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Policy Paper

Prepare for the worst

How to make Europe's bank crisis management framework fit for purpose

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#Banking
#Resolution
#StateAid

Amid a severe health, social and economic crisis, banks again take centre stage on the political agenda. This policy paper explains why decision-makers are worried about a looming banking crisis, sets out the existing European bank crisis management framework and makes proposals for addressing its shortcomings in readiness for a possibly systemic banking crisis. Instead of taking the supposedly easy way out and bailing out banks again, now is the right time to prepare for the worst in Europe's bank crisis management framework.

Executive summary

The Banking Union was created with the aim of preventing future bank bailouts and breaking the vicious circle ('doom loop') between banks and sovereigns. However, the weakness of the bank crisis management framework so far prevented the Banking Union from delivering on its promise. Now, as the economic fallout from the COVID-19 pandemic threatens to push the banking sector into serious trouble again, is the right time to make Europe's bank crisis management framework fit for purpose.

This policy paper explains why decision-makers are worried about a looming banking crisis, sets out the existing European bank crisis management framework and makes proposals for addressing its shortcomings so as to prepare for what may turn out to be a systemic banking crisis.

The economic recovery from the pandemic is asymmetric across sectors and countries and so is the impact on banks. Depending on banks' individual exposure to affected sectors, a surge in defaulted loans could materially erode banks' capital base. Small and mid-sized banks in Southern Europe seem to be most at risk.

At the heart of the European bank crisis management framework is the principle that the private sector must bear the losses of bank failures through bail-in. Failing banks are either wound up under normal insolvency proceedings or put into resolution if public interest so warrants. To safeguard financial stability, the provision of state aid to banks is still possible but subject to conditions.

Shortcomings in the current framework allowed member states to continue bailing out failing banks instead of applying resolution tools. Ambiguous formulations in the legal texts are a nod to circumventing the rules, impediments to banks' resolvability persist, bail-in may create financial contagion or unduly harm depositors, the Single Resolution Fund is underfinanced and national deposit guarantee schemes might well be overstrained by the resolution of a large bank.

To make resolution work, the current framework needs to become more credible and reliable. Low-hanging fruits include making use of all resolution tools already available, enlarging their scope to cover smaller banks and ensuring coherence across applicable laws. Legislative action is warranted that would eliminate ambiguities in the legal texts, introduce a general depositor preference and protect deposits at European level. Preparing for a systemic banking crisis requires even more fundamental changes in the architecture. To ensure financial stability, one should be able to temporarily limit the bail-in requirement and the European Stability Mechanism must provide a backstop to the Single Resolution Fund as well as guarantee the provision of liquidity to banks in resolution.

Despite the deficiencies of the current framework, bailing out banks again if things get worse is not an option. The COVID-19 pandemic is already seriously inflating public debt levels and state aid for banks would aggravate the dangerous 'doom loop' between banks and sovereigns that had become apparent in the euro area sovereign debt crisis. Five years after the entry into force of the European bank crisis management framework, we should not jettison sensible regulation at the first severe test. Instead of taking the supposedly easy way out and bailing out banks again, the challenges posed by the pandemic are a convincing argument for preparing the European bank crisis management framework for the worst.

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Introduction

At the time of writing, the resurgence of the COVID-19 pandemic is dashing any hopes for a quick economic rebound.[1] As of now, banks have been part of the solution and are helping to keep the real economy afloat. However, the longer the recovery takes, the bleaker the outlook for banks too. Losses from defaults by distressed borrowers will reach the banking sector sooner or later. Banks with low equity levels and high exposure to affected sectors will eventually get into trouble.

This is why in the midst of a severe health, social and economic crisis, banks again take centre stage on the political agenda. While some praise the advantages of an EU asset management company to deal with the expected surge in bad loans, others urging insurance of deposits at European level. We should not forget, however, that the already existing framework for dealing with failing banks is also in dire need of reform. The weakness of the bank crisis management framework so far prevented the Banking Union from delivering on its promise to phase out taxpayer-funded bank bailouts and break the vicious circle between distressed banks and ailing sovereigns.

"The weakness of the bank crisis management framework so far prevented the Banking Union from delivering on its promise to phase out taxpayer-funded bank bailouts and break the vicious circle between distressed banks and ailing sovereigns."

Against this backdrop, this policy paper outlines in Section 1 why decision-makers are right to worry about the health of the banking sector. Section 2 describes the standard playbook for distressed banks in the EU and the remaining possibilities for government bank rescues. Section 3 discusses the shortcomings of the current bank crisis management framework and why it has rarely been applied. Section 4 puts forward proposals to make the existing rules work, even in a potentially systemic crisis. Section 5 concludes.

1 COVID-19 will affect Europe's banking sector, but heterogeneously

Unlike the Great Financial Crisis, where the financial sector worldwide was struggling with the same risk originating from securitized U.S. real estate mortgages, banks' individual risks are now less strongly correlated. The pandemic-induced corporate defaults will be concentrated in a particular set of business sectors: food, agriculture, hospitality, accommodation, tourism, transport, retail, exhibition, leisure and sports in all probability. Several of these sectors are dominated by small companies which will find it harder to survive a prolonged period of low revenues. Their insolvency will primarily affect local and regional banks which traditionally finance small- and medium-sized enterprises (SMEs) in most member states. At the same time, bigger banks are more likely to suffer if big corporations default and from a severe slump in ship and aircraft financing.

