EBA EUROPEAN BANKING AUTHORITY

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From bank bail-outs to bail-in: progress and open issues

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Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

I would very much like to thank Prof. Gianfranco Vento for the invitation to Regent's University and for the opportunity to engage with you on a topic that is currently high on the list of priorities for the EBA - the implementation of the new EU framework for bank recovery and resolution.

As we meet here today, I am glad to say that the European banking sector has made major strides in recovering from the devastation of the double hit experienced from the Lehman crisis of 2008 and the sovereign debt crisis of 2011-12. It is now far stronger both in terms of capital and liquidity than when these events shook the system to its foundations.

However, this recovery, while necessary and very welcome, should not dull the memory of the magnitude of what occurred. Let me briefly recall a few key statistics to refresh your memory. Over the five year period from the commencement of the crisis, the European

Commission took over 450 state aid decisions on measures of national governments to support the financial sector. These included the authorisation of €4 trillion in guarantees for bank liabilities, over €800 billion in recapitalisation and €600 billion in asset relief measures. While these figures are in themselves staggering, they are by no means the complete picture. The debilitating social costs of the turmoil - rising unemployment levels, decreasing labour force participation and slow new job creation - and broader economic costs are enormous. According to the Basel Committee on Banking Supervision, GDP in G20 countries is still 30% below its pre-crisis trend - a loss in output of over $76 trillion. In many ways, even now, the financial aftershocks from these events are being felt and continue to challenge fiscal and monetary policy-making in Europe.

The crisis exposed many weaknesses in the system of financial regulation and supervision, and generated a complete overhaul of the infrastructure in Europe, with a two-pillar response focusing on micro- and macro-prudential supervision. In the context of the first pillar, the European Supervisory Authorities (ESAs) were created: the EBA was established together with its sister organisations in the securities and insurance sectors, ESMA and EIOPA. The second pillar, focusing on possible systemic risks, led to the creation of the European Systemic Risk Board (ESRB). In order to address the weaknesses in the construct of the single currency exposed during the sovereign debt crisis, the Banking Union was subsequently created, with the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB), both now operational.

These institutional developments have taken place in parallel with the development of a revised system of prudential regulation, centred around the idea of the Single Rulebook: a common set of rules, directly applicable in all Member States, putting an end to the use of the regulatory lever to favour national champions or attract business in domestic marketplaces – a practice that had significantly contributed to the weakening of bank regulations in the run up to the crisis. The EBA has provided its contribution to put in place this set of stronger and unified rules, with the development of more than 150 technical standards and guidelines. Understandably, the focus of these efforts has been on strengthening the financial system and increasing the buffers against future shocks.

However, as policymakers, we are also acutely aware that failure cannot be completely eliminated and regulation should not aim at that. Rather, failures must be managed in a way that minimises unnecessary disruption and internalises, to the largest extent possible, the cost of the failing entity, imposing losses first and foremost on its shareholders and creditors, rather than on taxpayers.

During the crisis, authorities came to the conclusion that in many instances it was not possible to smoothly resolve an ailing bank without generating potentially large collateral damage and contagion to other parts of the financial system. Also, thanks to the system of explicit and implicit public guarantees, banks had grown too big, too complex and too interconnected to be easily resolvable. National resolution regimes were often lacking key instruments and powers to support the wind-down or liquidation of banks; lack of consistency across countries impeded coordination of actions for addressing the problems in cross-border groups. In many cases, national governments had no choice but to bail out banks. Public resources were diverted from other uses to the support of failing banks, often at the cost of a significant deterioration of the fiscal position of the government. Conversely, creditors, including investors in subordinated debt that had been computed as regulatory capital, were in most cases unaffected and continued to receive regular payments of the coupons on their investments.

A paradigm shift was an absolute necessity. A commitment to bail-in private shareholders and creditors before deploying any public support was needed to protect public budgets and taxpayers, to restore the right incentives, address moral hazard and more generally, to provide a sense of fairness in societies deeply scarred by the crisis.

The core of the reform is that we have to prepare and plan in advance, as much as is practically possible, for dealing with banking failures. In the EU, the Bank Recovery and Resolution Directive (BRRD) is the key manifestation of this thinking and maps the way forward. It provides a credible set of tools to intervene sufficiently early and quickly in failing institutions. It seeks to ensure the continuity of the institution’s critical functions and minimise the impact on the rest of the financial system. Importantly, it requires that shareholders bear the losses first, followed by creditors as determined by the insolvency

hierarchy, to achieve, to the maximum extent possible, the internalisation of the cost of failure.

