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Challenges and prospects of the new banking resolution regime

**Report on the Executive Seminar on Banking
Resolution, organized by the Florence School of
Banking & Finance
14-15 July 2016**

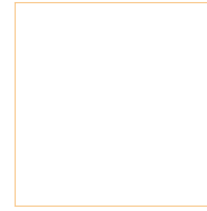
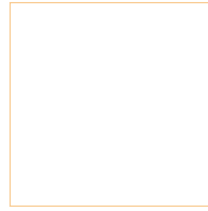
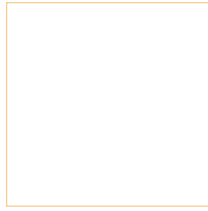
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Highlights

The consequences of the new banking resolution regime on the evolution of the European financial system were discussed at a Chatham House 'Executive Seminar on Banking Resolution' organized by the Florence School of Banking and Finance and held in Florence on 14-15 July 2016. The executive seminar brought together academics, EU policy-makers, investors, and industry practitioners to discuss the impact of the new resolution regime on banks, regulators and investors. Participants also exchanged views on liquidity support and exit strategies in the upcoming resolution phase.

The main conclusions stemming from the interaction among panelists are the following:

1. Most of the systemic institutions still need to improve their internal governance in order to be in line with what is considered international best practice;
2. Despite some criticisms and unresolved issues, bail-in represents a clear and radical improvement from the government bail-outs that followed the Eurozone crisis;
3. Information disclosure to large investors is a major upcoming challenge posed by resolution;
4. A deeper assessment of the liquidity available for resolution needs to be carried out.



Background

Following the disorderly government bail-outs of troubled banks during the Eurozone crisis, the EU adopted the Bank Recovery & Resolution Directive (BRRD) in 2014 to resolve systemically important banks that were failing or likely to fail.

The adoption of the BRRD sets new standards in the way bank failure will be dealt with in the immediate future, putting an end to the disorderly bail-outs era and making shareholders fully responsible for their investment decisions. The disruptive effects of bail-outs on the financial system, on the one side, and their spill-over effects to the real economy, on the other, have, in fact, highlighted the urgency to respond to the inefficiencies and costs that bail-outs impose on excessive risk-taking, on the sudden stops to credit intermediation, as well as on the public finances of EU-countries.

Equipped with tools for precautionary and early intervention, the BRRD has thus been designed to attain two main goals: first, to restructure failing or likely to fail banks to “ensure the continuity of their critical functions” in the economy while they are being restructured; second, and contemporaneously, to limit through market discipline the moral-hazard effects on banks’ risk-taking decisions.

Enforced as of 1st January 2016 by the Single Resolution Board (SRB) and National Resolution Authorities, the BRRD has been designed with the two-handed scope of increasing both financial markets’ ex-ante and ex-post efficiency. On the one hand, regulators claimed that bail-in will change banks’ risk-taking decisions, which will no longer be affected by the implicit and unsustainable government guarantee that taxpayers’ money will be used to bail-out troubled-banks. On the other hand, regulators also acknowledged that resolution prevents orderly liquidation and interruption of critical functions in systemically important banks, limiting disruptive effects to the financial system and possible spillovers to the real economy.

Implications of Resolution for Internal Governance of Financial Institutions

The first panel highlighted the implications and challenges that new resolution regimes entail for internal governance of financial institutions and, more specifically, for the way financial institutions manage their business models and target their risk appetite. The main points raised by participants concerned the necessity of greater information and transparency, and the need for the inclusion of other stakeholders than investors in banks’ decision making processes as a precondition for resolution.

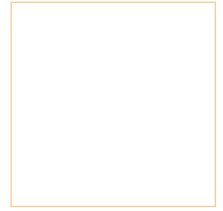
The panel opened with a remark on the first in-depth assessment carried out by the Single Supervisory Mechanism (SSM)¹ on two main issues:

- a) the compliance of banks’ internal governance with both the national and the European legislation;
- b) its consistency with the best international practices.

Participants discussed the results of this SSM assessment and converged on agreeing that future developments of the BRRD will be needed to carry out improvements in three main areas: the removal of information asymmetries that still characterize the information flow in decision-taking organs; the optimal design of government bodies’ characteristics, which should reflect independence, dedication, and professional qualification of its members; the harmonization and integration of the EU regulations with national laws.

Participants moved then to discuss some legal aspects of resolution, addressing the urgency of greater clarity in the context of financial support between banks and subsidiaries within cross-borders banking groups. Panelists suggested that, although the BRRD (art. 19 and seq.) foresees the possibility, and not the obligation, of banks’ financial support to a failing subsidiary – an approach known as “Rozenblum Doctrine” – the rules on consolidated supervision and capital requirements suggest a possible future shift towards an outright duty to support failing subsidiaries. Panelists stressed that this shift could potentially lead to backfiring effects on the stability of the whole financial system, as an outright duty to support a failing

1. SSM supervisory statement on governance and risk appetite, ECB, June 2016. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm_supervisory_statement_on_governance_and_risk_appetite_201606_en.pdf



subsidiary could trigger even greater bankruptcy risks that would be scaled up to the parent bank. Furthermore, the panel discussed whether the BRRD has changed the balance of powers between banks, their shareholders and creditors. Participants claimed that bail-in has put creditors into a much more likely possibility of losing part of their money, shifting negotiations between banks and their creditors in the shadow of a less friendly law.