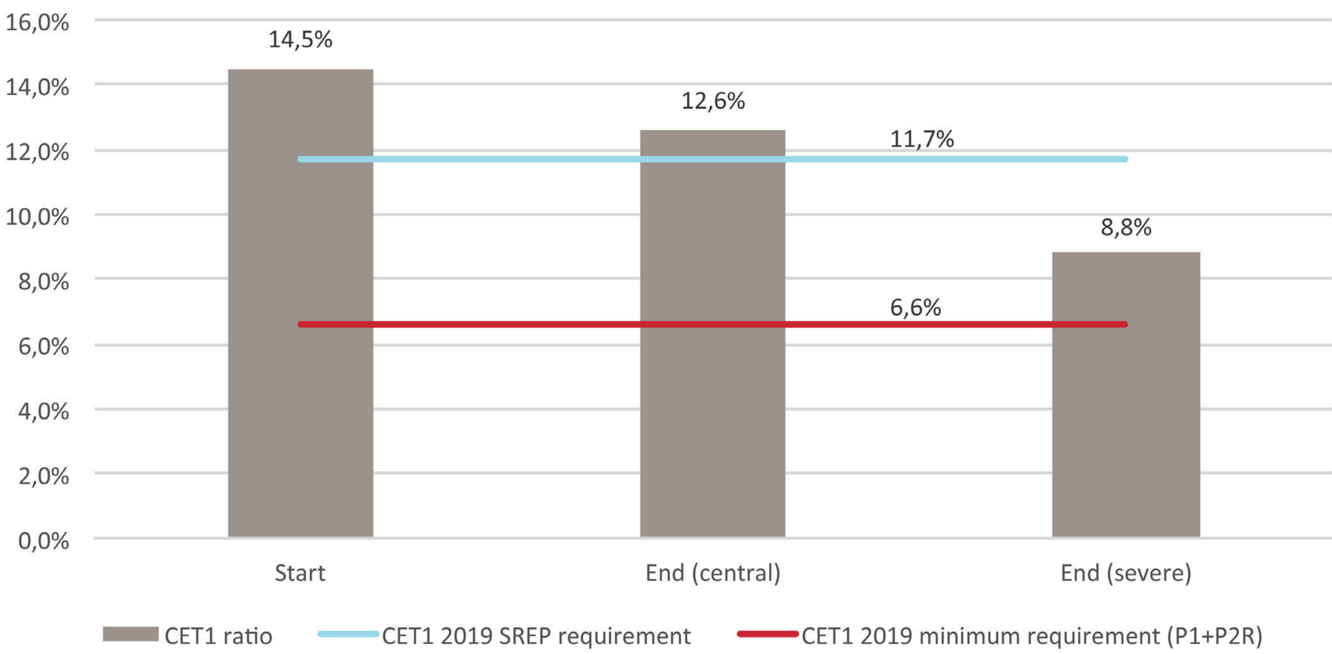
In its vulnerability analysis comprising a sample of the biggest banks in the Banking Union, the European Central Bank (ECB) confirms the hypothesis that the negative impact of loan losses is most severe for diversified lenders with exposure to several sectors affected by the pandemic. Small domestic and retail lenders will suffer more than global, systemically important banks or universal banks.[2] Figure 1 illustrates the projected capital depletion from the 14.5% pre-crisis level to 12.6%

[1] European Commission, *Autumn 2020 Economic Forecast*
[2] ECB *COVID-19 Vulnerability Analysis* of 28 July 2020

in a mild central scenario and to 8.8% in an adverse severe scenario. While banks on average would still exceed their 2019 capital requirement[3] (blue line) under the mild scenario, they would fall below under the severe scenario.

The aggregated ECB results showing only average figures can be fairly misleading. It may therefore be helpful to complement this perspective with a scenario simulation using bank-by-bank data which finds that some banks could get close to or even infringe the minimum capital requirement for bank authorisation[4] (red line). In particular, mid-sized banks in Italy, France, Spain, Cyprus and Greece seem to be affected most by COVID-19.

Figure 1: ECB COVID-19 projection for banks' average capital ratio



Own illustration based on ECB vulnerability analysis and ECB Overall SREP 2019 key messages

While the smallest banks are missing in both samples, the results may serve as an approximation of the biggest challenges for the European banking sector post-COVID-19. Depending on banks' individual exposure to affected sectors, the economic fallout from the pandemic could materially erode banks' capital basis. The following section outlines the standard playbook for banks in distress.

"Depending on banks' individual exposure to affected sectors, the economic fallout from the pandemic could materially erode banks' capital basis."

[3] *average 2019 CET1 SREP requirement* (including systemic buffers, countercyclical buffer, capital conservation buffer and soft pillar 2 guidance which competent authorities released to offset the effects of COVID-19)
[4] Dor, Eric, *Which European Banks are Very Exposed to the Sectors that are Depressed by the Crisis?* (August 24, 2020), SSRN working paper

2 Standard playbook for bank failures in the Banking Union

In 2009, political leaders worldwide affirmed that the cost of a bank failure would never again be borne by taxpayers. To prevent government bank bailouts, the European Union in 2014 adopted a new legal framework for bank crisis prevention and management.[5] In addition, the eurozone countries combined to launch the Banking Union. By transferring large parts of supervisory and resolution competences to the ECB and to the newly created Single Resolution Board (SRB), eurozone countries wanted to eliminate the sovereign-bank nexus, i.e. negative spillover effects from weak bank balance sheets on public budgets undermining their access to financial markets. Through these measures, state aid for banks was meant to become the very exception. This section outlines how the bank crisis management framework should work in theory.

2.1 Private sector must bear losses first

At the heart of the European bank crisis management framework is the principle that the private sector must bear the losses in any failures first.

When a bank violates its capital requirement or becomes unable to pay its obligations, the prudential supervisor – the ECB for the largest banks in the Banking Union – declares the bank to be failing or likely to fail. The responsible resolution authority – the SRB for the largest banks in the Banking Union – must then decide whether the bank is wound up under normal insolvency proceedings or put into resolution. Resolution is warranted if it is deemed in the public interest, i.e. necessary to safeguard financial stability or to ensure the continuity of bank functions critical to the economy, such as lending to small- and medium-sized businesses.

If a bank is wound up under normal insolvency proceedings, the outcome is different in each member state. Insolvency law is not harmonised within the EU so national bank insolvency regimes differ substantially from one another in terms of general structure (administrative or judicial), triggers to initiate insolvency proceedings or ranking of liabilities in the creditor hierarchy.[6] The most common but also most costly option is liquidation, where the bank stops operating and its assets are sold and distributed to its creditors. Depositors then lose access to their bank account while borrowers are forced to search for other business relationships on potentially less favourable credit terms. Private, non-financial depositors are compensated for up to EUR 100,000 by the national deposit guarantee scheme which recovers its losses from the remaining domestic banks.

