Stillborn Banking Union: Explaining Ineffective European Union Bank Resolution Rules

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Those interested in this topic should consult our full published journal article:

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Effective bank resolution rules serve a dual purpose in European Banking Union: they enhance financial stability and break the sovereign-bank debt loop. On the first, the internalization of losses in resolution instead of relying on bail-outs by governments leads to a fairer risk pricing of bank liabilities and ultimately enhances market discipline and financial stability. On the second, minimizing the need for bail-outs decreases the likelihood of host member states suffering from a debt crisis because of the need to rescue banks. The Single Resolution Mechanism is thus one of the three main pillars of Banking Union, including single supervision and deposit insurance, supported by a financial backstop and underpinned by the single rulebook for banking, which includes harmonised resolution rules in the Bank Recovery and Resolution Directive.

In 2014, EU member state governments agreed upon the main element of the European Union's (EU) bank resolution rules — the Bank Recovery and Resolution Directive — and the main element of the resolution regime that applies only to Banking Union countries — the Single Resolution Mechanism Regulation. We refer to the similar rules included in both the directive and the regulation as the EU bank resolution regime. The member state governments agreed that new rules were to be applied to nearly all — with few exceptions — of Europe's banks — both 'significant' and 'less significant' (SSMR, Article 4) — and that 'public interest' (BRRD, Article 32(5); SRMR, Article 18(5)) was sufficient to justify the use of the bail-in tool through which private share- and debt-holders were expected to assume some losses before resolution funds and the public sector provided financial support.

However, since the launch of Banking Union, the European-level resolution authority, the Single Resolution Board ('Board') appears to have interpreted 'public interest' narrowly, leading to the conceptual paradox that even 'significant' banks enter liquidation where the use of public funds with lower and more flexible bail-in preconditions are used to mitigate financial stability concerns. This reassessment of the application of EU rules indicates the lack of a credible resolution framework that would allow the Single Resolution Board to comply with its 'public interest' mandate. Ultimately, this reassessment reflects the ineffectiveness of the EU resolution regime — and thus a major lacuna in Banking Union more generally — by pushing the management of many insolvent banks back to the national sphere to be determined by the vagaries of national politics.

This ineffectiveness is illustrated by the experience with EU bank resolution since 2014. Only one out of six banks under the Single Resolution Board's remit facing solvency problems ended up in resolution, namely Banco Popular Español (Popular). Popular was sold to Santander for one euro, while part of the losses was covered through a bail-in of shareholders and junior subordinated debtholders. Popular must be seen as highly exceptional. Had Santander not accepted to intervene, Popular's Portuguese subsidiary would have ended up in liquidation. The banks in the other five cases — Monte Paschi di Siena, Veneto Banca and Banca Popolare di Vicenza, ABLV Luxembourg, and NordLB — avoided resolution.

We argue that the ineffectiveness of EU bank resolution rules — especially vis-à-vis retail banks that rely on deposit funding which comprise the very large majority of banks headquartered in the EU. In particular, we focus on those banks that are too small to liquidate under corporate insolvency rules and too large to have bail-inable buffers of high quantity and quality for resolution purposes — which amounts to approximately 120 banks out of the EU's largest two hundred banks in terms of assets. This ineffectiveness owes in large part to the difficulty to access and the insufficient availability of resolution and deposit guarantee scheme funds in most EU member states in conjunction with the relatively high minimum requirements for own funds and eligible liabilities (MREL) for many EU banks, which in many cases are unlikely to ever be met — particularly for those banks most likely to require resolution in the Eurozone periphery. We in turn explain this regulatory architecture by examining German and French preferences on EU bank capital requirements, MREL — set in the Bank Recovery and Resolution Directive — resolution financing and deposit guarantee schemes.

We argue that the antecedents of under-capitalized banks, combined with the absence of credible resolution financing, have resulted in a European bank resolution regime that is bound to fail. Market fragmentation and the lack of a true EU Capital Markets Union have resulted in many banks — especially in member states without deep financial markets — being unable to increase the amount or improve the quality of their MREL to ensure successful resolution according to EU rules. The inadequacy of MREL levels undermines the efficacy of the European bank resolution regime because for bail-in to be enforceable, banks need to have a sufficient level of capital, as well as a sufficient amount of 'eligible' liabilities to absorb losses. Without this capital and liabilities buffer (MREL) there is a greater risk of imposing losses on depositors or governments must pay to save or liquidate the bank. Large bail-ins affecting retail investors and depositors can be politically difficult for governments while bail-outs contribute to government debt and ultimately impose the costs of either saving or liquidating banks on tax-payers.

