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Consistent recovery and resolution of small and large banks in Europe



Recovery and resolution should not just be for the few big

The scope of the crisis management regime should be widened. This is key in order to sever the tie between government and banks and ensure consistent recovery and resolution in Europe.

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Government funds are only for the exceptional cases

It is essential that government funds are used only in very exceptional cases when the economy is at risk and the European Commission concurs.

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The deposit guarantee in recovery and resolution

If a solution is found to be better for the depositors than the alternative, the deposit guarantee scheme should be available for the recovery and resolution of a failing bank.

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Consistent recovery and resolution needed in Europe

A lot has happened in relation to recovery and resolution of credit institutions since the financial crisis. In 2014, the EU adopted a framework for the recovery and resolution of credit institutions in order to sever the tie between banks and government, so that the taxpayers no longer had to pick up the tab for failing banks. The objective was to provide Europe with a credible framework for resolving failing banks without the use of taxpayers' money.

In Denmark, the framework for recovery and resolution constituted only a minor innovation; at the time of the adoption of the European framework, Denmark already had a framework ensuring that the creditors of failing banks absorbed losses through bail-in. In other words, creditors' funds were used to absorb the losses of failing banks and ensure the orderly wind-down of the bank, with depositors still having access to their deposits etc. The Danish framework was introduced in 2010 with Bank Rescue Package 3 and was to serve as an exit strategy for the general government guarantee for depositors and other unsecured creditors, introduced by Denmark – and a number of other countries – during the financial crisis.

It has turned out that the manner in which failing banks have been resolved has varied across member states – despite a harmonised framework for recovery and resolution. So, as part of an upcoming European review of the framework for the recovery and resolution of banks and deposit guarantee schemes, this spring the European Commission invited member states to provide comments on their experience with the current framework and give their views on a possible revision of the regulation.

Below, Danmarks Nationalbank's assessment of a European revision of the regulation are summarised, with emphasis on the Danish experience with recovery and resolution of failing banks.

Inconsistent recovery and resolution in Europe

Despite a harmonised European framework for recovery and resolution, there are examples of inconsistent recovery and resolution of failing banks in Europe. The reason is that the European resolution authority, the Single Resolution Board, is responsible only for the recovery and resolution of the largest European banks, while national authorities are responsible for the recovery and resolution of smaller banks. This narrow approach to the scope

of the European framework for recovery and resolution is a problem because, under national regulation, there have been a few examples of smaller banks being resolved through the use of taxpayers' money instead of using the national regulation, which should have been applied – most often national insolvency regulation. There are examples of smaller failing banks being handled with taxpayers' money, and this shows that national regulation is not always fit to handle smaller failing banks.

Differences in the application of the European framework for recovery and resolution of large and small banks are inappropriate – especially because experience shows that small banks tend to be the ones failing. On the contrary, it is sensible and necessary to apply the framework for recovery and resolution to most failing banks, regardless of their size and complexity. It is essential that recovery and resolution under the European framework is not just for the few big.

The Danish framework for recovery and resolution works on banks of all sizes

The Danish bail-in framework, introduced with the Bank Rescue Package 3 in 2010, was an option for all Danish banks, and after the general Danish government guarantee was phased out, the principle has been for banks, small and large alike, to be resolved without the use of taxpayers' money. The principle of a fixed framework for recovery and resolution of the great majority of failing banks has been continued with the Danish implementation of the European framework for recovery and resolution.

The rationale for choosing to apply the framework for recovery and resolution also to small Danish banks is that virtually all Danish banks are found to perform critical functions, for instance by supporting deposits and the Danish *NemKonto* system. This is amplified because the Danish payment system is highly digitalised, and citizens need continuous access to *NemKonto* and payment systems such as the national card scheme, Dankort. Without an orderly model for recovery and resolution of small banks, the authorities could come under pressure to use taxpayers' money to resolve banks – regardless of the size of the bank.

Although most banks in Denmark perform critical functions, this does not mean that the same recovery and resolution measures or the same tools should be applied to all banks, either in Denmark or else-

where. The important thing is that the strategy of recovery and resolution does not involve use of taxpayers' money.

The general resolution principle for large Danish banks is that the whole group should be recapitalised and continued, so that critical functions can be maintained. This is generally done using the bail-in tool.

