Conference report: Managing and financing European bank resolution

On Monday 24th May the Systemic Risk Centre (SRC) co-hosted an all-day conference with the Financial Markets Group (FMG) on the topic of managing and financing European Bank Resolution.

The conference was opened by **Dirk Schoenmaker** (Duisenberg School of Finance) who gave a comprehensive overview of the most recent additions and contributions to the policy debate surrounding the European banking union.

in his overview Schoenmaker placed particular emphasis on the paradigm shift introduced by giving a more important role to the European Central Bank (ECB) when it comes to European financial stability. Namely, that the ECB has become a major player at the financial stability board by taking over the rule-making and supervision roles through the Single Supervisory Mechanism (SSM). However, deposit insurance as well as the Lender of Last Resort (LOLR) are both still located at a national level while the ongoing debate implies that both will soon be also taken over by the ECB.

Schoenmaker continued by stating that the formation of the European Resolution Authority requires alignment of two very different approaches; market led (Northern Europe) and state led (Southern Europe). The reconciliation of these differences lies in the mixture of two solutions: bail in of senior creditors and bail out undertaken by the European Resolution fund. The main proposition advocated by Schoenmaker was the creation of the European Deposit Insurance and Resolution Authority (EDIRA) with financing from a European deposit insurance and resolution fund.

Having a single decision-making supranational authority, requires building a single deposit insurance and resolution fund to which the risk-based premia would be paid by all Eurozone banks. Although the need for a supranational approach for resolutions has been recognised, it is yet to be finalised, but once it has been deposit insurance at the supranational level should follow as well.

Maria Nieto (Banco de Espana) continued proceedings as discussant for Schoenmaker. Nieto outlined two main points. First, he advocated that deposit insurance and resolution fund should not be defined as a single entity. However, when it comes to deposit insurance Nieto agreed that there is a strong need for a single deposit insurance fund at the Eurozone level. Finally, the potential size of the Deposit insurance and the Resolution fund was discussed, with the emphasis that its size should be endogenous to the strength of the supervision, quality of resolution process and credibility, and that it should prompt access to liquidity once crisis is declared.

In the next session **Simon Gleeson** (Clifford Chance) discussed why bank failures are very different from the typical firm bankruptcies. Namely a bank balance sheet can be solvent, yet at the same time it can be deemed to not have enough capital and the regulator can close it down. This particularity allows for different potential resolution options.

Sean Hagan (IMF) continued the session with his discussion of two major policy responses and their consequences following the most recent financial crisis. The first was a large scale intervention of the public system and the second, the implementation of changes in the system to avoid the need for another large public intervention. Three elements were of the most important for accomplishing the goals set after the crisis: The first was the need for increased capacity for cooperation between domestic regulators and national authorities. In order to achieve this, some minimum level of harmonisation in the resolution directive is required, as well as the development of relationships that allow coordination to be implemented. Hagan also emphasised the importance of the burden share between public authorities across countries, in case some intervention is needed regardless of the prevention measures undertaken. The issue of the burden share remains to be discussed in the future and bearing in mind how challenging it is to reach an agreement on the financing of the single resolution fund at the Eurozone level, it is only going to be even more challenging at the global level.

Discussion given by **Rosa Lastra** (QMUL) outlined three important issues for the ongoing policy debate. Lastra discussed the issue of sufficiency in terms of deposit insurance, and the credibility and difficulty in distinguishing between the illiquidity and insolvency in the resolution process. Lastra underlined a 4-pillar approach based on harmonisation, recognition, cooperation and information sharing, and funding and burden sharing, as the only way towards a cross-border resolution process.

After lunch **Charles Goodhart** (FMG/SRC, LSE) spoke about the differences between bail-outs and bail-ins, as well as underlining advantages and disadvantages for both types of intervention. This discussion is relevant as the need for bank recapitalisation remains in the world of many global systemically important banks, as well as in industry where the lack of it prevents mergers.

Typical problems related to bailouts, such as moral hazard and distributional concerns, were mentioned and although bail-ins may address these problems to a certain extent, other disadvantages can arise. One of the bail-in challenges discussed was that bail-in focuses the loss on a small group rather than distributing the burden of loss across the taxpayers of the country, like bailout. Also, Goodhart emphasised the potential ex post effects on procyclicality and contagion caused by bail-ins which may offset all the benefits they bring when it comes to ex ante reducing the moral hazard.

During this discussion, **Jon Danielsson** (SRC, LSE) raised the point of how clear the rules on bail-ins should be? And whether too much clarity might, in fact, induce strategic behaviour which would deem constructive ambiguity as a better approach to construct the bail-in rules?

Charles Randell (Bank of England) began his session by pointing out that tensions exist between the scope of the EU cross-border branch pass-porting and its fragmented resolution regimes. Although the host authority is vested with significant supervisory functions including the power to take prompt corrective actions, a non-European Bank Union (EBU) host authority has a limited say on the choice of resolutions tools. Randell further illustrated this point with a tale of two imaginary banks. Both of them are headquartered in a Eurozone member state and have branches in a non-participating member states. Because the non-participating state's resolution authority is not involved in the joint decision on measures to improve resolvability, and has no independent resolution powers, contagion may happen through direct cross-border lending and local lending of cross border subsidiaries. **Emilios Avgouleas** (University of Edinburgh) discussed Randell's session and offered two solutions. The first is to negotiate burden sharing arrangements between EBU resolution funds and non-EBU member resolution funds, for systemic branches in the style of the Baltic/Nordic pact. The second solution is to tacitly move to subsidiarisation if home or host country is a non-EBU member.

The last speaker of the day, **Thomas F. Huertas** (Ernst&Young) discussed the design of a resolvable bank; one which is safe to fail. The key feature is the separation of investor obligations from customer obligations at the operating bank. The bank should issue customer obligations, while the parent should issue investor obligations to third parties. The investment of the parent in the daughter bank should serve as the transmission link for losses at the bank level, to losses to investors at the parent level. Huertas claimed that investors, not taxpayers, should bear the cost of resolution and the bank should continue to perform critical economic functions. **Lauren Anderson** (Bank of England) served as the discussant and expressed her concern that the regulation changes which took derivatives trading away from banks, mostly in the US, may increase the transaction cost of counterparties of the bank. She also called for international cooperation among resolution authorities and central banks, in building resolvable banks.