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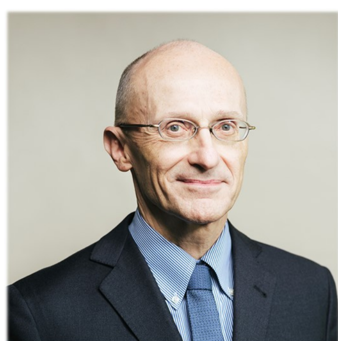
# Crisis management for medium-sized banks: the case for a European approach*



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*A consistent framework for managing crises of small and medium-sized banks is needed across the banking union. Key ingredients are a European deposit insurance scheme, regulatory harmonisation and European tools for the liquidation of banks of all sizes.*

The crisis management framework for banks has advanced significantly in the decade following the great financial crisis. At the global level, the Financial Stability Board identified best practices for managing crises at large and complex institutions, known as "key attributes of effective resolution regimes for financial institutions". In the EU, the implementation of those principles was coupled with the establishment of European banking supervision and the Single Resolution Mechanism (SRM), tasked with enhancing the standards of supervision and resolvability of significant banks, ensuring a consistent approach towards preventing and managing crises at the largest banks across the banking union. However, in the quest to address the "too-big-to-fail" issues exposed by the great financial crisis, less attention was devoted to the

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management of crises at small and medium-sized banks. It was assumed that, in most cases, they would not raise concerns for financial stability and could be dealt with under ordinary liquidation procedures at the national level.

However, the experience of these first years of the banking union has proved that assumption wrong. The significant differences in national legal regimes for the liquidation of banks imply divergences from the European supervisory framework; they generate level playing field concerns that might impair banking market integration and they may stand in the way of a smooth exit from the market for the weakest players.

In some cases, the declaration that a significant bank was "failing or likely to fail" (FOLTF) did not trigger ordinary insolvency procedures under national laws, putting the bank in a limbo situation in which it had failed but could not exit the market. This happened for instance in the case of ABLV, in which the ECB's FOLTF decision for both the Latvian parent and its Luxembourg subsidiary was followed by the assessment of the Single Resolution Board (SRB) that a resolution procedure was not in the public interest. In the end, the Latvian parent shareholders decided to liquidate the bank voluntarily. The Luxembourg subsidiary was subject to a suspension of payments regime until the start of the judicial liquidation process almost two years later.

Within the banking union, some Member States rely on administrative liquidation regimes for banks with instruments similar to those of resolution procedures, while others employ the same liquidation procedures that are applied to corporates. This raises even more complex issues, as similar cases may be managed in very different ways. For instance, in the case of the two large banks Banca Popolare di Vicenza and Veneto Banca – which in the SRB's view did not raise public interest concerns at the European level, notwithstanding the high level of combined assets in the same region – the Italian authorities were able to deploy a wide range of administrative tools to transfer the business of the failing entities to another bank, supported by State aid. Such tools, that would not be available in many other Member States, enabled a more favourable treatment of creditors than under the European resolution regime.

Besides the obvious level playing field issues, these differences stand in the way of a fully integrated market and run counter to the objectives of the banking union. Also, the level of protection enjoyed by different categories of investors and depositors could vary across participating Member States. As a result, the intrinsic value of a deposit in one Member State could differ from that in another, even within the banking union. But how should we envisage a consistent crisis management framework, conducive to an integrated banking market?

## Towards a more European framework

Such frameworks exist, the most prominent example being that in the United States, centred around the Federal Deposit Insurance Corporation (FDIC). Most cases of bank failure, and especially those involving small and medium-sized banks, are resolved by the FDIC through purchase and assumption and the subsequent sale of deposits and good assets to other banks, which may well be headquartered in other federal states. The failed bank's customers are notified that their deposit or loan contracts are now with another bank and barely notice the effects of their bank's default. This approach to crisis management, whereby the viable parts of an insolvent bank are matched with a thriving acquirer, enables small and medium-sized banks to also reap the benefits provided by a large, integrated banking market. The US model offers attractive features, including a smooth exit from the market, minimal impact on customers, especially retail depositors and small borrowers, the potential to smoothen asymmetric shocks for a specific region through federal solutions to banking crises and the potential lower impact on public finances. In my view, this is the model to look at.

When considering an FDIC-like solution in the banking union, the most important aspects appear to me to be: (i) the role of a deposit guarantee scheme (DGS) covering the whole area; (ii) complete regulatory harmonisation, ideally through EU Regulations; and (iii) the importance of administrative tools for the liquidation of banks of all sizes.

