Elisa Ferreira: Resolution and early supervisory intervention

Topics supporting address by Ms Elisa Ferreira, Vice-Governor of the Bank of Portugal, on the panel discussion of "Resolution and early supervisory intervention" at the "BCBS-FSI High-level Meeting for Europe on Banking Supervision", Lisbon, 18 September 2018.

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Accompanying slides of the speech.

The firm, cohesive European commitment to Banking Union helped counter financial fragmentation but its incomplete setup seriously jeopardises its key benefits. As the SSM was put in place and the SRM started working, the political will to build the third pillar – a European Deposit Insurance Scheme (EDIS) – and complete the overall architecture waned. New, bigger political hurdles continue to emerge with policymakers stuck in the risk-reduction vs. risk-sharing debate, losing sight of the final objectives.

Today, Banking Union means that supervisory and resolution decisions are mostly European, whilst the ultimate guarantor of financial stability remains national, with limited tools to act. The Meseberg declaration and last June's Euro Summit, by falling short again of proposing further risk-sharing while adding additional layers of risk-reduction measures, lead us to ponder whether the costs of attaining additional risk-sharing are worth the risks to financial stability that such measures may trigger.

An unstable balance has emerged from the lack of political will to complete the Banking Union preventing us from fully reaping the benefits of economic integration. Europe needs to have concrete plans going forward, and must address pressing questions on what we need to adjust to guarantee financial stability.

1. Treatment of cross-border banking groups

Without EDIS, as banks are to a large extent, still "national in death", instead of discussing the adoption of waivers, a specific regime needs to be developed to address Member States' concerns over the risks of potential failures of cross-border banking groups. Member States need tools to address financial stability issues arising from locally systemic undertakings. This involves:

- the rethinking of the Single Point of Entry (SPE)/Multiple Point of Entry (MPE) resolution model;
- the choice between subsidiaries or branches, together with the supervisory powers of host national competent authorities (NCAs); and
- openly debating the contentious topic of ring-fencing measures.

The transformation of subsidiaries into branches has emerged as an answer to this debate – however that implies, at least, that:

- national resolution authorities are involved in the definition of resolution plans and actions when local undertakings are of systemic relevance to the concerned Member State; and
- domestic supervisors should have the capacity to react to strategic decisions affecting branches as they would, had it been a standalone entity, so that the SSM, SRM and national authorities are accountable to the Member States.

2. Resolution/winding-down of medium-sized banks

The sustainability of business models of medium-sized institutions predominantly financed by capital and deposits is currently endangered, with insufficient instruments available to safeguard financial stability in case of failure. There is no clear room for a 'middle class' of institutions whose failure, and eventual liquidation, could be considered systemic but whose business model may be incompatible with accession, at a reasonable cost, to the international market, to satisfy their MREL requirements.

Resolution authorities need to be able to rely on alternative sources to support resolution actions, such as resolution funds, but are currently prevented from doing so. The current minimum internal loss absorption requirements (8% of total liabilities and own funds) and limitations on the amount of the use of resolution funds (5% of total liabilities and own funds) prevent it, which may subject senior debt and even unsecured deposits to risks incompatible with financial stability. In this context, the IMF's recent proposal of a 'financial stability exemption' should be further explored.

Recent experiences have put the harmonisation of EU banks' liquidation regimes on the agenda of policymakers. However, before we jump into harmonising liquidation regimes, in view of the public policy dimension, we must understand what bank liquidation means and assess if we have the right tools to ensure that bank liquidations are orderly in the current context. As a considerable social and economic impact results from the failure of a bank considered to be of no public interest at EU level but with systemic relevance at local level, we need to discuss alternatives for medium-sized and small-sized banks exiting the market, instead of moving towards a further straitjacketing of nations' room for manoeuvre. These might include the establishment of an enabling framework for the winding-down of locally systemic relevant banks combining elements of the resolution and liquidation frameworks while preserving value and protecting creditors and non-financial borrowers. For that, work is needed to:

- create special insolvency proceedings, with recourse to administrative options attributing additional instruments, such as the ones available in resolution, to a liquidating authority ,as an alternative to the 'atomistic' court-led liquidation regime. The liquidating authority and the funding sources available would need to be identified.
- ensure effective financing of the deposit insurance system for deposit transfers abiding by the least cost principle with the liquidating authority having the option to offer guarantees or enter into profit and loss sharing regimes. For that we would need to revise the applicable State aid rules.

Recent calls to form a sort of European FDIC, merging the Single Resolution Fund and EDIS into one single entity, merit our attention in this regard, provided that the legal framework is fixed and that financial stability – both at European level as well as at national level – is enshrined as the first and fundamental objective of any intervention.

3. The return of too-big-to-fail?

Regulation-driven consolidation has become an imminent risk, fostering concentration at local level and the comeback of too-big-to-fail. Existing regulatory requirements were not thought of as a way to promote consolidation but are currently working in that direction. Driven by profitability and efficiency concerns, recent calls for the creation of pan-European banks able to compete with larger institutions outside Europe as a matter of national sovereignty have added pressure on regulators and policymakers to review existing rules. This in turn has implicitly put on the table the return of too-big-to-fail with the ensuing moral hazard – something we were trying to avoid in the first place. Are we so afraid of what digital giants such as Google, Facebook, Apple and Amazon might give rise to in the future that to compete with them we are turning a blind eye to the risks of too-big-to-fail? Is a 'forward escape consolidation' the right answer when challenges remain regarding the failure of cross-border banks even for medium-sized banks? Shouldn't we instead focus on ways to address the economic dislocation and social costs that may arise from the gaps in the current architecture?