Review of the crisis management and deposit insurance framework - Summary of some related issues

Banking Union Working Group

In February 2021, the Commission launched a consultation that sought to gather stakeholders’ experience with the current crisis management and deposit insurance framework as well as their views on the revision of the framework. The results of that consultation were published in a summary report.

As the experience with the application of the current framework indicates that some adjustments may be warranted, this briefing summarises some of the underlying issues.

Resolution cases

The Single Resolution Board (SRB) is the central resolution authority within the Banking Union (19 euro area countries, plus Bulgaria and Croatia) that - together with the national resolution authorities - forms the Single Resolution Mechanism. The SRB is operational as an independent EU Agency since January 2015, tasked to ensure an orderly resolution of failing banks with minimum impact on the real economy, the financial system, and the public finances of the participating Member States. The rules and procedures for the resolution of failing banks are set out in Regulation (EU) No 806/2014.

Normal insolvency proceedings are considered the standard approach when dealing with failing banks. The SRB shall only step in and take resolution action when the failing bank is too systemically important and interconnected to allow for a liquidation through a normal insolvency process.

Since 2015, four banks have been declared failing-or-likely-to-fail (FOLTF), the situation that obliges the SRB to decide whether there is a need to take resolution action (see table 1).

In three cases, the SRB decided that resolution action was not in the public interest because the banks were small (or medium-sized), did not provide critical functions, and posed no threat to financial stability.

In case of Banco Popular, a bank declared failing due to its stressed liquidity situation, the SRB decided to take resolution action, bailing-in shareholders and selling the bank to its larger competitor Santander. While that resolution was swift, it was hardly a test case for the functioning of the resolution framework: when the liquidity problems of Banco Popular emerged, the acquiring bank Santander had already audited its books, having initiated a due diligence process way earlier; the decision to buy Banco Popular could therefore be taken in very short time, a situation that makes the case rather exceptional.
Moreover, while Banco Popular was declared failing on grounds of its liquidity position, the due diligence process also revealed a severe solvency issue, as Santander calculated a provisioning gap of EUR 7.9 billion (mostly related to Real Estate assets, see analyst presentation) and recapitalisation needs exceeding the capital that was bailed-in.

### Table 1: Summary of the resolution cases

<table>
<thead>
<tr>
<th>Decision (year)</th>
<th>Banco Popular, Spain</th>
<th>Banca Popolare di Vicenza (BPVi) and Veneto Banca (VB), Italy</th>
<th>ABLV Bank AS, Latvia, and its subsidiary in Luxembourg</th>
<th>AS PNB Banka, Latvia</th>
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<tbody>
<tr>
<td>SRB website</td>
<td>Link</td>
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<tr>
<td>Size (total assets)</td>
<td>EUR 148 bn</td>
<td>EUR 34.4 bn (BPVi) EUR 28.1 bn (VB)</td>
<td>EUR 3.8 bn</td>
<td>EUR 0.6 bn</td>
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<tr>
<td>Funding structure:</td>
<td></td>
<td></td>
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<tr>
<td>- Retail deposits*</td>
<td>56%</td>
<td>(combined**)</td>
<td>74%</td>
<td>83%</td>
</tr>
<tr>
<td>- Other debt</td>
<td>36%</td>
<td>45%</td>
<td>16%</td>
<td>10%</td>
</tr>
<tr>
<td>- Own funds/equity</td>
<td>8%</td>
<td>49%</td>
<td>10%</td>
<td>7%</td>
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*“Retail deposits” is only a rough approximation of the part of funding exempted from bail-in, not least as deposits exceeding EUR 100,000 can be bailed in in specific circumstances; the financial statements do not disclose which part of the funding would be exempted from bail-in.

**Approximation; the financial statements of Banca Popolare di Vicenza / Veneto Banca are no longer available in the public domain.

