Topical issues in bank regulation – from the perspective of the resolution and deposit guarantee authority

GSE Course in Money and Banking

Lecture by Chief Economist Hanna Westman

7 February 2022

RAHOITUSVAKAUSVIRASTO
VERKET FÖR FINANSIELL STABILITET
FINANCIAL STABILITY AUTHORITY

Many different regulatory files are relevant for banks

European Commission

Home > Business, Economy, Euro > Banking and finance

Banking and finance

Financial supervision and risk management

- European system of financial supervision
- Supplementary supervision of financial conglomerates
- Financial supervision of shadow banking
- Managing risks to banks and financial institutions
- Anti-money laundering and countering the financing of terrorism
- Supervisory data collection

Financial markets

- Securities markets
- Investment funds
- Post-trade services
- Corporate bonds
- Analysis of financial markets
- Capital movements

Banking union

- What is the banking union
- Single supervisory mechanism
- Single resolution mechanism
- European deposit insurance scheme
- Sovereign bond-backed securities (SBBS)

Sustainable finance

- Overview of sustainable finance
- EU taxonomy for sustainable activities
- European green bond standard
- Corporate disclosure of climate-related information
- EU climate benchmarks and benchmarks' ESG disclosures
- Sustainability-related disclosure in the financial services sector
- International Platform on Sustainable Finance

Consumer finance and payments

- Retail financial services
- Payment services
- Financial literacy

Digital finance

New financial technologies can facilitate access to financial services and improve the efficiency of the financial system.

Insurance and pensions

- Risk management and supervision of insurance companies (Solvency 2)
- Insurance distribution
- Insurance recovery and resolution
- Motor insurance
- Winding-up of insurance undertakings
- Insurance guarantee schemes
- Insurance of natural and man-made disasters
- Occupational pension funds
- Personal pension products
- Insurance / pensions authorities and organisations

Source: European Commission home page (https://ec.europa.eu/info/business-economy-euro/banking-and-finance_en). Similar listings with links to background information can be found on the home page of the European council (www.consilium.europa.eu/en/policies/?filters=1648).

Outline – questions addressed during the lecture

- Why are banks regulated and supervised?
- Why is bailout of banks not a good idea?
- What has been done to end “too big to fail”?
- How are deposits protected in bankruptcy?
- What is the bank resolution regime?
- Are banks paying for the cost of resolution?

Why are banks regulated and supervised?

Banks differ from normal companies

- Equity is only a fraction of the balance sheet.
- A sizable share of the funding are assets of the customers, i.e. deposits.
- Banks are vulnerable to shocks as the maturity of assets in terms of loans is long, while the maturity of the debt the bank funds itself with is much shorter; banks engage in maturity transformation.
- The value of bank assets and liabilities can change very fast.
- Banks are seen as less transparent than normal companies.
- Trust in banks can vanish instantly and without tangible reasons.
- Banks are linked to each other and to other players in the financial system.
- Many banks have similar business models and hence the same external shock, such as the bursting of an asset price bubble, can affect many banks simultaneously even if they would not be directly interlinked.

Examples of deposit outflows in crisis banks in Europe

Bank	Start of outflow	Duration	Size in billions (currency)	Run-off rate	Monthly run-off rate
Northern Rock	14 Sep 2007	Few weeks First 4 days	13 (GBP) 4.6 (GBP)	56% 20%	56% 100%
ING direct (internet bank)	Sep 2008	3 months	4.9 (EUR)	3.1%	1%
Landisbanki, Icesave in UK (internet bank)	April 2008	3-4 days	0.2 (GBP)	4.3%	32.1% - 42.8%
Dexia	End-Sep 2011	1 month	7 (EUR)	8.75%	8.75%
Cyprus Popular Bank	June 2012	9 months	10 (EUR)	40%	4.4%
Banco Popular	1 April 2017	2 months 3 days	18 (EUR) 6 (EUR)	24% 8%	12% 80%

Source: ECB *Liquidity in resolution: estimating possible liquidity gaps for specific banks in resolution and in a systemic crisis,*Occasional Paper Series, November 2020 (www.ecb.europa.eu/pub/pdf/scpops/ecb.op250~c7a2d3cc7e.en.pdf).

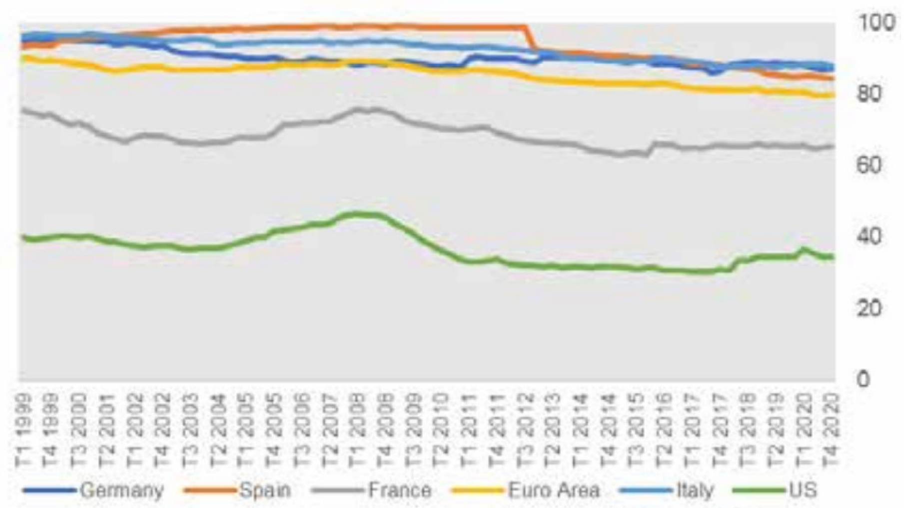
Banks have an important role in the society

- Banks provide customers with a safe mean to store value in terms of deposit and with secure and efficient payments services – the plumbing of the economy.
- Banks engage in financial intermediation by granting loans to customers for consumption or value creating investments, which on the other hand supports economic growth. This is particularly true in Europe, where corporates get funding primarily from banks rather than financial markets.
- Banks have an important role in trading, risk management, wholesale funding and asset management services.

CHART 4.

Share of Bank Credit in Total Corporate Debt, %

Source: Banque de France



Source: EUROFI Regulatory Update, September 2021 (www.eurofi.net/wp-content/uploads/2021/09/regulatory-update_ljubljana_september-2021.pdf).

The failure of a bank can have severe consequences on the society creating costs that banks do not pay