Central to the drive for successful management of a future crisis is the establishment of a consistent and harmonised approach to bank resolution across the Union. Without this, the level playing field for banks in terms of financing conditions, planning and other costs would be compromised. And, in a crisis, an absence of coordination would undoubtedly translate into an unnecessary destruction of value. Even more importantly, without trust amongst authorities that a cooperative solution would prevail in a cross-border crisis, each of them would face a strong incentive to ring-fence local operations as a mean to provide additional safeguards to domestic depositors. The fear of negative externalities in bad times would lead to market segmentation in good times, hence severely reducing the benefits of the Single Market.

The Directive seeks to deliver an incentive compatible structure. It represents a vast improvement on the pre-crisis situation. For instance, it makes banks cognisant of the need to consider not just how to grow their balance sheet and profits, but also potential recovery options and the feasibility of resolution, as they develop their business models. It has led to the establishment of resolution authorities throughout the EU, entrusted with far reaching powers to execute actions in the event of a crisis. It has delivered a consistent body of legislation in each Member State and at the EU level.

These are all very major accomplishments.

Still, it would be misleading to conclude that it is ‘problem solved’. As in any significant paradigm shift, having the new rules in place is just the first step, possibly the easier one. The real challenge is in actual execution.

Since the BRRD’s introduction at the beginning of 2015 we have, unfortunately, already had quite a number of bank failures which have highlighted the complexities that still exist in dealing with failing institutions, even relatively small in size and without significant cross-border presence. For instance, issues arising with Heta Asset Management in Austria, Novo Banco in Portugal, the application of resolution measures to four Italian banks and to Greek banks at the end of 2015, have focused attention on five key areas:

- the difficulties of the resolution planning process, including cross-border cooperation;
- the challenge of valuing the balance sheet in a clear and timely manner;
- the setting of proper minimum loss absorption levels:
- the transparency for investors, with a special focus on retail clients;
- the use of deposit guarantee funds in resolution.

Let me expand on these topics to provide the EBA perspective on these key outstanding issues and the way forward.

Resolution Planning

The most evident problem that the recent crisis highlighted was the lack of preparedness at all levels for dealing with the failure of major banks with a global presence. While simulation exercises were undertaken in advance to try to anticipate problems, the reality was that the magnitude and complexity of the events revealed a collective incomprehension of the weaknesses and interconnectivity in the financial system and an absence of legal tools to address the numerous problems that presented themselves. This lack of understanding existed not only within the boards and management charged with running the banks, but also with banking supervisors and those charged with maintaining financial stability.

The key action now is to start delivering resolution plans for banks that are both credible and feasible in terms of ensuring the continued provision of critical functions, maintaining financial stability, protecting the funds of the bank’s clients, especially depositors, and minimising the need for support with public funds. This is very far from being a simple exercise: it requires some tough decisions and will encounter resistance from those who may be negatively affected. However, it is important that those decisions are made as early as possible.

There have been delays, primarily in the transposition of legislation and the establishment and operationalisation of resolution authorities. The progress in developing credible and operational resolution plans needs to accelerate. It is important that resolution colleges are quickly established, resolution information is appropriately shared, impediments to resolvability identified and subsequently addressed, and that decisions are taken jointly by the relevant authorities on the strategy and detail of the plans. The expectation must be that 2016 will see significant progress, particularly with respect to large banking groups.

Our standards on resolution plans should facilitate the joint decision process. They have defined proportionate requirements, avoiding the imposition of unnecessary administrative burdens on smaller banks with simpler business models and a lower risk profile. The EBA, as a member of resolution colleges, will actively participate in the process for the larger banks and in other cross-border institutions experiencing stressed conditions. Our priority will be to assist the parties in reaching joint decisions. One of the key functions that the Directive attributes to the EBA is to provide binding and non-binding mediation in situations where disputes amongst authorities exist. During the crisis we did our best to foster cooperative solutions in cases of crises with cross-border spill overs. This experience led me to the conclusion that the only way to prevent future crises leading again to repatriation of business, ring fencing of capital and liquidity and segmentation of the Single Market is to prepare in advance and lay down precise commitments to cooperation in legally binding decisions.

Valuation

An up-to-date, credible and reliable valuation of an institution's assets and liabilities is key to the success of the resolution process. According to the BRRD, three different valuations are needed. The first seeks to inform the determination whether the conditions for resolution or the write-down or conversion of capital instruments are met. The second, which is also taken in advance of resolution action, is to inform the choice of the resolution action to be adopted and the extent of any eventual write-down or conversion of capital instruments and eligible liabilities. After resolution action is taken, a third valuation is

conducted to determine whether an entity's shareholders or creditors would have received better treatment if the entity had entered into normal insolvency proceedings – i.e., whether the "no creditor worse off" requirement has been met.

