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The pressing need to reform the European crisis management framework*

By Fernando Restoy[1]
Financial Stability Institute, Bank for International Settlements

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The current crisis management framework in the banking union does not provide sufficiently effective tools to deal with the failure of different types of banks without taxpayers' support. The required reform should crucially facilitate appropriate funding sources that could be deployed to support an orderly market exit of failing banks. Those funding mechanisms should be fully consistent with the banking union's objectives and consistent with different banks' business models.

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[1] Views expressed are solely my own and they do not necessarily reflect those of the BIS or Basel-based standard-setting bodies.

Introduction

The debate on how to improve the rules and procedures for dealing with bank failures in the European banking union already started a few years ago but gained momentum in 2017 when two significant banks – both of which were under the remit of the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) – failed. Those episodes illustrated how difficult it can be for the existing rules to facilitate the orderly market exit of different types of institutions whose failure could create systemic distress.

It is somewhat paradoxical that those difficulties have become so evident in the EU, as this is probably the jurisdiction that has most deeply modernised its crisis management framework by adopting the new international standards on bank resolution (the FSB Key Attributes) in a timely, comprehensive and rigorous fashion.

As you all know, the FSB Key Attributes were one of the main regulatory reforms undertaken by the international community in the aftermath of the Great Financial Crisis (GFC) in order to reduce the probability and economic impact of financial crises. They aimed to put in place a bank resolution mechanism that would help maintain the critical functions of failing systemic institutions without recurring to a massive deployment of public resources.

The EU had a clear motivation for embracing the new resolution framework based on its own experience during the GFC. Europe was the region where the GFC hit the banking sector most intensely and required voluminous public aid. Indeed, the net costs for European governments of supporting financial institutions between 2008 and 2014 exceeded €200 billion.[2] That of course put significant pressure on the public finances of most affected member states and triggered the adoption of procyclical fiscal austerity programmes that exacerbated the economic contraction that followed the outbreak of the crisis. Even more importantly, that connection between banks' vulnerabilities and the need for public support initiated a destabilising spiral between financial and sovereign risk that gave rise to redenomination risks, thereby threatening the very continuation of the European monetary union.

Against that framework, in Europe developing crisis management tools that could minimise the dependence on public funds to safeguard financial stability, in line with the FSBs' Key Attributes, was deemed essential to preserve both the social cohesion within member countries and the robustness of the European integration project.

The features of the current framework

In response, as early as 2014 European authorities created a single resolution mechanism (SRM) as part of the banking union project. The SRM establishes rules, tools and procedures for managing the failure of those banks in the banking union that are considered systemic, ie those that meet public interest criteria, to use the legal jargon. Those rules include an effective prohibition of government bailouts and a predominant reliance on creditors' bail-in to maintain the critical functions of failing institutions. Moreover, the new framework envisages the centralisation of resolution decisions in a European agency (the SRB) and the creation of a progressively mutualised fund (the Single Resolution Fund (SRF)) contributed by the industry. That fund can be used to support resolution actions, although only after a large amount of creditors' claims have been bailed-in. Consistently with those minimum bail-in conditions, banks are generally required to issue large volumes of

[2] See Eurostat: Supplementary tables for reporting government interventions to support financial institutions.

financial instruments that could become loss-absorbing at the point of non-viability (the minimum requirement for own funds and eligible liabilities, MREL).

The rules that govern the SRM constitute a highly stringent transposition of the FSB Key Attributes. Arguably, no other jurisdiction has imposed more explicit and severe constraints on the use of external funds (whether public or private) to support resolution. Moreover, outside the EU it is uncommon for authorities to generally require banks (and not only globally systemic ones) to meet MREL-type obligations. Again, the severity of those restrictions is largely a political response to the recent experience and the specific institutional constraints posed by the multinational character of the European banking union.

The issues

While the design of the EU resolution framework is internally consistent, it fails to provide a robust blueprint for managing the failure of a large part of the institutions in the banking union. It is important to note in that respect that the common resolution framework coexists with a constellation of domestic insolvency regimes, embedded in national legislation, which have not changed much in the recent past. National regimes – often consisting of the application of court-based general insolvency procedures – are still applied when failing institutions do not meet the public interest criteria required for resolution. Interestingly, the availability of public support under insolvency (in the form of liquidation aid) is, in general, substantially less restricted than under resolution.