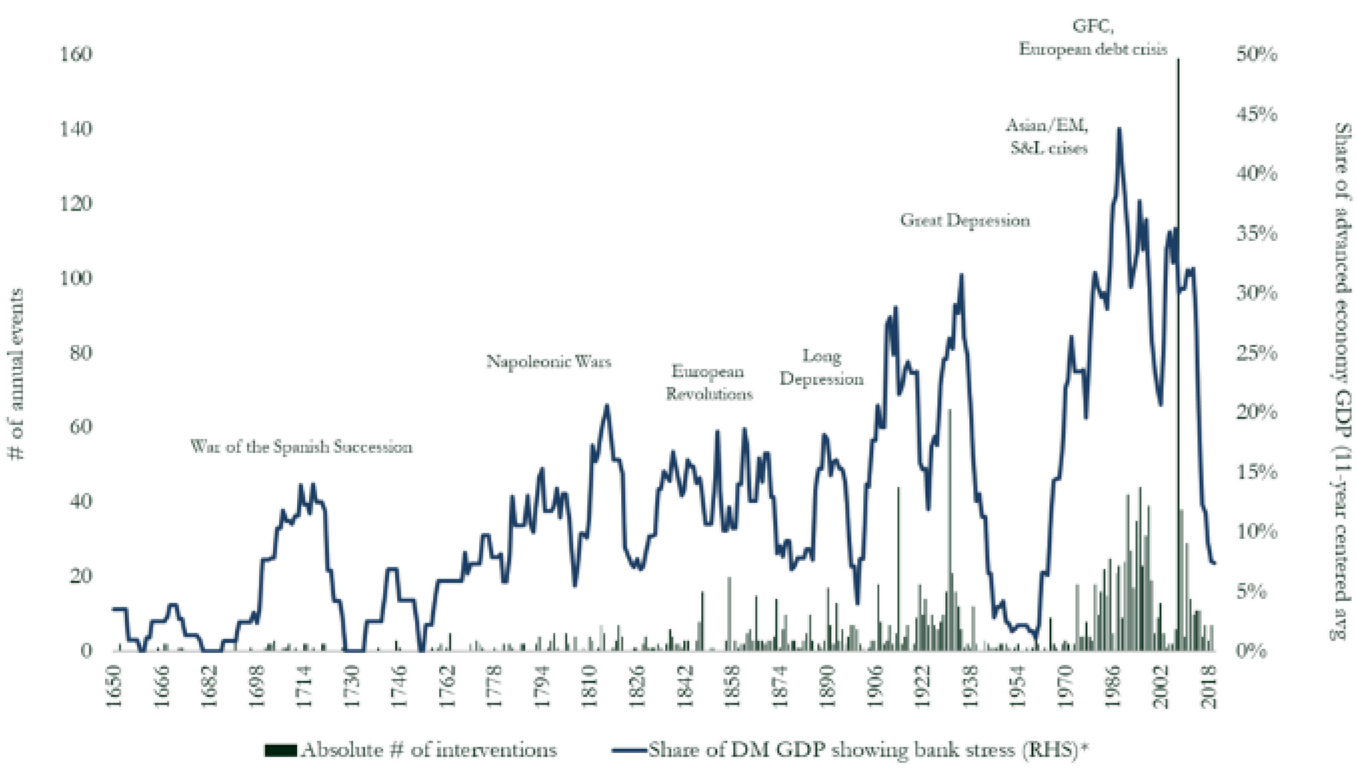
- A failure of a bank, particularly if it has a central role in the financial system, has large-scale implications for households and companies as the bank operations would suddenly stop.
- Problems of one bank easily transmit to other banks e.g. through interbank markets resulting in banking sector wide problems.
- Application of a normal bankruptcy proceeding is not appropriate to solve a crisis situation in a large bank as the process is too slow given the need to ensure continuity of banking operations and as the value of the assets would deteriorate during the long process.
- Therefor authorities have not really had any alternative, but to rescue i.e. bailout failing banks and support them with taxpayers money.

Previously many banks were ”too big to fail”

Why is bailout of banks not a good idea?

It has become increasingly costly to save banks thus depriving use of public funds for other purposes

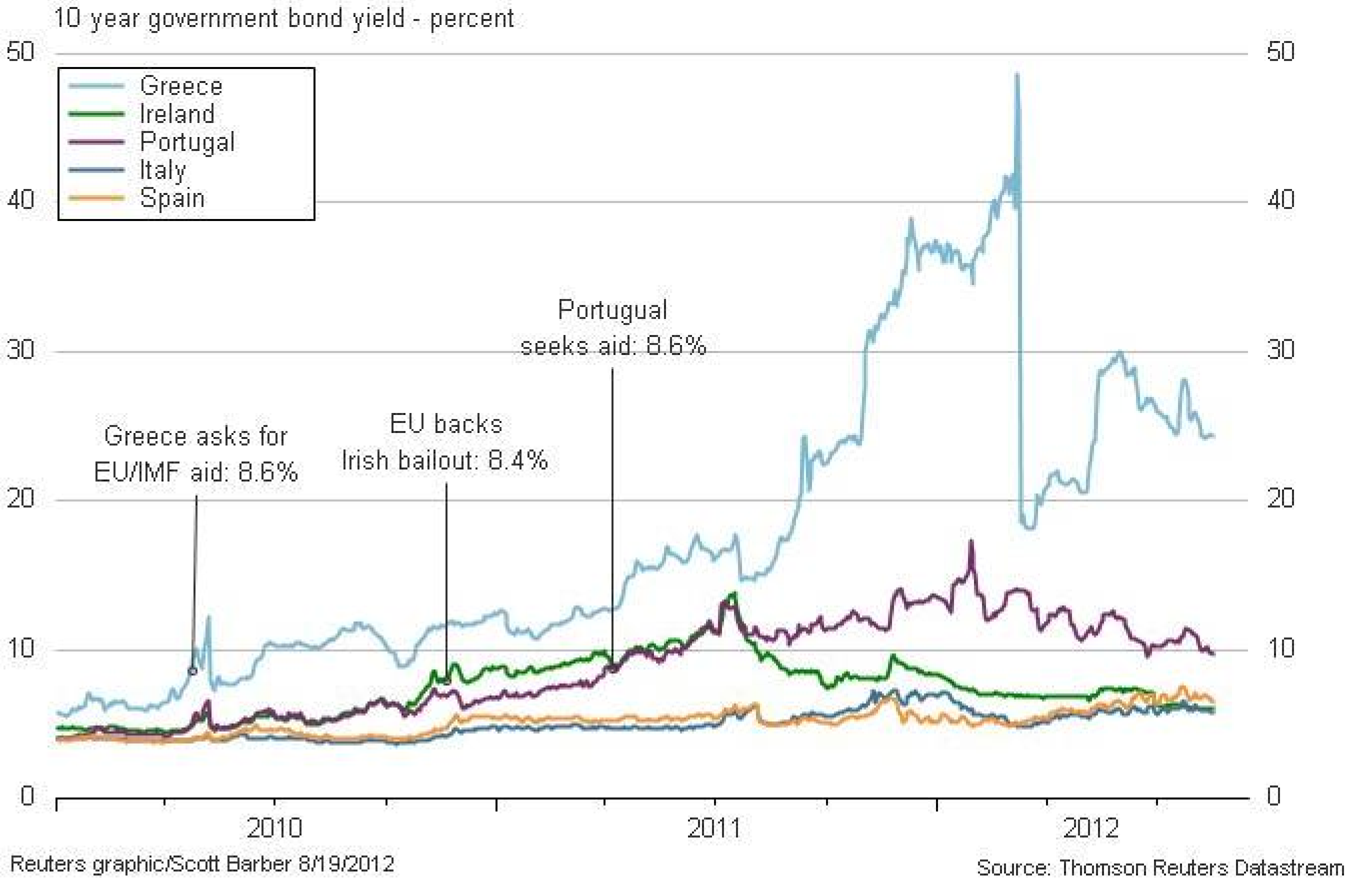
Figure 6: distribution of total interventions, by year, and share of advanced economy GDP exhibiting "bank stress", 1665-2019.

