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Closing Remarks

Challenges for Banking Resolution/FROB

Fernando Restoy
Deputy Governor and Chairman of the FROB

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1 Introduction

Good evening.

I welcome this opportunity to share with you some thoughts on banking resolution. I cannot think of a more qualified audience to discuss this matter than that invited by the FROB for this conference, with representatives of competent authorities in the field, among others.

I will organise my remarks as follows. First, I will briefly describe how I see the general global framework for banking resolution established after the crisis. Next, I will review the special features of the European case. And finally, I will concentrate on the lessons to be drawn from the Spanish experience, with a special reference to issues relating to the institutional design of banking resolution.

2 The global framework for banking resolution after the crisis

We all know that banking resolution has not achieved the status of a well- defined policy area until very recently. Actions taken by authorities in relation to failing or likely-to-fail institutions have followed a discretionary case-by-case approach, particularly with respect to the availability of public funds to protect banks' creditors. The idea was that, as there was no ex-ante commitment to possible public bail-outs, the risk of moral hazard in relation to risk management policies and investors' decisions could be sufficiently contained.

The recent crisis has however illustrated very clearly the limitations of this "constructive ambiguity" approach.

Thus, during the crisis, and in particular after the collapse of Lehman Brothers, the authorities have openly recognised that bank failures –even if they are not particularly large or complex- can seriously impair financial stability, making bail-out a natural policy response. As a consequence, there were widespread bail-outs of creditors of banks under stress. These rescues have obviously confirmed the existence of an implicit guarantee for banks' liabilities which constitutes a serious challenge for fiscal balances and a substantial distortion of the system of incentives for bank managers and fund providers.

There is now broad agreement that in order to restore the socially desirable incentives and minimise the use of public resources, it is not enough to work on preventing bank failures by adopting appropriate regulatory and supervisory policies, but rather it is also necessary to be able to deal with non-viable banks in an orderly fashion and obviate the perverse dilemma between two important public policy objectives: preserving financial stability and protecting taxpayers' money.

To that end, the constructive ambiguity approach must be replaced by clear resolution rules which can be credibly specified ex-ante and swiftly implemented ex-post.

In practice, an essential objective of the new approach is to put an end to the situation in which, as a result of public intervention, bank liabilities are not, de facto, subject to the usual loss absorption hierarchy applied to bankruptcy events under commercial legislation. In other words, a resolution action taken in anticipation of an otherwise unavoidable liquidation of a credit institution should not imply a general bail-out of that bank's creditors.

With these generally accepted objectives in mind, a consensus has emerged for the development of international standards for banking resolution –mostly at the Financial Stability Board level- which are now being gradually incorporated into domestic legislation around the globe.

One relevant matter in the ongoing discussion on the specifications of the resolution regime is the scope of bail-in arrangements, i.e. under what conditions and to what extent will banks' creditors be obliged to bear losses of banks under resolution. A specific issue that has attracted much discussion is the treatment of uninsured deposits and senior debt instruments.

Some support has been expressed for the argument that a stringent approach to bail-in arrangements would de facto affect a bank´s ability to attract stable funding sources at reasonable prices. However, the counterargument appears quite convincing: the ability of banks to issue senior debt or to attract depositors should not be based on an implicit public guarantee beyond that provided by the deposit guarantee scheme.

In the European Union, the recently approved Bank Recovery and Resolution Directive (BRRD) -which will come into force next year- provides for an ambitious resolution approach that fully incorporates the new bail-in culture.

As of 2016, the BRRD envisages a system under which before any external funds are used to recapitalise a bank, at least 8% of its total liabilities must be used to absorb capital shortfalls. The activation of the bail-in tools would follow a hierarchical order in which neither uninsured retail deposits nor the claims of the deposit guarantee scheme would be excluded, although they would enjoy a preferential status vis-à-vis junior creditors and bond holders.

Further actions may be needed in order to provide credibility to these bail-in arrangements and to reinforce the special treatment of deposits. In particular, it might be advisable, at least for the systemically important financial institutions, to add to the ex-post minimum global 8% bail-in threshold an ex-ante minimum amount of specific instruments that could be readily converted into equity immediately after the point of non-viability is achieved, e.g. through specific clauses in the subscription contracts of those instruments. This ex-ante requirement –which is now being discussed at the level of the FSB under the concept of minimum gone concern loss absorbing capacity (GLAC)- may indeed be a useful complement to the EU Directive that already permits competent authorities to instruct banks to adjust their balance sheets to facilitate bail-in pre-emptively.

That minimum requirement must however be well-parametrised to take into account the special nature of the different institutions while preserving a level playing field both nationally and internationally.

3 The European case

Let me now expand a bit more on the European resolution framework which has played a key role in the policy response to the financial and institutional crisis in the EU and is subject to relevant specific challenges.