This 'trap door' design resulted from national government preferences on capital requirements and MREL in terms of the preferences of nationally-headquartered banks and the structure of national banking systems. MREL requirements are not directly defined in the EU resolution framework and are set by the resolution authorities, yet they are designed to ensure the enforceability of bail-in to the extent required by the legislature. Therefore, as long as the legislature requires a fixed bail-in requirement before accessing resolution financing, resolution authorities need to draft the MREL policy accordingly. Capital requirements form part of the MREL requirements — while prudential capital comprises equity instruments and other instruments that qualify as own funds, MREL requirements can be met either with more equity or unsecured debt. The fixed bail-in requirements for all banks, as agreed in 2014, may lead to disproportionately high MREL requirements for the retail bank business model and reflects the efforts of a number of EU member state governments — led notably by the French and German governments — to force all banks that require resolution to be in a position to internalize losses entirely by issuing more eligible liabilities. Large universal banks — that can tap markets more easily — and small cooperative and savings banks — that do not qualify for resolution and hence do not require high MREL — are not severely affected by this approach. Instead, mid-sized retail banks that qualify for resolution — numerous in the EU periphery and in other countries that lack deep capital markets — are severely affected by this approach since the need to issue more MREL may threaten their viability. Setting the bail-in requirements at the same level for all banks and thus relatively high for retail banks reflects the powerful interests of national bank lobbies and was prioritized over policy developments that would both protect taxpayers and further European integration. This 'trap door' design also resulted from national government preferences on the revised Deposit Guarantee Scheme Directive agreed in 2014, the lack of a transfer mechanism among national deposit guarantee schemes and failure to create a European Deposit Insurance Scheme. Here we explain government preferences in terms of existing deposit guarantee schemes which in turn reflect both the preferences of nationally-headquartered banks and the structure of national banking systems.

We argue that German, French and most other EU member state governments accepted legislation on EU bank capital requirements and resolution rules on MREL and resolution financing that did not significantly threaten the business models of different banks — from big universal banks to smaller alternative banks. The German and French governments moved to water down the application of Basel III capital guidelines — notably by allowing silent participations. The governments of countries dominated by very large banks — notably France, the UK and the Netherlands — were indifferent to Commission efforts to increase minimum bail-in requirements and thus MREL. The German government largely shared this indifference, at least insofar as the impact on its own banking system was concerned. The Italian government and a number of others moved to dilute efforts to increase MREL due to the retail business models that are prevalent in their jurisdictions.

The fixed bail-in requirements and relatively high MREL found in the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation are unlikely to support effectively either resolution scenario — based on open-bank bail-in or based on transfer strategies — thus pushing banks into national liquidation. The reliance almost exclusively on MREL rather than offsetting MREL requirements with sufficient collective financing in national and EU level resolution funds fundamentally undermines the credibility of the EU's bank resolution regime, ultimately leading to government funded bail-outs instead of private sector bail-ins. Although the EU bank resolution framework relies on MREL to resolve banks, issuing MREL is very difficult for many retail banks. MREL must therefore be seen as a 'trap door' that renders the EU resolution regime inherently defective. Recent efforts in the revised Bank Recovery and Resolution

Directive and Single Resolution Mechanism Regulation from 2019 to recalibrate MREL by taking into consideration different banking models — such as cooperatives — is a step in the right direction. However, the revisions adopted fail to address effectively the fundamental issues of the same fixed bail-in thresholds, the lack of sufficient MREL and the problematic focus on MREL in the EU resolution regime.

Thus, a central element of European Banking Union is found lacking. In the meantime, a number of national resolution funds have not been filled to schedule and the Single Resolution Fund — even if it reaches the planned €50 billion figure — is likely insufficient to resolve large European banks and thus boost confidence in the capacity of the EU resolution regime to avoid a systemic crisis. We argue that the likelihood that these bank-provided resolution funds can ever be used to support resolution is limited because too many EU banks are unable to assume their share of the losses, prior to bail-in, thus preventing resolution. The EU resolution regime would have to be redesigned to ensure the automatic use of resolution funds and fundamental German government opposition means this is unlikely.

Our argument aligns with a number of other studies which point to messy Franco-German compromises on the core elements of Banking Union and thus deficiencies in the design of Banking Union. Our analysis supports claims pointing to the importance of banking system structures in shaping government preferences on both the building blocks and core elements of Banking Union and to the immense power of banks in shaping national preferences and the outcomes on Banking Union. Moreover, we demonstrate the deficiencies of Banking Union which would only be addressed — and only in part — in the context of a future systemic banking crisis and worsening public debt situation in which the capacity of national governments to bail-out banks is sorely tested. The macro-economic effects of the Covid-19 pandemic might well lead to such a crisis.

EU resolution rules were officially adopted to diminish the political pressures imposed upon national governments to rescue failing banks and thus bolster the stability of national banking systems. Fixed bail-in thresholds before accessing resolution funding and inadequate MREL levels undermine the efficacy of these resolution rules. Thus, the preferences of German, French and other EU governments on capital requirements, MREL and deposit insurance resulted in an EU resolution regime and a Banking Union that must be described as stillborn. The micro-economic interests of national banks trumped the macro-prudential stability concerns of governments and the ‘public interest’.