While it may sound obvious, it is vital that banks are constantly in a position to carry out accurate valuations of both their assets and liabilities. Recent bank failures and resolution actions have showed that this is not the case and this important weakness can lead to extremely unpleasant surprises for debt holders.

Up-to-date valuation clearly requires robust and integrated IT systems. It is absolutely imperative that this issue is now given highest priority by directors and senior management in banks and that appropriate levels of investment are made to meet the required standards.

Also, all the valuations need to occur within a fairly tight time frame, so that certainty is promptly established as to the overall amount of losses, its distribution amongst different categories of investors, and the stability of the new arrangements established as a result of resolution actions – e.g., the split between "good" and "bad" bank. Very lengthy processes and significant corrections in valuations may destabilise the resolution process, prevent the restoration of market confidence and increase the risk of protracted litigation. Resolution action is effective when it allows all stakeholders to "turn the page" and reset on the new reality. As recent experience shows, this is far from being an easy task.

Loss absorbing capacity

A decisive element in the successful management of any resolution involves ensuring the bank's own capacity to absorb losses in the case of failure. The BRRD minimum requirement of eligible liabilities (MREL) goes beyond existing requirements for own funds and ensures that losses will be borne first by the bail-in of shareholders and creditors. This should mitigate – if not extinguish – the negative externalities of a bank failure.

The EBA has submitted to the Commission its draft standards on MREL in July 2015. Loss absorption capacity should be aligned with the bank-specific resolution strategy

and anticipate recapitalisation needs after resolution. This should result in the post-resolution entity credibly meeting minimum capital requirements so that market confidence is restored. Our standards abide by the principle of proportionality, by imposing no additional requirements for small banks that are likely to be resolved via ordinary liquidation procedures. At the other end of the spectrum, if a bank is systemically important, then resolution authorities should consider the potential need to access the resolution financing arrangements: the assessment should therefore focus on the institution's ability to meet, at the point of resolution, the requirement set by the BRRD that shareholders and creditors make a contribution to loss absorption and recapitalisation of no less than 8% of total liabilities and own funds, before the resolution fund may be used. Our standards lay out the requirements for large systemically important banks in such a way as to be compatible with the global requirements set by the Financial Stability Board (FSB) on total loss absorbing capacity (TLAC). In addition, some adjustments to Level 1 legal texts might be considered and are currently being discussed. Although we understand that the Commission is pondering changes to our draft standards, it is essential that final decisions are taken quickly, within the foreseen timeline, to provide firms and resolution authorities with the certainty needed to plan ahead.

The EBA will soon publish the results of its impact analysis on the MREL requirements. Our study will provide quantitative information on the challenge banks have to meet in adjusting their liability structure to fulfil the new requirements. But while the issue of the "quantity" of loss absorbing capacity is dominating the debate, I believe that its "quality" is equally - if not more - important.

A clear hierarchy between different liabilities can significantly improve the quality of loss absorbing capacity, as every investor would know, in advance, the waterfall in case of a crisis – i.e., the sequence in which liabilities would be called in to absorb losses. If the "rules of the game" are well known in advance to all players and the different risk for each class of investors is well reflected in the pricing of the instruments, nobody is going to be taken by surprise when the resolution authorities start executing the plans in an actual crisis. Of course, instruments that are accepted as regulatory capital must have features that ensure the highest loss absorbency, permanence and flexibility of payments. As to other instruments, some type of subordination of long term senior liabilities to operational

liabilities is also helpful. It could be achieved via legislative provisions (statutory subordination), through the inclusion of specific contractual clauses (contractual subordination), or by issuing senior debt at the holding company level (structural subordination). Subordination gives additional clarity and protection to those creditors, especially retail clients, who are not willing to take on greater risk. Proposals to introduce common subordination requirements to ear-mark senior unsecured liabilities that would be subject to bail-in in a crisis were made during the negotiations of the BRRD, also by EBA staff. Unfortunately, the BRRD left the choice to Member States, which have introduced different subordination requirements in the national implementation of the Directive. While any step towards subordination is welcome, a greater harmonisation would have been desirable to facilitate cross-border coordination of burden sharing.

