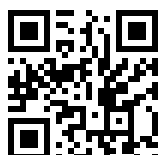


# Resolving Banks: The Retail Challenge

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External author:

Jakob DE HAAN





# Resolving Banks: The Retail Challenge

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## Abstract

The credibility to implement bail-in procedures to retail investors seems limited. ECB statistics suggest that Italy, Germany, France, and Austria have large retail investors' exposure to bank securities. Several policy options to deal with the retail challenge are discussed, including prohibiting banks' debt securities held by retail investors from being used to meet MREL, a ban on the distribution of complex capital instruments to retail investors, and more stringent MREL requirements for banks with a large exposure on retail investors.

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## LIST OF ABBREVIATIONS

<b>AMV</b>	Asset Management Vehicle
<b>BRRD</b>	Bank Recovery and Resolution Directive
<b>CET1</b>	Common Equity Tier 1
<b>DGS</b>	Deposit Guarantee Scheme
<b>EBA</b>	European Banking Authority
<b>EBU</b>	European Banking Union
<b>ECB</b>	European Central Bank
<b>EDIS</b>	European Deposit Insurance Scheme
<b>EU</b>	European Union
<b>ESM</b>	European Stability Mechanism
<b>ESMA</b>	European Securities and Markets Authority
<b>FDIC</b>	Federal Deposit Insurance Company
<b>MIFID</b>	Markets in Financial Instruments Directive
<b>MREL</b>	Minimum Requirements for Own Funds and Eligible Liabilities
<b>NRAs</b>	National Resolution Authorities
<b>PIA</b>	Public Interest Assessment
<b>SHS</b>	Securities Holdings Statistics
<b>SRB</b>	Single Resolution Board
<b>SRF</b>	Single Resolution Fund
<b>SRM</b>	Single Resolution Mechanism
<b>SSM</b>	Single Supervisory Mechanism

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## EXECUTIVE SUMMARY

Bail-in, i.e., conversion into equity or cancellation of (part of) bank debt owed to creditors and depositors, plays a key role in bank resolution. However, as the experience in some Member States illustrates, the credibility to implement bail-in procedures to retail investors seems limited ('the retail challenge'). Securities Holding Statistics suggest that Italy, Germany, France and Austria have large retail investors' exposure to bank securities, with Germany having the largest exposure. Furthermore, recent data suggest that in Italy, the amount of bank debt held by retail investors has rapidly decreased, while in the other countries, the amounts were fairly stable. Several policy options to deal with the retail challenge are discussed, including prohibiting banks' debt securities held by retail investors from being used to meet MREL, a ban on the distribution of complex capital instruments to retail investors, and more stringent MREL requirements for banks with a large exposure on retail investors.



## 1. INTRODUCTION

The financial crisis of 2007–2009 forced EU Member States to grant public support to banks on an unprecedented scale. While clearly necessary at that time to prevent widespread disruption, the financial crisis highlighted that public authorities lacked effective instruments to intervene at an early stage. Moreover, where a bank failed, new instruments were needed to rescue its critical functions, with minimum or no recourse to taxpayer money.

While regulations concerning banking supervision had, for a long time, been determined by European law, supervision of banks had remained solely within the responsibility of their respective home jurisdiction (Parchimowicz, 2022). Likewise, in the area of bank crisis management, national authorities were in charge. Financial crises in several euro area Member States illustrated the weaknesses of national crisis management.

The Bank Recovery and Resolution Directive (BRRD; 2014/59/EU) offered a new crisis management framework for banks in Europe. It provides authorities with more comprehensive and effective arrangements to deal with failing banks at the national level, as well as cooperation arrangements to tackle cross-border banking failures. As a corollary to centralised supervision by the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) was established as a framework for the management of insolvencies of significant banks within the euro area. The Single Resolution Board (SRB) is the central resolution authority within the European Banking Union (EBU) and, together with the National Resolution Authorities (NRAs) of participating Member States, forms the SRM.

Bail-in, i.e., conversion into equity or cancellation of (part of) bank debt owed to creditors and depositors, plays a key role in bank resolution and is supposed to forego bail-out, i.e., the rescue of banks by external parties, typically the government, using taxpayers' money for funding. As Enria (2017) puts it: *"The aim of resolution is to ensure an orderly and less disruptive restructuring of a bank, safeguarding the continuity of critical functions. This process cannot however leave creditors without any skin in the game. This is why the involvement of private investors is important to internalise the losses associated with the failure of an institution. This is a crucial step in the resolution process to ensure the sharing of losses is proportionate to the risks undertaken – as well as to the returns enjoyed – by the different categories of investors, as well as to limit any form of public support, including from the resolution fund."*

However, recently, doubts have been expressed about the credibility to implement bail-in procedures, due to the fact that part of the debt issued by banks is owned by retail investors. As the Chair of the ECB Supervisory Board put it: *"the possibility to allocate losses to these retail investors in a crisis situation could prove highly questionable"* (Enria, 2021). In an earlier speech, Enria (2017) called this the *"retail challenge to banks' resolvability"*. And a challenge it is, as data *"available for the euro area confirms that retail investors still hold an important share of EU debt issued by financial institutions."*<sup>1</sup> Note that cross-holdings among banks potentially enlarge the issue, due to potential contagion effects.

According to Enria (2017), at the end of 2016, the distribution of retail debt, i.e., senior unsecured and subordinated bank debt securities sold to non-professional retail clients (households), was concentrated in five Member States (Italy, Germany, France, the UK, and Austria) and very low in all the other jurisdictions. At the time, Italian banks had the largest nominal amount of euro area retail holdings (€71.9 billion) followed by Germany (€ 35.5 billion) and France (€ 18.6 billion). Furthermore,

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<sup>1</sup> If banks' subordinated debt is held by other banks this may also create risks, as bail-in may propagate risk from one financial institution to another, but this issue will not be discussed further here. See Götz and Tröger (2016) for a discussion.

as Enria pointed out, the amortisation profile of the existing stock is such that the retail challenge is bound to last for a while.

