SCOPE

Bank resolution: living wills should come with marriage contracts

Sam Theodore | May 2023

With yet another reassuring set of quarterly results behind them, Europe's large banks look remote from resolution. Preliminary results from the EBA stress tests currently underway reportedly show comfortable capital levels under adverse scenarios.

If so, this may be a good time to reassess whether the existing resolution framework is still capable of delivering what is expected of it: credibly managing a bank failure while preserving financial stability and protecting taxpayers and depositors. A bank failure that can be triggered not only because of capital depletion due to a pile-up of bad debt (regulators' central post-GFC scenario) but also because of a run on deposits while prudential metrics remain adequate, like Credit Suisse, SVB, or Signature Bank.

In my view, the takeover of a stressed bank by a financially healthy peer should be the end-game of bank resolution. It is difficult to assume, not least by depositors, that a failing bank will get to the end of a resolution process and continue as an independent entity with a clean slate. This inherently means that for a transaction to get over the line, it must offer more positives than negatives for the acquiring bank. That can be achieved through various resolution tools, including of course bail-in.

But pragmatically it may also entail elements of partial and temporary State support, if and only if the national political will for that is there. This, of course, runs counter to the zero-bailout credo embraced after the GFC, but it may be a necessary compromise in the new world we inhabit.

A merger forced through resolution, even if some State support complements the bail-in, is the best way to avoid the scenario of a full taxpayer bailout.

Forced merger into a healthy bank is the optimal solution

In the EU, the Bank Recovery and Resolution Directive framework adopted in 2014 and topped up with a few adjustments (not least the recent Crisis Management and Deposit Insurance proposal) represents a logical, intellectually compelling route for banks under growing financial stress. Resolution tools – sale of business, bridge institution, bail-in, or asset separation – are aimed at restoring failing banks' financial viability as going concerns and avoiding the nightmare of the massive GFC-era bailouts. The problem is that having the resolution process result in a financially restored independent bank is not a very plausible scenario.

It has never happened and it may never happen, because of depositors' and the market's panicked reactions when a bank is heading to resolution. And also because of the cataclysmic impact a significant bank threatened by failure could have on a country's economic and political environment, as it would catapult the national government into emergency mode.

The key element for resolving a failing bank without triggering a full public bailout is having it taken over by a financially healthy peer. Which means that rather than pursuing a scenario of restoring the failing bank to financial viability through the BRRD tools, the primary goal of regulators should be to identify and try to convince a suitable financially healthy candidate to accept a merger.

Indeed, what has sorted out failing banks in the recent past has been takeover by healthier peers– resolution or not. Like Santander agreeing to speedily take over Banco Popular in 2017.

If Popular's resolution had been initiated on the premise that it would be cleaned up, recapitalised and once again made viable as an independent entity, it would have failed. The same common denominator was present in the recent bank turmoil in Switzerland and the US, with UBS, First Citizens, New York Community Bancorp, and JP Morgan the consolidators.

But healthy banks, closely watched by their shareholders, would not accept taking over failing peers without receiving the proper incentives and making sure that the positives exceed the negatives. In this respect, a practical solution, according to the circumstances, may be a combination of bail-in and partial and temporary State support.

Specifically, going up the hierarchy ladder to trigger bail-in-able items (from CET1 and AT1 upwards) but also, if it is necessary for a transaction go through, receiving some form of public support, such as a contingent liquidity facility to preserve depositor confidence, or an excess loss guarantee to reassure the consolidating entity.

The oddity in the Credit Suisse case was not the write-down of the AT1s – which was contractually legitimate – but the residual value left in CET1 capital.

When a bank starts running into more significant financial stress, the rapidly emerging circumstances, suddenly loaded with political fears and uncertainties, warrant a radical yet pragmatic solution which may not neatly fit the binary bail-in vs. bailout option. A takeover from within the system is a far better solution than an outright government bailout funded by taxpayers or a bail-in-only route that is unlikely to be workable.

The liquidity element needs to be reinforced in resolution

Having the central bank or other public source provide sufficient liquidity in resolution is a critical element and one that has not sufficiently been attended to in the past. But it is an element that was strikingly obvious in this spring's bank runs.

In a recent speech, Dominique Laboureix, chair of the Single Resolution Board, emphasised this challenge, expressing caution about having enough quality collateral for secured central-bank funding. He rightly added that "if we do not have enough liquidity to handle a resolution, then we remove the option of resolution as a tool to preserve financial stability in the European Union".

But providing external liquidity in resolution is not enough. Unless they see a clear end-game, uninsured depositors would walk and understandably so. Bondholders may do the same, or at best will make the bank's market funding prohibitively expensive.

This is why a forced merger can be reassuring for everybody – except for the failing bank's shareholders and potentially junior bondholders.

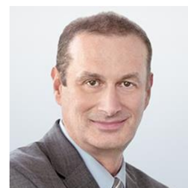
Forced-merger solution should be made more explicit

Regulatory authorities should be more explicit about the forced-merger solution. It has helped most stress cases in the past and there is no reason to believe it won't help in the future. But it also means two things, which are currently not contemplated.

First, that as part of the resolution process, making the failing bank sellable must be an explicit and well communicated goal. What elements would need to be adjusted during resolution to make the bank interesting for a competitor?

Second, if this is necessary, not rejecting *ab initio* the compromise of partial and temporary State support in resolution if the national political will to engage exists. It typically does exist, of course, because no government wants to see a major domestic bank collapse on its watch and be accused of not helping it out. A large bank is not only a set of financial statements, as many in the market see it. It is also a financial intermediator for a multitude of depositors and borrowers – households and businesses. In other words, segments of the voting public.

Analyst



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