"The resolution of banks under EU law provides a carve-out from national insolvency proceedings with the aim of ensuring overall financial stability."

The resolution of banks under EU law provides a carve-out from national insolvency proceedings with the aim of ensuring overall financial stability. To capture

[5] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, short: BRRD

[6] European Commission, *Study on the differences between bank insolvency laws and on their potential harmonisation,* Final report, 6 November 2019

the multiple combinations of the four available tools, resolution strategies are grouped into two main categories: (i) transfer and (ii) bail-in.

The (i) transfer strategies strive for the transfer of all or part of the failed bank to a purchaser. They include the sale of business tool, the bridge institution tool and the asset separation tool. When applying the sale of business tool, the resolution authority sells the failing bank or parts of its business to a purchaser. Under the asset separation tool, only some of the failing bank's assets and liabilities are transferred to a separate entity for an eventual sale at maximum value. The bridge institution tool offers the possibility of maintaining the bank's critical functions until a private purchaser is found. Any residual leftover from the failed bank after applying one of the transfer strategies must be wound up under normal insolvency proceedings.

In contrast, the (ii) bail-in strategy aims to recapitalise a bank to allow it to continue to operate or to provide capital for a bridge institution. Under bail-in, debt is written down or converted into capital. By reducing the liabilities of the failed bank, bail-in mitigates taxpayers' risks of being forced to cover losses and prevents the bank from disrupting critical functions such as deposit-taking, lending or processing of payments.[7] Shareholders, junior and senior creditors are subject to bail-in up to 8% of total assets before the Single Resolution Fund (SRF) can be accessed to cover additional funding needs required to safeguard financial stability. The SRF is administered by the SRB and gradually built up by ex-ante contributions from all banks within the Banking Union. The contribution of the SRF is capped at 5% of the bank's total assets.

According to the latest available data, banks making up around 85% of total EU domestic assets are eligible for resolution, leaving circa 15% earmarked for insolvency proceedings.[8] This distribution reflects the fact that larger banks are more likely to qualify for resolution because disruption of their critical functions is more likely to have an adverse impact on the real economy and financial stability. Bail-in is the preferred resolution strategy for large banks whereas banks that are limited in size regularly qualify for transfer strategies since it is easier for them to find a potential buyer for parts or the entirety of the bank.[9]

"Bail-in is the preferred resolution strategy for large banks whereas banks that are limited in size regularly qualify for transfer strategies."

2.2 Remaining possibilities for public financial support

While the fundamental principle of the bank crisis management framework is that losses from bank failures must be borne by the private sector, safeguarding financial stability may justify the mobilisation of taxpayers' money under extreme circumstances. The legal framework therefore allows for the provision of state aid but subject to conditions. Depending on the circumstances, the injection of public funds still requires burden-sharing by private investors, but often to a lesser extent than in resolution.

First, if a bank is wound up under normal insolvency proceedings, national or regional governments can provide liquidation aid to support an orderly market exit and preserve financial stability. In this case, the European Commission must

[7] For further details on critical functions, see Delegated Regulation (EU) No 2016/778.

[8] EBA, *Quantitative MREL report 2020:* 4

[9] Idem.

assess whether the public financial support involved adheres to the EU rules for state aid specified by the 2013 Banking Communication, in particular whether it is limited to the minimum necessary and shareholders and junior creditors are subject to burden-sharing.[10]

Second, if a bank is resolved, all bail-inable liabilities have been fully bailed-in and the contribution of the SRF has reached the limit of 5% of the bank's total assets, any additional funding needs could be covered by state aid from the member state where the failing bank is located.[11] If this would adversely affect the member state's own fiscal sustainability, the European Stability Mechanism (ESM) could step in and support banks in eurozone countries through its Direct Recapitalisation Instrument with a maximum total of 60 billion euros.[12]

Third, governments can prevent resolution by precautionarily recapitalising a bank that is still solvent but unable to raise capital in the markets after the prudential supervisor discovered a capital shortfall that would materialise if economic conditions were to worsen significantly.[13] Such an extraordinary public capital injection is meant to remedy a serious disturbance in the economy and preserve financial stability. In this case, shareholders and junior creditors must be bailed in, but unlike in resolution senior creditors are not required to take a hit.

Fourth, if a bank is still solvent but requires fresh capital to restore its viability, the national or regional government can provide public support which is not qualified as state aid as long as the measures are carried out on market terms, meaning that the state receives a remuneration in line with what a private operator would accept in the same circumstances. If the European Commission finds the transaction's terms to be plausible and market conform, thus free of any state aid, burden-sharing by private investors does not come into play.

The standard playbook for bank failures in the Banking Union is illustrated in Figure 2.