In a joint statement, the European Securities Markets Authority (ESMA) and the European Banking Authority (EBA) posed that the BRRD does not provide for a different treatment of eligible liabilities based on the nature of the holder. In case of resolution, the authorities have to apply the bail-in tool according to the waterfall of liabilities (see Chapter 2 for details; ESMA/EBA, 2018).

This position paper aims 1) to take stock of the retail challenge by identifying, as far as possible, the extent to which households hold bailinable securities, 2) to assess whether such holdings have an impact on the credibility of the resolution framework in place, and 3) to reflect on policy options that might address this “retail challenge”.

The rest of the position paper is structured as follows. It first outlines the resolution framework (Chapter 2) and then explains the background of the retail challenge in some detail after providing information on bank securities holdings by households (Chapter 3). The final chapter discusses policy options to deal with the retail challenge.

## 2. RESOLUTION OF BANKS

### 2.1. Single Resolution Mechanism

Apart from centralised supervision, carried out by the Single Supervisory Mechanism, the Single Resolution Mechanism is the second pillar of the European Banking Union. The SRM and the SRB were established through the Single Resolution Mechanism Regulation (EU 806/2014 which has been revised in 2019 by EU/2019/877). The SRM was established as a framework for the management of (possible) insolvencies (or generally speaking, the (potential) failing) of large (“significant”) credit institutions) within the euro area (Binder, 2022). So, the SRM does not cover the whole EU.

The SRM introduces centralised decision-making and a centralised resolution fund, rather than the decentralised approach as was previously in place.<sup>2</sup> The SRM Regulation (EU/806/2014) applies to all banks established in the EU Member States participating in the BU. The main institutional components of the SRM are the Single Resolution Board (SRB) and a Single Resolution Fund (SRF), to which all banks in the EBU contribute. The SRB has the status of an EU agency and is based in Brussels.

The SRM is responsible for the resolution planning and resolution of banks directly supervised by the SSM, as well as cross-border groups, i.e., groups that have entities established in one or more than one participating Member State (SRB, 2020). The national resolution authorities bear primary responsibility for all other banks (although all their decisions must be sent to the SRB for review as part of the SRB’s responsibility for the oversight of the SRM and the SRB may intervene), except where a resolution scheme foresees the use of the SRF. In such a case, the SRM becomes the relevant resolution authority, regardless of the size of the institution.

The SRB has also been responsible for the development of institution-specific minimum requirements on own funds and eligible liabilities (MREL), i.e., requirements designed so as to ensure that banks build up specific buffers of capital and debt instruments (to be held, ideally, by professional investors), which could be used, in the event of their failure, to absorb losses without affecting normal creditors. The SRB has also decision-making powers with regard to (a) the drafting of so-called resolution plans (i.e., preparatory plans for the treatment of failing banks by the SRB as resolution authority in an actual failure), (b) the assessment of resolvability with corresponding powers to require credit institutions and financial groups to adopt changes with regard to, *inter alia*, funding arrangements, business activities or even corporate structures, and (c) the initiation and calibration (i.e., the selection of resolution tools and definition of their specific use) in relation to actual resolution (Binder, 2022).

The SRB operates in two sessions: In its *executive session*, the SRB takes the key preparatory and operational decisions for resolving individual banks, including use of the SRF, and the decisions addressed to national authorities, as they are responsible for implementing the SRB’s decisions. Executive sessions involve the SRB chairman, vice chair, four permanent members, and the relevant national authorities in the countries where the troubled bank is established. Representatives from the ECB and the European Commission participate in the process as permanent observers. In its *plenary session*, the SRB takes all general and budgetary decisions. Individual resolution cases are also heard in plenary session if an SRF contribution of more than €5 billion is required. These sessions involve all of the above representatives, in addition to all national resolution authorities participating in the EBU.

The SRF is financed by contributions from all banks established in the Member States participating in the EBU. Once the reformed ESM Treaty will be in place (at the time of writing, it has been not been

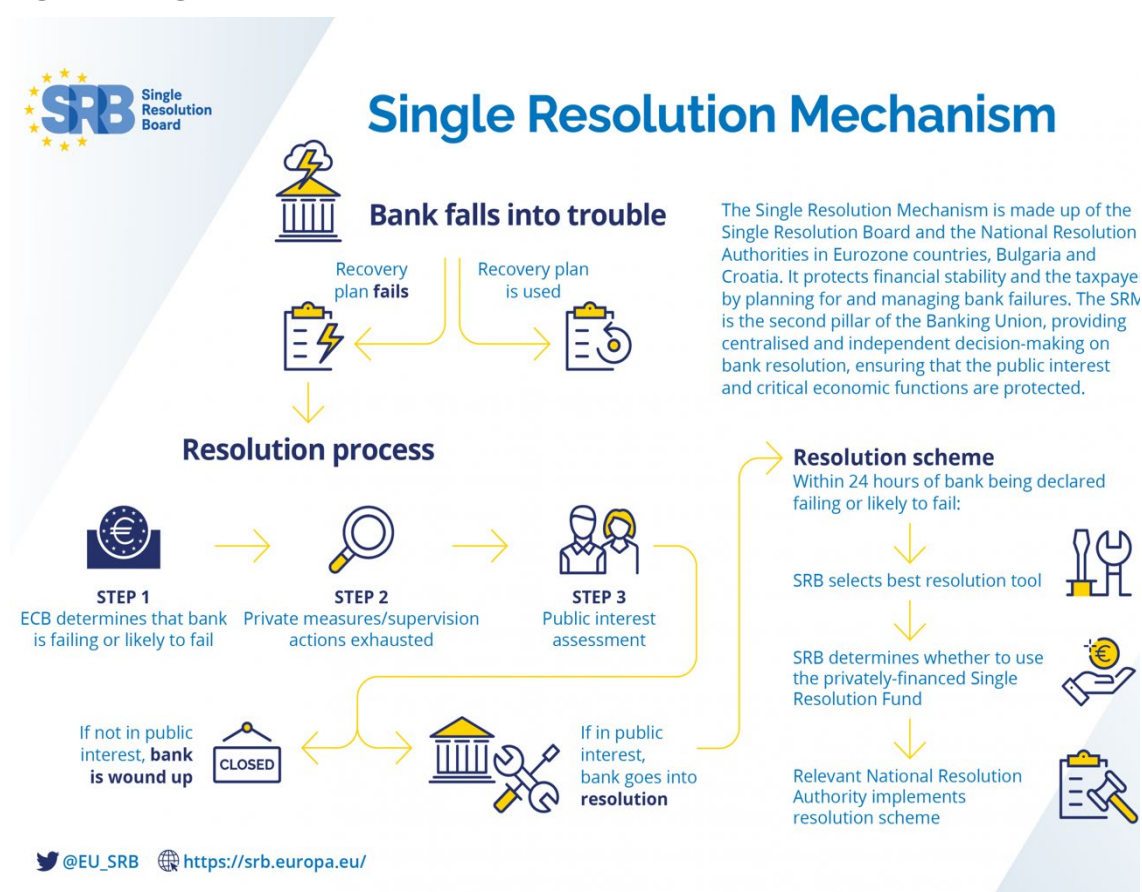
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<sup>2</sup> The section heavily draws on de Haan et al. (2020) and Binder (2022).

