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The challenges of the European resolution framework

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1 Introduction

Let me begin by thanking the organisers for the invitation to close this conference on corporate governance and credit institutions' crises staged by the Law Faculty of the Madrid Complutense University. It is always a pleasure to return to the University where I was an undergraduate and a lecturer for several years, even if it is to a different Faculty from mine back then.

The recent financial crisis, like others before it, has been marked by the use by national authorities of sizeable public funds assigned to preventing the bankruptcy of numerous credit institutions in situations of non-viability. To minimise systemic risk and prevent a serious deterioration in financial stability, substantial State aid in the form of capital was granted across the EU from 2008 to 2014. In countries such as Spain, Belgium and United Kingdom, the figures were around 5% of GDP, in Germany and the Netherlands between 2% and 3.5%, while in Greece and Ireland aid was in excess of 20% and 30% of GDP, respectively.

Given the severity and high public cost of the financial crisis, the response by the international authorities has been most resolute. First, solvency requirements have been appreciably strengthened, which will increase the resilience of the financial system and, therefore, reduce the likelihood of similar crises in the future. Further, measures have been set in place to mitigate the effects of banking crises, when they occur, on the public coffers and the economy in general.

As regards solvency requirements, the reform agenda has practically concluded, while awaiting the Basel Committee's final agreement on the so-called Basel III accord. Today I shall focus on the second objective of the international reform agenda, i.e. on the package of measures aimed at smoothing the management of bank crises while preserving financial stability and minimising the use of public funds.

At the base of the regulatory reform in this area is the work of the Financial Stability Board (FSB) conducted at the behest of the G-20 following the Lehman Brothers debacle. In 2011 the FSB published the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which lay down the principles for ensuring an orderly resolution of banking institutions.

Indeed, the *Key Attributes* specify the powers and tools the administrative authorities should have to see through the orderly resolution of non-viable banks, ensuring the maintenance of their core functions and their restructuring at the least possible cost to the taxpayer.

The *Key Attributes* further envisage the availability of recovery and resolution plans for each institution that set out a roadmap ahead of a potential crisis situation.

Lastly, they establish the principle whereby bank shareholders and creditors are those who should bear the bulk of the costs of the crisis. Using the parlance of the profession, the "bail-out" (or rescue of the bank with public funds) disappears and is replaced by the "bail-in" (generation of own funds, capable of absorbing losses, converting debt instruments into capital).

The internationally agreed principles have been passed through to European regulations through the Bank Recovery and Resolution Directive (BRRD). This framework has been completed within the Banking Union with the establishment of the Single Resolution Mechanism, a system comprising a central authority, the Single Resolution Board (SRB) – which adopts the relevant decisions for significant banking institutions – and the national resolution authorities that participate in the SRB and retain direct responsibility for the less significant institutions. This Mechanism has a Single Resolution Fund, endowed with contributions from the industry, that will enable financial support to be afforded to resolution processes.

Despite the undeniable progress that the new resolution framework adopted in Europe entails, its practical implementation is subject to major challenges that I would like to highlight today, drawing on the fact that the BRRD will shortly be revised on the basis of a recently submitted legislative proposal by the European Commission. Accordingly, I shall first refer to the general aspects of the European resolution regulations. Next, I shall look at the loss-absorption requirements for bank creditors, which is one of the central aspects of the regulations. And I will conclude with some brief comments of a more strategic nature.

2 General aspects of the European regulations

The European Union, as reflected in the FSB's second *Peer Review on Resolution Regimes* published in 2016, is one of the jurisdictions where the *Key Attributes* have been most rigorously implemented. Allow me to highlight some of the main features.

First, the regulations consider resolution as an alternative mechanism to ordinary insolvency procedures in the mercantile realm, applicable to banks only in specific circumstances pertaining to the public interest. In particular, resolution shall only be applicable to those banks whose failure may generate risks to financial stability, given that they perform critical functions.

Second, the use of public funds to support vulnerable institutions is severely restricted. The contribution of any form of State aid – except that received in connection with a stress test – is understood to be a symptom of the institution's non-viability and, therefore, it may precipitate resolution or, where appropriate, the liquidation in mercantile terms of the institution. Once the institution has been declared in resolution, the regulations require a bail-in for creditors. The ensuing assumption of losses must exceed a minimum amount equivalent to 8% of the bank's liabilities as a prerequisite for attaining access to public funds, which includes the Single Resolution Fund.