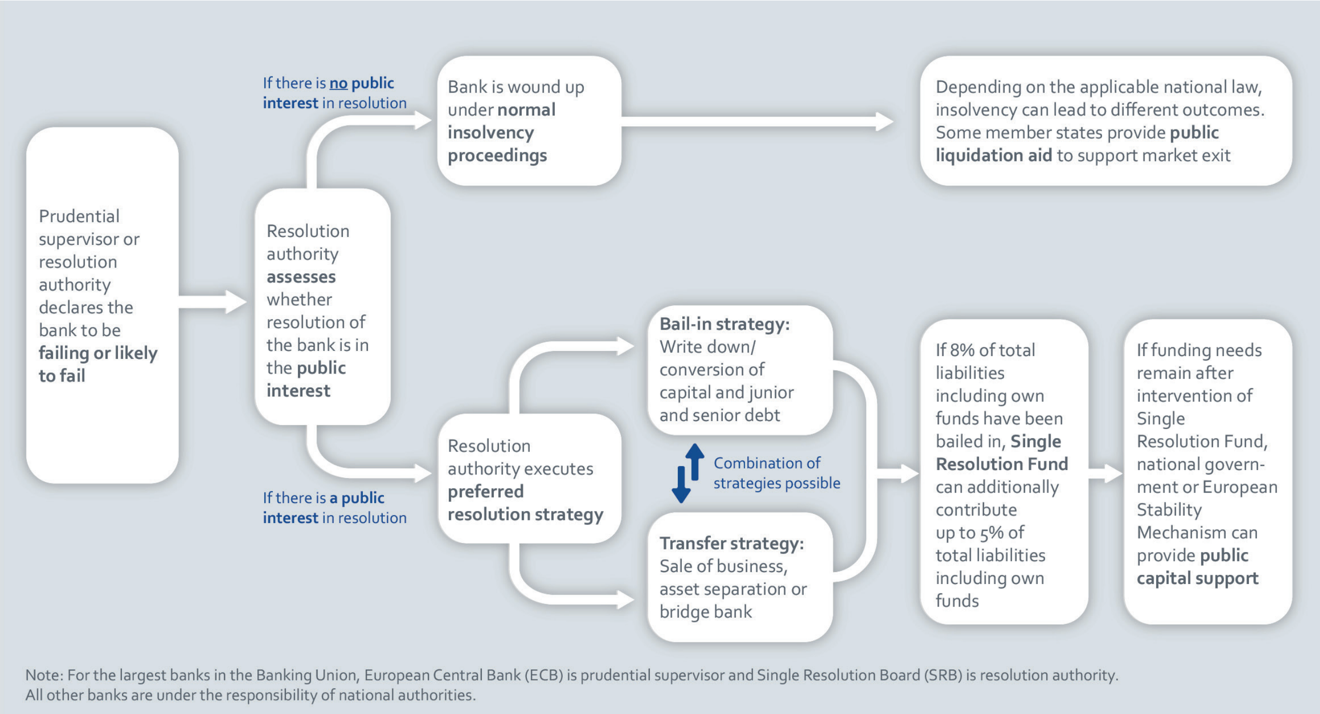
[10] Communication from the Commission on the application, from 1 August 2013, of state aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication')

[11] See Article 27 (9) SRMR and Article 44 (7) BRRD. As a last resort, Article 56 BRRD allows extraordinary public financial support even without any contribution from the SRF

[12] See *ESM Guideline on Financial Assistance for the Direct Recapitalisation of Institutions*

[13] Article 32 (4) (d) BRRD

Figure 2: Crisis management in the Banking Union.



Own illustration.

3 Shortcomings of the existing bank resolution framework

Despite the entry into force of the BRRD and the entry into office of the SRB, we have to acknowledge that the standard playbook for bank failures has been followed only infrequently in practice. Only in the case of the Spanish Banco Popular did the SRB decide that resolution was in the public interest and applied the bail-in tool. In the vast majority of bank failures within the Banking Union since 2015, member states circumvented the application of bail-in or even the involvement of the SRB. Thus, the unholy link between national governments and their domestic banks, the 'doom loop', remains in place. This section discusses the shortcomings of the current bank resolution framework and explains why member states often opted for bailing out banks with public money instead of applying the available resolution tools.

"We have to acknowledge that the standard playbook for bank failures has been followed only infrequently in practice."

3.1 Loopholes opening paths to circumvent bail-in

The conditions for state aid and the concepts guiding the decisions of prudential and resolution authorities in the bank crisis management framework are not clear-cut. While this discretion allows for flexibility in catering with different situations, practice has shown that it also opens the door for divergent interpretations by the actors involved and renders the framework vulnerable to abuse.

First, the concept of 'failing or likely to fail' is codified in the legal text but the broad principles provide the authorities with a certain degree of discretion.[14] Given

[14] Article 32 (4) BRRD

the heterogeneity of banks, some flexibility might well be justified when assessing banks' viability. However, when NordLB violated its Common Equity Tier 1 capital requirement for more than one year without being deemed 'failing or likely to fail' by the ECB, this brought quite justified criticism as such a serious breach would normally constitute a valid reason for immediate withdrawal of the banking licence.

Second, there is no clear-cut definition of 'financial stability' although it is a central element of the public interest assessment as to whether a bank is put into resolution or not. In the case of the two Venetian banks, Banca Popolare di Vicenza and Veneto Banca, the SRB deemed their failure too insignificant to cause financial instability and thus saw no public interest in resolution. In contrast, the Italian government claimed the failure of the two mid-sized banks would threat financial stability in the region where they are most active, justifying the provision of liquidation aid. The provision of liquidation aid is politically tempting because the bail-in requirement excludes senior creditors and is thus less strict than for resolution. Furthermore, the European Commission so far has not contested member states' assertions that a bank failure constituted a threat to financial stability justifying the provision of liquidation aid.[15]

Third, the concepts of 'solvent' and 'serious economic disturbance' are not defined in the legislation despite being prerequisites of precautionary recapitalisations.[16] Consequently, Banca Monte dei Paschi di Siena benefitted from a precautionary recapitalisation although there were doubts as to whether the bank was still solvent while the Italian economy was doing relatively well at the time of the recapitalisation in 2017. Since 2018, the ECB applies a stricter internal methodology for the assessment of 'solvency'. However, the new approach includes a forward-looking element that relies on assertions on future developments, rendering the assessment ambiguous once more.[17]

Fourth, whether a public capital injection is carried out on market terms relies particularly on the remuneration the state expects to receive from the bank in exchange for the capital provided. Since future cashflows must be estimated at the time of the capital injection, the 'private investor test' implies a high degree of uncertainty. The case of NordLB – requiring two public capital injections within eight years – underlines that estimating future cash flows can be prone to over-optimism.

3.2 Impediments to banks' resolvability persist

The smooth resolution of a failing bank depends on the successful removal of impediments to resolution and the existence of an adequate level of bail-inable capital that can absorb losses and provide fresh equity. In both cases, banks still have some homework to do.

Removing impediments to resolvability means making changes to banks' legal and operational structures so that their failure does not disrupt financial stability.

