

EU bank crisis management framework

The Chair opened the debate and mentioned that the Draghi and Letta reports have put in focus, and in context, a series of problems – some known and some less well known – that, collectively, are holding Europe back. Regulators in each sector have been intensively working on trying to address the issues identified in those reports.

The key answer in many sectors so far has been simplification. The European Commission has been quick in drawing up lists of regulations that could be simplified or even eliminated altogether. Simpler rules are good for everybody and, certainly, can drive growth.

A single European banking regulation is a great achievement. One rulebook instead of 27 and one authority instead of 21 makes the rules of the game simpler. In the last 10 years, the push towards more Europe has delivered – a simpler and yet more effective framework. Lowering our European standards does not seem to be the best way to go.

Creating a true Single Market carries massive growth potential. In our sector, this means delivering the Savings and Investment Union, the Capital Markets Union, the Banking Union. The Chair concluded by saying that, converging and harmonising our rules, aiming to a true Single Market, we can achieve great competitiveness without compromising anything on financial stability – an increasingly valuable asset in such volatile times.

The first round of contributions from industry representatives, policymakers and regulators focused on simplification, a concept that is gaining traction across the EU. Some argue that there is an irreconcilable tension between simplification and competitiveness. While in some cases simplification might improve competitiveness, in other cases it might undermine resilience. It could also be argued that simplification is synonymous with deregulation.

The discussion suggests that, to achieve a genuine banking union with a robust EU framework for bank crisis management, there are several priorities: ratifying the treaty enabling the European Stability Mechanism (ESM) to provide a backstop to the Single Resolution Fund (SRF); establishing legally binding intra-group support mechanisms allowing parent banks to support their subsidiaries in difficult according to clear trigger criteria; allaying the concerns of host country authorities; developing a credible resolution liquidity mechanism; and establishing a European deposit guarantee scheme, accompanied by an EU agreement on genuine freedom of capital and liquidity within cross-border banking groups.

1. Better EU bank crisis management is key to strengthening financial stability and integration

Panel participants are in broad agreement on the issues of ringfencing, flexibility, simplification and crisis management. It is vital that citizens, as the customers of banks, be considered and their confidence in the European crisis management framework strengthened.

1.1 Simplification alone cannot revive the EU economy without structural reforms and simplicity must not compromise regulatory effectiveness

A public representative suggested that simplification is becoming a dominant topic of debate. The question is whether the simplification of regulation and other elements of the banking system can boost productivity and competitiveness, in order to revitalise the EU economy. It is possible that it might only be a complementary measure alongside other, more decisive drivers. It would be a mistake to consider simplification alone sufficient to improve the EU's economic position without fundamental structural change.

There is an inherent trade-off in regulation between simplicity, on the one hand, and effectiveness and precision on the other. Opting for a simple, one-size-fits-all rule in every context may ultimately undermine overall effectiveness and productivity. EU policymakers and regulators should keep this in mind. The current focus on proportionality also risks the creation of unintended consequences. It is possible that regulation will become a distillation of the views of competing interest groups, blurring the distinction between necessary complexity and concessions made to stakeholders, the result of which is an overly complicated legislative process.

Stakeholders must carefully consider the legitimacy of the objectives pursued and assess the costs and benefits involved. In the financial sector, the cost of poor regulation, inadequate risk management and weak enforcement is particularly evident in light of past crises.

An industry representative argued that greater market integration is essential if the scale and productivity of and confidence in the EU economy is to increase, financing ongoing environmental, technological and geopolitical transitions. Confidence could be boosted by harmonising the CMDI regulation, which is currently too specific. Stakeholders must take a holistic view of the European system.

1.2 Strengthening the single market, not ringfencing, is key to boosting EU growth, improving banking efficiency

A public representative emphasised the need to recognise that the global context has changed. Most now understand that cooperation, collaboration and joint action are the most productive way forward for the EU. The most productive response to Europe's sluggish growth and the competitive challenge posed by the US is

to improve the single market. A recent study by the International Monetary Fund (IMF), and the ongoing difficulties in completing the banking union, demonstrate the significant remaining obstacles. Ringfencing perpetuates inefficiency, slows growth and reduces customer service quality.

