Giles Edwards

Sector Lead, European Financial Institutions, S&P Global Ratings

Continued bank bail-outs stretch the credibility of Europe's resolution intent

Following the financial crisis, European authorities introduced resolution legislation and tightened state aid rules to ensure creditors, not taxpayers, incur most of the costs of bank failures. The handful of banks that failed since the start of 2015 do not provide a comprehensive examination of how the rules will be applied. However, while resolution tools have on occasion been used to good effect, in other cases we see that some EU governments have continued to support failing and failed banks, sometimes resorting to creative methods to adhere to the letter of the law.

Given also that these bail-outs occurred even outside a system-wide stress scenario, it is little surprise that bank investors see considerable doubt over some European governments' commitment to this reform program. In S&P Global Ratings' view, these effective bail-outs have stretched the credibility of the EU's resolution agenda, though not yet to breaking point. While governmental and regulatory decisions remain unpredictable, the market will inevitably lack confidence in the effectiveness of the resolution process, and the scope and timing of any government support. We see four main, interconnected factors behind persistent government bail-outs:

1. There is still limited appetite to impose losses on certain senior and retail creditors.
2. Most banks are not yet resolvable. Resolvability is a multi-faceted concept, but options are heavily constrained without adequate resources to recapitalize banks and bolster liquidity while market access remains difficult.
3. The fragmented mix of regional and national decision-making within the Eurozone.
4. Some governments may see bank bail-outs as lower risk than the largely-untested resolution and orderly liquidation tools. Predictability in the use of resolution powers will increase as more banks build a sufficient layer of bail-inable debt that is subordinated to operating liabilities and deposits.

However, this step alone will be insufficient. We see also a need for:

1. Removal of some of the guesswork: expanding resolution authorities' ex-ante communications that try to guide market expectations, whether on their concept of resolution, on bail-in buffer requirements (including any unsubordinated element), and on resolution strategy for individual banks or types of banks, particularly the middle tier that would targeted neither for open bank resolution nor for liquidation.
2. Consistent rules, including a harmonized insolvency framework as this appears to be a key cause of inconsistency today.
3. Consistent actions, or at least logically inconsistent ones (since the fact-set will differ from case to case). This might be enhanced by reducing the number of decision-makers in the banking union.
4. Strong ex-post explanation of decisions around the use (or non-use) of resolution powers, subject of course to constraints arising from the inevitable legal proceedings.
5. Time. Whatever the quality of preparation, whatever the consistency of actions on smaller banks, parts of the market will still doubt regulatory intent until resolution is used for a major bank. ●