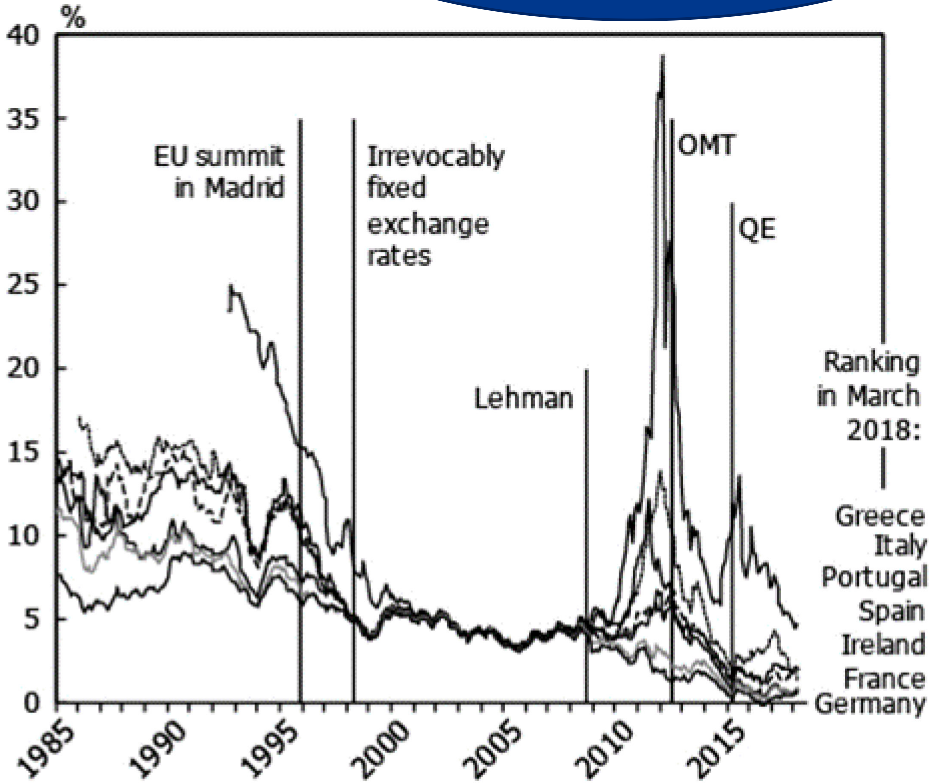


Source: Metrick and Schmelzing (2021) Banking-crisis interventions 1257-2019, NBER Working Paper 29281. The database created by the authors can be found here: https://data.nber.org/data-appendix/w29281/V___Appendix%20C_nber11.pdf. ECB, Liquidity in resolution: estimating possible liquidity gaps for specific banks in resolution and in a systemic crisis, Occasional Paper Series, November 2020.

Indebted countries needed assistance from the troika to bailout banks and funding costs skyrocketed

Troika – European Commission, ECB and IMF





Source: Article in Investing.com (www.investing.com/analysis/ecb-capping-rates-on-piigs-wait-till-traders-call-its-bluff-133470); Sinn (2018) The ECB's fiscal policy. International Tax and Public Finance 25 (https://doi.org/10.1007/s10797-018-9501-8)

Some banks are even “too large to bailout” as they outsize their home country in terms of assets to GDP

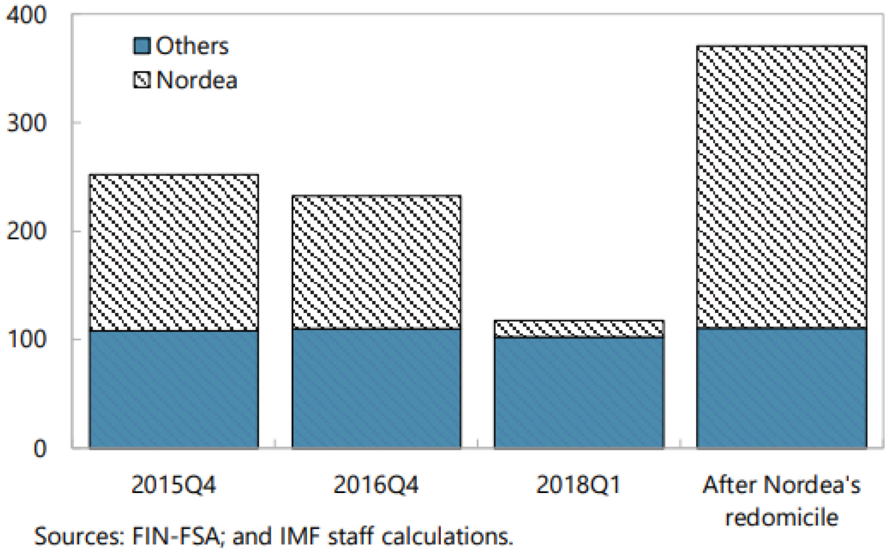
Europe's 50 largest banks

Pro forma for recent and pending acquisitions

Current rank^	Previous rank^^	Current vs. previous	Company (ticker-exchange)	Headquarters	Accounting principle	Total assets (€B)
1	1	NC	HSBC Holdings PLC (HSBA-LON)	U.K.	IFRS	2,419.47
2	2	NC	BNP Paribas SA (BNP-PAR)	France	IFRS	2,164.71
3	3	NC	Crédit Agricole Group	France	IFRS	2,010.97
4	4	NC	Banco Santander SA (SAN-MAD)[1]	Spain	IFRS	1,517.27
5	6	▲	Société Générale SA (GLE-PAR)	France	IFRS	1,356.30
6	8	▲	Barclays PLC (BARC-LON)	U.K.	IFRS	1,345.68
7	7	NC	Groupe BPCE	France	IFRS	1,338.06
8	5	▼	Deutsche Bank AG (DBK-ETR)	Germany	IFRS	1,297.67
9	9	NC	Lloyds Banking Group PLC (LLOY-LON)	U.K.	IFRS	984.15
10	14	▲	Intesa Sanpaolo SpA (ISP-MIL)[2]	Italy	IFRS	942.63
11	10	▼	ING Groep NV (INGA-AMS)	Netherlands	IFRS	891.74
12	11	▼	UBS Group AG (UBSG-SWX)	Switzerland	IFRS	866.31
13	12	▼	UniCredit SpA (UCG-MIL)	Italy	IFRS	855.65
14	15	▲	Royal Bank of Scotland Group Plc (RBS-LON)	U.K.	IFRS	853.32
15	13	▼	Crédit Mutuel Group**	France	IFRS	852.56
16	16	NC	Credit Suisse Group AG (CSGN-SWX)	Switzerland	U.S. GAAP	724.38
17	17	NC	Banco Bilbao Vizcaya Argentaria SA (BBVA-MAD)[3]	Spain	IFRS	696.93
18	18	NC	Standard Chartered PLC (STAN-LON)	U.K.	IFRS	641.95
19	19	NC	Rabobank	Netherlands	IFRS	590.60
20	21	▲	DZ BANK AG	Germany	IFRS	559.00
21	20	▼	Nordea Bank Abp (NDA SE-OME)	Finland	IFRS	554.85
22	22	NC	Danske Bank A/S (DANSKE-CSE)	Denmark	IFRS	503.32
23	26	▲	PAO Sberbank of Russia (SBER-ME)	Russia	IFRS	429.99
24	23	▼	Commerzbank AG (CBK-ETR)[4]	Germany	IFRS	426.30
25	24	▼	Caixa Bank SA (CABK-MAD)	Spain	IFRS	391.41

Size of Finnish Financial Sector

(Percent of GDP)



Sources: FIN-FSA; and IMF staff calculations.

Note: Estimates of size after Nordea's redomicile based on 2017Q4 data.

Source: S&P Europe's 50 largest banks by assets, 2020 (www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/europe-s-50-largest-banks-by-assets-2020-57901087); IMF, Finland 2018 Article IV consultation, Country Report No. 19/7, January 2019 (www.imf.org/en/Publications/CR/Issues/2019/01/15/Finland-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-46518) . Note: Nordea merged subsidiaries to Swedish parent in January 2017 and moved headquarter to Helsinki in October 2018.