ratified by Germany and Italy), the financial resources of the SRF will be reinforced through the creation of an emergency lending facility from the European Stability Mechanism (ESM). The SRF is not designed to replace private investors in absorbing losses and providing new capital to a bank, but to provide temporary financial support through guarantees or loans to ensure the viability of a bank's critical functions while it is being restructured (although in certain circumstances it can be used to recapitalize banks; see art. 76(1)(f) SRMR).

How is this structure supposed to operate in practice? Upon notification from the ECB that a bank is failing or likely to fail, the SRB first determines whether three conditions for resolution are met: (i) a bank is failing or likely to fail, (ii) there are no alternative private solutions and supervisory actions, and (iii) a resolution action is necessary in the public interest. Once these have been confirmed, the SRB will adopt a resolution scheme, including relevant resolution tools and the possible use of the SRF (see Figure 1).

Figure 1: Single Resolution Mechanism



Since the SRB is an EU agency and, therefore, is constrained in its discretionary powers, the Commission and, to a lesser extent, the Council have a role in endorsing or objecting to any resolution scheme it proposes. If one of them objects, the Board would have to amend the resolution scheme. The overall decision-making process may not last longer than 32 hours, to ensure that a bank can be resolved over the weekend.

National resolution authorities help the SRB prepare its actions, and are tasked with implementing the resolution decisions in accordance with the national transposition of the BRRD. Member States' resolution authorities are thus integrated into the overall structure with respect to the preparatory and implementation stages related to banks in their jurisdiction. The SRB closely monitors the implementation of resolution decisions, and can directly address executive orders to troubled banks if national authorities do not comply with one or more aspects of the resolution decision.

## 2.2. Resolution tools

The first tool that can be used in the case of a bank failure is the sale of business, whereby (parts of) the bank is (are) sold to one or more purchasers without the consent of the shareholders. The residual entity shall be wound up under normal insolvency procedures. The resolution authority can act as an honest broker. This role is important, especially given the time constraints under which most problems have to be solved and the information asymmetries involved. The sale of business tool may be applied in combination with other tools.

Under the bridge institution tool, a bank is set up that preserves the critical functions of the failing bank and separates it from the rest. All or part of the failing bank's assets, rights, and liabilities are transferred to the bridge institution. A bridge institution operates the bank until a sale to a private buyer can be concluded or the bank is liquidated.

The asset separation tool allows transferring assets, rights, or liabilities from a failing bank or a bridge bank to an asset management vehicle (AMV). These are managed by the AMV with the aim to maximise their value for an eventual sale or an orderly wind-down. The AMV is wholly or partially owned by one or more public authorities which may include the resolution authority. This tool is always applied together with another resolution tool.

Finally, the bail-in tool allows to write down debt owed by a bank to creditors or to convert it into equity. The bail-in tool can be used to recapitalise the bank under resolution so that it can continue performing its activities. Alternatively, it can be used to convert debt to equity or reduce the debt under the bridge bank, the sale of business or asset separation tools. Under bail-in, the resolution authority will first write down all shareholders and then follow a pre-determined order when bailing in other liabilities. Equity holdings must absorb losses in full before any debt claim is subject to write-down. After shares and other similar instruments, if necessary, losses will - in accordance with the applicable bank creditor hierarchy<sup>3</sup> - be imposed evenly among all holders of subordinated debt (extending to senior and preferred debt if needed), including retail and wholesale holders of debt instruments, with the exception of two cases in which exclusions from losses may occur: (i) some liabilities are automatically excluded from the scope of the bail-in on a mandatory basis (for example liabilities that are secured, collateralised or otherwise guaranteed, and certain types of unsecured liabilities, including deposits covered by deposit guarantee schemes (i.e. EUR 100 000) and liabilities to institutions with an original maturity of less than seven days); (ii) resolution authorities may make use of their discretionary power to exclude some liabilities from the scope of the bail-in on an ad hoc basis. Retail debt holders receive the same level of protection as any other debt holder that is not subject to a mandatory exclusion. They are therefore within the bail-in scope, contributing to the loss-absorbing capacity of the institution (ESMA/EBA, 2018).

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<sup>3</sup> Despite the harmonisation achieved by the BRRD, national differences still exist as discussed in more detail by Buckingham et al. (2019).

