EU bank resolution framework

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A centralized administrative liquidation tool for banks

This year marks the SRB's fifth anniversary – an appropriate time to reflect on how the crisis management framework has worked so far and consider areas for improvement.

The public interest assessment (PIA) – i.e. the evaluation of whether a bank may be wound up under national insolvency proceedings or should be resolved to maintain its critical functions and protect financial stability – has triggered a lively debate. These criteria are laid down in the SRM Regulation and the SRB has published its policy on its website[1]. In a nutshell: resolution is for the few, not the many. For smaller, less significant banks, insolvency will be the procedure at play if and when they fail.

Our experience to date has laid bare the need to find a solution for those medium-sized banks that are too "small" to meet the PIA, but possibly too "large" to be placed in insolvency. The SRB has been clear[2] that the harmonization of insolvency regimes for banks is a necessary end-goal. However, it is unlikely to be achieved in the short-term. The creation of a centralized administrative liquidation tool may be more feasible in the short-medium term, and would address many of the issues identified for medium-sized banks, with insolvency tools remaining available for smaller banks.

Such a liquidation tool could be created by amending the BRRD, SRMR and DGSD, and could provide for the powers to transfer (some) assets and liabilities in an orderly liquidation, much in line with current resolution tools. In the Banking Union, this could be entrusted to a central authority. As a first step, the SRB's toolbox could be enriched with a "pre-liquidation tool", allowing the application of resolution tools to save the good part of a bank without entering into liquidation, or without requiring a specific liquidation regime at European level.

The FDIC is a useful comparison, as it highlights the advantages of the purchase and assumption tool (P&A) for liquidation, which was used for the majority of US bank failures in the last decade. The FDIC's experience also shows the benefits of having a centralized authority with harmonized resolution and insolvency procedures, P&A tools and Deposit Guarantee competences.

By contrast, in the current patchwork of DGSs operating in the Banking Union, only some allow transfers of deposits as "alternative measures" to pay-outs, raising challenges around arbitrage, level-playing field and coordination. A centralized authority could enhance coordination across DGSs and enable a more effective management of bank failures. As the US experience shows, the use of transfer tools could reduce the cost of failure and overall impact on the DGS system.

Finally, it would help reduce moral hazard, by removing the need for Member States to provide liquidation aid, thereby better protecting taxpayers' money. This does not come free. However, based on adequate capital levels and clear rules, authorities should be able to find solutions early enough to secure functions that are critical to the franchise and minimize losses.

A centralized liquidation regime in the EU would address the current gap in the framework for medium-sized banks and improve the overall system: a further step towards the completion of the Banking Union that policymakers ought to explore further. ●

1. https://srb.europa.eu/sites/srbsite/files/2019-06-28_draft_pia_paper_v12.pdf
2. https://srb.europa.eu/en/node/622

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Towards a more effective crisis management and completion of the Banking Union

In the face of the unprecedented COVID-19 pandemic, affecting all economic sectors, the European institutions and agencies intensively coordinate with Member States to ensure adequate crisis management and to prepare for the recovery of the European economy. The exact extent of the economic consequences of this crisis (and the second-round effects on the banking sector) are still unknown but the post-financial crisis framework puts us in better position to withstand the test. Yet, the need to complete Banking Union is more acute than before.

At political level, there is a broad consensus about the need to improve the bank crisis management framework to increase ▶

its efficiency, have appropriate common safety nets, preserve financial stability and as a result facilitate further cross-border integration.

A coherent approach to crisis management might facilitate progress towards completing Banking Union.

The Commission will continue to engage with Member States to bring about a consistent framework, which can rely on effective tools and appropriate funding catering for the failures of all banks, irrespective of their size and business model and whether the failure is managed in resolution or insolvency.

To ensure a consistent treatment of banks and creditors, several issues will require careful examination. These include namely the conditions and the procedure to grant precautionary recapitalisation, the interaction between resolution and insolvency procedure, the role of deposit guarantee schemes and the application of the public interest test.

