EU bank resolution post-Cyprus

TOPIC: Banking
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Since the collapse of Lehman Brothers five years ago, authorities have been grappling with the question of how systemically important banks, which are too big to fail (TBTF), can be recapitalised without using taxpayer money or causing bank runs. Besides imposing heavy costs on taxpayers, publicly funded bailouts give rise to moral hazard by generating expectations of government support.

A TBTF bank that becomes insolvent must be recapitalised because the financial stability risks of liquidating a bank that is big, complex and interconnected with the rest of the financial system are considered to be too high. Up until the Cyprus rescue last April, governments recapitalised large banks with public funds in the absence of a better alternative.

Endnotes

The "bail-in" of creditors in the case of Cyprus was mandated by the size of the needed recapitalisation, which would be incompatible with the sovereign's debt sustainability. In other words, Cyprus could not afford an Irish-style bank bailout, so it was forced to opt for a bank bail-in. What made the bail-in chaotic, however, was the lack of clarity on the hierarchy of claims. An orderly resolution scheme must set clear rules on the future creditor pecking order, which should be known in advance by all parties. Caveat emptor! The chaos associated with the Cyprus rescue showed how important it is to have clear procedures for loss-sharing by shareholders, bondholders and ultimately depositors to deal with failing banks.

As the question of burden sharing evolved, so did the market reaction. The adverse reaction to increased risk following the Cyprus deal was muted, although markets with a direct link to Cyprus, such as Greece, sold off. The reaction was milder than the flight to quality that followed the Deauville Franco-German Summit in October 2010, when Chancellor Merkel and President Sarkozy announced that holders of Eurozone sovereign debt could face losses. Both policymakers and market participants have slowly realised that bailing out creditors damages public debt sustainability and creates a negative feedback loop between undercapitalised banks and heavily indebted sovereigns. Steps toward banking union would help break that link by ensuring that taxpayer funding of bailouts is minimised.

As a major component of future EU bank resolutions, bail-ins would help reduce the burden on taxpayers and avoid any associated cross-country fiscal transfers. The EU is now pushing ahead with plans to implement a bail-in regime that would let bondholders and big depositors take a hit if a bank becomes insolvent. Lawmakers in the European Parliament's economics committee have already voted in favour of a plan that, from 2016, would impose losses on large depositors if a bank fails. The plan is similar to the Cyprus rescue, where uninsured depositors at two banks took large hits to save the country from bankruptcy. Despite its trivial size (€10bn), the Cyprus bailout became a catalyst for new EU bank resolution rules[1].

Michel Barnier, the European Commissioner responsible for drafting a Single Resolution Mechanism

(SRM) to accompany the Single Supervisory Mechanism (SSM) toward a European banking union, spelled out the form that the mechanism would take. He laid out the future creditor pecking order for who gets hit when banks are resolved or restructured: losses are first handed to a bank's shareholders, then junior bondholders, then senior bondholders and then uninsured depositors, followed last by a resolution/deposit insurance fund to reimburse insured deposits below 100,000 euros. The Commission expects to issue its proposal on the resolution authority in June, and the issue will be discussed by Ecofin and the European Council at the end of June.

While there is agreement that shareholders and subordinated bondholders are first to take the hit, there are differences of opinion on the ranking of senior bondholders vs. uninsured depositors. Countries with large pension funds claim that senior bondholders should be given preferential treatment over uninsured depositors, while countries with large banking sectors claim the opposite.

Both the European Commission and the ECB support a "bail-in" order similar to the template used by the FDIC to wind down failing US banks, with uninsured depositors the last in line to take a loss if the bank fails. But opinion remains divided on this point, as well as over how much flexibility countries should have in exempting uninsured depositors, such as pension funds, and senior creditors from losses. The Netherlands, one of the four AAA-rated Eurozone countries, has backtracked from its earlier position that all creditors be liable when a bank fails, following the nationalisation in February of SNS Reaal NV, in which the government shielded senior bondholders to prevent a surge in funding costs for other Dutch banks. This suggests a "hybrid" approach toward failing banks, in which taxpayer funding may be used to avoid spooking senior bank creditors to the point that wholesale funding becomes unavailable at a fair price. Thus, while the "bail-in" principle has been firmly agreed, member states may seek some discretion on how to treat various creditors, casting doubt on whether a single EU rulebook will ultimately be established.

A separate rift has also emerged regarding the funding of the recapitalisation mechanism. Designed to enable substantial financial participation of existing creditors in future bank restructurings, the SRM would be funded by a financial transactions tax (FTT) on the EU banking sector. However, in the absence of a Treaty change, this proposal conflicts with the German vision of coordinated national schemes to shut down problem banks, instead of a system with shared Eurozone risk.

A third pillar involving a single deposit guarantee fund seems unlikely to be adopted and has been largely dropped. But the declaration that insured deposits below 100,000 euros will be protected will have little impact on depositors' behaviour unless a common EU backstop of national deposit guarantee schemes is set up.

A Bank for International Settlements (BIS) paper2, released on 2 June, proposed a simple recapitalisation mechanism that is consistent with the rights of creditors and enables recapitalisation of a TBTF bank over a weekend without the use of taxpayers' money. When a bank reaches the point of failure, it would undergo a forced creditor-funded recapitalisation by simply writing off some claims while respecting the pecking order for the repayment of creditors and ensuring guaranteed depositors are fully protected. The ownership of a bank would be transferred to a newly created temporary holding company over a weekend. The holding company would sell the recapitalised bank in the following months at market prices, and proceeds would be distributed to the written-down creditors. By eschewing government money, this recapitalisation mechanism would prevent risk from moral hazard, when expectations of a bailout can encourage banks to take more risks.

How likely are large depositors to take a hit in future bail-ins? The case of Cyprus is unique for two reasons: First, bank deposits amounted to four times the country's GDP; second, the cushion between shareholders and depositors was very thin (see chart), because Cypriot banks had lost access to the interbank market long before the rescue package was agreed, and very few bank bonds were still outstanding. At the time of the rescue, deposits amounted to €68bn compared with bank bonds of €1.4bn, which were obviously insufficient to cover the huge losses from the haircut on Greek government bonds held by Cypriot banks. The banking sectors of Malta and Greece have a similarly thin cushion between shareholders and depositors.

However, Malta's banks appear solid, while Greek banks lost access to capital markets, along with the sovereign, back in 2010 and were recapitalised with a €50 billion loan from the European Financial Stability Facility (EFSF) to the sovereign, along the lines of the Irish template. On the other extreme, countries like Austria, Italy and the Netherlands have a large cushion that can absorb losses, as wholesale funding exceeds 20 per cent of total bank liabilities.

Endnotes

1. Actually, a gradual shift to more market discipline was already occurring before the Cyprus rescue. Earlier this year Ireland negotiated a deal that involved a loss for some senior bank bondholders, while Spain's bank restructurings in late 2012 imposed losses on subordinated creditors.
2. Paul Melaschenko and Noel Reynolds, "A template for recapitalizing too-big-to-fail banks", BIS Quarterly Review, June 2013.