### 3. THE RETAIL CHALLENGE

#### 3.1 Background<sup>4</sup>

The challenge came to prominence in the run-up of the European sovereign debt crisis. Several Italian banks had sold own funds instruments (Additional Tier 1 and Tier 2 debt securities) and other debt securities to their clients. This was a cheap source of financing compared to obtaining funds from wholesale markets, which were effectively closed for Italian banks at the time. Some banks involved (allegedly) were marketing and selling these instruments as savings products (Conac, 2018) rather than subordinated, high-risk investment products. As pointed out by ESMA/EBA (2018), under MiFID, institutions must provide clients who buy instruments subject to the BRRD with complete and updated information on the potential treatment of such investments in resolution or insolvency. The exposure of retail investors to possible bank bail-ins was aggravated by the low trading volume of bank (subordinated) debt in secondary markets and the long duration of banks' subordinated debt which inhibited households' possibilities to divest their holdings of long-term subordinated debt (Götz and Tröger, 2016).

In 2015, four small Italian banks failed (Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio della Provincia di Chieti, with a combined market share of about 1%). The Italian authorities proposed resolution of each bank and the creation and capitalisation of four temporary bridge banks. They did so in November, so before the new EU rules under the BRRD would be in place. The banks' assets and liabilities, except for remaining equity and subordinated debt, would be transferred to these bridge banks. Italy's resolution fund would provide €3.6 billion to the bridge banks. Impaired assets would be transferred from the bridge bank to a newly created Asset Management Vehicle, guaranteed by the resolution fund. The European Commission approved these plans<sup>5</sup> under its rules on State aid to banks (EU's Banking Communication 2013),<sup>6</sup> considering that existing shareholders and subordinated debt holders contributed to the costs. However, customers who had bought these banks' own-fund instruments lost all their savings, creating a political backlash.<sup>7</sup> According to Banca d'Italia, there were 10,500 subordinated bondholders at the four banks, for a total €789 million, where half of this amount was placed with bank retail customers.<sup>8</sup> At the time, according to the Italian central bank, the total amount of subordinated bonds issued by Italian banks amounted to €67 billion. Net of securities repurchased by issuing banks, these bonds in circulation equalled €59 billion, of which €31 billion held by retail investors.

In June 2017 (i.e., before the new MiFID rules became applicable), the Italian banks Veneto Banca and Banca Popolare di Vicenza were liquidated under national insolvency rules. This allowed the Italian government to provide state aid without having to impose losses on retail investors. The European Commission authorized this state aid. To be more precise: the Commission approved the measures as liquidation aid under Italian national insolvency procedures (EP Briefing on the orderly liquidation of

<sup>4</sup> I am grateful to Brendon Pinch for his support in writing this part. For an overview of bank resolution in other EU countries, see World Bank (2016).

<sup>5</sup> [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_15\\_6139](https://ec.europa.eu/commission/presscorner/detail/en/IP_15_6139)

<sup>6</sup> 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'), 2013/C216/02.

<sup>7</sup> FT, Renzi faces political backlash over Italian banks' rescue, 10 December 2015.

<sup>8</sup> <https://www.bancaditalia.it/media/approfondimenti/2016/d-e-r-quattro-banche/index.html?com.dotmarketing.htmlpage.language=1#faq8761-3>.



Veneto Banca and Banca Popolare di Vicenza, PE 602.094). All this was possible in the first place because the SRB had decided that resolution was “not warranted in the public interest” because the failure of these banks was not expected to have “significant adverse impact on financial stability”. Indeed, the banks’ total balance sheets were €55 billion, about 2 percent of the Italian banking system suggesting that the banks’ failure would have a limited systemic effect. However, Italian policymakers considered that the failure of two important regional lenders would imply regional risks. According to news reports, resolution under the EU rules would imply that other Italian banks would need to provide some €12 billion to Italy’s deposit guarantee fund which may have had an impact on their credit worthiness.<sup>9</sup> According to the same reports, Italian policymakers also wanted to shield retail investors. A significant amount of the Veneto banks’ debt had been sold to retail investors, as part of an alleged mis-selling scandal.

The banks were wound down with the transfer of the performing business to Intesa San Paolo, subject to cash injections of €4.8 billion and guarantees to about €12 billion by the Italian government, while the non-performing portfolio was transferred to SGA, the vehicle previously used for the liquidation of another bank.

In yet another controversial case, involving the Italian bank *Monte dei Paschi di Siena*, resolution was avoided altogether by way of a precautionary recapitalisation in July 2017 (Binder, 2022).

In February 2018, the SRB decided not to take resolution action against *ABLV Bank A.S.*, of Latvia, and its subsidiary *ABLV Bank Luxembourg S.A.*, again on the grounds that the public interest was not met, given the institutions’ limited role in the markets.<sup>10</sup> Likewise, the ‘public interest’ assessment ended the 2019 case of *AS PNB Banka*, in August 2019. So far, in only two cases, involving *Banco Popular Español SA* and *Sberbank dd. and Sberbank banka d.d.*, the SRB actually initiated a regular resolution procedure as prescribed by the SRM Regulation (Binder, 2022).

In the renegotiation of the BRRD in 2019, the ‘retail challenge’ was considered. However, it was not treated as a resolution problem but framed as an investor-protection (i.e., mis-selling) issue. The adjusted BRRD (art. 44a, EU 2019/879) imposes a suitability test on the sale of subordinated debt securities to retail investors.<sup>11</sup> However, this is not required for senior-ranking debt securities, which can also be MREL eligible. In the case of the Veneto banks discussed above, retail investors held senior securities. So not only from a resolution perspective, but also from the perspective of investor protection, the adjusted BRRD does not adequately address the problem at hand. Compliance with art. 44a BRRD (and the ESMA guidelines) is monitored and enforced not by resolution authorities but by market authorities. In addition, the BRRD determines that if the retail client’s portfolio does not exceed €500,000, the seller must ensure that the retail client does not invest an aggregate amount of more than 10% of that client’s portfolio in such instruments and the initial investment is at least €10,000.

The SRB accepts liabilities held by retail investors as MREL. Still, the SRB (2020: 21) expects banks to “decrease the potentially excessive reliance on issuances of senior and subordinated eligible instruments towards retail investors, and be able to provide all necessary information to enable the SRB to identify potential impediments to resolvability related thereto.”