Expectation of bailout by the state create incentives for growth and risk taking, increasing risk of failure

More banks become ”too big to fail”

Banks become systemically important for the financial system and must thus be rescued, or bailed out, by state in case of failure.

”Heads, I win – tails, you loose”

The implicit safety net i.e. anticipation of government guarantee in terms of bailout by the state reduces funding costs and monitoring by investors.

Rapid growth, excessive risk taking and indebtness induced by the implicit safety net increases likelihood of banking crisis.

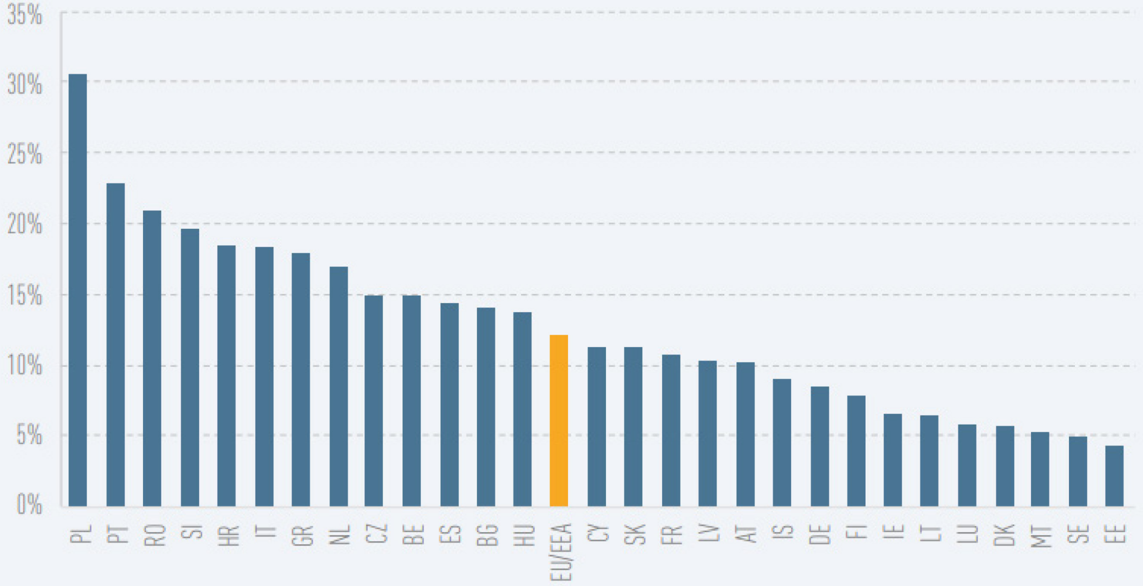
Source: Based on discussed presented in for example in the Liikanen Report (2012) (https://ec.europa.eu/info/publications/liikanen-report_en).

The doom-loop between banks and sovereign also work in the other direction

- Banks commonly invest in debt instruments of the domestic sovereign.
  - Banks' exposure to domestic sovereign debt securities has increased during the Covid-19 pandemic.
- Regulation increases the incentives to invest in these securities and renders capital buffers insufficient in case of a default on a sovereign debt instrument.
  - Sovereign default is seen as a zero probability event in the capital requirement regulation, where a zero risk weight is assigned to exposures to sovereigns.
  - Exposures to sovereigns are also excluded from limits on large exposures.
- Also central bank exposures are large.

Figure 24: Sovereign exposures as a percentage of total assets by country – June 2021

Source: Supervisory reporting data.



Source: EBA Risk Assessment, December 2021 (https://www.eba.europa.eu/eba-risk-assessment-shows-improvements-eu-banks-solvency-profitability-and-liquidity-asset-price).

What has been done to end "too big to fail"?

Scope and intrusiveness of bank regulation have increased

Reduce likelihood of bank failure

- Higher capital requirements and better quality of eligible capital
- New liquidity requirements
- Stricter requirement on governance and risk management
- Improved supervision and stress tests
- Macroprudential supervision and requirements such capital buffers related to systemic risk of banks and procyclicality of lending

Reduce damage in case of bank failure

- New recovery and resolution regime
- Harmonisation of deposit insurance and improvement of operational capability to manage pay-out

Ensured that banks could support real economy through Covid-19 crisis.

Note: Regulation enforcing structural changes ex-ante has been implemented in the US (Volker rule) and the UK (based on the Vicker report). The EU initiative inspired by the Liikanen Report (2012) has been withdrawn. Resolution authorities have the mandate to require structural change to ensure resolvability.

In Europe the banking union was created to eliminate the doom-loop between banks and sovereigns

2014

Single Supervisory Mechanism (SSM)
- ECB supervisor of significant institutions
- Close cooperation with the national supervisory authorities
- Common approach to supervision

2015

Single Resolution Mechanism (SRM)
- Single Resolution Board (SRB) resolution authority for significant institutions and cross boarder groups, with full resolutions powers as of 2016
- Close cooperation with national resolution authorities
- Common approach to resolution
- Single Resolution Fund (SRF) and backstop thereto

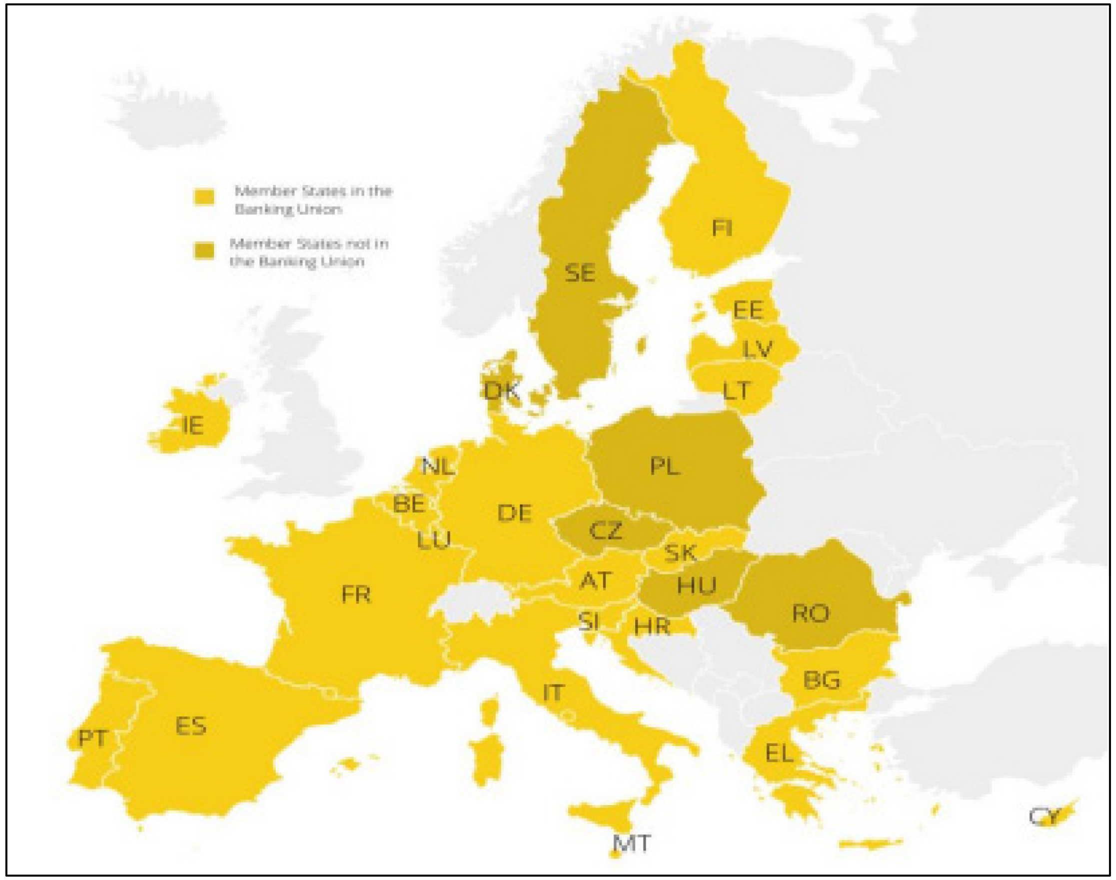
?