Once resolution authorities have defined the preferred resolution strategy and the MREL requirements, banks will have a time window to adjust – 48 months according to the proposals contained in our draft standard. This should allow substituting maturing liabilities with new ones of the appropriate quality. The journey has already started. The preliminary indications are positive: new instruments with enhanced subordination features are being issued with fairly contained impact on the cost of funding; several banks have conducted liability management exercises buying back old instruments and substituting them with others issued at holding company level or containing subordination clauses, also with a manageable – if not positive – impact on costs.

The adjustment might prove more complex for banks that still have fragile balance sheets and a significant legacy of poor quality assets. But resolution planning and MREL requirements should provide the right incentives to accelerate the process of cleaning balance sheets and restructuring existing business where needed.

One should also acknowledge the difficulties associated with the current environment of zero or negative interest rates for short and even medium term debt. With the MREL and the new regulatory requirements on liquidity risk, banks need sources of financing with longer duration, while at the same time some of them may have more deposits than they are able to channel to the economy as loans to households and enterprises. What we observe as a consequence are charges on larger deposits or deposit

related services, in particular in Member States with high levels and inflows of deposits from Member States whose banking systems are perceived as less reliable. In my view this shows deficiencies in the credit intermediation cycle and the single market, which banks will have to deal with for some time.

Transparency and distribution to retail clients

As the bail-in of private investors becomes the first line of defence in a banking crisis, there needs to be a leap forward in transparency.

The information disclosed by banks should enable investors to assess the quality of assets and to have a clear picture of the amount and type of capital and other liabilities available to absorb losses. Most importantly, it should be possible to make meaningful comparisons across banks. Until recently, this was very difficult. But since its establishment, the EBA has worked hard to develop common definitions of key balance sheet items - for instance of non-performing and forborne loans, regulatory capital, high quality liquid assets, and asset encumbrance. Also, we are well advanced in our work to ensure greater consistency and reliability of risk-weighted assets calculated by banks with their internal models.

Since our establishment in 2011 we have been regularly publishing extensive sets of data on the largest EU banks and we intend to further enhance our role as hub of relevant information on individual institutions.

Supervisors and resolution authorities also need to be more transparent: they should clearly communicate and explain their decisions, when these affect the triggers that may lead to suspension of dividends to shareholders and coupon payments to investors in other capital instruments (Additional Tier 1 and Tier 2), or to write down and conversion into equity of “bail-inable” instruments. The EBA recommended supervisors to disclose their decisions to request additional capital under the supervisory review and evaluation assessment (SREP). I am convinced upcoming decisions on MREL should also be subject to disclosure.

Doubts over the credibility of bank disclosures and lack of clarity in the signals sent out by supervisors, together with waning trust of market participants in the outlook for banks in a low interest rate environment, have been cited as key factors in explaining falling primary issuance volumes and rising spreads for senior and subordinated debt in early 2016.

Indeed, both banks and regulators have a role to play in the context of well-functioning markets. Predictability in the event of failure is a key element in reinforcing confidence in the process. The decisions on MREL should be used to make sure that all actors - resolution authorities, prudential supervisors, conduct authorities, issuing banks and investors - have the same understanding of the requirements and of the hierarchy of claims in going concern and in resolution.

The call for transparency is particularly topical for the marketing of subordinated or long term debt to captive retail investors. The mis-selling of risky instruments to retail clients, unaware of the underlying risks, has made some authorities reluctant to fully apply the bail-in requirements, even to instruments that were recognised as regulatory capital - Tier 2 or even preference shares. Some have raised fundamental doubts on the tool itself, calling for a fundamental reconsideration of the new regime. Others have suggested a complete ban on the distribution of instruments subject to write down or conversion into equity to retail customers. I am of the view that as retail investors may buy shares, they should also be allowed to subscribe for subordinated debt instruments. What is essential is that they are fully aware of the risks that they assume. The Markets in Financial Instruments Directive (MiFID) already requires that investors are carefully informed about the risks of the products being offered to them and makes clear that particular care needs to be exercised to actively manage the conflict of interest when financial institutions are distributing their own liabilities (the so-called “self-placements”). The EBA, ESMA and EIOPA issued, in June 2014, a joint paper reminding financial institutions to strictly adhere to these requirements in light of the regulatory reforms pushing banks to strengthen their capital and to issue loss absorbing liabilities. More recently, ESMA clarified that all instruments subject to write down and conversion should be considered as "complex" and be distributed to retail customers only after they have benefited from independent advice. A strict enforcement of these requirements should ensure adequate protection of consumers.