<sup>9</sup> FT, Why Italy’s €17 bn bank rescue deal is making waves across Europe, 26 June 2017.

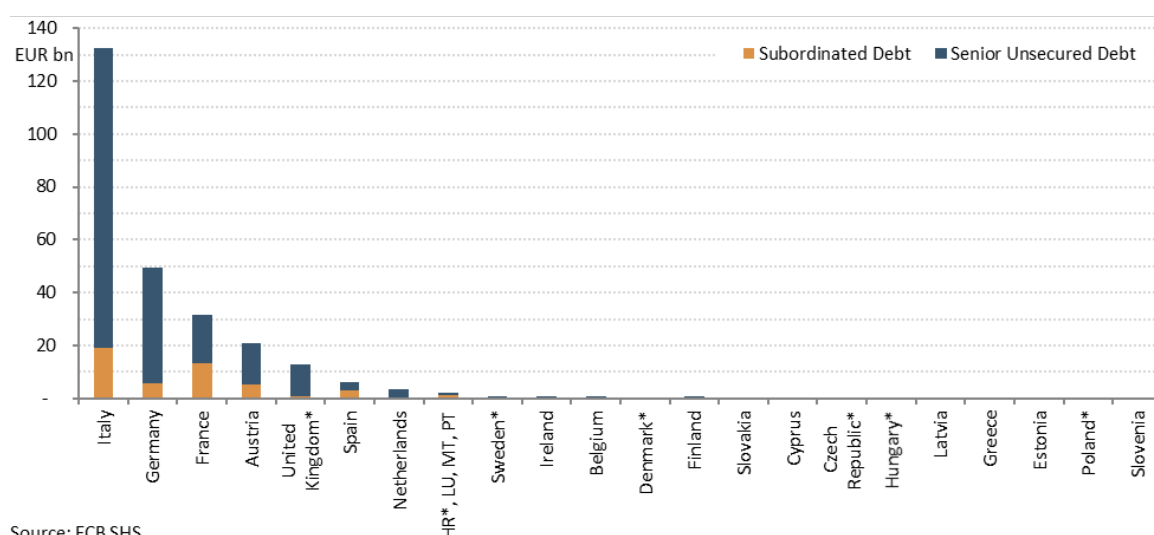
<sup>10</sup> In the end, the Latvian parent shareholders decided to liquidate the bank. The Luxembourg subsidiary was subject to a suspension of payments regime until the start of the judicial liquidation process almost two years later (Enria, 2021).

<sup>11</sup> ESMA (2016) had already issued guidelines about the sale of complex debt instruments, which seem to require more stringent investor-protection measures for debt securities at risk of bail-in.

### 3.2 Data analysis

It is not straightforward to assess the magnitude of the retail challenge. In a joint 2018 publication of the EBA and ESMA, it is reported that as of Q3 2017, retail investors of the euro area held € 262.4 billion or 12.7% of the EU bank debt securities issued to euro area investors. Senior unsecured debt constituted 81% (or €212.4 billion) of retail held debt securities, with the balance (19% or €50.0 billion) represented by subordinated debt. As Figure 2 shows, notably households in Italy, Germany, France and Austria held substantial amounts of bank debt securities in 2017. Measured as a proportion of banks' total debt, Italian banks had the largest proportion of euro area retail holders (36.9%). Retail investors also constituted a significant part of banks' debt issuance in Austria (35.8%). For German banks, the ratio of retail held debt to total bank debt was lower (12.1%).

Figure 2: EU banks' debt securities held by retail investors, Q3 2017



Source: ECB SHS.

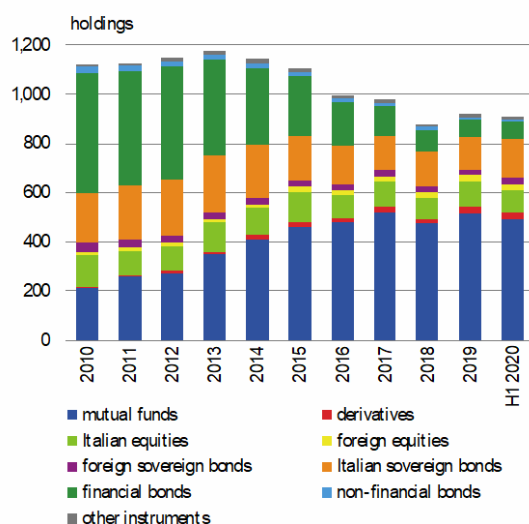
Source: EBA/ESMA (2018)

Some national sources also provide information on households' holdings of bank debt. Figure 4 shows the amounts of financial assets held by retail investors in safekeeping and administration by Italian financial intermediaries for investment services for the period 2010-2020 according to a CONSOB (2020) report. The figure suggests a decline in the share of financial bonds (mainly issued by banks) held by retail investors since 2010. This trend was mirrored by an increasing weight of mutual funds shares in the retail investors' portfolio.



Figure 3: Financial assets of clients in safekeeping and administration by Italian financial intermediaries for investment services, 2010-2020

(billions of euro; amounts at the end of the period)



Source: CONSOB (2020)

To provide an up to date assessment, the ECB Security Holdings Statistics (SHS) has been used.<sup>12</sup> Unfortunately, only aggregated SHS data for a relatively short period of time are publicly available. Furthermore, as pointed out by EBA/ESMA (2018), there are other limitations to these data. The data on holdings by households are collected mainly from euro area custodians and exclude therefore holdings by euro area residents in custody outside the euro area and rely on the identification of households by custodians among their clients. Available data are expected to cover a large proportion of the euro area households' holdings of bank debt securities, but the data cannot be regarded as complete. The publicly accessible SHS data also do not distinguish between subordinated and senior unsecured debt.