European Deposit Insurance Scheme (EDIS)
- Governed by the SRB?
- Role of national DGSs vs. European level authority?
- Size of national DGS funds vs. European Deposit Insurance Fund (DIF)?
- Level of mutualisation – temporary liquidity support vs. loss sharing from the DIF?

Single rulebook
- Capital requirement regulation and directive (CRR2/CRD5) — Update 2020
- Bank recovery and resolution directive (BRRD2) — Update 2020
- Deposit guarantee scheme directive (DGSD2) — Update 2015

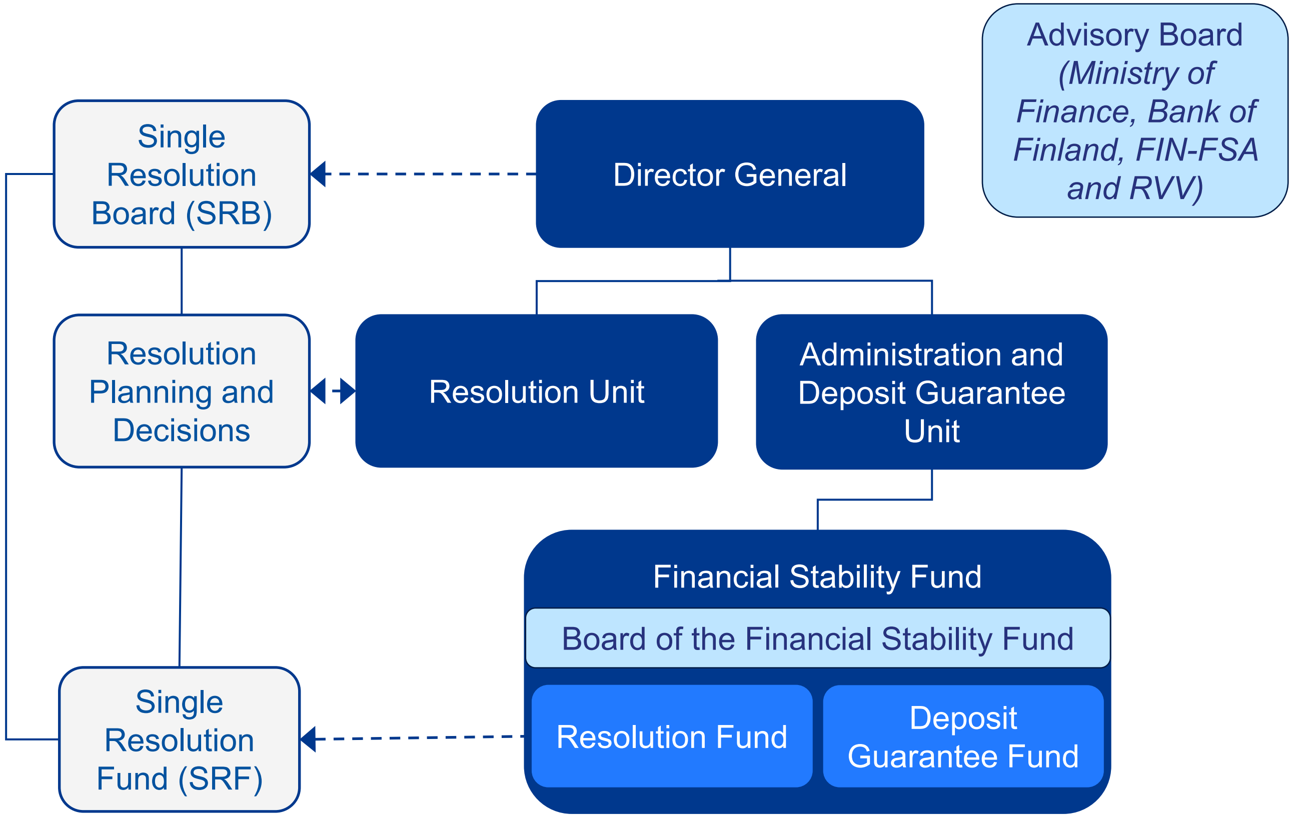
Note.: More information about EDIS can be found in the RVV blog "Pankkiunionin yhteinen talletussuoja (EDIS) hakee yhä muotoaan" (see https://rvv.fi/-/blogi-pankkiunionin-yhteinen-talletussuoja-edis-hakee-yha-muotoaan)

The banking union include euro area countries, Bulgaria and Croatia



In Finland the same authority is responsible for bank resolution and the deposit guarantee system

- The Financial Stability Authority (Rahoitusvakausvirasto, RVV) was established in 2015.
- RVV is an independent authority and is the national bank resolution and the deposit guarantee authority.
- RVV is part of the SRM and cooperates closely with the SRB.
- RVV is also involved in other international bodies related to bank resolution and deposit insurance.
- The cooperation is close with the Financial Supervisory Authority (FIN-FSA), the Bank of Finland and the Ministry of Finance.
- RVV has 20 employees.
- More information about RVV as well as on questions related to bank resolution and deposit guarantee can be found on our home page rvv.fi.



How are deposits protected in bankruptcy?

Covered deposits are payed out with funds from the deposit guarantee fund

Maximum of 100 000 euros of one depositor's deposits in one bank.

Covers all deposits by private persons and most deposits by companies, associations and foundations.

Banks pay risk based ex-ante deposit guarantee fees annually

- The deposit guarantee fund was established in 2015 as the operations of the Financial Stability Authority (a public authority) started.
  - Previously the deposit guarantee was private and managed by the banking federation in Finland (Vanha Talletussuojarahasto, VTSR).
- The target amount of the deposit guarantee fund is 0.8% of covered deposits, which is about 1.2 billion euros.
- The target amount is to be reached by July 2024. There is currently about 780 million euros in the fund.
- The fund is privately funded through ex-ante fees, which are collected from the banks annually.
- The fees are risk-based to account for the probability of failure.

What is the bank resolution regime?

In the new regime systemically important banks will be resolved instead of put into bankruptcy

- Resolution is applied to a failing bank if any of the five resolution objectives outlined in the legislation would be breached in case the bank would be put to bankruptcy. This would happen if …
  - … the bank has critical functions, e.g. a disruption in one or several functions would severely affect customers and substituting services are not available sufficiently rapidly from other banks or other financial services actors.
  - … the disruption of the banks operations would endanger financial stability, e.g. the problems would spread widely to other banks.
  - … the use of public funds would be greater in bankruptcy than in resolution.
  - … the depositors and investors are not protected in a bankruptcy as outlined in the legislation.
  - … the client funds and client assets in the bank are not protected as outlined in the legislation.
- Otherwise the bank is put to bankruptcy rather than resolution.
- In bankruptcy depositors receive the covered deposits from the deposit guarantee fund, while in resolution this is not needed as the banking operations continue.

The resolution authority can apply different tools

Sale of business

Part or all of the shares or other instruments of ownership or assets, right and liabilities can be sold to a private purchaser.

Bridge bank

Part or all of the shares or other instruments of ownership or assets, right and liabilities can be transferred to a temporary entity.

Asset separation

Assets, rights and liabilities can be transferred to an asset management vehicle, totally or partially publicly owned, if liquidation of the assets could cause market disruption.

