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Post-turmoil bank failure management: the European challenges

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Abstract

The 2023 banking crises in the United States and Switzerland tested those countries' post-GFC resolution frameworks. This episode showed that there are strong reasons to extend resolution planning obligations to all banks whose failure could have adverse effects on the financial system. Crucially, resolution plans should include well defined requirements for a minimum amount of loss-absorbing liabilities. Those requirements should be calibrated to directly support the feasibility of the envisaged resolution strategy and ideally be composed primarily of debt instruments. The EU now has a great opportunity to address the deficiencies identified in the current bank crisis management framework, particularly with regard to the failure of mid-sized banks. The European Commission's CMDI legislative proposal is a highly valuable initiative whose main features should be preserved in the ongoing political negotiations.

Note: This policy brief is based on speech by Mr Fernando Restoy, Chair, Financial Stability Institute, at the IMF-JVI-Yale Program on Financial Stability, Course on Financial Crisis Management, Vienna, 17 September 2024.

Introduction

One of the most significant policy reforms that emerged from the Great Financial Crisis (GFC) was the creation of a new bank resolution framework. Under the slogan "avoid the perception of too-big-to-fail banks", the Financial Stability Board established new standards aimed at reducing the impact of systemic bank failures.

The FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions contain the main elements of the new framework. The Key Attributes aim to facilitate orderly resolution of systemic entities without exposing public funds to losses. A key component of the new resolution regime is the bail-in tool that would allow resolution authorities to write down liabilities or to convert them into equity in order to absorb losses and, in some cases, recapitalise a firm in resolution.

During the 2023 bank turmoil, crisis management frameworks in both the United States and Switzerland were directly tested. In the US, the failure of two regional banks, Silicon Valley Bank and Signature Bank, required the use of a systemic exception as authorities felt that the preservation of financial stability justified waiving the restrictions on the support that the Federal Deposit Insurance Corporation (FDIC) is allowed to provide, in order to protect all the deposits of those banks. Moreover, a special liquidity facility was established by the Federal Reserve to ease potential system-wide funding pressures.

In Switzerland, the crisis of Credit Suisse, a global systemically important bank (G-SIB), was not managed under the new resolution framework but rather through a series of ad hoc measures taken to facilitate the absorption of Credit Suisse by UBS without the formal declaration of Credit Suisse as a failing institution. Moreover, although the measures adopted outside resolution included a substantial bail-in of some creditors, they also entailed the provision of public guarantees to support the liquidity and solvency of the resulting institution.

Arguably, the actions taken by authorities met the primary objective of preserving financial stability. At the same time, those actions did not follow the usual procedures and, contrary to the objectives of the post-crisis reforms, required different forms of external support.

While not directly affected by last year's turmoil, the application of the new resolution framework in the European Union had previously shown relevant flows. In particular, the crisis of two significant Venetian banks in 2017 had to be resolved with a large amount of government intervention. That triggered a still ongoing discussion on how to improve the current crisis management framework. In particular, there is now relatively broad consensus that, at present, there is no effective mechanism to deal with crises of mid-sized banks without public support.

This article discusses some of the issues that the recent turmoil and other recent bank failure episodes in Europe have raised in relation to the current policy framework for bank crisis management.[1]

Some issues stemming from the recent turmoil

Resolution planning

The speed with which apparently solvent banks became failing banks, particularly in the US, points to the need to strengthen resolution planning (FDIC (2023a)). This should first be achieved by enlarging the scope of application of meaningful resolution planning obligations to all banks that can be systemic in failure – something that is not yet the case in some jurisdictions, notably the US.

In addition, resolution plans for international banks should address practical issues relating to the operationalisation of resolution actions – particularly bail-in – in a cross-border context. Given that debt securities earmarked to be

[1] A more detailed analysis on some the issues covered in this speech can be found in my contribution to Acharya et al (2024).

bailed-in in resolution are typically issued in international financial centres, it is important that resolution decisions – such as a conversion of debt securities into equity – be effective in all relevant jurisdictions.

Moreover, resolution plans should contemplate different options and not focus on just a single resolution strategy (FSB (2023a,b)). As the case of Credit Suisse shows, the preparatory work conducted around the development of the entity's resolution plan proved very useful for managing the failure of the bank, even if the plan was not ultimately implemented. Yet the process would have been smoothed if, in addition to contemplating a massive bail-in, the plan had included provisions for a possible full or partial sale of business (SoB).