Table 1 shows households' holdings of debt issued by financial corporations in EU Member States. The table suggests that the countries as identified by EBA/ESMA (2018) as having a large retail investors exposure to bank securities (Italy, Germany, France and Austria) are still the Member States with a high exposure, but Germany now has the largest exposure. Furthermore, the recent data suggest that in Italy the amount of bank debt held by retail investors has rapidly decreased, consistent with the decline reported by CONSOB (2020), while in the other countries the amounts were fairly stable. The decline in Italy may suggest that retail investors have become more aware of the risks involved.

To put these numbers in perspective, Figure 4 shows debt of financial institutions owned by households (as reported in Table 1) as share of households' total holdings of domestic debt for the first quarter of 2022. Italy now ranks at the bottom, while France tops the list. Other countries where bank debt is a major component of households' total holding of debt include Austria, Estonia, Germany, Luxembourg and the Netherlands.

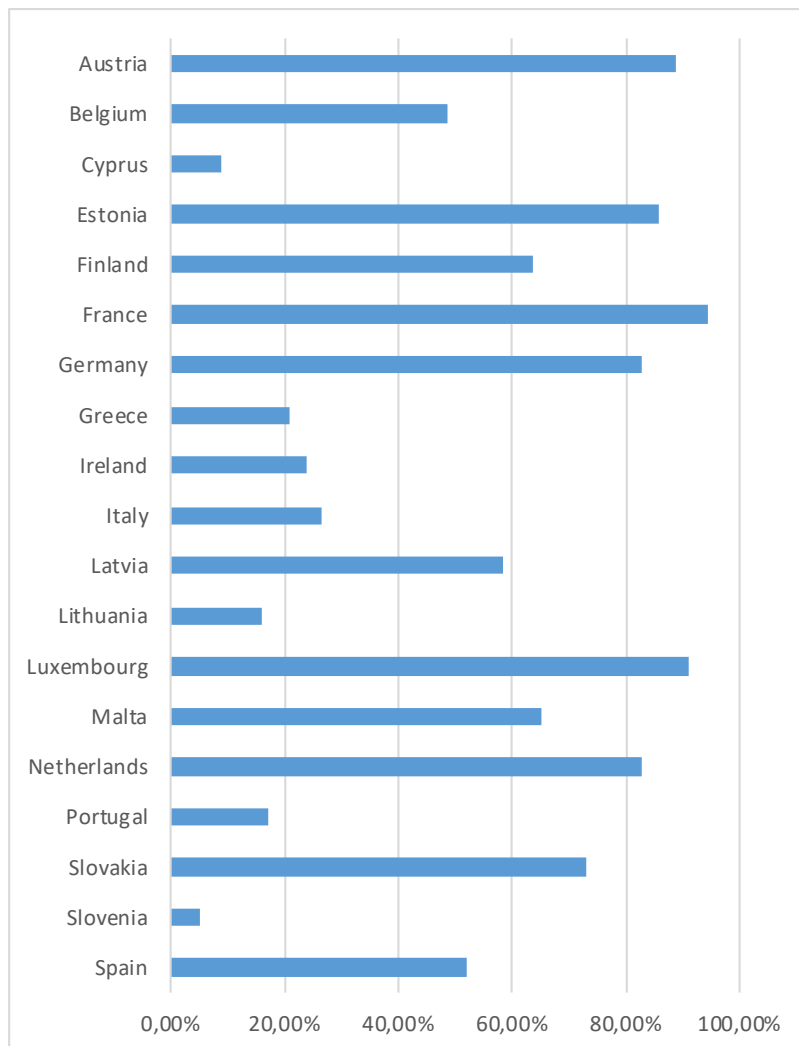
<sup>12</sup> I am grateful to Yingshu Deng for her support in collecting the data.

Table 1: Total household holdings of debt issued by financial corporations (in € million)

COUNTRIES	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1
Austria	15,808.74	15,328.97	15,010.58	14,884.24	13,673.18
Belgium	2,811.99	2,420.77	2,271.46	2,223.7	2,076.83
Cyprus	7.3	6.26	6.33	8.94	3.25
Estonia	58.87	61.3	60.39	65.01	67.29
Finland	894.84	836.37	727.91	685.82	606.94
France	17,743.48	17,127.06	16,012.63	15,565.51	15,708.94
Germany	76,557.39	75,773.02	74,936.33	75,118.09	75,340.94
Greece	258.6	275.56	459.1	548.97	618.28
Ireland	45.51	41.16	42.3	41.4	35.28
Italy	60,838.14	57,653.68	51,392.11	48,029.79	44,497.71
Latvia	31.5	31.7	32.08	36.12	36.52
Lithuania	16.14	15.74	14.1	19.01	21.25
Luxembourg	681.05	671.29	665.51	643.85	620.81
Malta	250.42	248.32	252.57	263.66	280.64
Netherlands	5,327.27	5,247.69	5,349.46	5,343.46	4,559.75
Portugal	860	810.5	754.82	746.87	711.73
Slovakia	1896.29	1887.85	1868.32	1889.35	1778.92
Slovenia	5.36	5.57	5.53	5.54	5.58
Spain	3,079.49	2,994.19	2,897.09	2,862.21	2,234.8