First of all, the reference to the positive role played by a federal agency in the United States, combining the deposit guarantee and the resolution authority role, points clearly to the urgency of developing a European Deposit Insurance Scheme (EDIS) as the natural core component of a comparable approach in the banking union. The introduction of EDIS will be a crucial milestone for the integration of European financial markets. Only with EDIS will it be possible to manage a bank crisis with the level of efficiency that integrated financial markets offer. Lacking a European dimension, national deposit guarantee schemes tend to focus only on national solutions and thus forgo the gains of the large European market. The banking union should change this for good. If we want to achieve a fully integrated banking market in the EU, we should recall that the FDIC's success is based on combining resolution and deposit guarantee functions for almost all banks in the United States. The flexibility provided by the combination of crisis management with the management of the deposit guarantee scheme could help in identifying least-cost solutions, in no case more expensive than the plain reimbursement of insured depositors, with benefits for all stakeholders.

EDIS is the only way of guaranteeing that each euro on deposit would carry the same value, irrespective of where the bank and the customer are located within the banking union.

Second, for more consistent crisis management, we need to see further harmonisation in the procedures and tools for dealing with failing banks that, in the SRB's assessment of the public interest, do not qualify for resolution. National insolvency laws are not currently harmonised and are not always tailored to the specificities of the banks. As mentioned before, experience has shown that, due to these differences, failed banks across the banking union are subject to divergent and somewhat uncertain outcomes depending on the features of the national legal framework. There is abundant evidence and research showing that the lack of harmonisation and, in some cases, predictability, in this area, acts as an additional deterrent for market participants, discouraging them from engaging in cross-border banking activity and cross-border consolidation, thus preventing further financial integration in the EU. I am not arguing for a harmonisation of insolvency laws across the EU, which would be welcome but very difficult to achieve. The objective should be to introduce a special administrative regime for bank liquidation with the maximum level of harmonisation, providing additional tools to those that can be deployed for most other companies.

Finally, the mix of tools and financing means available to the relevant authorities needs to be enhanced to adequately deal with the failure of medium-sized credit institutions. Resolution may not be suitable for those banks, while at the same time their liquidation, assuming a piecemeal depositors' pay-out liquidation, could well have an adverse impact in terms of destruction of economic value and financial stability, at least at regional level. We need to introduce adequate administrative tools to ensure that the failure of these banks can be handled in an orderly and effective manner, ensuring a timely and smooth exit from the market. This is very important: if the banks cannot exit the market in a smooth manner, there could be an incentive for governments to also extend some forms of support to banks that lack a sustainable business model. In the aftermath of the great financial crisis, this attitude has contributed to generating a heavy legacy of excess capacity in the system, which has significantly affected efficiency and market valuations – a problem we are still grappling with today.

## Identifying the main options to address the gaps

A more harmonised and fit-for-purpose crisis management framework for medium-sized banks in the euro area is therefore of the essence. What can concretely be done to achieve it?

From a supervisory perspective, as a first step, we should still focus on the actions that can prevent a bank's failure. Banks could have a wider range of credible options at their disposal to withstand severe stress. Banks' recovery plans play an important role here, and it is essential that banks not only identify potential barriers to the swift implementation of recovery options, but also take appropriate actions to address them in a timely manner. Within the banking union, European banking supervision will continue promoting and monitoring improvements in recovery plans, including for banks at which a crisis may well be addressed using liquidation procedures rather than through resolution.

We also need to make sure that failing banks not subject to resolution exit the market within a reasonable timeframe. The current Bank Recovery and Resolution Directive (BRRD) as recently amended provides clear guidance in this respect by requiring banks that have been declared "failing or likely to fail" to be wound up in an orderly manner. It is crucial that this provision is implemented in a way that avoids any residual risk of banks being left in limbo, otherwise additional legislative clarifications would be needed.

When it comes to the orderly market exit of a medium-sized bank, one option under discussion would be to broaden the scope of banks subject to resolution. This would level the playing field for failing banks in the banking union. Here, the question is whether medium-sized banks would be able to access adequate funding to support the preferred resolution strategy under the current resolution framework. For example, there are non-listed banks, predominantly financed by deposits, that do not regularly issue debt on regulated markets. It might prove expensive for these banks to tap senior non-preferred markets in order to issue the required amounts of liabilities eligible under the Minimum Requirement for own funds and Eligible Liabilities (MREL), as institutional investors might not be interested in their debt instruments. These banks might target retail investors instead. The BRRD has been amended to enhance the safeguards to avoid junior debt instruments being placed in the portfolios of captive retail customers under conditions that raise investor protection concerns, and discussions are ongoing about how protection for retail investors can be strengthened further. An excessive reliance on non-preferred and subordinated instruments placed in the portfolio of captive retail customers could also jeopardise the resolvability of a bank, as the ability to allocate losses to these retail investors in a crisis situation could prove highly questionable.