Simplification alone will not revitalise the EU economy or foster a new spirit of productivity. The single market offers greater opportunities in this regard and the banking union should be at the top of the agenda. The current fragmented approach is both costly and frustrating. With a common approach, firms operating across the single market could benefit from economies of scale and play by transparent, comprehensible rules.

1.3 European resolution rules must be simplified to enhance competitiveness and allow banks to focus on their core role of supporting economic growth

An official observed that, in the US, only banks with more than \$100 billion in assets are subject to full resolution planning. In Europe, a much wider range of financial institutions are subject to full resolution planning. Any substantive debate on EU competitiveness and simplification must take this interesting account. Poland has practical experience of resolution processes from which the EU could benefit, having conducted four resolution processes involving larger and smaller banks.

The primary role of banks is to carry out banking activities, rather than to be preoccupied with resolution planning and extensive reporting requirements. Given Europe's slow growth, it is increasingly important that banks focus on their core functions. European banks serve as the bloodstream of the economy by providing credit and regulators must recognise this role.

1.4 Ringfencing and internal barriers weaken Europe's financial sector and must be reduced to stay globally competitive

An industry representative highlighted the inextricable link between competitiveness and ringfencing. In order to meet the current geopolitical and economic challenges, Europe must forge a new dynamic by strengthening ties with international patterns and tackling internal rigidities. Ringfencing remains the main obstacle to the development of a stronger European financial sector and the emergence of European financial champions capable of competing on a global scale.

The CMDI must be considered through the lens of competitiveness. As noted in the Draghi report, internal barriers within the EU can be higher than the tariffs recently imposed by the US. In the words of Enrico Letta, if Europe does not act to remove or diminish these barriers, fostering greater integration, the EU risks becoming a colony of American finance, dominated by highly competitive US players.

1.5 Reaching a practical and trust-based compromise on CMDI is essential to strengthen the single market and avoid a renationalisation of the crisis framework

A public representative stressed both the practical and symbolic importance of reaching a compromise. Ringfencing and the failures of the single market cannot

be overcome without improved legislation. The CMDI is a positive development that would protect the economy and incentivise solutions for medium-sized banks. However, it is a complicated and technical exercise. Some stakeholders do not understand its necessity, likely because they do not foresee another relevant crisis taking place in the future.

The CMDI negotiations involve various interest groups with different priorities. In the European Council discussions in particular, there was a sense of action and reaction, with groups agreeing to make concessions in return for acceptance of part of their own agenda. The result was a compromise that is not workable. Nevertheless, there is hope for the continuing negotiations. A symbolic agreement would demonstrate that European actors trust one another and can reach meaningful, workable political compromise. If this proves impossible, there will be questions about the feasibility of the more fundamental, structural change required.

The aim of the CMDI, opening up the European system to the benefit of medium-sized banks, must be kept at the forefront of the ongoing discussion. Any solution devised should be practical and feasible within the timeline of the resolution weekend. Participants should be careful not to renationalise the crisis framework. The Polish presidency is working well on this basis. The key to the entire exercise is trust. On the CMDI and beyond, European actors must work together for success or face failure alone.

2. Priorities for stronger EU bank crisis management

2.1 Resolution must be simple, flexible and effective

An official noted that, more generally, regulation must be kept as simple as possible. Over time, layers of complexity have been added to the CMDI negotiations. The Bank Guarantee Fund, as the resolution authority, devotes significant effort to planning and testing, but the time available to take action is usually limited to only a weekend. The Polish experience demonstrates that decisions taken under pressure are subsequently subject to lengthy judicial review. Unnecessary complexity makes this process that much more challenging.

Regulation must be coherent to the general public. This is aided by simplification. Citizens must understand why and in whose name resolution measures are taken. Such measures are ultimately aimed at protecting taxpayers and depositors. Flexibility is also key. The 8% total liabilities and own funds (TLOF) rule is an arbitrary benchmark around which compromise efforts seem unproductive. The resolution of Poland's systemically important Getin Noble Bank, for example, required the intervention of eight private sector banks as a result of this rule. The TLOF rule must be revisited.