Loss absorbency

One of the main ingredients of the new resolution framework – and of the new resolution planning and resolvability requirements – that emerged from the crisis is the availability of sufficient resources within systemic banks' balance sheets to absorb losses and, if needed, recapitalise the institution after resolution is triggered. In particular, the FSB has issued standards for total loss-absorbing capacity (TLAC) that all G-SIBs should comply with.

In jurisdictions where the new resolution framework is being applied beyond G-SIBs (like the EU), there is a version of the TLAC standard, the minimum requirements for eligible liabilities (MREL), that is also binding for less systemic institutions. In other jurisdictions, such as the US, no TLAC-type requirement is applied for non-G-SIBs. Therefore, most US banks – including those failing in the recent turmoil – had no specific obligation to hold liabilities that could absorb losses in resolution beyond the capital requirements established in prudential regulation.

However, a recent proposal by the FDIC (Gruenberg (2023) and FDIC (2023b)) would require banks with more than $100 billion in assets to satisfy minimum long-term debt requirements. The counterpart of those debt instruments on the asset side could be transferred to the acquirer, but the debt instruments themselves would be left in the residual entity to be liquidated. This would make those debt instruments act as gone-concern capital supporting the transfer transaction (Restoy (2023)).

MREL obligations in the EU are, on average, substantially larger than the long-term debt requirements now considered in the US[2]. However, while the proposed US requirements can only be met with debt, MREL targets in the EU can be met with a variety of eligible liabilities that include equity, debt and even some non-covered deposits. In reality, many small and mid-sized institutions in the EU cover a large part of their MREL requirements with equity instrument.[3] This is probably due to the fact that it is difficult for those banks to tap regulated debt markets, given their lack of experience and their specific business model.

From a conceptual point of view, there is merit in, at least, limiting the eligibility of equity to satisfy gone-concern capital requirements. Experience shows that, unlike long-term debt, equity instruments tend to disappear quite quickly as a bank approaches the point of non-viability and during the resolution process itself as hidden losses emerge in the balance sheets.[4] Therefore, equity, being the most powerful loss-absorbing instrument in going-concern, might simply not be available in gone-concern.

[2] According to SRB (2023), the average recapitalisation amount for banks following a resolution strategy based on a transfer transaction is around 10% of risk-weighted assets, ie 4 percentage points above the long-term debt requirement stipulated in the US.
[3] SRB (2023) shows that for (significant) banks under the SRB remit classified as "non-Pillar 1", equity instruments represent on average more than 60% of the resources used to meet MREL requirements.
[4] In fact, this is partially recognised in the FSB TLAC Term Sheet, as it contains an expectation that at least 33% of the TLAC requirements will be met with debt securities.

Public support

The foundational principles of the new resolution framework developed after the GFC included the objective to minimise the cost of bank failure management actions for taxpayers. However, experience – including the recent bank turmoil – shows that there are instances in which some form of external support is required to preserve financial stability and the continuity of the systemically critical functions of failing banks.

Regular support for resolution actions is often provided by the deposit insurance fund (DIF). That support is normally capped by a least-cost restriction that prohibits the DIF from committing funds exceeding the expected cost (net of recoveries) of paying out covered deposits if the bank were liquidated (Costa et al (2022)). Additional support aimed at protecting public interest could be provided directly by the national Treasury or by dedicated funds contributed by the industry. In the US, extraordinary support for failing large systemic institutions can be provided by an orderly liquidation fund as provided for in Title II of the Dodd-Frank Act. Moreover, under the FDI Act, the least-cost restriction for FDIC support can be waived if a systemic risk exception is applied. In both cases, extraordinary external support can only be authorised through a special procedure requiring the endorsement of the regulatory agencies and the Treasury after consulting the US president.

A completely different model is in place in the European Union, where external support can be provided by the Single Resolution Fund (SRF), built up with contributions from the industry. However, the conditions for access and the available amounts are highly restrictive.[5] Moreover, beyond the SRF, the possibility of the state directly supporting resolution is almost non-existent. Since national insolvency regimes are less restrictive and allow for the provision of public liquidation aid, the failure of some European banks that could have systemic implications was in fact managed through national insolvency procedures, thereby effectively reducing the scope of application of the common resolution framework.

