EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

Complexity and Credibility in the Single Resolution Mechanism

Statement No. 39

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In this statement the European Shadow Financial Regulatory Committee (ESFRC) points to weaknesses in Europe's new Single European Resolution Mechanism from the point of view of the complexity and credibility of the mechanism.

We recommend that:

(i) *the Banking Union including the Single Resolution Mechanism should be extended to the EU as a whole as soon as possible,*

(ii) *the power of the Commission and the Council to object to resolution decisions by the Single Resolution Board should be constrained to enhance the credibility of the SRM,*

(iii) *the exemptions with respect to resolvability, in particular during a systemic crisis, should be clarified,*

(iv) *resolution procedures cannot be a substitute for high capital ratios but allow for simplification of the regulatory structure over time if the SRM gains credibility.*

Complexity in European integration

Banking Union is a major step forward in the design of European integration. The first pillar, single supervision, became a reality on November 4, 2014 with the ECB firmly at the helm of the Single Supervisory Mechanism (SSM). The second pillar, the Single Resolution Mechanism (SRM), is a valuable effort to solve the problems of "too big and interconnected to fail" and cross-border crisis management in the Euro area. However, we regard it as "work in progress", considering the *constitutional* complexity (given the different jurisdictional domains of the EU and the Euro area/banking union) and the *institutional* complexity (with the involvement of the Single Resolution Board, the national resolution authorities, the ECB, the funding arrangements, and the Commission and Council).

On at least two occasions in the past EU supervision has been streamlined as a result of a crisis. First, following the 2007-2008 financial crisis, the Lamfalussy complex structure of committees (for banking, securities, insurance and conglomerates) was replaced by the more simple system for European Financial Supervision, following the recommendations of the De Larosière Report. Second, in the aftermath of the sovereign debt crisis in some Member States in the Euro area, the system was centralized with the establishment of the SSM.

In the resolution area the design of a credible and effective resolution mechanism is only commencing. We should not need another crisis to address the deficiencies of the Single Resolution Mechanism that takes effect on January 1, 2016. To deal with the issues of complexity and credibility, it can be streamlined by permitting the establishment of an independent resolution agency with discretionary powers under EU law, going beyond the current doctrine. From a credibility perspective we are particularly concerned about the fact that the Commission and Council have the power to object to any decision taken by the Single Resolution Board, based on rather vague grounds.[1]

The alternative route to streamlining the institutional structure for rehabilitation and resolution would be to create a kind of European FDIC through an Intergovernmental Treaty among Euro area/banking union members, either through the revamping of the current ESM Treaty (changing rules on membership, operational and governance rules and others) or thorough a separate Treaty. Such a Treaty change is likely to involve time consuming negotiations.

Additional concerns with credibility and predictability in the SRM

The ultimate success of the SRM requires that its procedures establish credibility with respect to implementation of the bail-in mechanism, predictability of bail-in (priority) rules for creditors, public acceptance of these rules, and prevention of contagion from a bank's failure. Fear of contagion and lack of public acceptance undermine credibility. Lack of

[1] See Article 18.7 of the Single Resolution Mechanism Regulation (Regulation 806/2014): "The Council or the Commission, as the case may be, shall provide reasons for the exercise of their powers of objection".

predictability in the allocation of losses creates distrust in contractual agreements with banks. Widespread resistance among regulators and politicians to allow large banks to fail may remain even when a resolution mechanism has been implemented as a result of fears of political repercussions of bank failures when the rules for bail-ins make it transparent that specific groups in society must bear the losses.

In addition to the concern with lack of independence of the Single Resolution Board (SRB) from the Commission and the Council there are weaknesses in the SRM Regulation, which reduce the credibility of its intention to make creditor groups bear losses when a bank becomes insolvent.

Is there a supervisory grey zone in the transition from early intervention (a task of the ECB) to resolution under the SRB?

Regarding the handing over of responsibility from the supervisory agency (ECB) to the Resolution Board Mario Draghi, president of the ECB, has stated that "*We, as a supervisory body, decide only whether a bank is viable or not. Then the resolution authority has to decide what to do with the bank: close it, split it up or sell it*" (interview with *Der Spiegel*, December 30, 2013).