As bail-in becomes a key component of envisaged resolution actions, the current framework is not particularly effective for dealing with the failure of banks whose liabilities cannot be used – without a major disruption – for loss absorption or recapitalisation. This is the case of medium-sized banks which are largely funded with deposits. Those institutions are typically too large to be subject to standard liquidation procedures under insolvency, but also too small and unsophisticated to issue large amounts of bail-in-able debt (such as subordinated bonds) which are required for resolution[3]. In the absence of those instruments on these banks' balance sheets, authorities would not be able to recapitalise the institutions by making use of internal funds or by gaining access to the resolution funds as the minimum bail-in conditions for the latter would not be met. This is what we now generally call the "middle class" issue.[4]

Authorities have addressed the challenges posed by the failure of mid-sized banks precisely by resorting to national insolvency regimes and taking advantage of their flexibility to use public funds to ensure a smooth market exit. That has required delicate decisions regarding assessment of the systemic impact of banks' failures. In particular, those failures needed to fail the public interest test for resolution in order to be subject to national insolvency. But, at the same time, they had to be assessed as generating an adverse impact on the economic or financial system to justify the deployment of taxpayer funds.

That approach is suboptimal. It implies, somewhat ironically, that in order to activate the support required to avoid systemic stress, authorities have to avoid applying the framework designed precisely to deal with crises of systemic banks (resolution) and employ the regime envisaged for less significant institutions (insolvency).

Moreover, the extensive use of national insolvency regimes – funded fully with domestic resources – entails a departure from the principles that motivated the creation of the banking union, namely the urgent need to break

[3] See SRB (2020) and König (2021).

[4] See Restoy (2016, 2018).

the destabilising link between domestic financial risks and the sovereign. In fact, it would imply the renationalisation of bank failure management and, therefore, the renationalisation of banks' risks.

Some remedies

In order to fix the deficiencies of the current crisis management framework in the banking union, we first need more harmonisation of domestic insolvency regimes. While a fully fledged common insolvency framework seems politically unfeasible[5] at this stage, there should be scope to further harmonise those features of the domestic arrangements that have more potential to create frictions with the common resolution regime.

Importantly, when facing the failure of mid-sized banks, there is a need to avoid the perverse dilemma of having to choose between open bank bail-in under resolution and piecemeal liquidation under insolvency, as both options are potentially destabilising. Moreover, recourse to public support under insolvency cannot be assumed as a suitable fix for that dilemma.

A potentially useful formula for addressing the above challenges is to facilitate sale-of-business (SoB) (or purchase and assumption) transactions to engineer the orderly exit of failing banks. Those strategies – in which deposits and other sensitive liabilities of failing banks are transferred to stronger institutions – have been successfully employed in other jurisdictions, like the US, for many years,[6] but cannot be easily employed at present in the European context.

Logically, the success of SoB strategies requires the existence a suitable buyer. This depends very much on the value of transferable assets of the failing bank and the availability of external funding to compensate buyers for taking over failing banks' deposits if, as is often the case, the available assets do not suffice.

The amount of assets that can be transferred can be increased by requiring mid-sized banks to hold, as a counterpart, liabilities that could be written down or converted into capital as the banks fail. A reasonably calibrated MREL could therefore help make the transfer strategies more feasible[7].

Yet, given the limited scope for mid-sized banks to issue and remunerate bail-in-able liabilities on a permanent basis, some external funds should be available to compensate buyers. In several jurisdictions, that external funding can be provided by the deposit guarantee scheme (DGS). However, DGS funding is typically subject to a financial cap: it is available only if the expected cost of the intervention is not greater than that of paying out deposits under liquidation.

In the case of the EU, DGS support for SoB transactions is severely limited (if not made irrelevant) by legal provisions that stipulate that DGS claims are more senior than uncovered deposits in the creditors' hierarchy. That "super-preference" of DGS claims protects them from assuming losses in liquidation. The result is that the financial cap makes European DGS unable to support SoB transactions, even if those would help avoid a potentially disruptive and value-destructing piecemeal liquidation[8].

[5] See Garicano (2020).

[6] See FDIC (2018), Restoy (2019) and Gelpern and Veron (2020).

[7] See Restoy et al (2019, 2022).

[8] See Restoy et al (2019).

Similarly, in the current framework the SRF is also not, at present, a suitable source of funding to generally support SoB transactions for mid-sized banks. The SRF is available only for failing institutions meeting the public interest condition required for resolution and only after a substantial creditors' bail-in has been executed. As discussed before, mid-sized banks will often find it very difficult to meet those conditions.