[15] See paragraph 68 in European Court of Auditors, Special Report 21/2020: *Control of State aid to financial institutions in the EU: in need of a fitness check*

[16] Article 32 (4) letter d BRRD

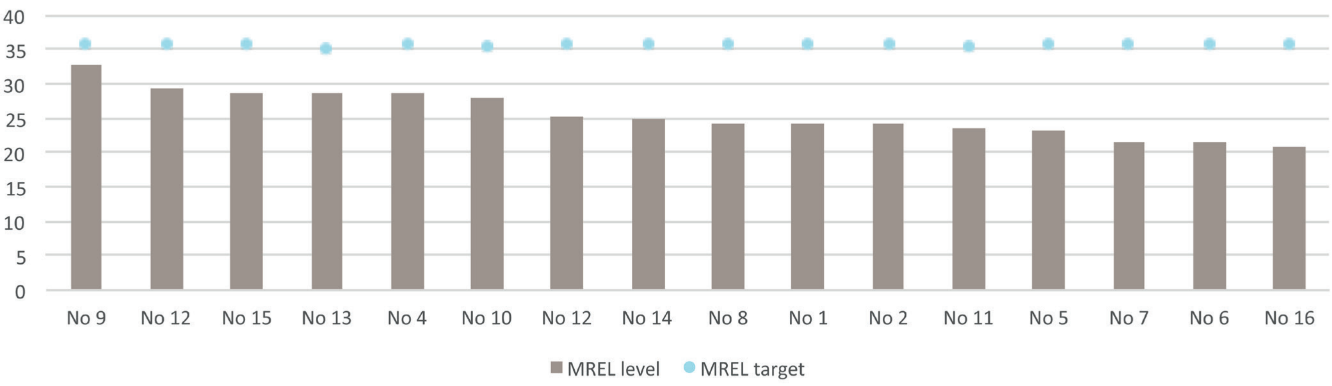
[17] See *letter of 23 June 2020 from Andrea Enria, Chair of the Supervisory Board, to MEP Sven Giegold*

To this end, the SRB in 2019 adopted resolution plans for 106 institutions corresponding to 83% of the 128 banks under its remit.[18] By 29 October 2019, no resolution plan adopted by the SRB contained a fully-fledged resolvability assessment.[19] The SRB claims that the most recent resolution plans cover almost every aspect of resolution planning, including the crucial resolvability assessment.[20] One of the remaining impediments to resolvability is banks' exposure to retail bondholders. While most retail investors dispose of several hundred thousand euros in net wealth[21] and should thus be resilient enough to absorb losses, they complicate bank resolution with their potential withdrawals and litigation endangering the bank's future viability. While the SRB is working with banks to gradually remove impediments, making them fully resolvable will take time.

"While the SRB is working with banks to gradually remove impediments, making them fully resolvable will take time."

Regarding the build-up of capital that can be bailed-in in resolution (Minimum requirement for own funds and eligible liabilities, MREL), the biggest banks have already accumulated a substantial stock. However, the global, systemically important institutions (G-SIIs) were given until end-2023 to build up their final MREL target level. The latest available data reveals MREL shortfalls for all 16 European G-SIIs. While some of the largest banks are already close to their MREL target level, several G-SIIs still have a long way to go. The actual numbers are probably higher than the data of 31 December 2018 illustrated in Figure 3. Likewise, G-SIIs are now required to subordinate a material amount of their bail-inable instruments which substantially facilitates the execution of the bail-in tool.[22] Even so, more bail-inable material is needed to ensure smooth resolution of all large banks.

Figure 3: MREL levels and targets of the 16 EU G-SII resolution groups in % of risk weighted assets.



Source: EBA Quantitative MREL Report 2020: 7.

[18] SRB, *Annual Report 2019*, 7 September 2020
[19] *Reply by SRB Chair Elke König to a written question by MEP Sven Giegold*
[20] SRB, *Annual Report 2019*, 7 September 2020
[21] Lindner, Peter and Redak, Vanessa-Maria, *The resilience of households in bank bail-ins*, OeNB Financial Stability Report, 2017, issue 33, 88-101
[22] Article 92a in conjunction with Article 494 CRR2

3.3 Bail-in may create financial contagion

By design, the bail-in tool will, if applied, affect other financial institutions and investors that hold bail-inable securities of the bank being resolved. Losses incurred by other institutions may in turn impair their own viability and could therefore have destabilising consequences for the wider financial system. The negative impact of an idiosyncratic event such as the failure of one bank seems to be rather limited. In 2017, an ECB study concluded that in a "baseline scenario of an idiosyncratic bail-in, the impact on the equity ratios of the counterparties of a bailed-in bank is very small".[23] From June 2021 onwards, legislative changes will further disincentivise cross-holdings of bail-inable instruments among the largest banks.[24] However, the risk of financial contagion would be elevated in a systemic crisis where several banks simultaneously fail because they are still relatively interconnected: eurozone banks together hold roughly 12% of the bail-inable debt instruments they issued.[25]

"The risk of financial contagion would be elevated in a systemic crisis where several banks simultaneously fail."

3.4 The Single Resolution Fund is underfinanced

The Single Resolution Fund (SRF) is meant to preserve financial stability if the failure of a bank causes losses exceeding 8% of the bank's total assets. The SRF can then contribute up to 5% of the bank's total assets to recapitalise the bank and ensure continuity in its critical functions. For this purpose, the SRF's total amount collected from the industry as of July 2020 stood at 42 billion euros, more than halfway towards the 70 billion euros due to be reached by end 2023.[26] This end-stage amount equals the hypothetical support that, according to estimates, would have been required from the SRF if the European resolution framework had already been in place in the Great Financial Crisis.[27] However, during the transitional phase until end 2023 when the SRF is fully loaded and afterwards in any systemic crisis where several large banks simultaneously run into serious difficulties, the SRF might not dispose of adequate firepower to safeguard financial stability in the Banking Union.