The involvement of national governments in the resolution of the financial crisis established a perverse destabilising link between sovereign and financial risks which was at the root of the severe turmoil in public debt markets that started in 2010. That turmoil challenged the very existence of the single currency as it caused the reemergence of a country risk component in all relevant asset prices and impaired the correct functioning of the monetary union.

The reaction by the authorities was to adopt an ambitious common framework not only for the prevention of banking crises -through the creation of the Single Supervisory Mechanism (SSM)- but also for the resolution of those crisis through the newly founded Single Resolution Mechanism (SRM).

The SRM ensures not only that the resolution framework will be harmonised in the euro area -as provided by the BRRD- but also that resolution policy, at least for SSM countries, will be managed centrally by a Single Resolution Board (SRB), which will enjoy a high degree of autonomy. Moreover, this board will manage a common resolution fund –funded by the industry- that over time would become a common backstop to cover resolution costs for all significant banks in all participating countries.

Arguably, the envisaged system is relatively complex. Major resolution actions may involve not only the Single Resolution Board but also the European Central Bank, as a supervisor, the national resolution authorities, the European Commission and, finally, the Council. Given the limited time-span in which decisions must often be taken, swift interaction among those agencies in a resolution process will be required.

Indeed, the coordination of the SRB and the ECB is crucial for the success of the SRM. Experience in most countries shows that the supervisor should be fully involved in decisions to trigger resolutions and in the design of resolution plans. Indeed, as of now, in many European countries the resolution authority is embedded in the supervisory agency, albeit in some cases with specific decision making processes. Although the draft SRM regulation envisages a framework for cooperation between the resolution board and the supervisor, more concrete arrangements are needed to ensure satisfactory coordination.

Moreover, although the minimum 8% bail-in envisaged in the regulation and the €55 billion resolution fund established by the Intergovernmental Agreement accompanying the SRM Regulation will probably provide a sufficiently large buffer to meet resolution costs in most cases, it remains to be ensured that a suitable public backstop –for instance in the form of an ample credit line for the Singe Resolution Fund- would also be available, following the example of other jurisdictions, such as the US.

4 Lessons from the Spanish experience

Finally, let me comment on some of the lessons learnt from the Spanish experience.

Amid intense debate on the precise specifications of the resolution framework, but before the BRRD was approved, Spain passed in 2012 a relatively ambitious legislative reform which anticipated many of the main features of the Directive.

That new legal framework allowed the Spanish authorities to employ new resolution powers –alongside public support- to resolve as many as five financial institutions and to restructure four more under the financial assistance programme. In all cases, previous shareholders were almost completely wiped out (in six institutions) or suffered considerable dilution. Junior debt holders were also bailed in to generate around €12 billion in new capital. In addition, all nine banking groups receiving State aid were required to transfer problematic assets to an external asset management company at prices that were administratively set.

A good, albeit somewhat extreme, example of the scope of the new resolution powers took place very recently when a very small cooperative bank reached the point of non-viability. That bank proved unable to find by itself a suitable solution. As a consequence, the Banco de España put the institution into resolution and appointed the resolution fund (FROB) as an administrator. The FROB then took full control of the institution and sold it –through an express auction- to another cooperative bank. The whole process was conducted in roughly 24 hours and entailed no cost for depositors, creditors or even holders of capital instruments.

All resolution actions have been taken with sufficient care, particularly with respect to the fulfillment of the no-creditor-worse-off principle. Indeed, so far we have faced very limited litigation, and no decision has been successfully challenged to date in the courts of justice.

I believe that the recent Spanish experience may offer some insight into issues aired in the ongoing debates in the European Union and the rest of the world.

First, as I said, the Spanish bank restructuring process was conducted without a clear European resolution framework. Yet, as in all cases in which Member States offer support to weak institutions, resolution and restructuring plans had to be submitted to the Directorate General for Competition of the European Commission to clear compliance with EU State Aid Rules. Naturally, it is easy to agree on the need to minimise possible competitive distortions associated with any form of public intervention in the European banking market. Moreover, in no way, could we complain about the rigour and professionalism of EC officials involved, which generally followed technically sound yet sufficiently pragmatic criteria. Still, it could be argued, from a conceptual point of view, that purely competition-based considerations should not necessarily always prevail over other major policy considerations such as those concerning financial stability or public finances.

Naturally, the BRRD and the SRM legislation would provide a more consistent and homogeneous resolution framework in which financial stability considerations and the preservation of taxpayers' interests would be fully considered when approving resolution decisions within the European Union. Yet, as these legislative reforms involve no change with respect to State-aid rules, a good understanding will have to be reached on how different policy angles and responsibilities will be effectively combined when addressing the suitability of resolution plans involving State aid.

