EU bank crisis management framework and EDIS

The Chair explained that the panel would focus on crisis management and deposit insurance (CMDI). In June 2022, the Eurogroup decided that it should be at the centre of discussions on the Banking Union. The banking turmoil of the previous year provided an opportunity to reflect on how modern banking crises are managed in other jurisdictions. The European Commission presented a comprehensive package on the CMDI in April 2023. The review of the CMDI has to take into account different business models and numerous, sometimes conflicting, policy objectives.

The discussion consisted of general comments on the design of the EU framework, including the issue of the scope of resolution, a discussion on the financing of resolution from internal resources and safety nets, and a discussion on liquidity in crisis management.

1. The EU bank crisis management framework

1.1 An ex ante non- credible and ex post inefficient system

One public representative stressed that Europe is still far from having a fully credible ex ante and efficient ex post crisis management system. National Supervisory Authority (NSA) colleagues still believe that ring-fencing is the optimal solution for some of their concerns. There is a persistent home/host problem in Europe. Financial crises in Europe are more protracted and have longer-lasting macroeconomic, social and political effects, demonstrating the distance from an ex-post efficient system.

The European approach tries to be extremely detailed and precise. There are attempts to have complete legislation covering all possible cases, but this is not achievable. While it is positive to have legislation that is as precise as possible, it is important to always have the possibility for competent, accountable and legally protected authorities to exercise discretion.

Without the third pillar, the European Deposit Insurance Scheme (EDIS), the system remains incomplete. The European Stability Mechanism (ESM) must be on the table to add firepower to what is in place. Without meaningful steps in this direction, the system will continue to lack ex-ante credibility and be inefficient ex-post.

It would also be appropriate to make the resolution principles more macroprudential and medium-term oriented, in terms of minimising the use of public funds. Contagion must also be taken into account. The work cannot be done on a bank-by-bank basis, as that is too narrow. There must be broader linkages and a medium-term orientation to minimise the cost to the taxpayer.

We need a financial system that allocates capital efficiently across countries, industries and companies. There are many inefficiencies associated with ring-fencing. Without a credible resolution regime, the banking sector will not be able to work together to attract more investment to Europe.

1.2 Key components of crisis prevention

Successful crisis prevention and management needs to be embedded in a broader framework covering all stages of a crisis. This starts with a strong risk culture and a sound capital base and includes early intervention at the onset of a crisis, as well as flexible resolution tools once it has crystallised.

1.2.1 Having a strong risk culture

An industry representative noted that crisis management is part of a continuum that begins with business as usual. Deficiencies in the governance framework and risk culture of banks have been identified as common causes of past crises. The Credit Suisse case showed that a lack of sound governance and risk culture is linked to unsustainable business models. From a European perspective, there has already been significant investment in governance since the financial crisis, including through the annual supervisory and review assessment process. However, these efforts have often been perceived as prescriptive and more of a paper exercise, particularly from an international perspective.

Building on the lessons of the recent crisis, this paradigm appears to have shifted, with a move away from prescriptive governance towards more practical mechanisms. These include quantitative parameters and behavioural elements to promote a good risk culture, such as clear lines of responsibility and decision-making processes, a strong tone from the top on risk and compliance, a culture of constructive challenge on all types of risk, long-term incentives in compensation, performance management and promotion frameworks, and strong boards.

1.2.2 The exercise of early intervention powers

An industry representative stated that if a bank's efforts to address the causes of distress are insufficiently determined, authorities need to be able to exercise early intervention powers to prevent further deterioration. Regulators across jurisdictions should strengthen their early intervention frameworks, ensuring that supervisory measures are based on clearly defined, objective criteria. Supervisors need to be able to use their powers effectively, even when reported prudential ratios are in line with regulatory requirements, and to ensure timely escalation and appropriate remedial action to avoid critical failures in areas such as governance and risk culture.

1.3 The availability of a public liquidity backstop

Improving access to central bank liquidity in times of market stress is crucial: commercial and central banks need to work together to ensure that they have well-planned operational and legal arrangements for pledging and receiving a wide range of less liquid assets as collateral for central bank funds.

