BRIEFING

European Parliament

Exchange of views with Mrs Elke König, Chair of the Single Resolution Board

ECON on 20 March 2018

This briefing presents selected issues regarding the work of the Single Resolution Board (SRB) in advance of the exchange of views with Mrs Elke König, Chair of the SRB, in ECON on 20 March 2018. The briefing thematically covers events since the last hearing: the SRB's 2017 MREL Policy, the ECA's special report on the SRB, it updates on the SRB resolution decision in case of Banco Popular, in particular with a view on the published non-confidential versions of the related valuation reports, and provides summaries of external expert briefing papers on the topic of "cash outflows in crisis scenarios".

I. Some events since the last hearing in ECON

Composition of the board of the SRB

On 18 December 2017, the mandate of Mrs Elke König, Chair of the SRB, was extended for additional five years as of 23 December 2017. The European Parliament approved the **renewal of the mandate** on 12 December 2017.

Agreement with the FDIC

On 14 December 2017, the SRB and the Federal Deposit Insurance Corporation, which insures deposits at the US nation's banks and savings associations, signed an agreement that aims to **strengthen the cooperation** between the two organisations. The agreement provides a basis for the exchange of information in resolution planning and to conduct, for example, cooperative analyses of cross-border operations of banks and the challenges resulting thereof for resolution approaches. However, the agreement does **not create any legally binding obligations**, confer any rights, modify or supersede any domestic laws, or restrict those institutions in the exercise of their statutory powers.

No resolution action in relation to ABLV Bank

On 24 February 2018, the SRB published a press release stating that it would **not take resolution action** in relation to ABLV Bank in Latvia and its subsidiary ABLV Bank in Luxembourg, as there was no public interest in doing so (in this context also see previous external briefings on the provision of critical functions by Merler, Lastra et. al., and De Groen).

Background: On 12 February 2018, the Financial Crimes Enforcement Network (FinCEN) at **the US Treasury** **proposed to ban** **ABLV,** a significant Latvian bank directly supervised by the European Central

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Bank (ECB), from having a correspondence account in the United States due to money laundering concerns. After the FinCEN statement, clients started pulling out deposits from ABLV, which eventually resulted in an acute liquidity shortage. On 18 February 2018, the Latvian banking supervisor - the Financial and Capital Market Commission - imposed a temporary restriction on payments in order to allow for a stabilisation of ABLV's financial situation, following the ECB's respective instruction. On 23 February, the ECB determined that ABLV Bank (and its subsidiary in Luxembourg) was failing or likely to fail due to the significant deterioration of its liquidity situation. On 26 February 2018, the shareholders of ABLV decided at an extraordinary meeting to voluntary liquidate the bank.

Multi-Annual Programme and Work Programme 2018

On 4 December 2017, the SRB published its first Multi-Annual Programme, which sets out its **roadmap** for improving the resolvability of the banks under its remit over the next three years, and which also sets out the work programme for 2018. Its key objective is to have resolution plans, including **binding MREL targets**, for all major banking groups ready in place – **by 2020**.

By 2020, the SRB also expects to have reached a steady state from an organisational point of view, availing itself of matured internal policies and fully established support functions. In a short term perspective, the SRB aims to adopt resolution plans for 99% of the groups under its responsibility, only those banks that are subject to structural changes are thought to be not covered by a resolution plan.

II. 2017 MREL Policy

On 20 December 2017, the SRB, together with the national resolution authorities (NRAs), published its 2017 policy statement on the minimum requirement for own funds and eligible liabilities (MREL). The SRB now started to **move from informative targets to bank-specific and binding MREL targets** for the largest and most complex banks under its remit. The SRB MREL policy is based on a gradual approach for reaching final MREL targets in a multi-year timeframe; bank-specific transition periods allow banks to implement the requirement by progressively building up their MREL capacity. Individual transition periods may last up to a maximum of four years; however, for transition periods exceeding two years the SRB will set non-binding interim targets to ensure the feasibility of reaching the target at the end of the transition period.

