

Financial Stability Institute

A photograph of a modern building with a curved facade, featuring large windows and a metallic, copper-colored cladding. The building is set against a clear blue sky.

## Reforming the European crisis management framework Intervention at the "Banking Union Workshop". European Parliament

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*Views expressed are those of the presenter and do not necessarily reflect those of the BIS.*

# Outline

1. The main features of the current regime
2. What are the (really) relevant challenges?
3. What needs to be done to address them?
4. Outline of a basic reform
5. Towards an integrated crisis management framework
6. A transitional regime
7. Concluding remarks

# 1. Main features of the current regime

1. Distinction between resolution (common) and insolvency (national, for banks that do not meet the Public Interest test -PIT)
2. Stringent resolution requirements: i) Stringent constraints on any public support; ii) stringent minimum bail-in for access to external funds (SRF); and iii) stringent loss-absorption requirements (MREL)
3. Heterogeneous (and generally inefficient) insolvency regimes (Table 1)
  - i. Form: general/bank-specific; judicial/administrative
  - ii. Substance: powers of actors, tools available, creditor and employee rights...
  - iii. Test for entering insolvency
  - iv. Possibility of external support (*liquidation aid*)
4. Tight constraints for the use of DIS funds beyond pay-out.

# Insolvency regimes and proceedings – range of practices

Court-based vs administrative proceedings and type of regime

Table 1

Jurisdiction	Type of regime	Administrative vs court-based proceedings
Europe		
France	Corporate insolvency law	Court-based
Germany	Corporate insolvency law	Court-based
Greece	Free-standing bank insolvency regime	Administrative
Ireland	Modified corporate insolvency law	Court-based
Italy	Free-standing bank insolvency regime	Administrative
Luxembourg	Free-standing bank insolvency regime	Court-based
Slovenia	Free-standing bank insolvency regime	Administrative
Spain	Corporate insolvency law	Court-based
United Kingdom	Modified corporate insolvency law	Court-based
Switzerland	Free-standing bank insolvency regime	Administrative
Rest of the World		
Brazil	Free-standing bank insolvency regime	Administrative
Canada	Free-standing bank insolvency regime	Court-based
Mexico	Free-standing bank insolvency regime	Administrative
Philippines	Free-standing bank insolvency regime	Administrative
United States	Free-standing bank insolvency regime	Administrative

Source: Baudino et al, *FSI Insights* no 10 (2018).

## 2. What are the (really) relevant challenges?

**Problem 1:** Tensions between the common resolution framework and domestic insolvency regimes:

- Different triggers leading to a “limbo” problem (failing banks eligible for neither resolution nor insolvency)
- Application of *no-creditor-worse-off* (NCWO) principle (in particular wherever liquidation aid is feasible)

**Problem 2:** Inefficiency (slow, cumbersome, low value preserving power) of existing liquidation procedures in domestic regimes.

## 2. What are the (really) relevant challenges? (contd)

**Problem 3:** *The middle-class problem*: some (significant) banks are too small and too traditional to meet resolvability requirements and too large to be liquidated (without bail-out). In particular:

- For resolution: Strict MREL conditions, that are justified by:
  - Strict minimum bail-in obligations to have access to SRF
  - Strict conditions (financial cap) for DIS contribution to resolution, eg use of the *sale-of-business* tool
- For liquidation:
  - Inefficient insolvency procedures (see above) can be very destabilising

### 3. What would be required to solve/mitigate those three problems?

...without modifying core elements of BRRD (eg restrictions for public support, minimum bail-in conditions for access to SRF)

**For problem 1 (compatibility resolution-insolvency):** Sufficient harmonisation of domestic regimes

**For problem 2 (inefficient insolvency):** Upgrade insolvency regimes (use FDIC as a reference)

- Administrative authorities granted resolution-like powers (P&A, bridge,...)
- Ability to deploy resources (from DIS) to support P&A.
- A sensible (not overly restrictive) financial cap for DIS support.

### 3. What would be required to solve/mitigate those three problems?

**For problem 3 (the *middle-class*) :** By far, the most challenging task. Essentially two options:

- Option R (within resolution). Seek ways to support market exit (sale-of-business tool) for mid-sized banks that pass PIT without overly restrictive conditions:
  - Make conditions for access to external funds (DIS) to support sale-of-business tool less restrictive. In particular, consider a sensible financial cap for DIS contribution
  - On that basis, adjust downwards MREL obligations for mid-sized banks.
- Option I (within insolvency). For banks that do not meet PIT:
  - Improve domestic insolvency regime (as for problem 2).
  - Introduce sufficient flexibility in DIS financial cap to ensure financing, at a minimum, of deposit transfers from failing mid-sized banks.