An industry representative stressed that the prompt availability of and access to central bank liquidity was critical to restoring market confidence, as demonstrated by the Credit Suisse crisis. The residual risk of losses to taxpayers from the public liquidity backstop was considered relatively low, given the requirements for a credible restructuring plan to be approved by the Swiss Financial Market Supervisory Authority (FINMA) and the privileged status from a credit perspective in bankruptcy. Banks eligible for a public liquidity backstop must have comprehensive measures in place to prepare for a recurrent resolution under the "too big to fail" regime.

In the context of the Banking Union, the question is who pays and how ECB lending could rely on a potential public backstop. The difference between Switzerland and Europe is that such backstop would require several Member States' political support to be implemented at European level.

2. Resolution should not be the general solution

2.1 The need for a more holistic view

An official explained that, although financial services are changing very rapidly, the resolution framework is relatively new in the EU. The benefits of crisis preparedness through resolution plans and the building up of Minimum Requirement for Own Funds and Eligible Liabilities (MREL) were demonstrated in the last crisis. Thus, the CMDI is a logical next step. The Council and the Parliament has given its opinion on the proposal, and the negotiations can start when the Parliament is ready. This a complex dossier, so difficult negotiations are expected in the trilogue with the Parliament. It took time to set up the resolution framework in the EU, the MREL and the Single Resolution Fund (SRF). Widening the scope and looking at the efficiency and scale of the instruments are logical next steps.

There is a need to recognise the synergies and possible interactions between the different resolution tools. MREL and the bail-in tool are well developed, but there are other tools too. Taxpayers' money should be protected, and the still viable part of the bank should be saved. The financing burden is borne first by shareholders and creditors. However, the nature of crises means that it is not possible to be fully prepared, and this is where other sources of financing should come into play. Moreover, in several cases only liquidity support is needed, so the safety nets are expected to be replenished.

Attention should be paid to the diversity of banks and crises situations, which may become even more complex in the highly integrated framework of the Banking Union. Credibility of funding is a key issue. The build-up of loss-absorbing capacity, typically through the successful issuance of eligible instruments, and the conditionality of access to safety nets, such as resolution funds or deposit guarantee schemes, are all elements of this credibility. Greater consideration should also be given to transfer instruments.

2.2 Applicability of the resolution process to a broader range of smaller banks

A regulator agreed on the need for an appropriate amount of discretion on the part of the competent authorities. National resolution authorities and national supervisors should have discretion to determine the public interest and the scope of circumstances taken into account for the purposes of the public interest assessment.

This assessment should not be mainly based on the size of the bank. There are more than 500 cooperative banks in the Polish market, for example. Most of them are not systemic at the national level, from the perspective of the country's financial system, but many of them are relevant to the local environment. The public interest should be assessed, taking into account local circumstances and the impact of the potential failure on the local business environment, as well as the risk of contagion. The risk of contagion from the failure of one cooperative bank to the cooperative banking sector as a whole must be considered. There should be a pragmatic approach to assessing whether the public interest condition is met.

One question is why there is such a detailed and sometimes quite dogmatic set of rules governing crisis management and resolution. In most cases, a very detailed set of rules is a consequence of a lack of trust between the authorities and the relevant actors. There has to be trust that the relevant authorities will exercise their discretion in good faith to preserve financial stability and minimise the use of taxpayers' money. If the pan-European resolution regime is designed too narrowly or to rigidly, national authorities or countries will circumvent the system by using non-harmonised national insolvency procedures and public funds outside the common regime. Another problem for harmonization is the lack of EDIS.

Many of the small banks that would ideally be dealt with on the basis of the resolution regime may have difficulties issuing MREL liabilities. There are still areas that need to be improved in the CMDI proposal to make resolution a viable strategy for small banks.