There is too much focus within CMDI negotiations on finding common ground on process. Stakeholders should centre themselves on the objectives to be achieved if appropriate and effective compromise is to be reached. It would be helpful to this end to consider the example of

other jurisdictions, such as the US, or to delineate a threshold, with one set of rules applying to banks with the largest market share and another, more simplified set to medium-sized banks. The current one-size-fits-all approach is not productive.

2.2 Making sure that minimum requirements for own funds and eligible liabilities (MREL) remain the first line of defence in resolution and clearly limiting the use of the Deposit Guarantee Scheme to avoid unfair costs for banks and customers

2.2.1 Making sure that MREL remains the first line of defence in resolution

An industry representative stated that internal market barriers, such as the internal MREL, should be reduced. In a true banking union, such restrictions would not exist. Proportionate MREL policies could enhance the competitiveness of European banking groups. Maintaining and strengthening confidence in the framework nevertheless depends on preserving some level of MREL as a line of defence. The industry is in favour of this. Any reduction beyond a sensible limit would create a moral hazard and weaken consumer confidence in the financial system.

Additionally, if the EU maintains the current output floor, the level of MREL and capital required for resolution will increase, putting EU banks at a disadvantage in a global market context. Meanwhile, the 8% TLOF rule likely will not have changed. There is an inconsistency here that must be addressed, while prioritising simplification and flexibility. This sentiment is reflected in the European Association of Cooperative Banks (EACB) 'Less is More' report. Despite this, regulatory complexity continues to increase, most notably in capital requirements regulation 3 (CRR 3), which has doubled in volume compared to its predecessor. There also remains duplication between the CMDI proposals and existing (MiFID II) rules, particularly in relation to the sale of MREL-eligible instruments to real estate clients.

2.2.2 Limiting the use of the Deposit Guarantee Scheme to avoid unfair costs for banks and customers

An industry representative recommended that use of the Deposit Guarantee Scheme (DGS) for small and medium-sized banks going into resolution be clearly framed and restricted in line with the scheme's goal of protecting covered depositors, rather than absorbing losses. Limiting access to the DGS or SRF is a method of limiting contribution post-resolution of other banking participants, for which customers would eventually be invoiced.

The European Council's CMDI proposal, and particularly the introduction of a four-tier creditor hierarchy and complex maturity criteria, would be operationally challenging to implement. Recent Single Resolution Board (SRB) consultations on testing and valuation demonstrate the significant investment required on the part of the industry. Going forward, a more integrated, EU-wide approach to resolution would be beneficial, in a move away from the current fragmentation of national authorities attempting to deal with their own banking situations. Any new guidance must carefully balance costs and benefits to avoid undermining the broader objective of simplification.

2.3 Reaching an agreement on establishing a European deposit insurance and liquidity in resolution mechanisms

2.3.1 True integration and simplification in crisis management are hindered by the lack of a common safety net, making ringfencing costly

A regulator characterised simplification as the dominant theme of the debate. The concept must be examined in the context of crisis management, as simplification has important implications for financial stability. Within the current framework, there are clear interdependencies between flexibility and ringfencing. While there is some limited scope to enhance flexibility, for example through refining the macroprudential framework or introducing enforceable intra-group support arrangements, such measures are not transformational in nature.

The incomplete nature of the EU's crisis management framework means that ringfencing remains embedded in the architecture of the banking union. Without a comprehensive safety net, including a common deposit insurance scheme, national authorities will continue to be reluctant to dismantle existing barriers. While stakeholders understand the collective benefits of integration, they have not yet found a mutually beneficial way to achieve it. It is true that integration brings benefits in times of stability, but can increase contagion risks in time of crisis if the appropriate safeguards are not implemented.

Ringfencing has significant costs and inhibits banks' ability to diversify and scale up, widening the EU's competitiveness gap with the US. US banks, in contrast, benefit from a strong crisis management framework underpinned by robust backstop arrangements. While simplification might help eliminate redundancies and reduce the administrative burden, financial stability must be kept in mind. There is insufficient urgency amongst stakeholders in terms implementation of the fundamental reforms required to complete the crisis management framework. The urgency is instead directed solely at the need for simplification.