Recent developments show that the minimisation of public support should remain a key objective. However, there should be no ambition to establish a resolution framework that can eliminate any possible need to use external funds to support the orderly resolution of any systemic bank.

A specific situation in which some sort of public support would normally be required is the provision of liquidity in resolution. Once a bank has been resolved, there is no guarantee that it will immediately recover the trust of its clients and other fund providers. Therefore, there is a need to put in place an effective funding-in-resolution facility, backed by some sort of public indemnity that would allow a bank in resolution to obtain funding from the central bank even when it does not hold all the required collateral.

The European challenges

The failures of the two Venetian banks in 2017 clearly showed the internal contradictions of the European bank failure management regime. Importantly, it also illustrated the EU's lack of an effective regime to resolve mid-sized banks, ie those deemed too large to be subject to regular piecemeal liquidation procedures but too small and unsophisticated to issue large amounts of bail-in-able liabilities (Restoy (2016)).

Against that framework, a key flaw of the current resolution regime is the absence of effective conditions to operationalise SoB resolution strategies, which are arguably the most appropriate for mid-sized banks (Restoy et al (2020)). The tight constraints on the provision of external support to facilitate these transactions make them unfeasible in most cases. Arguably, the assets acting as counterparts of MREL could help compensate acquirers. However, strict MREL obligations can be a challenge for many mid-sized banks, which would tend to meet them with equity that – unlike debt instruments – might not be available when the bank is declared non-viable.

[5] Access to the SRF for banks under resolution should be preceded by a bail-in of at least 8% of total liabilities of the institution in resolution. Moreover, SRF support cannot exceed 5% of that institution's total liabilities.

Those deficiencies in the common resolution framework are particularly relevant in a context in which there is no last-recourse source of funds that could be mobilised if resolution actions are unable to meet their objectives and, in particular, preserve financial stability.

In any case, the main weakness of the current European bank failure regime within the banking union is the absence of a common deposit insurance regime. Since the banking union's main objective is the denationalisation of bank risk, it can scarcely be contested that the absence of a common deposit guarantee scheme renders the union not only incomplete but potentially also unable to meet its stated objectives.

The CMDI proposal

The legislative proposal by the European Commission (EC (2021)) for a reform of the current crisis management and deposit insurance (CMDI) regime constitutes a valuable attempt to correct some of the main flaws and inconsistencies of the current framework.

The CMDI contains three important proposals:

First, while the dual route for bank failure management (resolution or insolvency) is kept, the definition of "public interest" criteria to determine the application of one regime or another is clarified. In the proposal, the public interest criteria would include the expected disruption of financial stability "at the national and regional level".

Second, the external funding of SoB transactions is significantly strengthened by alleviating the existing financial cap for DIF support and the minimum bail-in restrictions for access to the SRF. The formulation of the least-cost constraint on DIF support for SoB transactions remains unaltered. However, in line with the US regime and the proposals made by several observers,[6] the current super-preference for DIF claims in insolvency is replaced by a general depositor preference rule. Moreover, any contribution made by the DIF (together with any bail-in of eligible liabilities) would count to meet the 8% minimum bail-in required for SRF access.

Third, while the (now more ample) available external support could not be directly considered for the purposes of MREL determination, the CMDI now formally allows the SRB to adjust MREL for banks with a preferred resolution strategy of SoB based on a set of pre-established criteria such as size, business model, risk profile or marketability.

Naturally the CMDI could not remedy all imperfections of the current European bank failure regime, as there is not yet political support for more ambitious reforms. For instance, a key deficiency that will remain is the lack of an effective mechanism for providing liquidity in resolution. At present, there is no guarantee in the banking union that banks in resolution could satisfy the conditions required to obtain funding from the ECB/Eurosystem. That would most likely require a sort of public indemnity such as that available in other jurisdictions, including Switzerland, thanks to the emergency legislation that was passed in March 2023. While the SRF could be used to provide liquidity to banks in resolution, its current resources are worth only €80 billion. It is now foreseen that the European Stability Mechanism (ESM) could provide a backstop to the SRF as soon as the ESM Treaty is properly amended. Yet, even with the (still pending) approval of the backstop, the new maximum lending capacity (of around €140 billion) would remain quite restrictive for managing systemic bank failures in the banking union.

More importantly, the CMDI could not make any progress on the completion of the banking union. The enlargement of the scope of the common banking union resolution regime – as opposed to the national insolvency regime – strengthens the European framework. Yet enhancing the role of national deposit insurance funds in bank resolution makes the lack of a European fund particularly problematic.