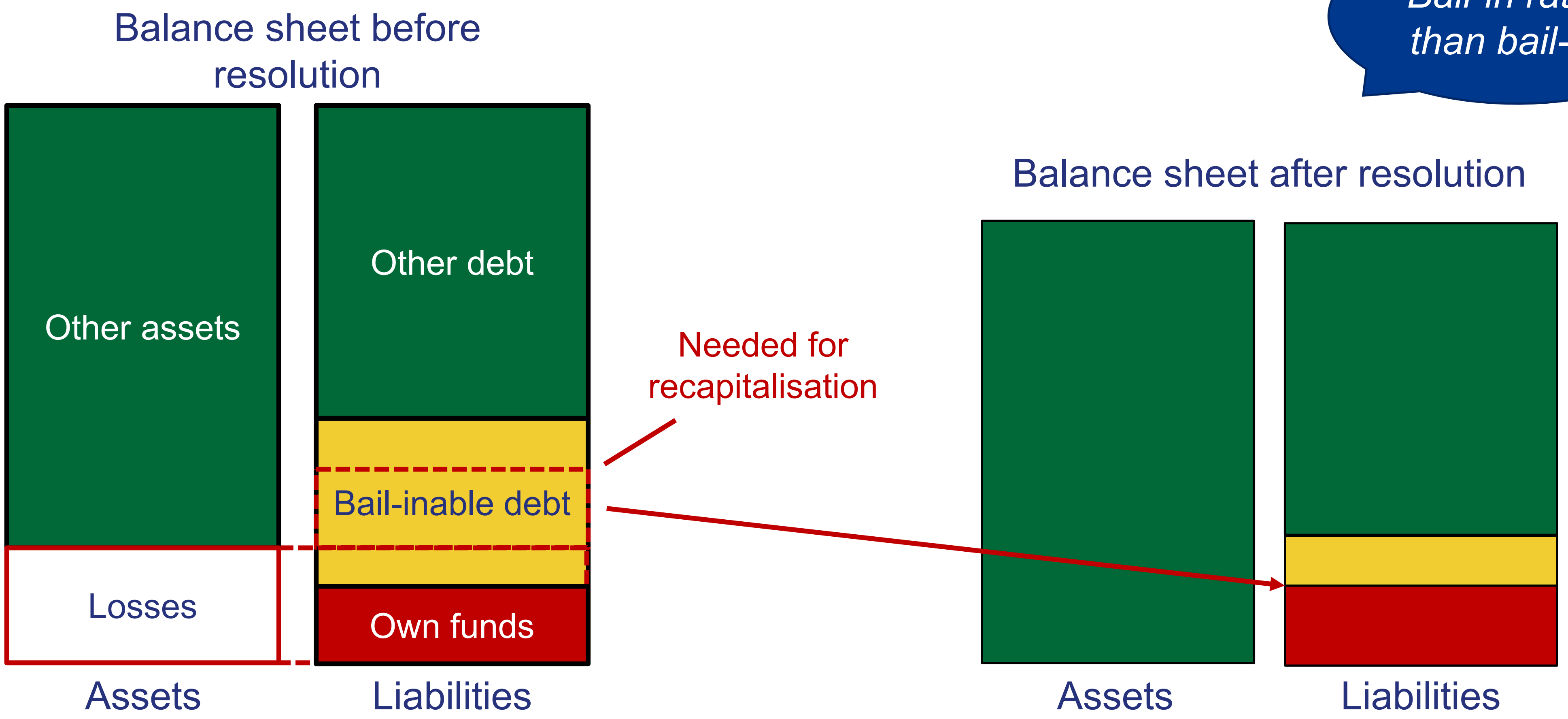
Bail-in

Equity and debt can be written down and converted placing the burden on shareholders and creditors of the bank rather than on the public.

This is really all about corporate finance.

Implementation of the bail-in tool entail changes to the balance sheet of the failing bank

Bail-in rather than bail-out



It is important that the order of loss absorption used when applying the bail-in tool is known by investors

Order of loss absorption i.e. loss waterfall

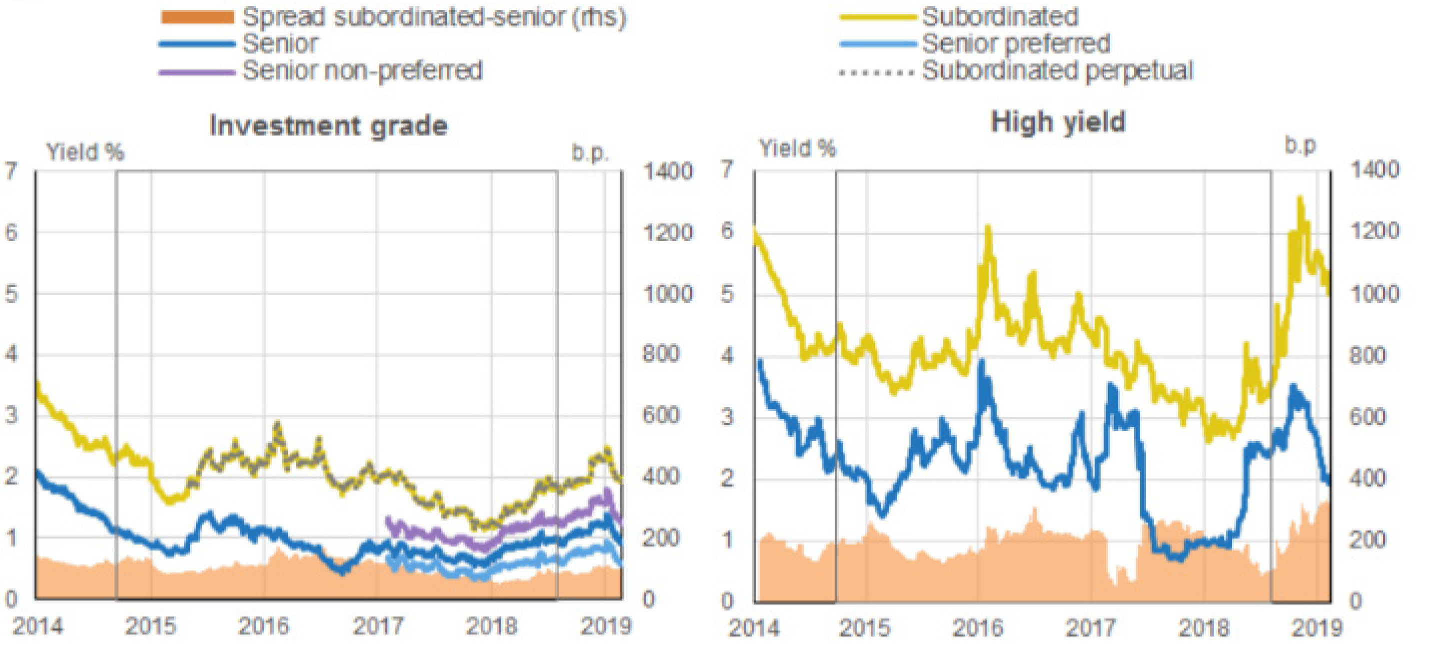
Common Equity Tier 1 capital	Shareholders' equity and retained earnings
Additional Tier 1 capital	Preferred shares, perpetual term contingent convertible securities
Tier 2 capital	Deeply subordinated debt that is eligible as own funds
Senior non-preferred debt	Subordinated debt instruments senior to tier 2 capital, but junior to senior unsecured debt
Senior unsecured debt	Corporate (non-SME) deposits, bonds and other instruments
Deposits not covered, but preferential	Retail and SME deposits in excess of 100 000 euro

Liabilities legally excluded from bail-in:

Covered deposits (≤ 100 000 euro)	Secured debt such as covered bonds and secured derivatives	Customer funds, salaries etc.