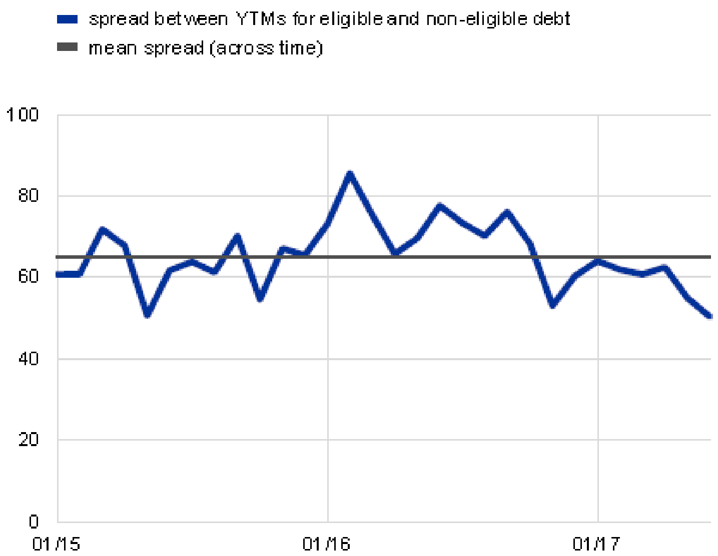
With respect to the quality of MREL and eligibility of liabilities, the SRB overall maintains its 2016 approach but gives further details. The SRB generally **excludes liabilities governed by the laws of a country outside the EU** unless there is evidence that the write-down or bail-in of those liabilities by the SRB would be recognised by the courts of that country. The SRB also set out that Post Brexit issuances under UK law will be treated like other third country issuances, subject to any relevant agreement.

The 2017 policy statement furthermore clarifies that the SRB does not see any legal basis for resolution authorities to exclude ex ante from MREL or from bail-in uniformly eligible liabilities for the sole reason that they are held by natural persons or small and medium-sized enterprises, even though the SRB ackowledges that large holdings of subordinated or senior instruments by **retail customers** could be an impediment to resolution.

The SRB's 2017 policy statement does not disclose for how many banks binding MREL targets have actually been set, let alone to disclose at entitity level what those targets are. In the context of the SRB' 6th Industry Dialogue on 21 November 2017, however, Dominique Laboureix (SRB board member) gave a presentation on the MREL Policy 2017, which indicates the **estimated outcome** of the 2017 MREL policy. According to that presentation, the estimated MREL targets would on average represent 26% of banks' risk-weigthed assets, and the aggregate MREL shortfall would amount to an estimated EUR 117 billion (based on a sample of 76 banks).

In the same context, the ECB recently assessed the **financial markets' capacity** to absorb the issuance of MREL-eligible debt and concluded (see Macroprudential Bulletin, Issue 4, December 2017, p. 14) that "*Overall, the capacity of financial markets to absorb [MREL] shortfalls is sufficient. Nevertheless, the market for bank debt in some countries of the euro area is characterised by home bias and bank cross-holdings. Hence, the ability of the market to absorb MREL shortfalls in those countries may depend on banks' ability to open up their debt placement to international investors*." That ECB publication furthermore states that the average **spread between MREL-eligible and MREL-ineligible bonds** has been hovering at around 66 basis points over the past two years (see chart 1), concluding that the extra cost of issuing MREL bonds does not pose a challenge for banks' core profitability and capital.

Chart 1: ECB's analysis of spread between the adjusted yields to maturity for MREL eligible and ineligible debt (in basis points) over the past two years



Source: Macroprudential Bulletin, Issue 4, December 2017, p. 11

III. ECA special report on the SRB

On 19 December 2017, the European Court of Auditors published its special report on the SRB (No 23/2017: "*Single Resolution Board: Work on a challenging Banking Union task started, but still a long way to go*").