In any case, it is unlikely that broadening the scope of resolution would fully solve the issue, as there will still be banks to which the European resolution framework would not apply as no public interest has been identified. Hence, alternative policy options should be explored.

One option put forward in the current debate would be to ensure, through harmonisation at the European level, that all national resolution authorities have administrative powers to transfer assets and liabilities in liquidation, supported by national deposit guarantee schemes. Under this option, national resolution authorities would be given special administrative liquidation powers that allow for the transfer of some assets and liabilities as an alternative measure or as a complement to insured depositors' pay-out.

DGS funding can already be used for alternative measures under the current framework as an option given to Member States, but amendments to the super priority of the DGS and the assessment of the least-cost criterion would need to be considered in order to allow for a broader use of DGS resources to support effective crisis management.

Transforming this option into a common tool available to all national resolution authorities within a regulatory framework with maximum harmonisation would ensure a more effective treatment of failing banks across the banking union compared to the status quo. However, as discrepancies in national implementation and practices would still be possible, some form of coordination at European level would be needed. Moreover, the financial capacity of national DGSs and their use in practice could vary greatly across Member States, leaving this solution open to the risk of being sub-optimal at the European level, as it would maintain a strong link with the national sovereigns.

We should therefore look at more European solutions. Administrative liquidation powers, including the power to transfer assets and liabilities supported by national DGSs, and in the future by EDIS, can be allocated at the European level. Here, the toolkit available to the SRB would be expanded and equipped with the power to liquidate a bank when no public interest is identified, including by transferring some of its assets and liabilities to another bank within the banking union. As regards funding, one short-term option could be to grant the SRB powers to expand its use of DGS funds coupled with the establishment of a hybrid common deposit insurance.

This could be an intermediate stage towards the establishment of EDIS, which remains the ultimate objective. Giving an EU authority a more relevant role would promote more consistent treatment of banks and would enhance the system-wide effectiveness of crisis management in the banking union, enabling further integration of the banking sector while relying on cooperation with and among national authorities as well as national DGSs until a full-fledged EDIS is in place.

This European approach would be most conducive to ensuring orderly wind-ups across the banking union. But I am aware that in the absence of EDIS the misalignment in incentives between decision-making powers at European level and financing tools at national level could raise serious concerns. Thus, in a pre-EDIS scenario, specific governance arrangements should be designed in order to ensure the adequate involvement of the national resolution authority (NRA) and the national DGS in the SRB decision-making process. One idea could be to establish a "two-keys" process: the SRB would maintain a strong role in triggering liquidation and proposing the transfer of a bank's assets and liabilities, but the NRA would maintain the right to block the transaction if it were considered excessively expensive for the national DGS.

## Conclusion

So far, the impact of the COVID-19 pandemic on banks' balance sheets has remained limited. Banks entered this difficult period with a much stronger capital and liquidity position and strengthened risk management processes thanks to the financial reforms adopted after the great financial crisis. This has proven to be a fundamental element of strength, enabling the banking sector to continue lending to households, small businesses and corporates and to support the recovery of our economy.

But we should not be complacent. We cannot rule out that once the government support measures are lifted, some banks may experience a significant deterioration in their asset quality. Having an effective and integrated framework for managing crises, including for small and medium-sized banks, is essential to preserve the trust of depositors and the public at large, to avoid financial fragmentation and to safeguard financial stability.

There are incremental steps we can take to strengthen our crisis management framework, including for small and medium-sized banks. The proposals outlined here could be important steps towards the completion of the banking union, which will only be achieved once a full-fledged EDIS is in place.

## About the author

*Mr* ***Andrea Enria*** *took office as second Chair of the Supervisory Board of the European Central Bank in January 2019. Before that he was the first Chairman of the European Banking Authority (EBA) since March 2011. He previously served as Head of the Regulation and Supervisory Policy Department at the Bank of Italy, and as Secretary General of the Committee of European Banking Supervisors (CEBS). He also held the position of Head of Financial Supervision Division at the European Central Bank. Before joining the ECB he worked for several years in the Research Department and in the Supervisory Department of the Bank of Italy. Mr Enria has a BA in Economics from Bocconi University and a M. Phil. in Economics from Cambridge University.*

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