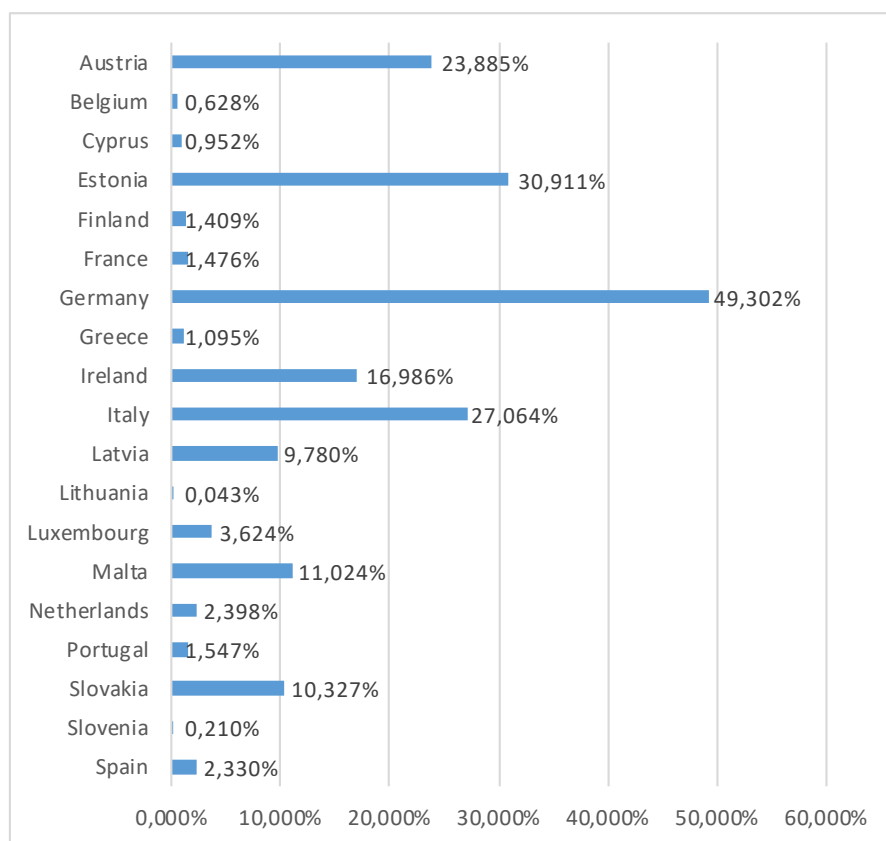
Source: ECB, SHS

Figure 4: Total household holdings of debt issued by domestic financial corporations as share of total household holdings of domestic debt, 2022Q1



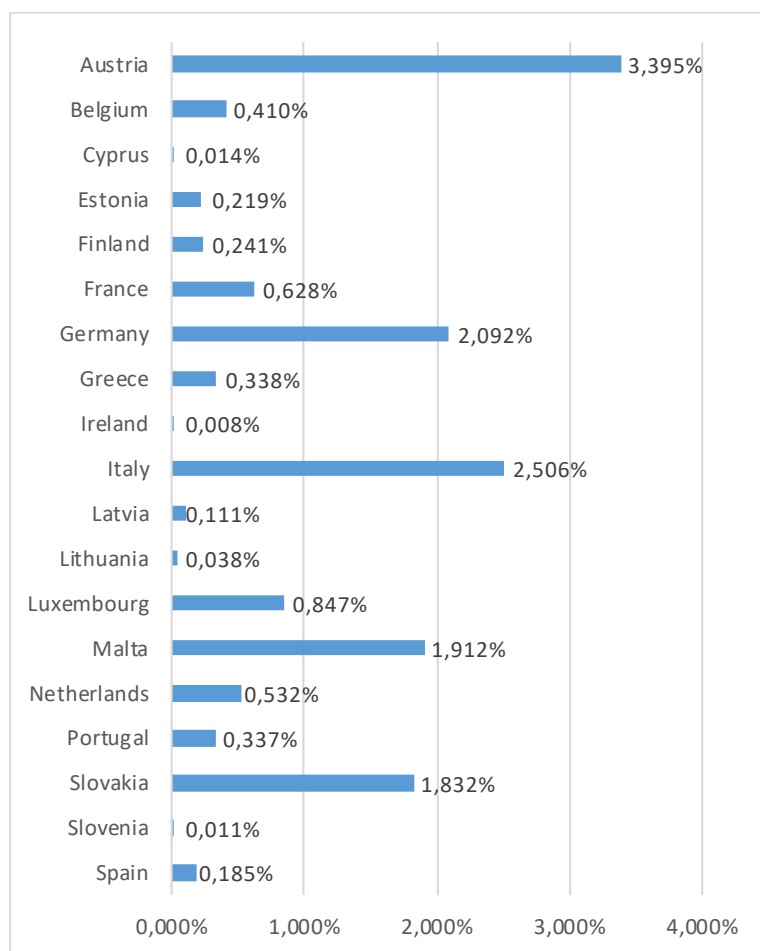
Alternatively, we can scale households' holdings of bank debt by debt issued by domestic banks (see Figure 5). This gives similar results as Figure 4, although Estonia now also ranks high.

Figure 5: Total household holdings of debt issued by domestic financial corporations as share of total debt of domestic banks, 2022Q1



Finally, Figure 6 shows retail holdings of banks as share of GDP. This gives a similar picture as Figure 5.

Figure 6: Total household holdings of debt issued by domestic financial corporations as share of GDP in 2021



## 4. POLICY OPTIONS

Bail-in is a crucial part of the EU resolution framework. Treating different holders of *pari passu* bank debt differently undermines the resolution framework and would be at odds with the principle that creditors of the same class are treated in an equitable manner (art. 34(1)(f)BRRD). Nevertheless, there are examples of inconsistent recovery and resolution of failing banks in Europe. The reason is that the SRB is responsible only for the recovery and resolution of the largest European banks, while national authorities are responsible for the recovery and resolution of smaller banks. As a consequence, small and large banks may not be treated in the same way. The application of the European framework for recovery and resolution should be the same for large and small banks, especially because experience shows that small banks tend to be the ones failing (Dyrberg Rommer and Kleiner, 2021). It is essential that recovery and resolution under the European framework is not just for the few big.

The Danish experience shows that there is no need to make an exception for small banks. As pointed out by Dyrberg Rommer and Kleiner (2021), the Danish authorities have applied bail-in to four failing banks: Amagerbanken (2011), Fjordbank Mors (2011), J.A.K. Slagelse (2015) and Københavns Andelskasse (2018). The credibility of bail-in was not an issue. After the failure of Amagerbanken, the credit rating agency Moody's downgraded several Danish banks as the new framework for recovery and resolution caused Moody's to reassess the probability that the Danish government would bail out a failing bank without creditor losses. Likewise, after the introduction of the Danish framework for recovery and resolution in 2015, the credit rating agency S&P assessed that the probability of government support to banks in Denmark was 'uncertain', and as a result, S&P decided to stop including this support in the rating of Danish banks (Dyrberg Rommer and Kleiner, 2021).