### The Public Interest Assessment (PIA)

The identification of public interest is a necessary pre-condition for taking resolution action in respect of a failing bank. Resolution action is only in the public interest if it serves one or more of the following objectives (Art. 31(2) BRRD):

- ensuring the continuity of critical functions,
- avoiding a significant adverse effect on the financial system,
- protecting public funds,
- protecting covered deposits, and/or
- protecting client funds and assets.

Those resolution objectives are of equal significance, and resolution authorities shall balance them as appropriate to the nature and circumstances of each case. The SRB has developed an approach to the PIA for the banks under its direct responsibility.

In the case of the two Veneto banks, the SRB decided that resolution was not in the public interest, considering that:

1) the functions performed by those banks (deposit-taking, lending activities and payment services) were not critical, provided to a limited number of third parties only and hence replaceable in an acceptable manner and within a reasonable timeframe;

2) their failure was not likely to result in significant adverse effects on financial stability taking into account, in particular, the low financial and operational interconnections with other financial institutions; and

3) normal Italian insolvency proceedings would have achieved the resolution objectives to the same extent as resolution, since such proceedings would also ensure a comparable degree of protection for depositors, investors, other customers, clients’ funds and assets.
Those two banks were, however, not put into normal insolvency proceedings but sold to Intesa Sanpaolo as part of a liquidation procedure that required a sizeable amount of **State aid**, i.e. cash injections of about EUR 4.8 billion and guarantees of about EUR 12 billion.

While shareholders and subordinated bondholders contributed to the cost of the wind-down, senior bondholders were spared. The Commission addresses that aspect in its **State aid decision** (recital 106): “Nonetheless, the Commission points out that it was the decision of Italy not to implement a greater degree of participation from senior creditors in order to distribute the resulting costs between creditors of VB and BPVi and the Italian taxpayers. Such a greater degree of **burden sharing** would have reduced the net cost to the State and have been fully in line with – although not required under State aid rules”.

State aid is only permissible under very specific circumstances, for example in order to remedy a serious disturbance in the economy (Art. 107(3)(b)). The Commission’s **State aid decision** cites the reasoning put forward (recital 49) as follows: “Given the common geographic footprint of the two banks and their main focus in some specific regions, negative effects would entail the risk of a serious disturbance to real economy at **local level**, which could also impact on the ongoing moderate recovery, remaining fragile despite latest improvements”.

The fact that the SRB saw in its assessment no significant adverse effect on the financial system when opting for normal insolvency proceedings, while the Commission accepted the need for State aid in view of serious disturbances at local level, raises the question whether there is a need for clarification or alignment of the rules. Merler (2017) for example writes: “...while the definition of critical functions seems clear as regards the SRB’s assessment of the existence of public interest, it is not equally clear what role it plays in the EU discipline on liquidation aid, as the 2013 Banking Communication does not include guidelines on how the local effect of liquidation should be evaluated. In the absence of clarity on **what constitutes a serious impact** on the regional economy, the rules on liquidation aid leave room for governments to effectively re-instate at the local level the public interest that the SRB has denied at national (or, in the Italian case, even at the regional) level.”

**Funding/liquidity in resolution**

To complete the reform agenda, the Financial Stability Board mentioned “liquidity in resolution” early on as an issue that needs to be addressed. It **described** the potential problem in 2015 as follows: **“Insufficient liquidity to maintain critical operations and meet increased margin requirements, the risk of termination or inability to roll over short-term borrowing or the loss of access to alternative sources of credit all have the potential to hinder the execution of the preferred resolution strategy”**.

The Eurogroup, taking stock of the set-up for liquidity provision in resolution, **conceded** in 2018 that “**There is broad support for the assessment of the institutions that there are limitations in the current framework which may hamper its effectiveness**”.

In April 2021, the SRB publishes new **guidance on liquidity and funding in resolution**, in which it states that “**Even after a successful execution of the resolution strategy, liquidity stress may persist for some time due to the asymmetry of information regarding the viability of the resolved bank’s business model**”, and the SRB hence asked banks to develop methodologies to estimate ex-ante the liquidity needs for the implementation of the resolution strategy.