This is even more true if the bank undergoing resolution depends on the SRF not only for its recapitalisation but also for replenishing its liquidity buffers. In general, banks' liquidity needs are met through interbank lending, regular monetary policy operations or emergency liquidity assistance from the central bank. However, banks undergoing resolution may face difficulties in tapping the market for unsecured funding and at the same time they may not dispose of sufficient valuable assets to be used as collateral for receiving liquidity from the central bank. The SRF may provide liquidity even without collateral, but large banks' liquidity needs after a resolution are likely to exceed the financial means the SRF has at its disposal. The ECB estimates liquidity gaps in resolution can be up to 184 billion euros for specific banks and exceed even 313 billion euros in a systemic crisis.[28]

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[23] Hüser, Anne-Caroline et al., *The systemic implications of bail-in: a multi-layered network approach,* ECB Working Paper Series No 2010 / February 2017

[24] G-SIIs will no longer be able to count TLAC instruments held from other G-SIIs to meet their own TLAC requirements

[25] FSB, *Evaluation of the effects of too-big-to-fail reforms,* Consultation Report, 28 June 2020

[26] SRB, *SRF grows to €42 billion after latest round of transfers,* press release of 14 July 2020

[27] Willem Pieter De Groen and Daniel Gros, *Estimating the Bridge Financing Needs of the Single Resolution Fund: How expensive is it to resolve a bank?,* November 2015

[28] Amamou, Raschid et al, *Liquidity in resolution: estimating possible liquidity gaps for specific banks in resolution and in a systemic crisis*

3.5 Bail-in unduly harms depositors

To minimise the costs of bank failures for taxpayers, resolution requires shareholders and creditors to bear associated losses. While protection of deposits is one of the resolution objectives enshrined in the legal texts of the bank crisis management framework, bail-in can also involve depositors. Only deposits of natural persons, micro, small and medium-sized enterprises of up to EUR 100,000 are protected by national deposit guarantee schemes. Some member states also confer special protection on large corporate depositors and resolution authorities may exclude certain deposits on a case-by-case basis in order to prevent widespread contagion and severe disruption of financial markets.[29] But in general, the EU legal framework does not protect deposits of large corporations or those of natural persons, micro, small and medium-sized enterprises exceeding EUR 100,000. In case of bail-in, depositors may also be required to take a hit and corporate deposits are particularly at risk. This can have severe economic implications for companies losing all or parts of the cash they had with the struggling bank to pay employees and contractors such as suppliers.

"In case of bail-in, depositors may also be required to take a hit and corporate deposits are particularly at risk."

3.6 Resolution might overstrain national deposit guarantee schemes

Resolution can have the same negative repercussions for national deposit guarantee schemes as normal insolvency. Where resolution action ensures that depositors can still access their deposits, the relevant national deposit guarantee scheme will be liable for the amount of losses that depositors covered by it would have suffered under national insolvency proceedings. Given that the target amount collected by national deposit guarantee schemes equals 0.8% of covered deposits and that most national schemes in the EU are still under construction, the failure of a single large or several medium-sized institutions has the potential to implode the deposit insurance scheme of one single member state. Since the remaining banks located in the same member state are required to fill the financial gap in the national scheme, such a situation may easily create widespread contagion in the domestic financial system.

4 How to make resolution work

The previous section outlined why the current bank crisis management framework has been followed infrequently in the past. Given the upcoming challenges posed by the COVID-19 pandemic, now is the right time to address existing shortcomings and to sever the negative feedback loop between failing banks and struggling sovereigns. Instead of reverting to old recipes such as bank bailouts, this section outlines possible solutions for making the current resolution framework more credible and prepare it for a potentially systemic crisis. Table 1 summarises the various proposals for reform we discuss categorised according to their degree of feasibility.

29 Article 44 (3) BRRD

Table 1: Summary of proposals for reform

Degree of feasibility	Proposals for reform
Low hanging fruits	• Make full use of transfer strategies in bank resolution • Align European Commission's state aid rules with the BRRD • Allow for controlled wind-up of smaller banks
Legislative action at European level	• Eliminate unclarities in the bank crisis management framework • Introduce a general depositor preference • Protect depositors at European level
Safeguards for systemic crises	• Financial stability exemption to full bail-in • ESM backstop to the SRF • Liquidity in resolution

4.1 Low-hanging fruits

Several of the shortcomings identified in Section 3 do not require lengthy legislative changes but could be remedied relatively easily, if there is the political will to do so.

4.1.1 Make full use of transfer strategies in bank resolution

Not all banks that qualify for resolution require bail-in of shareholders and creditors. The preferred resolution strategy of banks that are limited in size is "transfer" and not bail-in. Since bail-in is limited when executing the sale of business, bridge bank or asset separation tool, transfer strategies in general do not cause major financial contagion. Instead of circumventing resolution of distressed banks out of fear of the economic implications of bail-in, resolution authorities should make use of transfer strategies wherever possible. Such an approach would mirror the successful approach of the U.S. FDIC (Federal Deposit Insurance Corporation) in conducting 'purchase and assumption' (P&A) transactions where a healthy bank purchases some or all of the assets of a failing bank and assumes some of the liabilities, including all insured deposits.[30] In the U.S., the experience of the FDIC has proven that P&A transactions work in normal times as well as in stress situations.

"Instead of circumventing resolution of distressed banks out of fear of the economic implications of bail-in, resolution authorities should make use of transfer strategies wherever possible."

4.1.2 Align European Commission's State aid rules with the BRRD

The '2013 Banking Communication', the internal rules guiding the European Commission's assessment of state aid for banks, deviates in certain aspects from the bank crisis management framework that was put in place in 2015. The discrepancy between the two texts leads to inconsistencies such as that resolution requires bail-in of shareholders, junior and senior creditors while burden-sharing in the course of precautionary recapitalisations or liquidation aid excludes senior creditors. Within today's temporary state aid framework, the European Commission has even suspended the already weaker burden-sharing requirement for national measures which "address problems linked to the COVID-19 outbreak". To make the bank crisis management framework more credible and reliable, the European Commission should therefore modify its Banking Communication and ensure that

[30] See *FDIC Resolutions Handbook*

the criteria for granting state aid adhere to the stricter conditions stipulated within the BRRD's legislative text.