A more coherent approach to crisis management might facilitate progress towards completing Banking Union and achieving a common deposit insurance scheme. A comprehensive, robust and well-functioning Banking Union should be at the core of a resilient European Monetary Union and is essential to strengthen the international role of the euro and, more generally, the European Union's economic sovereignty. It will also be necessary to ensure solidarity across the EU and to support economic recovery following the current crisis.

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Resolution regimes: There is progress, but more needs to be done

After the 2008 global financial crisis, policymakers focused on implementing and enhancing resolution regimes governing global systemically important banks ("G-SIBs"). The objective was to prevent two untenable outcomes: a taxpayer-funded bailout; or a Lehman-style bankruptcy. Much progress has been made in various ways, including changes in legislation and the development of resolution plans. While some policymakers assert that G-SIBs can now be safely resolved, others find more work is needed. A key resolution objective is to ensure the bank in resolution can retain access to systemically important financial market infrastructures ("FMIs") such as CLS, which is the primary settlement service for the global FX market and settles a daily average of USD5.5 trillion in payments. Because of the credit and liquidity benefits CLS provides, a G-SIB in resolution losing access to CLS would likely adversely impact the resolution's success.

Fortunately, resolution of a G-SIB is designed to be a rare occurrence under these new regimes. So how can the robustness of such regimes be tested? One way is through a well-designed "war game" that tests key aspects of a resolution scenario. CLS recently conducted a war game based on the resolution of a hypothetical G-SIB. The scenario benefited from the participation of many CLS members and input from central banks and certain resolution authorities.

While the war game confirmed progress in some areas, it also revealed shortcomings and potential impediments to resolvability that merit attention, including:

- Multicurrency liquidity challenges – Nostro agents of a bank in resolution are less likely to fund on that bank's behalf in the relevant currencies without prefunding or collateral. Despite G-SIBs' extensive international activities, there continues to be an overwhelming focus on ensuring sufficient liquidity in the home currency during a bank resolution, with less consideration as to how to ensure funding in relevant foreign currencies. Per the Financial Stability Board's June 2018 Funding Strategy Elements of an Implementable Resolution Plan, resolution plans should address how funding obligations in all relevant currencies will be met, including any potential shortfalls. This may be challenging over a resolution weekend.
- Procyclicality concerns – The majority of market participants are still likely to have procyclical responses (e.g., significantly reducing or effectively eliminating credit limits) to a bank's entry into resolution, which may jeopardize the resolution's success. In addition, authorities' use of "moral suasion" on market participants in order to bolster confidence in the resolution may not be as effective as expected.

Testing exercise reveals shortcomings and potential impediments to resolvability that merit attention.

- Enhancing communications – Timely and effective communication is critical to fostering market confidence in a resolution, especially from the resolution authority and central banks. For example, the hypothetical G-SIB's nostro agents indicated their desire for information from their own regulators regarding the resolution. Communication plans and information-sharing arrangements (e.g., crisis management groups) should consider how to address these needs.

Successfully addressing these issues will require coordinated, proactive efforts across a variety of stakeholders.

Mark Venus

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Liquidity in Resolution: the case for constructive certainty

For centuries, the doctrine of 'constructive ambiguity' played a key role in central banks' approach to failing banks. Uncertainty as to whether the liquidity lifeboat would arrive was felt to discourage reckless skippers at the helm of banks from sailing too close to the wind, or indeed to the rocks.

But the rules of navigation have now changed.

Banks are now equipped with double hulls, in the form of enhanced capital requirements and behind that an additional protective sheet of MREL or TLAC to give them the ability to recapitalise. They are like self-righting boats. To assist, we have built repair dockyards, in the form of resolution authorities, with all the necessary tools : bail-in, transfer strategies, asset separation vehicles, restructuring plans.

However, we have a problem in the Eurozone. We have built a dry dock, and banks, like any other vessel after repair, need liquid(ity) in order to float properly and go back to sea.

The absence of a liquidity provider for banks in resolution is the missing piece in the Eurozone resolution framework. Banks in resolution are the archetype of the banks that Walter Bagehot (in Lombard Street: A Description of the Money Market) saw as being deserving of support by a 'lender of last resort'. They are solvent, because their losses have been absorbed and they have been recapitalised, but they may be illiquid. They are stuck in dry dock.