## 4. A basic reform

### a) Features:

**Feature 1: Harmonise (some key aspects of) banks' insolvency** regimes to make them compatible with BRRD: At least:

- Triggers
- Creditor hierarchy
- Conditions for the availability of public support (if any)

**Feature 2: Revise conditions (financial cap) for the use of DIS funds for resolution and insolvency:** Two (not mutually exclusive options):

- Make the formulation of financial cap sufficiently flexible
- Remove super-preference of DIS-protected deposits

## 4. A basic reform (contd)

### b) What would be achieved?

- Address Problem 1 (“limbo” problem and NCWO).
- Help address Problem 2: develop “alternative DIS functions” to improve domestic regimes
- Mitigate Problem 3: DIS to more effectively support sale of business under R or P&A under I

### c) The remaining challenges

(Mostly related to the middle-class issue)

- Even with more flexible conditions for the use of DIS funds, P&A may not work well for mid-sized banks under option I. In particular, lack of funding to ensure successful P&A.
- Under option R, the availability of bail-in-able liabilities may help, but the more flexible use of domestic funds to support a resolution action which is decided and conducted by the SRB for a bank supervised by the ECB, may be challenging.
- Reliance of domestic DIS to support the winding-up of significant banks looks incompatible with the very objectives of banking union.

## 5. Towards an integrated crisis management framework

### a) Features:

In addition to features 1 and 2 above:

#### **Feature 3: Create an EDIS to be administered by the SRB.**

- EDIS funds will be used to both protect deposits and support the winding-up of institutions

#### **Feature 4: Give SRB powers over the entire banking system in the euro zone**

- The SRB to manage the resolution or winding-up of **all** institutions.
- Powers to use different tools (bail-in, bridge banks, sale-of-business (P&A)) for different bank failures depending on a PIT test and least-cost option considerations
- Could delegate specific functions to NRAs on a case by case basis
- National insolvency regimes would only apply to strict liquidation (eg non-transferred assets and liabilities in a sale-of-business transaction)

## 5. Towards an integrated crisis management framework (contd)

### b) What would be achieved?

- Full consistency of resolution and liquidation procedures.
- Full alignment between decision making and funding.
- Enhanced capacity to manage the failure of mid-sized banks. That would be normally conducted by a combination of bail-in (if PIT is met), sale of business (P&A) and liquidation of non-transferred assets and liabilities.

### c) The challenges

- If sale-of-business proves unfeasible, despite EDIS support, preservation of critical functions of mid-sized banks may remain challenging (due to limited MREL).
- Effective functioning of a SRB with substantially broader functions and responsibilities.
- Creation of a (sufficiently mutualised) EDIS with sufficient fire-power to effectively support crisis management.

## 6. A transitional regime

### a) Features

- Implement features 1 (harmonised insolvency) and 2 (revised DIS functionalities).
- Postpone features 3 and 4 until (a sufficiently mutualised) EDIS is implemented
- Meanwhile establish co-decision arrangements between the SRB and NRA (or whoever administers national DIS) to manage the use of domestic DIS to support the implementation of sale-of-business tool for the resolution of mid-sized banks meeting the public interest test.

### b) What would be achieved

- As in the basic reform, but with more capacity to manage the failure of mid-sized banks within resolution

### c) The remaining challenges

- As in the basic reform option
- Difficult compatibility of co-decision with no or very limited mutualisation

## 7. Concluding remarks

- Strong case to reform the current crisis management framework within the banking union. Such reform would comprise four main tasks (that could be implemented sequentially):
  1. **Harmonise (some key aspects of) banks' insolvency regimes**
  2. **Revise conditions (financial cap) for the use of DIS funds for resolution and insolvency**
  3. **Create an EDIS to be administered by the SRB**
  4. **Give SRB powers over the entire banking system in the euro zone**
- No low-hanging fruits for an effective, consistent and comprehensive crisis management framework that safely minimises the need for bail-outs
- Stable solutions require more transfer of responsibilities (more Europe)
- ... and sufficient resources available (from EDIS) to fund alternative crisis management tools
- ... which should logically be mutualised at some point