4.1.3 Allow for controlled wind-up of smaller banks

In "peace times", small banks in general do not qualify for resolution and are wound up under national insolvency proceedings instead. However, preserving customers' access to deposits and avoiding value destruction is beneficial not only for large banks. By transferring assets and liabilities including deposits to a healthy bank or to a bridge bank, economic losses and the need for support with public money can be minimised. The Deposit Guarantee Schemes Directive allows for supporting transactions protecting deposits via monies from national deposit guarantee systems.[31] However, "alternative measures" administered at national level bar the way to the Europeanization of deposit protection any time soon.

Therefore, it seems preferable to also wind up smaller banks within the framework of the BRRD if it is in the public interest. Denmark, for example, has been running such a scheme with the approval of the European Commission since 2010.[32] Beyond asking the Commission for approval, member states would need to modify the scope of the public interest test carried out by national resolution authorities to cater also for smaller banks. Since any potential use of the SRF requires approval by the SRB, member states would be unable to abuse the scheme. Nevertheless, to overcome any fragmentation in the internal market, the long-term goal should be to find a permanent solution at European level providing for legal certainty. An integrated approach not limited to the largest banks would render the entire bank crisis management framework more predictable and effective.

4.2 Legislative action at European level

Some of the shortcomings of the current bank crisis management framework require legislative action, i.e. amendments to existing legislation or adopting new legislation.

4.2.1 Eliminate ambiguities in the bank crisis management framework

To ensure coherent application of the current rules, the conditions for state aid and the concepts guiding the decisions of prudential and resolution authorities must be clarified and harmonised throughout the set of laws constituting the bank crisis management framework. Broad principles should be beefed up with additional guidance to avoid different interpretations. This is warranted in particular for 'failing or likely to fail' when assessing bank viability, for the definition of 'financial stability' with relevance for the public interest test on resolution as well as for the 2013 Banking Communication on state aid, and for 'solvent' and 'serious economic disturbance' as prerequisites for precautionary recapitalisations. Minimising the room for interpretation would render the framework more reliable and predictable.

"Minimising the room for interpretation would render the framework more reliable and predictable."

[31] *Article 11 (6) DGSD*
[32] See *Decision of European Commission on State Aid N 407/2010 – Denmark*

4.2.2 Introduce a general depositor preference

Introducing a general depositor preference in the creditor hierarchy so as to treat all deposits, whether insured or not, equally within resolution would be highly beneficial as it would substantially reduce the impact of bail-in on the real economy.

"Introducing a general depositor preference would substantially reduce the impact of bail-in on the real economy."

First, it would create a level playing field across the EU. In their national insolvency laws, Cyprus, Hungary, Italy, Portugal, Greece and Slovenia confer special protection on the deposits of large corporations.[33] The differentiated treatment of corporate depositors among member states complicates the work of the SRB in cross-border resolutions and provokes resentment in countries that treat all creditors alike.

Second, it would reduce the negative impact of resolution on economic stability. The bail-in of senior unsecured bank debt instruments and other senior liabilities is regarded as carrying a lower contagion risk than that of operational liabilities such as deposits. For the European resolution framework, the IMF therefore sees merit in introducing a general depositor preference.[34]

Third, it would facilitate bail-in. Experience shows that corporate fixed-term deposits are unsuitable instruments for bail-in.[35] Deposits often represent 'working capital' that a company needs to participate in economic life. If a bank becomes distressed, corporates might try to withdraw their deposits to protect them from bail-in. The ECB therefore suggests a general depositor preference based on a tiered approach.[36] Large corporate deposits (and possibly also deposits by credit institutions, collective investment undertakings, pension funds etc.) would then rank below covered deposits and deposits of households, micro and SMEs, but ahead of other senior liabilities. According to the ECB, a general depositor preference is "likely to render the bail-in of senior unsecured bank debt instruments more effective and credible, thus fostering effective resolution action and reducing the need to have recourse to the resolution fund".[37]

There is consequently a strong case for a general depositor preference that applies to all deposits throughout the EU.

4.2.3 Protect depositors at European level

As long as deposit insurance remains purely national, national deposit guarantee schemes are vulnerable to severe local shocks. A joint European deposit insurance fund, managed under SRB auspices, would prevent bank runs and deposit flights out of countries hit by a severe banking crisis. Likewise, it could offset funding

[33] European Commission, *Study on the differences between bank insolvency laws and on their potential harmonisation*, Final report, 6 November 2019

[34] IMF, *technical note — bank resolution and crisis management, euro area policies, financial sector assessment program*, Country Report No. 18/232

[35] Restoy, Fernando, *Bail-in in the new bank resolution framework: is there an issue with the middle class?*, Speech at the IADI-ERC International Conference: „Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes", Naples, Italy, 23 March 2018

[36] ECB, *Opinion on a proposal for a directive of the European Parliament and of the Council on amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy* (CON/2017/6)

[37] idem

needs that otherwise would need to be met entirely by supplementary payments from the domestic banking sector.

While the European Commission on 24 November 2015 submitted a draft law to establish the European Deposit Insurance Scheme (EDIS), the legislative process has come to a halt, pending an agreement within the Council and the European Parliament. In order to break the deadlock, the proposal for a European reinsurance scheme put forward by the German Finance Minister Olaf Scholz in November 2019 could serve as a starting point.[38] While Scholz's suggestion could balance out the varying capacities of the national deposit guarantee schemes in the Banking Union, each member state would remain liable for losses occurred in the domestic banking sector. However, to sever the infamous 'doom loop' between ailing banks and struggling sovereigns, member states together should become liable for losses exceeding the European fund.

4.3 Safeguards for systemic crises

The EU resolution framework was designed to deal with idiosyncratic events, i.e. the failure of a single bank, and not to cater for a system-wide crisis. To prepare the bank crisis management framework for such a severe scenario, changes beyond ordinary legislation will be necessary.