Therefore, the feasibility of SoB transactions requires significant changes to the current setup to facilitate sufficient coverage of their funding needs.

One possibility is to relax the financial cap for the deployment of DGS funds to support transfer transactions which is currently linked to the costs associated with payout deposits in liquidation. However, any action in that regard should preserve the DGS' ability to deliver on its main objective, ie to protect covered deposits.

A related discussion is whether the current super-priority of DGS claims in Europe is warranted on public policy grounds. It could be argued that there is no obvious policy rationale for DGS claims to become senior in relation to uncovered deposits. Indeed, the super-preference of DGS claims implies that individuals holding deposits above the maximum amount covered by the DGS are less protected in insolvency than the indirect positions held by DGS-affiliated banks vis-à-vis the failing institution. The logic of that privilege is not straightforward. Moreover, following the example of other jurisdictions like the US and replacing the super-preference of DGS claims with a general deposit preference rule could help to mitigate risks of bank runs, thereby protecting financial stability. Naturally, that alternative preference rule would automatically relax the currently tight constraint on the use of DGS funds to support SoB transactions, without unduly compromising the DGS' main objectives.

Another alternative source of funds could be the SRF. As I discussed earlier, that would entail alleviating the currently stringent minimum bail-in conditions for the use of those resources. Indeed, there seems to be a clear case for considering that conditions for the SRF to facilitate an orderly market exit of failing banks, for example through an SoB transaction, should not be as restrictive as the ones imposed to ensure that the failing bank could keep operating and performing critical functions. It could therefore be envisaged lower minimum bail-in conditions for (typically medium-sized) banks following an SoB resolution strategy.

Notice that while funding from the SRF would only be available for banks subject to resolution, DGS funding could support all bank failures regardless of whether the public interest test is passed or not. It is therefore probably the case that we need to make both DGS and SRF funding more easily available for conducting an SoB transaction for all types of institutions.

We should keep in mind, however, that while the SRF would eventually be fully mutualised, DGS remain, at present, national. That means that more intensive use of DGS funds, as proposed, to manage banking crises in the banking union may further contribute to a renationalisation of banks' risks. Moreover, for banks subject to the common resolution framework, reliance on national DGS would also create inconsistencies between the centralised decision-making process and decentralised funding mechanisms. That is why the proposed formulas to enhance the feasibility of SoB strategies as a key objective to improve the functioning of the European crisis management framework further strengthen the case for completing the banking union with the creation of a European deposit insurance scheme. Furthermore, since support from a European DGS would be available under both resolution and insolvency, there is clear logic in entrusting the SRB with managing that fund and deciding on how best employ it to facilitate an orderly exit of all types of banks, and not only those which are currently under its remit.

Concluding remarks

Any successful attempt to strengthen the current crisis management framework in the banking union needs to facilitate appropriate funding sources that could be deployed to support an orderly market exit for most institutions at the point of non-viability. An appropriate funding mechanism should be fully consistent with the banking union's objectives and, in particular, with the denationalisation of banks' risks. But it should also be compatible with different banks' business models. As seen before, some formulas could be considered to meet that politically complex, but also pressing, objective. Those formulas fit some of the options included in the recent public consultation recently issued by the European Commission[9].

As a follow-up to that consultation, authorities need to move swiftly, if not to deliver a comprehensive blueprint soon, at least to put forward a clear and effective roadmap for continuous progress towards the desired objective.

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[9] See EC (2021).

About the author

Fernando Restoy *became Chair of the Financial Stability Institute on 1 January 2017. He had been Deputy Governor of the Bank of Spain since 2012. Previously, he held other senior positions at the Bank of Spain, which he joined in 1991. From 1995 to 1997 he was Economic Advisor and Head of the Monetary Framework Section at the European Monetary Institute in Frankfurt. Mr Restoy was Vice Chair of the Spanish Securities and Markets Commission (CNMV) from 2008 to 2012 and Vice Chair of IOSCO Technical Committee (now Board). He was the Chairman of the Spanish Executive Resolution Authority (FROB) from 2012 to 2015 and has been a Member of the Supervisory Board of the ECB's Single Supervisory Mechanism from 2014 to end 2016. Fernando Restoy holds an MSc in econometrics and mathematical economics from the London School of Economics and an MA and PhD in economics from Harvard.*

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at