Lastly, so as to be able to carry out the bail-in, all institutions liable to be subject to resolution, i.e. those which, given their significance, would not be wound up in the event of insolvency, are required to hold a minimum volume of loss-absorbing instruments in the event of resolution. This is known as the MREL (Minimum Required Eligible Liabilities) requirement.

Accordingly, the European regulations are precisely tailored to the new resolution principles and contain provisions that minimise the likelihood of crises resulting in the disbursement of sizeable public funds. That said, the challenges posed by the practical implementation of these provisions are manifold.

For example, the relative rigidity with which it is stated that receiving public aid generally implies the non-viability of an institution and, therefore, facilitates the activation of the resolution (or, where appropriate, winding-up) process, considerably constrains the supervisor's management of financial crises. It might be advisable to make this aspect of the regulations more flexible, albeit maintaining, in any event, the subjection of any public support to the prevailing State aid arrangements managed by the European Commission.

Yet the main challenge for the industry and its supervisors stems, to my understanding, from the potential implications of the new resolution framework for banks' business models and for the structure of the banking sector. Allow me to expand on this.

The demands of the regulations would point, in principle, to a configuration of the financial system that, in simple terms, would comprise two groups of relatively differentiated banks.

On one hand, there would be a group made up of relatively small institutions, which would not perform functions critical to the industry as a whole. In situations of non-viability these institutions would be subject to liquidation under an ordinary insolvency procedure and not resolution, given that the bankruptcy of the institution would be deemed not to generate harmful effects for the stability of the financial system as a whole.

As a result, these institutions would not be obliged to hold minimum loss-absorbing liabilities and nor, naturally, would they have access to the Single Resolution Fund. Hence the insolvency of the institution would precipitate insolvency proceedings whereunder only the holders of deposits covered by the Deposit Guarantee Fund would enjoy protection beyond that provided by the institution's net worth.

Given the likelihood that, in the future, ordinary insolvency procedures will be applied more frequently than in the past to financial institutions that are not systemic, it may be advisable to consider specific adjustments to mercantile regulations when they are applied to these cases. The formal involvement of the Deposit Guarantee Fund in the management of the insolvency process might be an option worth considering.

On the other hand, there will be a second group of institutions, normally bigger in size, whose potential failure would be considered to be of public importance given the harmful effects for the stability of the financial system that might ensue. This group would, therefore, be liable to pursue resolution processes.

To this end, under the regulations, the resolution plans for these institutions should ensure the continuity of their critical functions under any circumstances. Thus, in general, these plans envisage business reorganisation, restructuring or segregation measures if the institution reaches the point of non-viability and they provide for the availability of a sufficient minimum volume of own funds and eligible liabilities (the aforementioned MREL), that enable losses to be absorbed and the institution's capital base to be shored up, if necessary.

Indeed, the degree of stringency ultimately adopted in respect of the MREL requirement may determine the relative size of the two groups of banks indicated, i.e. those that may be wound up and those that may be resolved. In particular, demanding MREL requirements that were to entail the need for susceptible banks subject to resolution to issue large volumes of eligible liabilities on the markets might not be assumable by certain types of banks. This might be the case for banks pursuing a traditional retail banking model, funded essentially by capital and through the raising of deposits, and with little tradition of participation in the capital markets.

What is involved is a potentially numerous group of banks, not necessarily very small in size. Consider that, in the Single Supervisory Mechanism (SSM), 70% of significant institutions are not listed on the markets, almost 60% have never issued convertible instruments and almost one-quarter of them do not finance themselves with subordinated debt.

Allow me to focus on this important aspect of the European regulations, namely the MREL, which will foreseeably be subject to discussion in the forthcoming passage of the revised Directive.

3 Loss-absorption requirements (MREL)

The stringency of the MREL requirement will be determined both by the nature of the eligible instruments and the minimum required volume thereof.

Regarding the nature of the eligible instruments, for the MREL to fulfil the objective of providing for the orderly absorption of losses by creditors and the recapitalisation of the bank, the eligible instruments must conceivably be consistent with the seniority of the bank's liabilities as stipulated in national insolvency regulations, and they must evidence a sufficient degree of stability should the bank undergo serious difficulties.