Still, as the experiences in Italy have shown, it may be politically very difficult to let retail investors lose their savings in case a small bank gets into financial difficulties. If the SRM is responsible for the resolution of a significant bank in the EBU, it is more likely that the bail-in framework will be properly applied than when the resolution is done by national authorities, which are more exposed to domestic political pressure. Whether or not the SRM gets involved is determined by its Board's Public Interest Assessment (PIA), i.e., the test of whether a failing institution can be liquidated under national insolvency law without systemic repercussions. As shown in Chapter 3, in several instances it was decided that public interest was not sufficient and that therefore the SRM would not get involved. A possible option could therefore be to make this test less restrictive. However, Binder (2022) argues that *"A restrictive interpretation of the PIA is ... perfectly justifiable in the light of the underlying policy rationale. Along with other conditions for resolution, the PIA has been designed so as to ensure proportionality of resolution actions. As the new resolution toolbox, in comparison with more traditional instruments for the management of insolvencies of financial institutions, comes with a rather wide range of powers for the resolution authority on the one hand and very limited creditor participation on the other hand, its application should be restricted to cases where the public interest in the preservation of financial stability outweighs the rights of individual stakeholders, which is precisely what the PIA is intended to ensure."*

According to EBA/ESMA (2018, p. 17), *"Resolution authorities may devote attention to the potential impact of bailing in retail debt liabilities, when relevant and material, in their resolution planning. These liabilities may, under specific and exceptional circumstances, be exempted from bail-in."* In my view, exempting retail debt liabilities from bail-in is not the proper answer. The publication also states: *"An example of one element that may be of particular importance when assessing a potential exemption for retail holdings is 'the number of natural persons directly and indirectly affected by the bail-in, visibility and press coverage of the resolution action, insofar as that has a significant risk of undermining overall confidence in the*

*banking or broader financial system.*<sup>13</sup>” Mentioning this as an option, albeit under specific and exceptional circumstances, is certainly not the best way to avoid exempting retail debt liabilities in case of a bail-in.

In my view there are several more promising policy options. A first option could be to prohibit banks’ debt securities held by retail investors from being used to meet MREL. This option requires that precise information on the ownership of these debt instruments is available. This option would hurt banks that use retail investors as important source of funding as they may not meet their MREL requirements on time and have to resort to other (more expensive) instruments. A more gradual phasing in of these requirements may make for a smooth transition.

A second option is that policymakers decide to ban the distribution of bank debt securities to retail investors all together. Götz and Tröger (2016: 5-6) argue that households *“are not sophisticated investors ... and, as such, are unlikely to charge an adequate risk premium for bail-in able debt, limiting the market disciplining effect of this regulatory tool. Furthermore, households may invest a large amount of their personal wealth in a bank’s bail-in able debt. A bail-in then leads to a substantial loss of their personal wealth with detriments to psychological health and financial difficulties due to an erosion of savings. Politicians may feel compelled to compensate households in case of a loss due to a bail-in.”* Implementing this option requires precise criteria to whom bailinable debt securities can be sold. As under the first option, banks might be given flexibility to replace debt securities owned by retail-investors by other instruments. Enria (2017) argues against this option: *“as retail investors are entitled to purchase bank equity, they should also be allowed to invest in subordinated or senior non-preferred debt, as long as they are adequately informed of the potential risks attached to such financial instruments and the institution recommending the instruments has assessed the suitability of the investment for the clients.”* I disagree. In my view, retail investors know the difference between equity and debt, but despite the new MIFID rules may not fully realise the risks they face if they invest their savings in bank debt instruments. As the Italian experience has shown, a substantial part of these investors was (probably) not aware of these risks, allegedly also because they were not properly informed by the banks selling these instruments. But even if they were fully informed and aware of the risks involved in investing in these instruments (and Italian households may have learned from the experiences as discussed in the paper), as long as a substantial number of small savers will lose their money under bail-in, political pressure for a different solution cannot be avoided. So, in my view, a ban on selling this type of financial instruments to retail investors should be seriously considered as it will enhance the probability for proper implementation of the resolution regime in place.

As long as such a ban is not in place, MREL requirements for banks with exposure on retail investors could be made more stringent. Alternatively, the resolution authorities could impose a minimum percentage of instruments that are subordinated to senior debt liabilities. Even though this would not eliminate the retail challenge, subordination will materially mitigate such risk (Enria, 2017).

Finally, and on a slightly different note, Enria (2021) comes up with a more fundamental approach, namely a framework similar to the US Federal Deposit Insurance Corporation (FDIC). According to Enria, this requires (i) a European Deposit Insurance Scheme (EDIS) as national guarantee schemes tend to focus on national solutions; (ii) further harmonisation of the procedures and tools for dealing with failing banks that do not meet the PIA; and (iii) enhancement of the tools and financing means available to the relevant authorities so that they can deal with the failure of medium-sized banks. It seems to me that an agreement on EDIS as envisaged by Enria is unlikely in the near future; if anything, a scheme

<sup>13</sup> Article 8(2)(b) of Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 the Delegated Regulation.

based on reinsurance seems most likely and whether that would suffice for a European equivalent of the FDIC is uncertain.

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The credibility to implement bail-in procedures to retail investors seems limited. ECB statistics suggest that Italy, Germany, France, and Austria have large retail investors' exposure to bank securities. Several policy options to deal with the retail challenge are discussed, including prohibiting banks' debt securities held by retail investors from being used to meet MREL, a ban on the distribution of complex capital instruments to retail investors, and more stringent MREL requirements for banks with a large exposure on retail investors.

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