The second relevant lesson from the Spanish experience relates to the need to ensure an appropriate investor base for bail-inable instruments. It is already commonly accepted that for the bail-in tool to be effective in helping to resolve banks without affecting financial stability, arrangements have to be put in place to limit the exposure to these instruments of other institutions with the potential for generating systemic distress.

Yet, the case of Spain also suggests that the bail-in of junior debt instruments entails significant additional complexity when they are held by retail investors. As a consequence of the commitments agreed with European authorities in the context of the financial assistance programme and the application of EU State-aid rules, Spanish authorities had to promote or directly implement the conversion of preference shares and subordinated debt into equity and apply large haircuts in all institutions requiring public support. That massive bail-in of instruments mostly held by retail investors not only generated a significant social problem but also reduced the value of the franchises, thereby exacerbating the fragility of the institutions requiring public capital support.

It is now clear that preference shares and subordinated debt instruments were sometimes mis-sold to bank customers who were unable to understand the risk entailed by those assets. The possible infringement of rules of business conduct –notably the EU Directive known as MiFID- is being investigated by the securities regulator and the courts of justice. However, more generally, legislation should be passed at EU level –as has already been done in some jurisdictions- to strengthen regulation and tighten controls over the sale of complex instruments carrying an implicit option to be converted into equity in specific circumstances.

Finally, a third thought drawn from the Spanish experience relates to the institutional arrangements for resolution actions. In Spain, the restructuring process of the banking sector has required close coordination between the Government, the Banco de España and the Resolution Fund (FROB). The Managing Board of this latter agency is composed of representatives of the Banco de España and of the respective Economy and Finance Ministries.

The institutional arrangements aim at combining the knowledge and technical expertise of the supervisor with the necessary involvement of government representatives, given the substantial amount of public resources employed in the resolution and restructuring processes.

At the technical level, it was essential to ensure good communication between the staff of the Banco de España and of the FROB, because both agencies were directly and intensely involved in the resolution policies. Indeed, under national legislation the Banco de España is entrusted with the tasks of initiating resolution and approving resolution plans. The FROB's role is to prepare resolution plans, monitor compliance with those plans once approved by the Supervisor and implement all resolution actions, including the bail-in tools. Furthermore, the FROB has the power to run institutions under resolution on a temporary basis if so decided by the Banco de España and to manage the government's stakes in financial institutions that have received public support, including the definition and implementation of divestment strategies. I think that all the parties involved and most external observers agree that these arrangements have worked very effectively so far.

At the same time, in the context of the forthcoming establishment of a Single Resolution Mechanism in Europe, national Governments may consider it warranted to make some adjustments to the current institutional settings. Indeed, the new European resolution framework will bring a transfer of competences to the Single Resolution Board and, more importantly, a smaller role for taxpayers' money as a consequence of the bail-in requirements specified in the BRRD and the availability of a resolution fund, which will be fully funded by private contributions from the industry.

Indeed, if the bail-in clauses in the BRRD had been enforceable in 2012 and the SRM had been established -including the availability of a fully funded Single Resolution Fund- the banking crisis in Spain could have been fully resolved with very limited contribution from the Government.

Then, since taxpayers' money is likely to be required only in relatively rare situations, this will strengthen the case for delegating resolution actions and decisions to an independent body, such as the central bank or an ad-hoc agency, as already occurs in many jurisdictions. Frankly, I believe that –provided the public budget is not significantly involved- banking resolution should be subject to an institutional setting similar to that of banking supervision, in which delegation to an independent prudential authority has long been successful in most jurisdictions.

In any event, based on the experience of Spain and other countries, I consider that in all key aspects of the resolution process, the direct involvement of the supervisor is crucial to avoid information gaps, prevent duplications and ensure efficient use of the resources employed to monitor financial institutions.

5 Conclusions

To conclude, I believe that as resolution authorities we have a very exciting policy agenda in front of us. Indeed, it is hard to think of other policy tasks which are so closely related to such a large number of first-order public objectives such as financial stability, the orderly functioning of the capital markets and the integrity of the public finances.

Yet it is clear that, since resolution policy is arguably in its childhood as a recognised policy area, we still lack something like a comprehensive manual to guide our actions in the field. Therefore our decisions must often be taken as if we were exploring an uncharted territory full of legal and economic risks. That is why I think that events like this, which allow competent authorities to exchange experiences and thoughts, are no doubt extremely useful in counteracting our uncertainty until a sufficiently large store of knowledge, if not doctrine, becomes available.

I wish to thank Antonio Carrascosa, Mario Delgado and the rest of the FROB team involved in the organisation of this conference, and all of you for your participation.

Thank you.