In November 2020, the **ECB** published a related **research paper** that **cautions**: “**Under extreme circumstances some banks could generate liquidity gaps far above the size of the SRF and its backstop**.” More specifically, that research paper sets out that in the case of a systemic crisis, average liquidity gaps remain below EUR 50 billion, but they can reach values close to EUR 200 billion in extreme circumstances (see table below).
Liquidity in resolution: estimating possible liquidity gaps for specific banks in resolution and in a systemic crisis.

Insolvency proceedings / creditor hierarchy

In September 2020, the Chair of the SRB, Elke König, wrote that the creditors of a failing bank can be treated differently, depending on whether the case ends up in resolution action or in an insolvency process:

“When talking about the predictability of the resolution framework, one has to state clearly, that we have a viable system in place, providing clear rules on using resolution tools and allocating losses in case of a bank failure. For example, a harmonised creditor hierarchy provides clarity and transparency to authorities and investors alike as to who has to bear losses and in which order”.

“Unfortunately, Europe lacks key legal elements to enhance the consistency of a bank failure, when the resolution of a bank is not in the public interest. In this case, the failing bank must be wound down in line with [national insolvency procedures]. In practice, the outcome of [national insolvency procedures] can vary considerably depending on factors such as the national insolvency system, and national handling, including discretions, of the respective deposit guarantee scheme”.

The BRRD established a tiered depositor preference system, giving covered deposits preference over uninsured eligible deposits, with a further preference of both categories over other senior unsecured, general creditors (see box 1).

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**Box 1 - Hierarchy of claims under BRRD**

According to Article 108 of BRRD, a priority ranking is established between certain classes of creditors:

(a) Own funds instruments as defined in CRR and subordinated liabilities that do not qualify as own funds instruments with the following ranking (i) CET1, Additional T1, Tier 2, Subordinated debts;

(b) Non preferred senior debt;

(c) Ordinary unsecured debts;

(d) Eligible deposits from natural persons and micro, small, and medium-sized enterprises which exceed the DGS coverage level of EUR 100,000; and

(e) Covered deposits.

Class (b) has been added by Directive (EU) 2017/2399 of 12 December 2017 amending BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy.

By changing the insolvency creditor hierarchy, the introduction of depositor preference may alter the relative cost of senior unsecured debt vis-à-vis bank deposits of individuals, SMEs, and corporates, which may potentially change the funding costs of a bank. A publication by the IMF elaborates further on that aspect ("The Case for Depositor Preference", published in December 2020).
Public consultation

In February 2021, the Commission launched a consultation that sought to gather stakeholders’ experience with the current crisis management and deposit insurance framework as well as their views on the revision of the framework, the results of which (the Commission received 188 official responses) were later on published in a summary report.

According to that consultation, most respondents (59%) found that - as regards retail clients’ protection - the current protection is sufficient:

**Consultation: What are your views on the policies regarding retail clients' protection?**

![Survey results on retail clients' protection](image)

Source: [Summary report](https://www.europarl.europa.eu/supporting-analyses), figure 15

As regards access conditions to funding sources in resolution, however, the question whether the use of DGS should need a minimum bail-in of 8% found approximately the same amount of agreement and non-agreement among the consulted stakeholders:

**Consultation: What are your views on the access conditions to funding sources in resolution?**

![Survey results on access conditions](image)

Source: [Summary report](https://www.europarl.europa.eu/supporting-analyses), figure 13

As regards the question whether additional tools should be introduced in both resolution and insolvency frameworks, the majority of stakeholders apparently did not see any need for that:

**Consultation: What further measures could be taken regarding the availability, effectiveness and fitness of tools in the framework?**

![Survey results on additional tools](image)

Source: [Summary report](https://www.europarl.europa.eu/supporting-analyses), figure 12