ENHANCING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

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Building a common European crisis management framework fit for all banks

The European crisis management framework is a strong, flexible framework that is well-designed to manage bank failure. However, work remains to be done to enhance the framework. I will focus on two key issues: ensuring we have the options needed to manage the failures of small and medium-sized banks, and ensuring we have a harmonised framework across the Banking Union for banks of all sizes.

While there is broad support for widening the use of resolution tools to cover medium-sized banks, how to finance those tools remains more controversial.

The European framework is built on the assumption that banks within the scope of resolution are able to build up loss-absorbing capacity, typically through market issuance of instruments eligible to meet the MREL requirement, which can be used in resolution. To address concerns of moral hazard, strict conditions are applied for access to additional financing (both for deposit guarantee scheme ("DGS") funds and the Single Resolution Fund). Where such conditions cannot be met, this raises the risk there will be inadequate loss-absorbing capacity to support a resolution at the level of the firm, but that it will also not be possible to access additional funds. This could pose risks to the SRB's objectives of preserving financial stability and protecting depositors. This may incentivise finding ways to circumvent the framework.

...more banks under the scope of resolution [...] must go alongside effective funding arrangements.

On its side, the SRB stands ready to incorporate more banks under the scope of resolution, but this must go alongside effective funding arrangements. Banks' shareholders and creditors will always be the first to bear losses, but the question may be asked whether it is desirable to bail in deposits in some cases (e.g. where it undermines financial stability or depletes the franchise value). In the absence of a European Deposit Insurance Scheme, DGS funds can still play a key role under a robust and harmonised "least cost test" and with a clear market exit strategy. However, the current use of DGS funds in resolution is extremely restricted due to their priority afforded to covered deposits, even relative to other deposits, in the creditor hierarchy. Moving to a general depositor preference would allow DGSs to play a greater role in the financial safety net. DGSs could step in in lieu of deposits, once shareholders and creditors have been bailed-in and before accessing SRF funds, where needed. This would put in place a clear and predictable framework that would enable DGSs to support the Resolution Authority in protecting all depositors, though, of course, only where needed in the public interest.

Importantly, DGS funds must only be used in resolution when it is less costly than the counterfactual pay-out to depositors. Given the need for immediate pay-out of the whole deposit book in such a scenario, past cases show how costly pay-out can be for a DGS, even for smaller banks. The key difference would be that changing DGSs' position in the creditor hierarchy would increase its potential losses in a counterfactual insolvency, and, as a result, its possible role in supporting a resolution scheme. As noted, this should only be possible to support market exit, ensuring that industry funds are only used to support the efficient removal of market actors and minimise value destruction.

The second issue concerns the wide-ranging set of approaches across Member States for the management of small bank failures. This leads to an uneven playing field, prevents predictability across the Banking Union and hinders its integration. The current framework allows for significant national discretion, particularly as regards the treatment of creditors and the possibilities to use DGS funds: this can lead to a wide divergence in the outcomes across Member States.

In this context, the Banking Union urgently needs a more harmonised creditor hierarchy and a single set of criteria that would apply for the use of DGS funds, however those funds are used (preventive measures prior to failure, alternative measures in the context of insolvency, or to support resolution). A crucial element relates to the least cost test for which a robust framework is critical, aligning its calculation across both Member States and the different possible interventions. Taken together with the above measures to expand access to DGS funds in resolution, this would remove options that circumvent the framework or lead to the use of public funds, without increasing risks to financial stability or depositors.

Coming to a conclusion, European DGSs are a key part of the financial safety net, and this role could be further enhanced by revising the crisis management and deposit insurance framework. Expanding the scope of resolution without proper funding presents a clear risk that resolution authorities will not be able to deliver their mandate.

Co-legislators and the industry should beware of leaving gaps in the framework that undermine predictability, financial stability and, ultimately, Banking Union integration.

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Constrained flexibility, the missing element to manage banking crises

The forthcoming European Commission proposal for the review of the crisis management and deposit insurance framework (CMDI) represents a unique opportunity to address the rigidities and the weaknesses in the current framework.

Evidence from the last decade shows that, for national and European authorities, managing the crisis of ailing banks has been a strenuous exercise of adaptivity and interpretation. In fact, ensuring the ordinary resolution or liquidation of banks, while – at the same time – preventing spill overs threatening financial stability (e.g., by shielding certain un-covered deposits from disruptive impacts), requires a comprehensive toolkit, adaptable to various business models and different scenarios.

Such lesson is pivotal in view of the upcoming reform. Resolution is not a goal per se, but a means to the end of preserving financial stability and tackling moral hazard. To that end, an adequate degree of "constrained flexibility" is needed in the framework. In this regard, three elements are still missing but essential.

First, the EU banking sector is characterized by the coexistence of a variety of banks, which differ in terms of size, business model, and funding structure. Biodiversity, a strength of the EU banking system, must be preserved. In that respect, a resolvability approach focused solely on the MREL requirement would, on the one hand, represent a competitive distortion (i.e., it would rule out the business model of local banks that lack sustainable access to wholesale markets) and, on the other hand, be unjustified, since there are other means to ensure the goals of resolution.