2.3 Insolvency as the default exit strategy for small credit institutions

An industry representative noted that the tools, and MREL in particular, were designed for systemically important institutions because their failure would have a major impact on financial stability. One question is what is the right approach for smaller banks. Part of the task is to ask what a small bank is. Common sense would suggest that a small bank does not pose as great a risk of systemic impact. There should be clear size thresholds for resolution. For smaller institutions, resolution should remain the default option. For example, a threshold of at least €30 billion in total assets could be appropriate for

the application of the resolution regime. Smaller and regional banks should be able to remain competitive. Detailed and complex resolution tools would increase their administrative burden and reduce their competitiveness.

2.4 Liquidation as the general solution for small banks

Not all failing banks should be resolved. One supervisor pointed out that there are both significant and less-significant institutions within the Single Resolution Mechanism. Around 100 SIs groups have been earmarked for resolution. These larger banks are within the direct remit of the SRB. A further 70 less-significant institutions, in the direct remit of National Resolution Authorities, have also been identified by the market as systemic. The original objective of the CMDI proposal is to expand the scope of resolution to more small and medium-sized thus increasing financial stability. However, according to SRB's analyses, the banks "switching" from liquidation to resolution would not be a large number. That means that all the other banks, ie. the vast majority, will stay with a preferred strategy based on liquidation.

Why earmarking some banks for resolution? Because resolution works better than liquidation. To make a couple of examples, 1. resolution explicitly excludes the use of taxpayers' money. 2. when a failed bank reopens after resolution, customers continue to have access to its full range of services. This is not the case in liquidation.

2.5 Consequences of the extension to the scope of resolution

An industry representative noted that any bank that is earmarked for resolution could be resolved. This implies that they should be ready by being able to finance the resolution with their own resources and thanks to their own creditors and be prepared for it. For smaller or medium-sized banks, the obvious resolution strategy is to sell the business. However, they may not know what that means as they may not have experience in mergers and acquisitions. They should therefore specifically prepare themselves to understand what is involved, e.g. for the preparation of a proper data room. Flexibility to determine which bank should be earmarked for resolution should remain in the hands of the resolution authorities.

3. Contentiousness of funding in resolution

3.1 Ensuring a level playing field

A regulator stated that when banks are earmarked for resolution, they will need to work to become resolvable. Among other things, they will have to reach MREL compliance. Post CMDI this will not change. MREL will remain the first line of defence for absorbing losses and recapitalising the failing bank. By broadening the scope of resolution and leaving the MREL requirements unchanged, CMDI will increase the total amount of MREL in the system and not reduce it. CMDI will also give resolution authorities the flexibility to deal with smaller banks at a limited cost to the industry. Banks need time to become resolvable. The big banks have been given eight to ten years reach their current level of resolvability (including MREL). If one of the banks that enters in the scope of resolution via CMDI fails in the following year, it will not be ready in terms of loss-absorbing capacity, for example. Among other things, the Commission's CMDI initiative offers a pragmatic and flexible solution to this problem.

In a crisis, resolution authorities should have the tools that are flexible enough to take a successful resolution decision. If that is not possible, resolution authorities have no other choice but liquidation. Some of the amendments proposed by the Parliament and Council may curtail the flexibility provided by the Commission's proposal. Flexibility is essential to restore confidence. We hope that the trilogues will produce a compromise that is in line with the original objectives of the reform – a broader scope of resolution for more financial stability.

An industry representative suggested that the SRB's initiative to anticipate possible MREL reductions has been positive, and it can only be encouraged to go further in this direction. For smaller banks, the resolution strategy would be to sell the business. A MREL around 16% of risk-weighted assets (RWA) should be a minimum, in addition to the combined buffer, which means that if they fail and the authorities intervene early enough, they will still be able to recapitalise at the regulatory minimum. Parliament went in the right direction by setting a minimum, although it should be set at a higher level.

The SRF should not be used repeatedly. It is seen by investors in the European banking system as a guarantee of financial stability in Europe. If they see the fund being used repeatedly, they will be even more reluctant than they are now.