In its special report, the ECA states that the task of setting up the SRB from scratch in a very short timeframe has posed a very **significant challenge**, and that it identified shortcomings in the SRB's preparation of resolution plans. The ECA particularly critices that the resolution plans adopted in 2016 did not meet a substantial number of requirements laid down in the Single Rulebook, conceding that this problem is somewhat mitigated by the availability of additional background information, but also pointing out that **significant deficiencies** remain relative to the legislative requirements.

The Single Rulebook requires the SRB, for example, to identify and address substantive impediments to resolutions, classifying them in at least the following categories: (a) structure and operations; (b) financial resources; (c) information; (d) cross-border issues; (e) legal issues. The ECA special report highlights that despite this legal obligation, the process of **addressing substantive impediments** had not yet begun at the time of the audit.

As regards the distribution of operational tasks between **national authorities and the SRB**, the ECA special report furthermore points out that the **division of responsibilitiesis** is still unclear, that internal resolution teams are understaffed, and that the SRB needs to urgently address the identified shortcomings.

IV. Update on the SRB resolution decision on Banco Popular

Background

On 7 June 2017, the SRB took a resolution decision in case of Banco Popular (BPE), transferring all shares and capital instruments to Banco Santander. The timeline of events is summarised in a previous EGOV briefing.

Publication of non-confidential version of documents related to the resolution of Banco Popular

On 2 February 2018, the SRB in case of BPE **published non-confidential versions** of the Resolution Decision, the Valuation Reports and the 2016 Resolution Plan.

On 28 November 2017, the SRB Appeal Panel[1] confirmed that full disclosure of certain documents related to the resolution of Banco Popular would raise financial stability concerns. Taking into account the time that has elapsed since the resolution action and after careful consideration of potential financial stability concerns, following consultation of the relevant stakeholders, the SRB decided to disclose additional parts of the Resolution Decision, and parts of the Valuation Reports as well as of the 2016 Resolution Plan, which are considered to be of a non-confidential nature.

Certain **parts of those documents remained confidential** to prevent that their disclosure could undermine the protection of public interests as regards the financial, monetary or economic policy, or undermine commercial interests of BPE and/or its purchaser, or affect the still on-going valuation process which is carried out in order to determine whether former shareholders or creditors would have received a better treatment under normal insolvency proceedings.

The Valuation Report 1 of 5 June 2017, drafted by the SRB ("Valuation 1"), sets out in section 2.2 that "*For the sake of completeness, it is noted that the liquidity of the group is the key factor that is triggering the failure of the bank*".

However, no further information on the deterioration of BPE's **liquidity situation** can be derived from reading that particular section, as all numbers have been **blackened out** and have not been replaced with **ranges or meaningful summaries** of the redacted information (contrary to the practice for non-confidential versions of State Aid decisions by the European Commission).

The Valuation Report 2, dated 6 June 2017 and drafted by Deloitte, aims to inform on the choice of the applicable resolution tool, which in case of BPE was to sell the business to Santander. A number of parts of that report have likewise been blackened out.

In the Valuation Report 2's cover letter to the board members of the SRB, Deloitte points to the fact that due to time restrictions it could only provide a provional valuation and includes a caveat which reads: "*In light of the challenging liquidity position of Hippokrates [BPE],* ***we have been required to***

[1] Decisions of the SRB may be challenged before the Appeal Panel of the SRB and before the Court of Justice of the European Union. The Appeal Panel of the SRB consists of five members who shall act independently and in the public interest, and who in case of BPE had to deal with numerous requests of investors to get access to the files.