Panelists finally highlighted that the future challenge of the BRRD will be to raise the convergence of interests between shareholders and other banks' stakeholders in order to ease resolution. They argued that this could be carried out in three steps:

- a) by reducing the failures of knowledge or comprehensions within the internal governance of banks;
- b) by dealing with the failures of banks' willingness to comply with the resolution authority;
- c) by coping with the failures of banks' capacity to comply with the resolution authority.

As for the failure of knowledge within the internal governance, participants stressed the urge to align banks' business areas with their legal entities, by implementing a clear booking model, as well as clear intragroup relationships. Furthermore, they highlighted the need to remove the presence of asymmetric information between shareholders and credit holders when it comes to defining banks' risk appetite and, more generally, to include credit holders in the decision making process of banks. Indeed, in order to be effective, the inclusion of creditors' interests needs to be timely and efficient. As for the concerns over the failures on the willingness to comply, instead, participants stressed the need for an independent board composition and an incentive-consistent capital structure within groups, both geared towards a government structure characterized by debt investors playing the new role of market discipline providers. Finally, participants agreed that failures of banks' capacity to comply with resolution authorities cries for the need of defining adequate internal loss-absorbing capacity (TLAC), greater skills for the board of directors, and a more detailed scenario testing.

Implications of the New Resolution Regimes for Regulators

The second panel shifted its focus from the internal governance issues to the challenges that the BRRD left to regulators. The two main points considered were the bail-in/bail-out dichotomy and the issue of credibility within the current resolution framework.

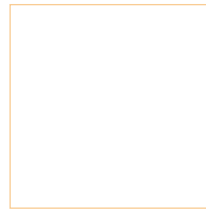
The panel started with a discussion on the reasons that brought the BRRD to include bail-in rules in banking resolution, as a response to the massive bail-outs witnessed in the recent Eurozone crisis. The need for a change came from the widespread consideration that "bail-outs have been an economic success, but a political failure"², which urged the authorities to respond by means of a new set of regulations. The challenges that the new bail-in scheme, embedded within the BRRD, had to address were to:

- a) deal with the perverse effects of using tax-payers' money to subsidize banks' excessive risk-taking;
- b) endeavor to break the unsustainable sovereign/bank "doom-loop";
- c) avoid the social costs of liquidating systemic banks.

The failure and liquidation of troubled-banks would result, in fact, in spillovers to the real economy, amplifying the initial effects of a financial crisis. Although many participants agreed on the necessity of a change from bail-out practices, different voices raised when participants discussed issues that the current bail-in regulation poses to regulators.

A first set of issues concerned the contagion effects that bail-in might lead to. Participants suggested that, although bail-in increases credit holders' monitoring efforts, bail-inable debt could be dangerously accumulated by pension funds, insurance companies or other undercapitalized banks which, if resolution is triggered, could encounter solvency problems, leading to a contagion effect throughout the whole financial system. In other words, unless clear rules are set on whom can hold bail-inable debt and to which extent, the current resolution framework might destabilize financial markets.

2. Although many participants agreed that the bail-outs carried out during the Eurozone crisis have been widely recognized as a political failure, fewer agreed on the extent to which bail-outs were an economic success.



A second set of issues focused on the credibility of the bail-in scheme. The matter of credibility arises from a relevant discretion over the decision to put a bank into resolution and it increases financial markets' uncertainty. On the one hand, participants claimed that excessive political discretion might lead to time-inconsistent behaviours of governments in the absence of a credible liquidity backstop. On the other hand, though, a mandatory bail-in according to an established waterfall and rigid rules would neither be desirable nor credible as the framework would have to account for systemic exceptions.

A third set of issues concerned asset valuation and the related time frame that the assessment of non-performing-loans (NPL) would have to take. Participants suggested that traded financial market instruments, such as bail-inable debt, ask for a rapid response to information flow and to higher uncertainty, while valuation of NPL would take a much longer time frame (months probably) which would, in turn, decrease the value of equity. Moreover, a longer time horizon needed for valuation and greater uncertainty would result in higher funding costs for banks.

Participants also added that bail-outs in the future will still be possible and desirable, although bail-in would have to be implemented first. The system moved from a bail-out-only regime to a bail-in-only one, although participants believe that a future convergence to a mix of the two, given the difficulties to fully implement the latter one, will be possible and desirable.

Finally, participants claimed that regulators and authorities should consider an additional possible way of reducing resolution costs, that is implementing higher capital requirements. Providing banks with a larger buffer of equity to weather against losses constitutes a third and less explored solution.