That would suggest a definition of MREL that essentially includes capital instruments plus debt instruments that have a less privileged status than deposits in the insolvency pecking order. The consideration of wholesale deposits at over one year as eligible, which is not excluded in the European Commission's proposal, will undoubtedly be much discussed in the legislative proceedings, given the special nature of these instruments and their debatable availability to absorb losses in a resolution process.

Yet at present the seniority of the liabilities as established in the regulations differs from one Member State to another, specifically as regards the status of senior debt in relation to deposits. That hampers the homogeneity of MREL requirements and prevents the development of an integrated market for senior debt convertible into equity in the event of resolution. Accordingly, the European Commission's recent proposal, which introduces a new category of senior debt instruments, subordinate to deposits, is a step in the right direction.

In any event, the most critical element of the MREL-setting policy is the determination of the minimum volume of eligible liabilities and own funds. Under the current regulations, within the Banking Union, it is for the Single Resolution Board (SRB) to determine, case by case, this volume for all significant institutions (which are supervised directly by the SSM), as well as for non-significant institutions engaging in cross-border activity or whose supervision has been assumed by the SSM, following consultation with the prudential supervisor.

For the moment, the SRB has publicly voiced its inclination for a stringent approach, ensuring an extensive availability of loss-absorbing instruments on bank balance sheets.

Indeed, by way of indication, it has been advocated that the institution subject to resolution should have loss-absorbing capacity of a volume equivalent to its regulatory capital requirements (the so-called loss-absorption component) and the ability to restore immediately the minimum level required (or recapitalisation component).

However, MREL requirements like those arising from the mechanistic formula indicated may entail very high needs in respect of the issuance of eligible instruments – such as subordinated debt or convertible bonds – for numerous banks, owing to the above-mentioned reasons. Further, these issuance requirements would be concentrated in the same period of time for all the institutions concerned, hampering market take-up.

But, moreover, the cost for banks of issuing these instruments may, in many cases, prove most burdensome. By way of illustration we can consider the following example.

Let us take a bank financed only with capital and deposits and that comfortably meets – e.g. with a surplus of 2 pp – its regulatory capital requirement, which we will place in this example at 10% of its risk-weighted assets (RWAs). If the MREL stands at twice the regulatory capital, i.e. at 20% of RWAs, this bank, whose position would not differ greatly at present from that of a large number of banks with a traditional business model, would need to issue eligible instruments equivalent to 8% of its RWAs in order to meet the requirement set. Assuming, somewhat optimistically at present, that the issuance cost were not greater than the return on equity (ROE), the additional financial expense that compliance with the new MREL requirement would entail would account for almost half the bank's profit after tax.

This example illustrates that maintaining excessively demanding requirements would exert significant pressure on the profitability of a portion of the banking industry, calling into question the business model of a by no means negligible number of institutions.

Hence, it is worthwhile rigorously adjusting the MREL-setting policy so as to avoid a non-desirable impact on the viability of specific institutions or business models, without of course distorting the rationale behind this requirement.

A reasonable approach would be to adjust the MREL requirement – in both its loss-absorbing and recapitalisation components – so that it takes into consideration at least three factors. First, a balanced assessment of the volume of losses banks will foreseeably post at the time of going into resolution; second, the ensuing change in the level of capital required of banks that have undergone a resolution process, owing to changes in the size of the balance sheet and in its risk profile; and, lastly, the very resolution strategy of the bank in question.

Concerning the first point, the volume of MREL required to absorb the bank's losses might be adjusted downwards if it is taken into account that, generally, banks are declared to be in resolution when they fail to meet the regulatory requirements and, therefore, before depleting – due to losses – all the capital they hold.

Secondly, the restructuring required in a resolution typically involves an appreciable reduction in the size and in the latent risk of the bank's balance sheet. It is therefore reasonable to think that regulatory capital subsequent to resolution should be lower than that required beforehand.