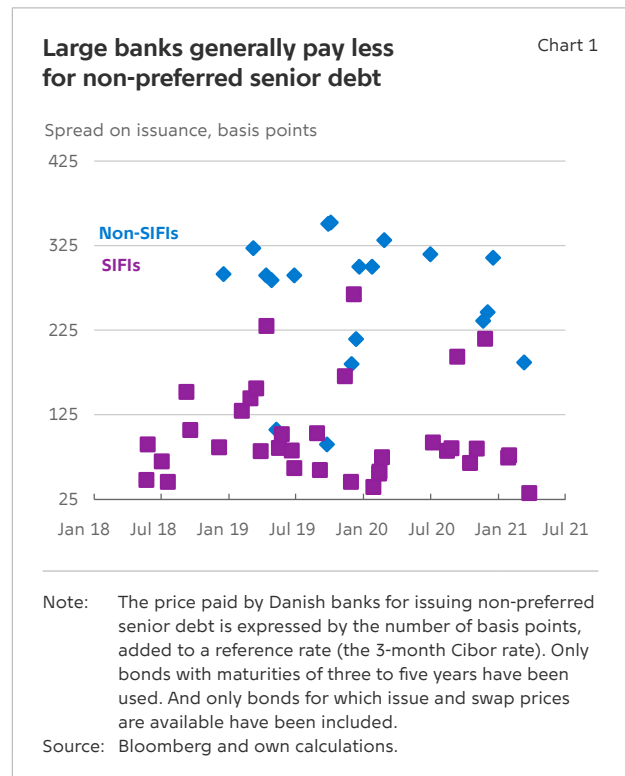
A fundamental principle of the framework for recovery and resolution is that, in the vast majority of cases, creditors must pick up the tab of recovery and resolution when a bank is failing – regardless of the size of the bank.

To support the bail-in tool and ensure that there are 'eligible' creditors to absorb the losses of a failing bank, the authorities set a minimum requirement for eligible liabilities (MREL) for banks. This is to avoid a situation in which political pressure builds to use government funds rather than bailing in creditors, for instance if a large portion of the creditors are private savers.

In Denmark, small failing banks are subjected to an orderly wind-down. This means that as many of the activities as possible will be sold quickly, while the remainder of the bank will be continued temporarily in a bridge institution under the auspices of the resolution authority Finansiel Stabilitet. Prior to the continuation, Finansiel Stabilitet bails in the creditors, who can expect to suffer losses in connection with recovery and resolution. If the losses are vast enough, unsecured creditors will also be bailed in. This means that the recovery and resolution of small Danish banks combines the resolution tools sale of business, bridge institution and bail-in.

To ensure that the deposits of a bank can be continued, MREL must be set for small banks too. MREL for small Danish banks is lower than for large Danish banks because the authorities expect that only part of the bank will be continued in a bridge institution.

Danish experience shows that a number of small Danish banks can issue debt that may be used to meet MREL and is also eligible to absorb losses – also referred to as non-preferred senior debt. The use of this type of debt as the first line of defense to absorb losses of a failing bank helps increase transparency for creditors when it comes to assessing the risk of loss from their investment. It is usually more



expensive for small banks to issue this type of debt than for large banks, see chart 1. The non-preferred debt of small banks (non-SIFIs) is typically held by domestic holding companies, while the non-preferred debt of large banks (SIFIs) is typically held by foreign investors.

Banks that are unable or unwilling to issue MREL instruments, for instance non-preferred senior debt, in the market have to rely on capital and retained earnings to meet MREL.

Markets believe in the Danish framework for recovery and resolution

The Danish authorities have applied bail-in to four failing banks: Amagerbanken (2011), Fjordbank Mors (2011), J.A.K. Slagelse (2015) and Københavns Andelskasse (2018).

In all four cases, the authorities were clear in their communication to the public about the application of the framework for recovery and resolution, and thereby the creditors' funds, and depositors were secured access to their accounts.

The credibility of the Danish framework for recovery and resolution, under which creditors pick up the tab for recovery and resolution, is also reflected by

credit rating agencies. After the failure of Amagerbanken. In 2011, the credit rating agency Moody's downgraded several Danish banks. One reason given by Moody's for the revised credit ratings was that the application of the new framework for recovery and resolution caused them to reassess the probability that the Danish government would bail out a failing bank without creditor losses.

Similarly, immediately after the introduction of the Danish framework for recovery and resolution in 2015, the credit rating agency S&P assessed that the probability of government support to banks in Denmark was 'uncertain', and as a result, S&P decided to stop including this support in the rating of Danish banks.

The institution's credit rating is also impacted by the bail-in of creditors if a bank is failing. This means that the price of bank funding will be more reflective of their risk profile. This will incentivise banks to enhance their financial strength and reduce risk-taking. In combination with enhanced resilience requirements for banks, this helps to support financial stability.

Government funds should be used only in very exceptional cases

Where, in the recovery and resolution of a failing bank, a member state is left with no alternative but national insolvency regulation, there are examples of member states opting to use the state aid rules in the recovery and resolution of a failing bank. This is an option available to member states under the EU Treaty, provided certain conditions are met.

If, for instance, it is assessed that aid is granted to remedy a serious disturbance in the economy of a member state, the member state may – with the approval of the European Commission – use state resources for recovery and resolution without the bank being considered to be failing under the framework for recovery and resolution. This follows directly from the EU Treaty. But in order for the European Commission to approve the aid, a number of specified conditions must be met.