In any event, the proposal certainly provides for a substantial technical improvement of the current framework. Resolution would arguably become the default option for all bank failures with any sort of systemic impact. At the same time, by improving the available funding for SoB transactions, the CMDI effectively expands the SRB's ability to

[6] See eg Restoy (2019), Restoy et al (2020), Gelpern and Véron (2020) and Garicano (2020).

deal with the failures of mid-sized banks, thereby helping to address the most significant flaw of the current framework.

Importantly, the BU resolution regime would continue to exclude the government stabilisation tool as a last-resort option. Under those conditions, the legislative framework's ability to preserve the stability of the financial system upon the failure of a mid-sized bank would depend exclusively on the effectiveness of the existing resolution tools. In particular, the available external support from the national DIF and the SRF would need to be sufficient – together with MREL – to facilitate an SoB transaction under which deposits and other sensitive liabilities could be assumed by a suitable acquirer.

The ongoing negotiations

In that context, it is somewhat worrying that in the current negotiations around the Commission's CMDI initiative in the European Parliament, and particularly the Council, some opposition has emerged against the key aspects of the proposal aimed at enlarging the available funds to support SoB transactions. In particular, the position that the super-preference of DIF claims in insolvency should be kept seems to be gaining support, although the interpretation of the least-cost constraint could be made more flexible. Also, a number of additional conditions and obstacles would be introduced to allow DIF support to count towards the satisfaction of the 8% minimum bail-in condition for the SRF to provide support to facilitate SoB transactions.

Those amendments to the original CMDI could put at risk the objectives of the original Commission proposal. First, as discussed before, the super-preference of DIF claims in insolvency does severely undermine the DIF's ability to support resolution by considerably tightening the least-cost constraint, as understood today. Introducing more leeway to interpret the costs for the national DIF of paying out deposits in liquidation, by considering indirect effects on the industry, would blur the line between the roles to be played by the SRF and the national DIF, introduce uncertainty about the effective available support and provoke inconsistencies across countries.

Moreover, introducing additional constraints and operational obstacles to reduce the minimum bail-in required to obtain support from the SRF would most likely further constrain the available funding for SoB transactions. At the very least, the timely verification that all those conditions are met could be operationally challenging given the speed with which resolution actions need to be adopted.

In sum, there is a risk that, under some of the proposed amendments in the CMDI, the SRB could find itself unable – due to the lack of sufficient funding instruments – to deal with the failure of mid-sized banks even if they pass the now more flexible public interest test. Ultimately, that might require the SRB to transfer the responsibility to national authorities in order for them to apply national insolvency procedures including liquidation aid to be provided by the domestic sovereign. That would not only contradict the spirit of the European bank failure regime and the objectives of the new resolution framework at the global level but also challenge the very purpose of the banking union.

Conclusions

This article has argued that there is scope to consider several possible reforms of bank failure management regimes. In general, adjustments to the current setup should aim to satisfy two basic objectives. The first is to improve the resolution framework and resolution tools to make them more effective and therefore reduce the need for government support to be provided to failing banks in order to preserve financial stability. The second is to embed sufficient flexibility and pragmatism in the arrangements as regards the use of different tools and the availability of external funds.

In particular, there are strong reasons to extend resolution planning obligations to all banks whose failure could have adverse effects on the financial system. Crucially, resolution plans should include well defined requirements for a minimum amount of loss-absorbing liabilities in resolution. Those requirements should be calibrated to directly support the feasibility of the envisaged resolution strategy and ideally be composed primarily of debt -instruments rather than equity as the latter might well largely disappear before resolution is triggered.

In addition, as there is no way to foresee all the possible conditions that might occur in a resolution weekend and affect the feasibility of resolution measures, planned resolution strategies should be more an array of options for deploying different tools than a rigid playbook. Importantly, experience shows that it is wise to put in place well defined procedures for the delivery of extraordinary external support in extreme circumstances.

Finally, the EU now has a great opportunity to address the deficiencies identified in the current bank crisis management framework, particularly with regard to the failure of mid-sized bans. The European Commission's CMDI legislative proposal is a highly valuable and internally consistent initiative. The rest of the European authorities would do well if, despite the difficult negotiations that reflect a disparity of national interest, they manage to achieve a political compromise that would preserve the proposal's main features and objectives.

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