The risk of default stemming from the credit hierarchy is reflected in the cost of funding

Figure 1: Yield spread between subordinated and senior unsecured bonds indices, with maturity higher than one year, EUR.



Source: Markit Iboxx. Notes: breakdown of preferred and non-preferred not available for high yield bons. The timespan of the analysis is marked with bars.

Source: ECB (2019) Has the new bail-in framework increased the yield spread between subordinated and senior bonds, Working Paper Series 2317 (https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2317~3a5259cba1.en.pdf).

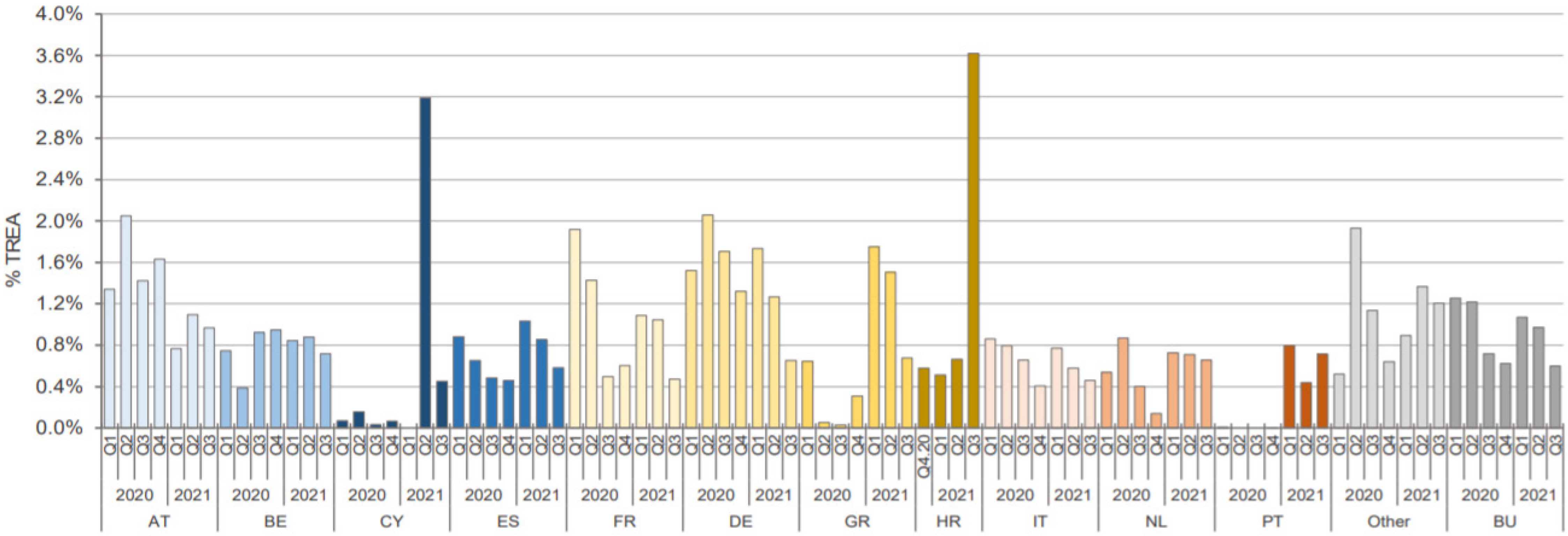
MREL requirements are set to ensure that there is sufficient bail-inable debt in case of failure

	Capital requirement in terms total capital to risk exposure amount (TREA)	Leverage ratio requirement	Minimum requirement of own funds and eligible liabilities (MREL)	
			… as of risk exposure amount (TREA)	… as of leverage ratio exposure (LRE)
Nordea	14,5%	3%	22,71%	5,98%
Svenska Handelsbanken	18,05%	3%	27,86%	6%
SEB	17,90%	3%	27,66%	6%
Swedbank	17,77%	3%	27,46%	6%
Danske Bank	18,0%	3%	29,6%	6,0%
DnB	14,9%	6%	Expected 37%	n.a.

Source: Nordea Capital and Risk Management Report Third Quarter 2021; Nordea Third quarter Financial Report 2021; Finansinspektionen, Capital requirements of Swedish banks as of Q3 2021; Riksgälden press release 17.12.2021, Decisions on resolution plans and MREL; Danske Bank Interim Report Q3 2021; Translation of a decision dated 20.12.2021 from the Danish Financial Supervisory Authority (Finanstilsynet); Results DNB Group Q3 Third quarter 2021; DNB Capital presentation 25.1.2022
Note: The MREL requirements of Nordea and Danske Bank is already in force, while they apply as of 1.1.2024 for the other banks. Danske Bank have to fulfil the requirements with subordinated debt only, while the other banks has separate, lower subordination requirements.

During 2021 issuance has been possible even in southern European countries where banks are weaker

MREL gross issuances by country (% TREA)



Source: SRB MREL Dashboard Q3 2021 (https://www.srb.europa.eu/en/content/mrel-dashboard-0).
Note.: More information about the MREL requirements, banks' MREL resources and issuances can be found in the RVV blog "Tehokas viranomaisseuranta tukee MREL-vaatimusten toteutumista" (see https://rvv.fi/-/blogi-tehokas-viranomaisseuranta-tukee-mrel-vaatimusten-toteutumista).

Acting as bank fails is only possible if rigorous preparations are done beforehand

Bank is failing or likely to fail

Annual preparatory measures

Supervisory authority

- Recovery plan by bank

Resolution authority

- Resolution plan
- Minimum requirement for own funds and eligible liabilities (MREL)
- Measures to ensure resolvability
- Contributions to resolution fund

Early intervention

Supervisory authority

- Implementation of measures in recovery plan
- Extended scope of reporting and disclosure
- Changes in strategy and legal structure of bank
- Change of management of bank
- Appointment of an authorised representative

Resolution

Resolution authority

- Public interest assessment
- Resolution strategy and selection of tools
- Use of resolution fund

Are banks paying for the cost of resolution?