It is up to the individual member state and the European Commission to assess when a serious disturbance exists in the economy of a member state. EU rules are not explicit on this point and do not define when a serious disturbance exists in the economy of a member state.

In the period after the implementation of the framework for recovery and resolution, several smaller failing European banks have been resolved through the use of taxpayers' money rather than through the tools prescribed by the framework for recovery and resolution. This creates an uneven level playing field, with the risk of creditors taking excessive risks, leading to distortion of the incentive structure.

It is essential that the use of government funds alone are considered, allocated and approved in accordance with the regulation on control of state aid to the financial sector, including, in particular, that government funds are used only when a serious disturbance exists in the economy of a member state. In all other situations, the framework for recovery and resolution should be applied to failing banks. At the same time, the cases involving government funds to smaller failing banks demonstrate the need for expanding the scope of the framework for recovery and resolution or its principles to include smaller failing banks. Put bluntly, it does not work with a European framework under which large banks are resolved through bail-in of creditors, while smaller banks are resolved through government funds.

In a special report from 2020, the European Court of Auditors assessed whether, during the period from 2013 to 2018, the European Commission performed its control of state aid to financial institutions appropriately with a view to ensuring that aid was exceptional and limited to the minimum necessary. In the report, the European Court of Auditors especially criticises the European Commission for not contesting member states' assertions that the threat to financial stability existed in the individual cases of state resources to smaller banks. It is also stressed that the EU rules are not sufficiently explicit on this point and do not define what a serious disturbance is. Finally, the European Commission is criticised for not carrying out a thorough evaluation of its state aid rules since 2013, entailing the risk that the current EU rules are no longer aligned with market realities.

If a bank is failing, the framework for recovery and resolution should be applied in the vast majority of cases. The European Commission's control of state aid is a key element in ensuring this, in cooperation with member states, resolution authorities and banks. It is essential that government funds are granted to banks only on an exceptional basis to avoid or remedy a serious disturbance in the economy of a member

state. In other words, the framework is not intended to be used for the recovery and resolution of smaller failing banks. Recovery and resolution should be effected through an expansion of the scope of the framework for recovery and resolution.

Deposit guarantee schemes should be available for recovery and resolution

Depositors are a group of creditors that are generally not considered to be eligible for absorbing losses of a failing bank. So, at the European level, there is agreement that depositors should generally be well protected and ranked at the lower end of the order of losses of a failing bank.

However, this does not mean that depositors are exempt from contributing to the recovery and resolution of a failing bank. As creditors of a failing bank, depositors are obviously also bailed in if losses are so great that this is necessary during the application of the bail-in tool. However, in connection with recovery and resolution, deposits of up to 100,000 euro are covered by a Guarantee Fund, and the Guarantee Fund must contribute if losses are so great that deposits covered are bailed in. In Denmark, all banks contribute to the Danish Guarantee Fund.

If tools other than the bail-in tool are used in connection with recovery and resolution, for instance the bridge institution tool, banks through the Guarantee Fund will be required to contribute to a solution with the amount it would otherwise have been required to cover if the bank had been declared bankrupt. The Danish authorities may opt to use this tool to resolve a failing bank in Denmark.

The Guarantee Fund serves as an insurance for depositors. This applies across the EU due to harmonised EU rules on deposit guarantee schemes. It is essential for financial stability that a large portion of depositors' deposits is guaranteed – this is the key task of the deposit guarantee scheme, and the performance of the task must be ensured.

The Guarantee Fund may also be used to support private solutions. At the European level, it has been left to individual member states to implement the private solution options. In Denmark, rules specify that the deposit guarantee scheme may help to support private solutions to ensure that an institution does not have to be resolved with involvement of the resolution authorities. The deposit guarantee

scheme is financed by the banks. In a current situation, the involvement of the deposit guarantee scheme will take place through the Guarantee Fund's provision of funds and a guarantee to cover the non-subordinated creditors (dowry) of a failing bank when the failing bank is transferred to another bank without involvement of the resolution authorities. The Guarantee Fund may provide a dowry as part of a transfer equivalent to the amount the Guarantee Fund should have covered if the bank had been declared bankrupt – this is known as the least-cost principle.

For EU member states that have decided that the framework for recovery and resolution will not apply to all of their banks, similar rules for the participation of the deposit guarantee scheme in private solutions will be an advantage. The reason is that member states that do not have a framework for recovery and resolution of smaller banks only have general insolvency rules to rely on in the resolution of smaller failing banks. This applies whether or not they participate in the banking union.

The possibility of using bank funds through the deposit guarantee scheme for recovery and resolution and the computation of the least-cost principle should be predictable and consistent across Europe. This is key to ensuring depositors' confidence that their deposits are safe.

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The analysis consists of a Danish and an English version. In case of doubt regarding the correctness of the translation the Danish version is considered to be binding.

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