The SRB takes responsibility when an entity is deemed to be "failing or likely to fail." One of the criteria is that "*extraordinary public financial support is required*", but there are exceptions when extraordinary financial support by Member States seeking to preserve financial stability provides a State guarantee to back liquidity facilities or newly issued liabilities, or inject own funds "without conferring an advantage on a bank" (Article 18.4.d).[2]

These reasons for exempting a failing bank from the SRM seem to leave ample scope for the SRB to avoid resolution while a member state supports the bank in different ways.

What happens if resolution is blocked? Formally, standard insolvency law should apply

[2] Regulation (EU) No 806/2014, July 15, 2014.

but there are many ways authorities can delay the allocation of losses by, for example, practicing forbearance with respect to valuation of assets or by recapitalizing a bank as a precaution. In the preamble, paragraph 57, the SRM Regulation explicitly states that extraordinary public financial support should not trigger resolution in a situation when a bank complies with capital requirements but, nevertheless, requires recapitalization that it is unable to obtain privately in markets. Precautionary recapitalization in this way could be prevented by restrictions on state aid and thereby subject to approval by the Commission but we cannot see that the Commission could force resolution by denying recapitalization under the stated conditions.

The Systemic Crisis exemption

During times of a systemic crisis there are fears that resolution of a large bank or several smaller banks will exacerbate the crisis. The SRM regulation explicitly states in Article 10.3 that a bank is resolvable if "*any significant adverse consequences for financial systems, including circumstances of broader financial instability or system wide events, of the Member State in which the entity is situated*" can be avoided to the maximum extent possible when resolution powers are exercised.

There are good reasons for a systemic crisis exemption but we are concerned that this exemption can be used to avoid resolution of a large bank even if there is no clear systemic threat. In order to avoid having to resolve a bank the Board should prepare a report after consulting the competent authorities about impediments to its resolvability. Thereafter, the Board should analyze and work on removal of these impediments. However, the time to remove impediments is not likely to exist when a bank is close to failure.

To avoid that failing banks will be considered not resolvable even when there is no obvious systemic threat, minimum requirements for considering a crisis systemic should be clarified. Although there is no consensus about a definition of systemic risk it should be possible to conservatively specify a minimum requirement with respect to, for example, the share of the banking system being in violation of capital requirements or of trigger points for prompt corrective action.

<u>Predictability of loss allocation</u>

There are clauses in the SRM regulation that opens the door for subjective interpretation and, thereby, reduces the predictability of the values of claims on banks. Article 27.5 states the following:

"In exceptional circumstances, where the bail-in tool is applied, certain liabilities may be excluded or partially excluded from application of the write-down or conversion powers where:

(b) the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions;

(c) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium-sized enterprises, which would severely disrupt the functioning of financial markets………"

It is inevitable that the resolution authority is given some leeway to exercise subjective judgment of what can be considered "exceptional circumstances", "strictly necessary" and "severely disrupt." The need to take special circumstances into account must be balanced against the benefits of predictability for creditors about conditions for write-downs of the value of their assets.

The recently published report from the Financial Stability Board on "Key Attributes of Effective Resolution Regimes for Financial Institutions" recommends greater specificity with respect to write-downs of creditors' claims and which assets should be exempted from write-downs. The incorporation of these key attributes may enhance the predictability of the resolution procedures under the SRM.

Resolution procedures cannot be a substitute for high capital ratios

The efficiency enhancing properties of a resolution mechanism hinges on its credibility. We believe that, for several reasons, there may be issues with respect to the credibility of the bail-in mechanism. If so, unexpected losses may be not be absorbed by unsecured debt holders. Therefore, there is still a need for relatively high capital buffers. Following previous recommendations by the ESFRC we advocate a minimum tier 1 capital requirement (*leverage ratio*) of at least 10%. This non-risk weighted capital requirement may consist of at least 5% common equity while the remaining 5% may take the form of additional tier 1 capital instruments such as CoCo bonds which automatically convert into equity when the financial position of the bank deteriorates. The 10% leverage ratio is to be implemented gradually during a transitional phase of 5 to 7 years.

At the present time the leverage ratio should be considered as a complement to the risk-weighted capital requirement. Either of the two can be binding. However, if the SRM gains credibility over time, it should be possible to concentrate entirely on a leverage ratio. Empirical evidence indicates that the simple leverage ratio has been a much better measure of probability of default than risk-weighted capital ratios.