***draft this Report in an extremely short period of time**. The principal work has been limited to twelve days since the date on which we had access to the relevant documentation, whereas we would normally expect a project of this nature to take at least six weeks [...] **This valuation should therefore be regarded as highly uncertain, and provisional for the popuses of article 36 BRRD**. "*

SRB Chair's speech to the Inquiry Committee on the financial crisis in Spain

While the extent of BPE's liquidity shortage cannot be derived from the non-confidential version of the Valuation Report 1, as set out above, Elke König presented a **clear picture of the liquidity situation** in her speech given in the Congress of Deputies in Madrid on 11 December 2017, addressing the Inquiry Committee on the financial crisis in Spain: "*BPE was failing on the evening of 6 June 2017, as the bank had experienced serious outflows of liquidity in the previous weeks or even months, and had to acknowledge on that evening that it would not be in a position to match its liquidity outflows on the next day. There was simply no liquidity left. On 6 June the ECB concluded that BPE was failing and also BPE itself communicated to the ECB that it considered it was 'Failing or likely to Fail'*."

In that speech, Mrs König also commented on the close cooperation between the SRB and FROB, the Spanish authority dealing with the BPE case, on the role of valuation reports in the context of different resolution procedures and in the context of determining a purchase price, on the selection of independent experts providing valuation reports and related public procurement procedures, and on the SRB's considerations about the appropriate level of public access to documents underpinning the SRB's decision making.

Pointing out that it would be an illusion to think that resolution could elimate the inherent costs of a bank's failure, she also underlined the overarching objective of taking action by mentioning that "*It goes without saying that a resolution action – as any insolvency proceedings – is by nature 'intrusive'. However, resolution provides the tools to tackle negative external effects of the failure of a bank, if the insolvency proceedings cannot sufficiently safeguard the public interest in the specific circumstances*."

V. Summary of external briefing papers

On request of ECON coordinators, EGOV commissioned external briefing papers from academic experts on the topic "**Cash outflows in crisis scenarios: Do liquidity requirements and reporting obligations give the SRB sufficient time to react**?".

Background: Two significant banks directly supervised by the ECB, BPE and ABLV, were recently declared "failing or likely to fail" due to a significant deterioration of their liquidity situation in a comparatively short time. While the SRB decided in case of BPE that the bank had to be and could be resolved overnight, it decided in case of ABLV that there was no public interest justifying to take resolution action.

Those two cases lead to question whether the current liquidity requirements, reporting obligations, and arrangements regarding the exchange of information generally give the SRB sufficient time to react to such a quickly evolving situation of liquidity shortages. The panel experts were therefore invited to examine whether overnight resolution may be regarded as an exceptional case in a liquidity crisis, whether severe liquidity crises will typically require resolution action at very short notice, and which procedural, operational, regulatory, and inter-institutional improvements may be advisable to give the SRB sufficient time to react to a sudden liquidity crisis.

Alexander Lehmann, Bruegel, argues that the European resolution framework for bank resolution is now well established and passed an important milestone with the resolution of a significant Spanish bank in 2017. However, **the framework has been designed for the scenario of a slowly building solvency crisis**. In reality, **most bank failures are precipitated by liquidity crises which evolve much more rapidly**, and may stretch the already complex process.

In his briefing, Lehmann points out that the **new rules on banks' liquidity coverage** which came into effect in 2015 are just a **limited safeguard in a cash crisis**. After the long period of monetary easing all banking systems, and all large banks, amply meet this requirement (though this may change once the long period of accommodative monetary conditions comes to an end). He mentions that in case of Banco Popular, the liquidity coverage ratio clearly did not provide a sufficient safeguard against failure. Only weeks before the ECB determined that Popular was failing, a presentation by their management to the bank's apparently sound liquidity position, with the LCR at 146 per cent compared to the 80 per cent coverage that was required at the time.

Table: Liquidity coverage ratios in selected euro area banking systems

Member State	2017 Q3
Austria	139.7%
Belgium	138.6%
Cyprus	219.6%
Estonia*	172.3%
Finland	138.9%
France	125.6%
Germany	157.0%
Ireland	138.8%
Italy	178.3%
Latvia	339.3%
Lithuania	240.8%
Luxembourg	142.4%
Malta	179.4%
Netherlands	126.2%
Portugal	165.0%
Slovakia	190.6%
Slovenia*	375.5%
Spain	153.5%

Source: Bruegel based on European Banking Authority (Lehmann 2018, p. 8 f.)