Why can banks in resolution be solvent but illiquid? The essential reason is information mismatch. The dockyard, or resolution authority, knows perfectly the state of the hull and that they have carried out the necessary repairs. The bank is solvent once again. But prospective passengers, or private sector liquidity providers, will have an obvious desire to see for themselves that the bank can float before they venture aboard with their cash.

This is where we need to import into the Eurozone the concept of 'constructive certainty'. The markets needs to know that there is a dependable liquidity provider to enable banks to successfully emerge from resolution. If this is the case, the probability that private sector liquidity will become available is all the higher.

Liquidity provision in resolution is not the same as liquidity provision in the run-up to resolution. That function is a far more risky proposition, from which central banks understandably shy away. The debate as to who should provide the liquidity in resolution in the Eurozone has been going on for too long, and appears to have reached deadlock. This debate was resolved in the US and UK long ago.

> *They may be illiquid, they are stuck in dry dock.*

Some confuse the provision of liquidity with the provision of capital and claim it constitutes State Aid. Others say that the ECB cannot provide liquidity because it would be incompatible with the monetary financing prohibition, and that the provision of liquidity in resolution is a government task and should be carried out by Treasury. But there is no Treasury for the Eurozone. The ESM may be the nearest thing to that, but any ESM schemes proposed to date have proved to be too cumbersome to be of practical use.

The current COVID crisis has shown that the ECB can act decisively in crisis conditions to provide liquidity to the entire banking sector. Surely it should be able to do so in response to the need to enable single banks in resolution to successfully leave dry dock, and it should say so. ●

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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.

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Much still needs be done!

At the time of writing, Europe is entering a Corona lockdown. The impact on our economies and the subsequent challenges for the banking system in the Eurozone are yet to emerge.

Gladly, important progress has been made since the last financial crisis. Banks, urged by the international regulators, have successfully built up absorbing capacity. A statutory resolution framework, run by dedicated authorities, is now firmly in place, and banks are progressing towards resolvability.

However, much still needs be done. Policy priorities in the Eurozone include liquidity in resolution, resolution decision-making, harmonization of insolvency regimes and a European Deposit Insurance Scheme.

Starting with liquidity in resolution: By 2023, the Single Resolution Fund is expected to have accumulated €60bn of contributions from the European banking system. This represents a big step forward but potentially will not be sufficient to fund multiple failures of significant banks. In addition the Eurogroup has designated the European Stability Mechanism, or ESM for short, as a backstop.

Until then and beyond the capacity of both schemes, temporary central bank funding remains paramount. The instrument currently in place is Emergency Liquidity Assistance, or ELA for short, where the main responsibility and risks continue to ly with the national central banks.

As a result, the ESM and the national central banks will need some involvement in resolution planning when it comes to projecting potential funding needs. A common standard on collateral eligibility for ELA would help ex-ante preparation by banks and could come with a requirement for a positive Governing Council approval of ELA instead of the current objection rule.

Now to decision-making for resolution. This is already a complex undertaking, involving the Council, the Commission, the Single Resolution Board, national resolution authorities as well as the European Central Bank - and it will become even more complex with the ESM Board of Directors and several national central banks. I find it worthwhile and quite important to reflect on this complexity and consider simplifications in the decision-making. In my opinion the provision of ELA needs to be with the ECB, and speedy decision making may well be a priority.

Failing banks not passing the „public interest test" and that therefore are not resolved are to be wound down under insolvency rules. The fact that the applicable rules are national and not yet harmonized can create rather different outcomes for investors and are likely to create improper pressure on governments to bail-out debt holders. This is important as no creditor can be worse off in resolution than in insolvency. A European bank insolvency law would of course reduce the complexity of the resolution of banks and increase transparency for investors.

The final piece remains a European Deposit Insurance Scheme operating on a "least cost basis". This would allow for optimal use of resources when losses in insolvency would be higher than a solvent wind-down of the bank. These initiatives will require joint efforts by law-makers, regulators and industry experts, and some will take longer to reach political consensus.

Europe cannot afford to be complacent and needs to get all of the above done. I remain optimistic but joint efforts are of the essence.