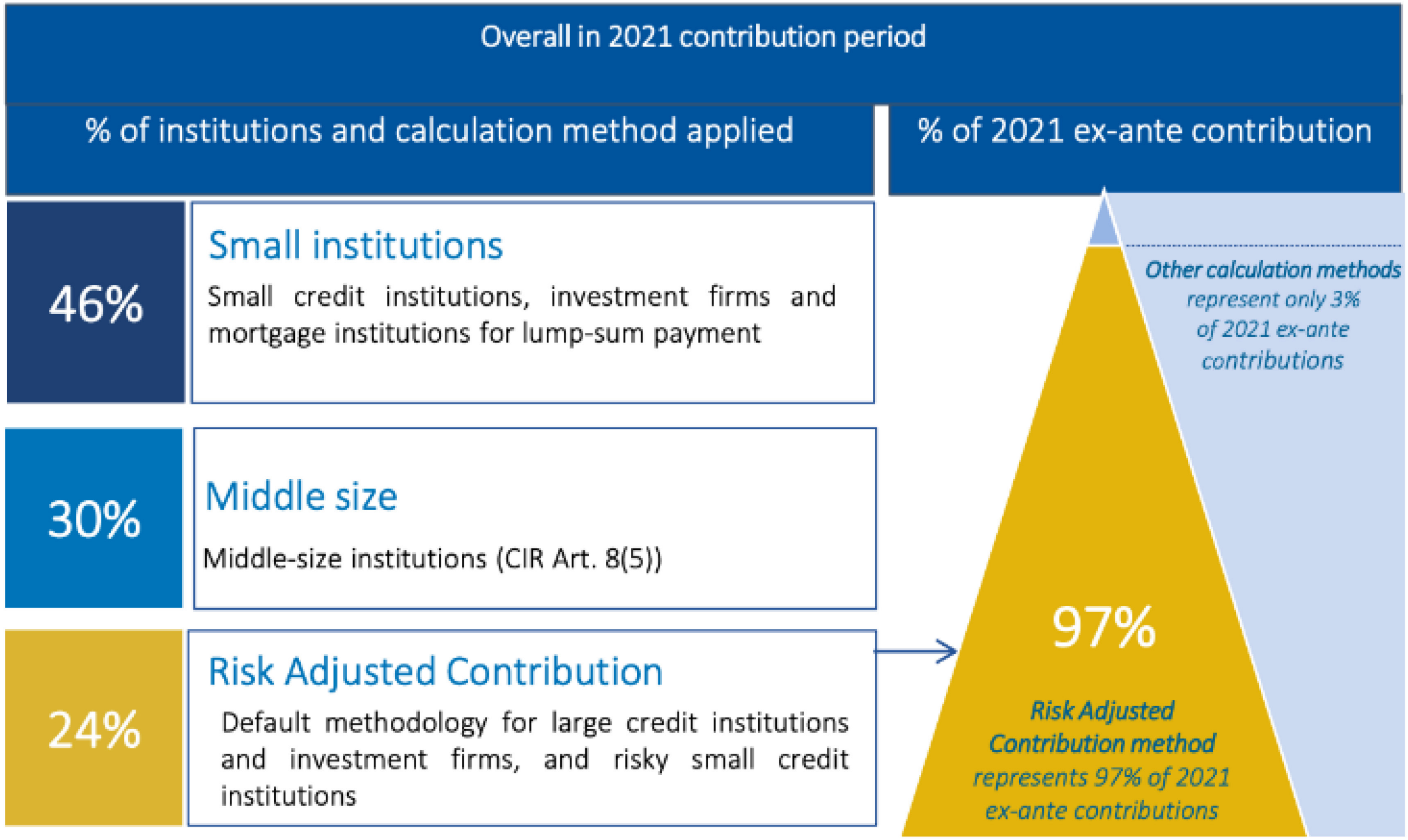
Single Resolution Fund (SRF) common for all banking union countries

- The target level of SRF is 1% of covered deposits in the banking union countries, which is estimated to be 73-78 billion euros.
- The target is to be reached by the end of 2023. Currently the size of the SRF is about 52 billion euros.
- The SRF can be used for capital and liquidity support to ensure effective implementation of resolution tools.
- There are strict conditions in case SRF funds are used as the bail-in tool is implemented and then the SRF contribution cannot exceed 5% of total liabilities and own funds (~ total assets) of the bank under resolution.
- In the beginning of 2022 the SRF got a backstop in the form of a credit line from the European Stability Mechanism (ESM), which doubled the funding available in resolution.

But will this be sufficient for liquidity support in case a significant bank is failing?

Note.: More information regarding why contributions are collected from banks can be found in a RVV blog ”Varför betalar bankerna miljoner till krisfonder?” (see. https://rvv.fi/-/blogi-miksi-pankit-maksavat-miljoonia-kriisirahastoihin-?languageId=sv_SE for Swedish and Finnish version).

The size and risk profile of banks affect the amount of contribution (~fee) annually collected from them



Source: SRB Banking Industry Dialogue, 14 June 2021

To finish

Was answers to the questions provided?

- Why are banks regulated and supervised? Bank failures creates externalities, i.e. significant costs for the society.
- Why is bailout of banks not a good idea? It is expensive, weakens public finances, results in suboptimal allocation of tax payer money and creates incentives for excessive growth and risk taking by banks.
- What has been done to end “too big to fail”? Bank supervision has become more stringent, regulatory reforms has been implemented and new authorities has been established.
- How are deposits protected in bankruptcy? The national deposit guarantee authority pays covered deposits up until 100 000 euro within seven working days by using funds that the banks have paid to the national deposit guarantee fund.
- What is the bank resolution regime? Mandate provided to authorities to restructure a bank’s balance sheet, legal structure and operations as it is failing and take all necessary actions beforehand to make such measures feasible.
- Are banks paying for the cost of resolution? Yes, though the annually collected contributions to the Single Resolution Fund.

Keen to know more? Check out (at least) these

Bail-In: EU Rules and Their Applicability in the Nordic Context

Esa Jokivuolle
Vesa Vihriälä
Kimmo Virolainen
Hanna Westman

Abstract

The global financial crisis has led to extensive regulatory reforms around the globe. The bail-in rules introduced in the Bank Recovery and Resolution Directive are an essential part of the new bank crisis management landscape in Europe. The paper seeks to clarify their implications and applicability in three ways. First, we provide a concise overview of the issues involved based on recent – mainly theoretical – literature. Second, we describe the key features of the European resolution framework. Third, we discuss the implications of the bail-in approach for crisis management in the Nordic context.

Keywords: Resolution, bail-out, bail-in, BRRD, systemic risk.
JEL codes: G21, G28.

ORIGINAL ARTICLE
WILEY

From bailout to bail-in: Making banking a legitimate part of the market economy

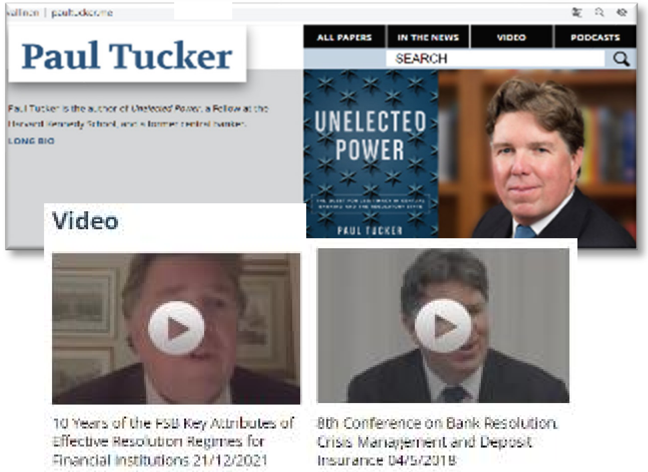
Pär Holmbäck Adelwald

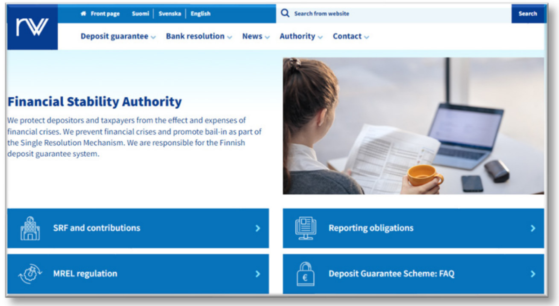
Abstract

More than a decade has passed since Lehman Brothers wreaked havoc in the global economy, putting the spotlight on the 'too big to fail' predicament and leaving governments the choice between financial collapse and bailouts. A new framework – resolution – was devised to allow for the orderly management of such situations. While capital regulations remain important for maintaining financial stability, bondholders also need to be on the hook if we are to credibly claim that bailouts belong to the past. In sum, resolution is about nothing less than the restoration of the fundamental principles of the market economy to the banking sector.

KEYWORDS

JEL CLASSIFICATION





Thank you!

RAHOITUSVAKAUSVIRASTO
VERKET FÖR FINANSIELL STABILITET
FINANCIAL STABILITY AUTHORITY