charged by the United States Congress with the responsibility for insuring deposits and serving as receiver of insured depository institutions (i.e., banks) following failure. The FDIC's powers and authority under the Federal Deposit Insurance Act have proven flexible over time, allowing the FDIC to develop strategies and capabilities to manage the failure of banks across financial crises and rapidly changing conditions.

Since the 2008 financial crisis, the FDIC has served as receiver for more than 525 failed banks. Nearly all of those banks were small community banks. Approximately 95 percent of those resolutions conducted by the FDIC involved the sale of the failed bank's franchise and assets to an open institution, generally to a single acquirer that assumed nearly all of the failed bank's liabilities. This type of transaction, termed a purchase and assumption (P&A) transaction, is often both the easiest for the FDIC to execute and the least disruptive. P&A transactions, nonetheless, require lead time to identify potential buyers and to allow them to conduct due diligence of the failing bank.

In addition to being P&A transactions, in the vast majority of those cases, acquiring institutions assumed all of the deposits – including uninsured deposits – of the failed banks. These "all-deposit" transactions only could occur following a determination by the FDIC, as required by law, that they would result in the least cost to the Deposit Insurance Fund (DIF) of all possible resolution options. For most small community banks, that test is met because the amount of uninsured funding is minimal and the transfer of those liabilities as part of the transaction helps to preserve franchise value of the bank.

In short, the typical FDIC resolution experience since the most recent financial crisis involved the failure of a community bank for which the FDIC had enough lead time prior to the bank's failure to market the franchise and conduct an auction. The typical outcome was a P&A transaction in which all deposits were transferred to the acquiring institution and depositors suffered no loss.

The FDIC builds on its experience to prepare for challenges not faced in the past. Larger banks, for example, can pose unique challenges in resolution due to differences in their funding structure, relative size, and complexity of operations and relationships with affiliates, counterparties, and the larger economy.

Larger banks tend to rely to a greater extent on uninsured deposits and market funding. This funding structure impacts both the timing of a resolution and the availability of resolution options. Funding structures that rely less on insured deposits generally compress the failure timeline. Uninsured deposits and market funding are more likely to be withdrawn rapidly if a bank exhibits signs of financial distress. While a bank's failure resulting solely from capital inadequacy typically unfolds over months (or longer), a failure triggered by a bank's lack of liquidity can unfold much more quickly.

The size of a failing bank also may limit the FDIC's resolution options by significantly reducing the number of potential P&A acquirers. Certain banks may be too large to be acquired by any other open institution in a P&A transaction, due to legal limitations on liability concentration, operational or economic conditions, or other regulatory hurdles.

Considering this, larger banks may be less likely to be resolved through a P&A transaction and more likely to be resolved through the use of a bridge bank. The purpose of resolution planning for larger banks, therefore, is to focus on challenges presented by resolution involving the use of a bridge bank, where the FDIC would be tasked with continuing the failed bank's operations to avoid disruptions to depositors and to maximize value to the receivership in the ultimate disposition of the bridge bank. ●