Of course, cases of mis-selling have to be treated as such, enforcing the relevant rules. However, there is also an issue of transition from the old to the new world. If a bank's liabilities, including senior and subordinated debt, are predominantly held by retail customers, the exercise of bail-in could be more difficult. I am of the view that this needs to be considered by resolution authorities, in their assessment of the resolvability of a bank. At the same time, banks should consider setting out a plan to manage the substitution of maturing liabilities placed to retail investors with issuances to institutional ones. Liabilities management exercises could also help speed up the transition.

Deposit guarantee schemes

An evident concern at the heart of the reform that has taken place is the protection of deposits. A key challenge in this debate has been how to secure depositor confidence while at the same time withdrawing state guarantees.

The starting point was to extend to the new framework the sacrosanct principle of the protection of covered deposits up to 100,000 euro, which was explicitly recognised as a resolution objective. Covered deposits were carved out from any burden sharing, deposits were given a preferential ranking in the hierarchy of claims and deposit guarantee schemes (DGSs) were considerably reinforced in all dimensions: increased coverage level, shortened repayment deadlines, ex ante funding requirements, amongst others. DGSs are now integrated into a wider system of crisis management tools and are required to contribute to resolution costs *in lieu* of covered depositors. The EBA accompanied this effort, fleshing out the single rulebook on deposit guarantee with guidelines on risk based contributions, payment commitments, cooperation agreements and DGS stress tests. We are also increasingly playing our role as a watchdog, ensuring an appropriate application of the common rules. For instance, in 2014 we issued a breach of Union law recommendation to the Bulgarian authorities requesting them to trigger the reimbursement of covered depositors at the failed bank KTB.

I see at least three challenges in the future.

First, full delivery on the recent reform on deposit guarantees will take time. Some Member States are still finalising the implementation of the Directive into domestic laws. For all schemes, the funding capacity will be built-up progressively. Mind-sets also need to change. As a matter of principle, DGS funds are not to be used to bail out failing banks. The Directive does allow for the use of DGS funds to prevent failure, but this can only happen under very specific conditions. Saving a weak bank with competitors' money, via a DGS scheme, cannot be seen as the way forward. DGSs are there to save depositors in failure, not to save banks from failure.

Second, the exact limits of DGS intervention need to be assessed. While it is clear that DGSs are under an obligation to contribute to resolution pro quota to the net losses they would have in liquidation, questions arise as to whether DGSs can contribute to a further extent, provided it is still below the cost of a full pay-out. This matter is under active consideration.

Third, given the importance of depositor confidence, one needs to consider the concerns that may exist about the financial strength of national schemes. The European Deposit Insurance Scheme (EDIS) proposed by the Commission would generate critical mass within the Banking Union and is a very welcome proposal. Nevertheless, a solution for the countries outside the euro area should also be considered. For instance, EDIS could be an open architecture, allowing DGSs from other Member States to join in, or to benefit from financial support under well-defined conditions, specified ex ante.

Conclusion

The strides that have been made in recent years to provide a robust framework for the resolution of failed banks are very significant and are a key feature of the Union's response to the financial crisis. The shift from reliance on taxpayer support for failing banks, to explicitly imposing losses on the shareholders and unsecured creditors, is one of the most profound reforms and its implications must not be underestimated.

However, there is still a long way to go before we reach a position where we have feasible and credible plans in place that provide the appropriate level of comfort in terms of

our preparation for future shocks. Difficult decisions will have to be taken in order to remove impediments to resolution. Appropriate levels of loss absorbing capacity are needed to ensure compliance with capital requirements after resolution and to restore confidence in the resulting entity. Equally important is a framework for the continued access of banks to sufficient liquidity for their operating needs throughout the resolution process. To achieve all this, adequate expertise and resources are to be devoted to the resolution planning process.

I have mentioned transparency on a number of occasions and the importance of ensuring that the changes that have occurred are understood by all stakeholders in the banking industry. To deliver on this we need to ensure that all outstanding level 2 legislation and standards, particularly around loss absorption capacity, are brought to completion. Clarity and transparency are central to proper price formation and any ambiguity that exists around issues such as the creditor hierarchy or constraints to coupon payments on convertible and subordinated capital instruments must be addressed swiftly and unequivocally.

A key priority for the EBA is to contribute to a robust safety net that protects depositors, maintains critical functions and safeguards financial stability in future crises.

The transition to the new regime will raise significant challenges, for banks and authorities alike. Impediments to effective resolution exist, addressing and removing them will take some time. The BRRD provides decision makers with the flexibility to deal with idiosyncratic issues, especially in cases that may put systemic stability at risk. But adhering to the core tenets of the new regime is fundamental to avoid confusing market participants. The difficulties experienced in some recent resolution cases should not deflect us from the long term objectives of the new regulatory framework.