3.2 Addressing the funding gap in resolution for medium-sized banks

An official explained that the problem in Europe is that there is no effective mechanism to deal with the crises of small and medium-sized banks. At present, there are no effective ways to operationalise sale-of-business resolution strategies, which have proven to be the most effective approach for such banks. This is related to insufficient funding. Funding can come from several sources. The first is internal resources: ie loss-absorbing liabilities that can be left behind in a residual entity while their asset counterparts can be transferred to an acquirer as a compensation for taking over some sensitive liabilities, including deposits. The second source is external support, which is often required, as the experience of other jurisdictions shows. In Europe, this support can in principle come from deposit guarantee schemes (DGS) or the Single Resolution Fund (SRF) but only if very stringent conditions are met. In the case of the DGS the available support is capped by the expected costs that it would have to bear by paying out covered deposits in liquidation. The SRF can only provide support after bailing-in 8% of banks' liabilities.

The CMDI goes a long way towards addressing these issues. By removing the priority of deposit insurance

claims in liquidation, it is possible for deposit insurance funds to support the sale of businesses, even under the least cost constrain-. Moreover, the funds provided by the DGS would count to bridge the gap between available bail-inable liabilities (MREL) and the minimum bail-in for access to the Single Resolution Fund. CMDI would therefore make the availability of funds from both the Deposit Guarantee Fund and the Single Resolution Fund more flexible.

However, there are concerns about the current state of the negotiations. The compromise proposed by the Council and the Parliament completely dismantles the good ideas contained in the CMDI. In particular, it is unwise to maintain the super-preferential treatment of DGS claims in insolvency. Even if a more flexible interpretation of the least cost constraint is accepted, that super-preference makes if very difficult, and often impossible, for deposit guarantee funds to contribute to the resolution of small and medium-sized banks. Moreover, the introductions of as many as 22 conditions for activating the bridging function of the Deposit Guarantee Fund, would make it very difficult to even verify that the conditions can be met within the short available time to activate resolution actions. In effect, it undermines the possibility of using funds from the SRF. Therefore, the available support from external funds to support the sale of businesses would remain severely impaired. The result is that, in the best-case scenario, nothing will really change, and the flaws of the current regime will remain.

In that scenario, the Single Resolution Board will continue being unable to deal with the crisis of mid-sized significant banks that are earmarked for resolution, and the ticket will have to be handed back, as we have seen in 2017 to national authorities for them to apply insolvency rules with large amounts of public support. This undermines not only the objectives of the Banking Union, but also the more general agreement reached at the global level to try to resolve the crisis of significant banks by minimising the contribution of taxpayers' money.

An industry representative stated that the unlimited financial involvement of Deposit Guarantee Schemes (DGS) in the financing of resolution and the deterioration of their ranking and creditor hierarchy undermines financial stability. Confidence is the only important aspect, but the extensive use of DGSs for resolution measures would seriously weaken existing well-functioning DGSs and undermine depositor confidence. It would therefore be counterproductive.

3.3 Addressing the issue of banks' unfair advantage

One supervisor pointed out that there may be cases where the public interest and least cost assessments lead to the conclusion that resolution is the more pragmatic approach, but the banks concerned are not prepared because they have not had the capacity to issue MREL. Part of the discussion at Eurofi in Ghent was about these banks getting an unfair advantage by becoming resolvable without bearing the costs of preparing for resolution. This argument should be dismantled. There have been similar cases in the Polish market, and the decisions taken on the fate of such institutions were not about providing them with an advantage. Rather, it was about minimising costs for the entire financial sector and others. The measure is not for the benefit of those companies that are not prepared. It is for financial stability, and it is the right thing to do.

3.4 The Council's compromise text

One supervisor explained that when a bank is earmarked for resolution it will need to build the right capabilities to become resolvable. There is no point in having additional conditions for the use of the DGS. Banks entering into the scope of resolution will be treated as their peers – proportionally.

Resolution authorities (in the Banking Union), according to the Council compromise text, will need to satisfy 22 conditions during the resolution weekend. However, there are just so many hours in a weekend. If there is not enough time, the best thing to do from a legal point of view is not to take the risk of implementing an unsuccessful and, possibly, illegal resolution decision. The bank will therefore be allowed to go into liquidation with more risks for financial stability (and / or waste of taxpayers' money).

Too much rigidity may get in the way of fulfilling the original objective of the reform.