In fact, the CMDI review should not provide a one-size-fits-all recipe but rather allow for a wider recourse to industry-funded safety nets to manage the crises of different banks, including the use of DGSs to support transfer strategies (as successfully done by the FDIC for almost a century in the US as well as in some Member States), both in resolution and in liquidation. To effectively pursue this goal, and foster value-preserving transfer strategies, two adjustments are imperative: the elimination of the so-called DGS super-priority, and the inclusion of indirect costs in the least-cost test (LCT).

> **Constrained flexibility for authorities is needed to secure financial stability in banking crises.**

As highlighted by several studies (most recently, the ECB's October occasional paper), ranking DGSs' claims pari passu with uncovered deposits (through a single-tier system, or the so-called depositors general preference) underpins financial stability and comes at a lower cost compared to a mere depositors pay-out in liquidation. 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.

Second, inherent rigidities of the resolution framework (including the application of the so-called 8% TLOF rule) substantially limit the possibility of using the Single Resolution Fund (SRF) to manage bank failures. The latter will soon reach its €80 billion target, while its function seems doomed to remain only on paper, due to the above-mentioned rigidities. For an efficient use of such resources combined with the ultimate goal of preserving financial stability, it should be clarified that national DGSs are allowed to fill the funding gap needed to reach the 8% TLOF threshold.

By ensuring effective access to the SRF, the risk of bailing-in deposits in resolution (which would raise financial stability concerns) could be averted. Such tool would prove particularly useful when the resolution strategy envisages the use of the sale of business tool, making – in turn – the transfer strategy even more credible.

Finally, the EU framework should adopt a holistic approach in the field of banking crisis management: BRRD and State aid rules should be more consistent and be both cognisant of the need to allow for State support in order to preserve financial stability, while curbing moral hazard. A financial stability exemption (proposed by the IMF) should always be available as an important safety valve, allowing the resolution to operate also in extreme situations. A wide and flexible toolkit available to authorities when dealing with banking crises under strong time pressure, encompassing also a well-framed State aid regime tailored to the specificities of the financial sector, is needed to ensure and foster financial stability.

Fixing the CMDI framework in Europe will be a stepping stone to get to a truly integrated banking and financial Single Market: as game theory tells us and past experiences showed, what happens in the gone concern stage does impact the incentives of market players and national institutions to trust each other in going concern.

An effective CMDI will therefore be key to bring together the Banking Union and the Capital Markets Union, a goal which is fundamental to have deep and liquid EU capital markets to finance the green and digital transitions.

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The role of bank resolution in the turbulent macroeconomic context

The current environment of high inflation, rising interest rates and elevated uncertainty puts financial institutions under stress. A bump in the road – the failure of a medium-sized or even a small bank – can result in financial markets questioning if it is a systemic moment, implying contagion risks. The recent banking turmoil in the United States and Switzerland vividly demonstrates that in a highly unpredictable macroeconomic and financial environment, a resolution toolkit that prevents contagion should have a broad basis in its applicability.

In Europe, in contrast to the US, higher capital and liquidity requirements, and stress tests established following the Global Financial Crisis account much better for the resilience against systemic risks. For example, unlike in the United States, all banks in Europe are subject to Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) requirements. Hence, a broader implementation of Basel III regulation has put the continental banking system in a more favourable position compared to its US counterparts. Despite this, the digitalisation of economies – rapid spread of financial news and rumours on social media, the ease with which deposits are transferable across the banking system, the rise of instant payments which can be performed 24/7, including weekends – puts individual banks at greater risk of liquidity dry-ups and evaporation of trust.

The risks to individual banks also arise through the asset side of the balance sheet. An environment of higher interest rates tests the viability of firms' business models and risk management practices. Besides higher interest rates, weaker growth and higher energy bills dampen corporate profitability in affected economic sectors, implying a higher risk for the banks' assets performance.

The banks have crucial importance in the financial ecosystems of every European Union economy. Hence, it is even more important to further expand and sharpen the resolution tools such that they remain able to ensure banking sector's continuous contribution to the real sector in case of shocks and financial difficulties.

The overarching principle for the second pillar of the Banking Union is to strengthen financial stability by ensuring that a sufficient range of EU banks is resolvable. Even though the EU crisis management framework for banks has undergone several improvements since the Global Financial Crisis, there are additional steps that are yet to be taken.

Stronger EU bank resolution framework would make the Union more resilient.

While larger banks issue MREL instruments to absorb losses in resolution and avoid tapping into the public funds in case of a failure, medium-sized and smaller banks may have a harder time accessing capital markets, especially in smaller economies. Therefore, the crisis framework could be improved further by enabling a more effective use of the Deposit Guarantee Scheme (DGS) funds in resolution or alternative financing measures. This could enable the controlled market exit of banks while minimising market panic and preserving the value of the bank under resolution.