4.3.1 Financial stability exemption to full bail-in

In a systemic banking crisis, strictly applying the bail-in requirement might cause financial contagion. Instead of bluntly bailing out banks to safeguard financial stability, it would be preferable if the bank crisis management framework provided for temporary exceptions to the bail-in requirements in exceptional circumstances.[39] To limit the economic and political costs of any resolution, it should be possible to exclude senior creditors (and uninsured depositors in the absence of a general depositor preference) from the bail-in requirement as recommended by the IMF.[40] Loss absorption by shareholders and subordinated debtholders would still be required but the SRF would be accessible even without reaching the 8 percent bail-in requirement. To forestall any potential abuse, this extraordinary 'financial stability exemption' would need to be strictly temporary and subject to rigorous conditionality.

"To limit the economic and political costs of resolution in a systemic banking crisis, it should be possible to access the SRF even without reaching 8 percent bail-in."

Applying the financial stability exemption to the resolution of the largest banks would require modifying the scope of the bail-in tool. The relevant Single Resolution Mechanism Regulation (SRMR) could be amended relatively easily under the ordinary legislative procedure. However, changing the rules for bail-in would mean also amending the intergovernmental agreement on the financing of the

[38] See Federal Ministry of Finance, *Proposals for completing the banking union,* 6 November 2019
[39] Article 27 (5) SRMR and Article 44 (3) BRRD allow the exclusion of certain liabilities from the application of the bail-in tool, but require then to increase the level of write-down or conversion applied to other eligible liabilities to take account of such exclusions. The overall requirement to bail-in at least 8% of total liabilities and own funds before accessing the SRF in principle cannot be altered under the current rules
[40] IMF, *technical note — bank resolution and crisis management, euro area policies, financial sector assessment program,* Country Report No. 18/232

SRF since the provisions on bail-in directly affect the use of the common fund.[41] The amendment requiring unanimity among member states would not change the overarching principle that losses need to be borne by the private sector first but would allow for safeguarding financial stability in an extraordinary situation like the COVID-19 pandemic. As suggested by the IMF, the financial stability exemption could evolve while the Banking Union is being completed, e.g. when all banks have reached their MREL end-stage target levels, the quality of MREL has been improved by extensive subordination requirements, and all major impediments to bank resolvability have been removed.

4.3.2 ESM backstop to the SRF

In a time of crisis, as highlighted by former SRB Vice Chair Timo Löyttyniemi, market confidence is key.[42] To dispel any doubts that the SRF could be depleted by the resolution of a large bank or in a systemic banking crisis, the ESM is meant to act as a backstop and lend the necessary funds to the SRF. While the backstop would be fiscally neutral since the banking sector must cover the cost of any use of backstop via ex-post contributions, its establishment requires a change in the ESM Treaty. On 4 December 2019, the Eurogroup agreed in principle on a wider ESM reform package including the backstop of the SRF and the option of introducing it before 1 January 2024. However, the ESM reform was put on hold early this year and has not been concluded yet. Given the damage a systemic banking crisis could cause for the wider economic system, policymakers should push ahead with adopting at least the backstop part of the ESM reform package.[43] An early introduction will be key to weather the financial stress caused by the COVID-19 pandemic.

"An early introduction of the backstop will be key to weather the financial stress caused by the COVID-19 pandemic."

4.3.3 Liquidity in resolution

For a successful resolution, restoring bank's solvency through bail-in and recapitalisation is insufficient. To ensure a bank's operability after resolution, one must also replenish its liquidity buffers. Given the limited financial means of the SRF, the ECB is the only institution that has sufficient firepower to meet the liquidity needs of large banks after resolution. While the central bank in general provides liquidity only against collateral, the ECB would, as a measure of last resort, probably need to deviate from this principle if required to ultimately safeguard financial stability.

Another way out of this dilemma would be to allow the ESM to provide a guarantee to the ECB which could then lend money to a bank under resolution.[44] To protect taxpayers from bearing the risk of potential losses, the ESM could resort to the SRF which has the power to recoup ex-post contributions from the banking sector. Empowering the ESM to give guarantees to the ECB would, however, necessitate changes to the ESM treaty.

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[41] *Article 9* of the Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund stipulates that the use of the Fund shall be contingent upon the permanence of the bail-in rules

[42] Löyttyniemi, Timo, *The Common Backstop: how it will strengthen the Single Resolution Fund,* SRB article of 30 October 2018

[43] Guttenberg, Lucas, *Time to come home: If the ESM is to stay relevant, it should be reinvented inside the EU,* Jacques Delors Centre policy brief

[44] For more details, see Demertzis, Maria et al, *How to provide liquidity to banks after resolution in Europe's banking union*

Conclusion

In the Great Financial Crisis, national governments were forced to bail out banks to safeguard financial stability. Since then, the EU has established a bank crisis management framework which was meant to become a viable alternative to public bank rescues. The new rules require the financial sector to prepare for eventual failures and to bear any losses should they materialise. However, shortcomings prevented the bank crisis management framework from being applied in practice. Facing the challenges posed by the COVID-19 pandemic, there is now a strong need for making the framework finally and fully work.

"Facing the challenges posed by the COVID-19 pandemic, there is now a strong need for making the bank crisis management framework finally and fully work."

A new round of bank bailouts is not a valid option. Systematically rescuing failing firms in a market economy creates moral hazard problems. Putting taxpayers' money into unviable banks does not address an overbanked European banking market suffering from low profitability. But first and foremost, governments simply cannot afford to supply the banking sector with capital yet again. Fresh state aid would aggravate the vicious circle between banks and sovereigns that the Banking Union was designed to break.

Five years after entry into force of the European bank crisis management framework, we should not jettison sensible regulation at the first severe test. Instead of taking the supposedly easy way out and bailing out banks again, we should remedy the shortcomings in the existing rules and enhance these so as to withstand a possibly systemic crisis. Now is the right time to prepare the European bank crisis management framework for the worst.

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