Financial stability risks are clearly increasing. Europe cannot wait for the next financial crisis to expose systemic vulnerabilities. Deregulation could lead to the repetition of past mistakes. Open dialogue, such as that fostered by Eurofi events, remains crucial to determining a cooperative way forward.

2.3.2 Overcoming ringfencing and completing the banking union, including a European deposit guarantee scheme, are essential to enable true pan-European banking and effective crisis management

An official reiterated that ringfencing remains a critical obstacle to effective management of pan-European and international banking groups. It limits banks' flexibility to move resources within groups and discourages pan-Europeanisation of the banking sector. National authorities have clear responsibilities for safeguarding financial stability within their jurisdictions. Domestic industry and taxpayers often bear the cost of financial instability, creating an inherent tension between objectives and responsibilities at a national and European level.

The Financial Stability Board (FSB) aims to establish international standards that foster understanding between home and host authorities. Through initiatives such as the total loss-absorbing capacity (TLAC) standard, crisis management groups have been established to facilitate cooperation. Despite this progress, there remains a need to pre-position internal resources within subsidiaries to ensure orderly resolution. To tackle ring-fencing effectively, Europe needs to deepen its banking union and provide the right incentives for the pan-Europeanisation of banking activities, removing existing barriers to facilitate the mobilisation of resources within groups.

Opinions differ on how to achieve this. Some advocate for a quasi-compulsory intra-group arrangement, while others are sceptical about their stability and effectiveness. Legal obstacles and the natural reluctance of national authorities complicate matters. Domestic authorities, financial systems and taxpayers must not bear disproportionate risk in the event of institutional failure. The establishment of a European deposit guarantee scheme is vital in this context. Centralising crisis management would help remove ringfencing incentives but would also require accompanying appropriate tools and mutualised funding, with the SRB responsible for a larger and more diverse range of banks.

2.3.3 Securing a reliable liquidity in resolution mechanisms is urgent to strengthen confidence, manage funding in resolution during crises

A regulator shared the view of the ESM, in that strengthening and securing resolution funding arrangements is essential to enhancing an overall feeling of confidence. It is concerning that the amendment ESM treaty is yet to be ratified, leaving the system without a relatively straightforward element of the solution. Without a reliable resolution mechanism, tensions between home and host will persist, complicating cross-border crisis resolution. It is also imperative to put in place credible mechanisms to address the liquidity needs of the resolution process. EU financial stability risks continue to grow and a solution is urgent.

Reliable resolution mechanisms can also serve to reassure host countries. Building trust requires legally binding intra-group support mechanisms, through which parent banks can support distressed subsidiaries under clear supervisory triggers. In the current geopolitical environment, sudden market disruption can increase systemic risk. A national response is insufficient. A common, European approach is required to ensure that crisis response is credible, effective and proportionate.

2.4 Rethinking the balance between internal and external funding by exploring more flexible models, like the UK's approach, could strengthen the system without undermining resolution

An official concluded that, in resolution scenarios, creditors essentially absorb losses and contribute to the recapitalisation of an institution. However, there are other, external sources that could also be used to fund resolution strategies, including industry-contributed funds. Access to such external sources of funding is limited under the banking union. The minimum bail-in requirements for access to the SRF are particularly stringent and shareholders creditors might absorb losses equivalent to the 8% TLOF rule before an institution can receive SRF support. Moreover, strict least-cost constraints make deposit insurance funds rarely accessible to support resolution challenging to access. Other jurisdictions do not face these obstacles.

Stakeholders should explore the possibility of a different balance between internal and external resources to fund resolution. While the current European approach is a legitimate political compromise, there may be other, more effective solutions. For example, the UK is in the process of developing a solution allowing the resolution authority to levy funds from the banking industry in support of sale-of-business transactions. EU actors should carefully consider such cases going forward. It would not be prudent to change MREL requirements in line with TLAC without acting to change the system at a more fundamental level.