Implication of the new resolution regime for investors

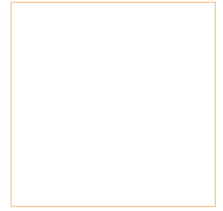
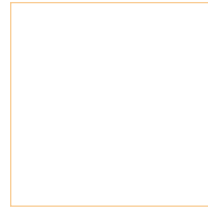
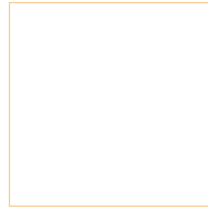
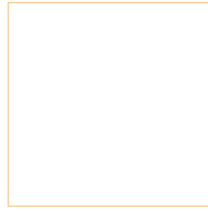
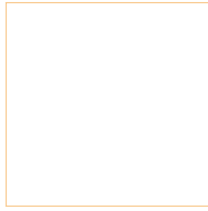
The third panel discussed the effects that the new resolution regime had on investors and was mainly focused on the key role played by information disclosure. As losses can by no means be legislated away, but at most shared within a resolution framework, participants highlighted

the importance of reducing asymmetries and increasing disclosure of information affecting those rules that dictate how losses should be shared among banks' stakeholders. The panel thus stressed how investors are aiming for clearer and greater information as a compelling condition for their investment decisions in the next future. The discussion covered different types of additional information required, which can be declined in three main areas:

- a) greater information over the resolution hierarchy;
- b) greater predictability of resolution;
- c) greater harmonization of rules.

As for point a), participants claimed that investors are in desperate need for clearer information regarding the level on which they position themselves within the debt hierarchy, should the bank fall under resolution. This would allow them to price risks more clearly, lowering the premium they require on lending and simplifying transactions when debt securities are traded. Moreover, as mentioned already in the previous panels, participants also stated how crucial it is for investors to have a greater predictability of when and under what conditions bail-in can be triggered by the authorities. Although participants agreed that leaving some discretionality to the resolution authorities can be indeed desirable, they also believe that one of the BRRD's future challenges will be to reduce investors' uncertainty by lowering the current level of resolution unpredictability. On this same topic they also stressed that by no means discretion should be guided by political interest, but, rather, by the only purpose of providing greater financial stability. Finally, as of point c), participants supported the undoubted relevance of the harmonization of rules across EU countries, especially for cross-border operating banks.

The trade-off between authorities' discretion and investors' predictability was also addressed when discussing the risk of potential financial instability given by the BRRD. Participants admitted the presence of possible unforeseeable consequences coming out of direct application of the BRRD, such as financial contagion. On this point, clearer rules regarding limits on TLAC held by other financial institutions should be clearly specified so as to guarantee the effective functioning of firebreaks in case of contagion.



An additional reason for more precise information was identified in the distinction between MREL and TLAC. While some of the participants suggested that a reconciliation among the two would benefit financial markets by reducing uncertainty and possibility of regulatory arbitrage, others did not fully support this view and acknowledged important differences between the two.

One final comment that was raised suggested the need for a greater disclosure of information regarding how BRRD should operate when the economy is not in steady state. Some participants stressed that some recent BRRD failures might not be completely imputable to the lack of information, but, rather, to the transitory phase that the resolution regime is still undergoing and to an environment characterized by markets that are still not completely operating. Banks' balance sheets are still not completely recovered from the financial crisis and some banks are still building up their equity buffer.

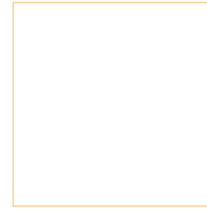
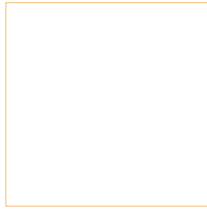
Liquidity Support and Exit Strategy in the New Resolution Phase

The fourth and last panel of the conference highlighted regulators' growing concerns over the liquidity issues that could arise following the introduction of banking resolution standards. Participants claimed that, while bail-in requirements such as MREL and TLAC address solvency concerns, they might have backfire effects on banks' liquidity, especially when it cannot cover its needs using the Eurosystem as a liquidity backstop.

Participants stressed that the liquidity planned for resolution and implemented by the BRRD might not be sufficient to address all of banks liquidity needs, both when the system gets at its full regime, and especially now during its ad-interim process, when the amount of non-performing assets are still consistent and the resolution funds is yet to be completed. Participants stressed that, if banks lack collateral, they cannot resort to the Eurosystem monetary policy operations and governments are left with more intrusive solutions to their liquidity needs, depending on how systemic the crisis is and on the shape of the involved banks. These measures may vary from the Emergency Liquidity Assistance, to fiscal backstop, resolution fund and all the way down to capital controls.

Other participants expressed their concerns on whether the existing measures to deal with liquidity shocks are, in fact, usable when necessary. They argue that tools such as the liquidity covering ratio (LCR), for example, might not be used without causing panic reactions.

Finally, participants stressed the importance of using private sources of funding that minimize moral hazard costs and to rely on the public sector as a backstop mechanism only when private money is not available and with the aim of providing market confidence and of promoting more stable funding to systemic institutions.



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