There is a need to unify principles of the least cost test, which is important for more cost-efficient interventions by the DGSs. While this test is to be applied in case of the DGS interventions other than the payout of covered deposits, there may be some differences in how it is implemented in practice because the designated authorities have some room for discretion.

The fragmentation of EU insolvency regimes adds another layer of complication. Hence, harmonisation, at least in terms of the creditor hierarchy, is needed to level the playing field by providing industry and investors with an equal degree of certainty in liquidation. Such harmonisation would mitigate the risk of breaching the "no creditor worse off" (NCWO) safeguard in the current resolution framework.

There are many detailed steps involved in implementing the above principles, but these steps need to be taken to make improvements with respect to the Banking Union's Pillar II. They are also important from a broader perspective. The current macroeconomic juncture has brought a costly invoice to the public finances table – there is a need to step up investments in defence and foster green as well as digital transformations. At the same time, debt sustainability needs to be safeguarded and public finances protected from incurring additional costs.

The banking sector – a strategically important industry – requires a broad and powerful set of tools ready to be used in times of distress. Crucially, we need to be strategic in learning from recent events in the United States, as well as in Switzerland, and strengthen our bank resolution framework going forward.

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A CMDI Review that has the specificities in the national banking sectors in mind

The European Commission's task of drafting a well-balanced proposal reviewing the Crisis Management and Deposit Insurance Framework (CMDI) is everything but trivial. While most aspects may appear to be of technical nature, they can quickly lead to repercussions with other objectives and elements of the Banking Union, which explains why Member States and voices from the EU's diversified banking sector have expressed legitimate concerns.

After last June's Eurogroup statement, the CMDI Review appeared to have the necessary political backing and guidance. Importantly, the statement stressed that the proposal needs to have the "specificities in the national banking sectors in mind". This unambiguous acknowledgement of the importance of the EU's diversified banking sector to financial stability by the EU's Finance Ministers offered a clear baseline. But still, the debates accompanying the review suggest that the Commission could be aiming for a fundamental overhaul which would be incompatible with structural neutrality.

In fact, the CMDI Review appears to be intended as just another step on the path towards a full mutualisation of deposit funds in the EU. In June, the Finance Ministers decided to discontinue discussions on EDIS with the intention to allow for tangible progress on CMDI within the remaining institutional cycle. A fundamental overhaul of the existing framework would be neither in line with the Eurogroup result nor would it seem politically achievable.

One debated aspect is the suggestion of including small and medium-sized institutions in the resolution regime. This paradigm shift towards "resolution for the many" would end the current assumption that resolution is only suitable if it is in the public interest, e.g. due to financial stability concerns. Institutions added into the scope would face unnecessary burdens from an administrative side, due to resolution planning and reporting obligations, and financially, due to higher MREL requirements. This is exactly what legislators wanted to avoid in 2014 when setting up a proportionate framework assigning regular insolvency procedures where financial stability is not at risk. Instead of further blurring the lines, the duality between insolvency should be strengthened.

Recent events in other jurisdictions have shown that it is necessary to subject large banks to thorough resolution planning on a European scale. Efforts should not be wasted on small banks, especially if there are additional protection measures in place.

What is needed, is a CMDI Review building on a framework that has proven its capabilities.

It seems likely that the proposal tries to free additional financing sources by extending the use of Deposit Guarantee Schemes (DGS). To allow for this, changes to the creditor hierarchy are discussed allowing for an easier access to DGS funds by introducing a pari-passu ranking for all deposits. As a result, the available means of DGSs and their credibility would be negatively affected. Furthermore, there are considerations of modifying and harmonising the "Least Cost Test", which is the assessment of whether insolvency and pay-outs to depositors would be a less costly alternative when compared to support measures and business continuity. If these changes were applied to preventive measures, Institutional Protection Schemes (IPS) would be significantly restricted in the use of their funds. How does this comply with the Eurogroup Statement (June 2022), according to which the proper functioning of IPSs has to be ensured?

It is to be feared that the proposals will not guarantee effective protection for customers and financial markets. In the event of a crisis, overly detailed and bureaucratic regulations will leave insolvency or wind-down as only possible outcomes. If legal depositor protection is reduced to a paybox, it has procyclical effects.

It is not obvious why these far-reaching measures are being considered. What is needed instead, is a Review focussing on improving of a framework that has proven its capabilities – even more so when considering that the DGSD already provides for so-called alternative measures. They can be used to allow a failing mid-sized institution that is not going into resolution to maintain business relations with its customers avoiding a disruption of the economic cycle. The European Court of Justice has confirmed their sound legal basis.

Instead of discontinuing or at least significantly limiting these measures, the Commission should enhance their usability and encourage Member States to make better use of them.

Whatever the proposal will look like in the end, it will need to strike the right balance for the wide array of the EU's banking models. The stability of the Banking Union during crisis hinges on this diversity of business models, sizes, and ownership structures. This setup allows to cushion shocks by diversifying risks and thus enables parts of the financial system to compensate for the failure of affected banks. In order to maintain these benefits, there needs to be a holistic approach on the way forward for the Banking Union.