The **root causes** of bank failures – lack of profitability and solvency, or sudden reputational or integrity problems – may nevertheless still precipitate a cash crisis, and banks are vulnerable to contagion from sovereign markets.

Liquidity of a distressed bank and the success of any resolution scheme will depend on both the bank's own contingency funding plans and potential official liquidity assistance. Market confidence in liquidity provision before and after resolution will limit distressed asset sales, though clearly moral hazard from overly generous liquidity support need to be minimized. The principles designed by the Financial Stability Board, and public sector funding backstops established in the UK and US, offer valuable models in this area.

Lehmann therefore finds that the **European resolution framework is at present still poorly prepared for a liquidity crisis of a large cross border bank**, let alone a more systemic crisis. Decentralized implementation of emergency liquidity assistance by individual central banks, and intervention in creditor rights through payments moratoria based on national law are incompatible with the emerging integrated euro area banking market.

He concludes by saying that, while some major innovations in post-crisis financial regulation now discipline overly risky funding models of banks, they will not shield banks from cash crises. The liquidity run and subsequent resolution of Spanish bank Popular should be a salutary lesson in this regard.

Lehmann recommends to review key aspects in the ongoing work on completion of the banking union are: i) a strengthening of cooperation and **information exchange between the ECB and SRB**, including by taking macro-prudential risks into account in resolution planning of individual banks; ii) harmonizing the **use of payments moratoria** across the euro area, and extending their use throughout the resolution process and across all asset classes; iii) establishing a credible and transparent liquidity backstop for funding of the resolution process by the ECB, guaranteed by the SRF and national budgets.

Willem Pieter de Groen, CEPS, also finds that – despite the new liquidity requirements (LCR and NSFR) – BPE had insufficient liquidity at the moment that resolution was triggered.

De Groen points out that there is a **need for liquidity in case resolution tools are applied**, not only for the bank that is being resolved but also if the resolution is based on asset separation or bridge institutions. There are currently **two sources** for liquidity at the moment that regular market liquidity dries up, **central banks on the one hand and the resolution fund on the other,** but **both have some clear limitations**. Central bank liquidity in either form (MRO, MLF, or ELA) requires banks to have unencumbered assets that can serve as collateral, and it is in any case only available to banks that are deemed solvent. Failing banks, however, may neither be in a position to provide the collateral required, nor be deemed solvent. Moreover, national central banks are not obliged to provide ELA. Access to monetary policy facilities can therefore be anticipated in the resolution planning context only for those parts or entities that remain fully compliant with the counterparty eligibility criteria.

De Groen thinks that the **Single Resolution Fund** (SRF) has become the **de facto lender of last resort** under the resolution mechanism, but the SRF does not have the means to act as such. After the transition period up to 2023, the SRF will have about EUR 76 billion in total funds (ex-ante and ex-post contributions) available for liquidity, capital and offsetting legal claims in resolution. In his briefing he points out that the amount finally available to the SRF is substantially less than the more than the about EUR 100 billion that some individual large banks required after the burst of the global financial crisis, and just a fraction of the total about EUR 1.100 billion in liquidity support that was injected in the financial system. **The limited funds available might therefore make it impossible for the SRB to act promptly** and use the resolution tools appropriately, which might unnecessarily aggravate the losses in resolution and have negative spill-over effects on the rest of the financial system and wider economy. While additional funds might be raised via an increased target size of the fund, De Groen sees no strict need to do so, given that liquidity support should generally be repaid and the fund hence be replenished. De Groen mentions that the firepower of the SRF for liquidity purpose could be increased substantially with a credit facility provided by the ESM.

De Groen also recommends that the information exchange between national central banks, ECB/SSM and SRB should be improved, and that the **responsibility for providing Emergency Liquidity Assistance** could be shifted from the national central banks to the ECB.

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