Thirdly, the bail-in tool (loss absorption and recapitalisation through the conversion of debt into capital) is only one of the resolution strategies of banks. Resolution plans may envisage measures such as the sale of the business or the creation, through the segregation of certain assets and liabilities, of so-called bridge banks, which perform, after resolution, the bank's critical functions with a significantly smaller balance sheet. Some of these resolution measures other than a bail-in might be potentially appropriate in the case of commercial banks pursuing a traditional business model. The bank resulting from a resolution process where these strategies are implemented will generally have lower capital requirements than the original institution and, therefore, a lower MREL might be required of it.

I thus believe there is substantial leeway for adjusting MREL requirements on the basis of more accurate assessments of capital needs during the resolution process and, in particular, of the strategies foreseen in each bank's resolution plans.

4 Transition

In light of the foregoing, even if the minimum volume of the loss-absorbing instruments that banks should have is revised downwards, the new MREL demands may undeniably only be assumed by a large number of banks if they have a sufficiently lengthy transition period to comply with the requirements. This transition period will, moreover, be necessary so that the market should not have to absorb a large number of issues over a limited period of time. Indeed, the European Commission's recent proposal includes the possibility of setting for each bank a time margin for compliance with the MREL requirement, although this margin would be decided on a case-by-case basis by the resolution authority, i.e. the SRB, in the case of the Banking Union.

Admittedly, setting a relatively long transition period may add complexity to the resolution processes that have to be managed during that period. As stated, current regulations require that resolution funds should only be activated when the institution has absorbed losses for an amount equivalent to 8% of liabilities. Evidently, if the bank did not yet have sufficient loss-absorbing debt instruments because the transition period were not over, the established requirement would only be met if haircuts were imposed on other creditors, such as deposit-holders. While the deposits covered by national guarantee schemes would be excluded from loss-bearing, there is no doubt this step might prove destabilising.

Thus, in the ongoing revision of the Directive, it might be wise to add a flexibility clause in respect of the requirements established for the use of funds external to the banks concerned in their resolution processes, at least for the duration of the transition period set for the fulfilment of the MREL requirements.

Lastly, before concluding this section, a remark on the need for coordination among the different Banking Union authorities. The current regulations and the European Commission's proposals for their revision afford the SRB extensive discretion for deciding, case by case, on questions as important as the objective volume of MREL, the nature of the eligible instruments and the transition regime. These decisions interact appreciably with the solvency requirements set by the prudential supervisor and they give shape to a series of regulatory demands that may affect the viability of institutions and the structure of the industry. A fruitful framework of collaboration between the SRB and the SSM is thus needed and, specifically, the criteria the SRB develops to exercise the discretion afforded it by the regulations should be properly discussed with the prudential authority.

5 Final remarks

In conclusion, I have referred in my address to the intense work in all jurisdictions to amend the bank crisis management framework so that it strengthens the capacity available to maintain financial stability without this requiring the massive use of public funds, as occurred in the recent financial crisis. The progress made in Europe has been considerable, having incorporated the most demanding international standards into the regulations.

The new resolution regulations pose most considerable constraints, which are in many cases weightier determining factors than solvency requirements themselves for financial institutions. It is thus necessary to harness the ongoing revision of European legislation and the subsequent re-definition of the policies to be pursued by the resolution authorities so as to fine-tune demands in a way that provides for the orderly adjustment of the industry to the new regime. As earlier discussed, adding flexibility to some requirements and setting transitional arrangements for others may be of help here, while also reinforcing the authorities' ability to manage crises in the short and medium term.

All told, institutions should be mindful that the new resolution framework will require those banks that exceed a certain size and are liable to generate systemic risk to ensure that their balance sheet structure allows their resolution at the expense, essentially, of their shareholders and creditors. They should, therefore, ensure that their business model is compatible with the issuance of loss-absorbing instruments on the capital markets and that their income statements allow for the remuneration of the supplementary risk that the new resolution regime entails for holders of bank debt.

It thus seems likely that several institutions will face objective difficulties adjusting to the recently established resolution framework. These new regulations, therefore, contribute to reinforcing the perception of excess capacity in the sector and, foreseeably, they will contribute to promoting a change in the industry structure that will correct such excess by means of consolidation processes giving rise to banks more capable of comfortably complying with the new demands. The supervisor's role essentially consists of setting in place the means needed for this seemingly inevitable adjustment process to unfold in as orderly a fashion as possible.