Europe’s Single Resolution Mechanism: Governing Through Financial Markets

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Outline

One useful role for an academic is to query contemporary enthusiasm for fear of group-think, which the last crisis has shown may prove a dangerous aspect of policy making in the financial sector

(Goodhart and Avgouleas, 2015)

Context

Argument

European Union: governing through financial markets

The European resolution framework in detail

Contributing remarks

Context

- General opinion: European regulatory architecture is complete and it will guarantee financial stability, greater integration and equality of treatment in the EU (Resiliency Authors, 2016; Merler, 2018; Binder 2021; Restoy, 2019)
  - ➢ Banking Union lacks means to enforce its strict rules, namely by shaping the national liquidation framework to avoid bypasses to liquidations or extensive bail-ins
- Critical literature:
  - ➢ Dangers of bail-in as rule and “liquidationist genie”
  - ➢ Asymmetrical effects of the Banking Union
  - ➢ Lack of an effective fiscal backstop associated to a common deposits guarantee scheme

Argument

- Overlooked outcomes of Banking Union's **Resolution Framework**:
  - Asymmetric effects across countries and different banking structures
  - **Concentration of banking capital and "marketization" of business models**
- European financial integration at expenses of a r**egulatory driven consolidation** in the banking sector
  - Another step in the post GFC neoliberal restructuring process, aimed at reinstating market discipline and reshaping the banking system towards market-based finance
  - Banking Union's resolution framework reinforces political control of finance as described in the **governing through financial markets literature**

EU: Governing Through Financial Markets

- **Governing through financial markets**: governance that repurposes financial instruments and markets as *instruments of their statecraft* to achieve economic policy goals at minimum fiscal cost (Quinn 2017, Braun et al 2018, Gabor and Ban 2016)

In the post-crisis environment, the new European policy orthodoxy insists on avoiding statefunded bailouts of banks in distress under all but the most exacting circumstances (Hadjiemmanuil 2017)

- ➢ Policy makers expect that curtailing markets will also curtail the effectiveness of their own market-based policy instruments, making them lose legitimacy and power
- ➢ The pursuit of market-based economic steering will tend to align with the interests of financial-sector counterparties, thus boosting the latter's political power: **Infrastructural power approach** (Braun 2018)
- ➢ Part of a larger literature that entails the ongoing harnessing of financial markets for economic policy and governance purposes (Krippner 2007, Gabor and Ban 2016)

EU: Governing Through Financial Markets

- **The European Polity:** a multi-layered technocratic arena with deeply ingrained financial market-based solutions portrays the tendency towards the financialization of economic governance (Dutta 2018). Resilience of market-based policies in the post-crisis regulatory framework goes against joint objectives of risk-sharing among member-states and overall financial stability (Braun et al. 2018)
- Consensus of the **Banking Union** as a post-crisis necessity, with divergent interests between Member States over the level of mutualization accouting for the asymmetric policy designs and the Union's incompleteness (Schafer 2017, Quaglia 2019)

The Single Resolution Mechanism: policy use of financial markets and instruments in the face of financial distress beyond the simple "regulatory and guidance" approach, reinforcing the marketization of the EU regulatory framework and consolidating the power of finance in the European polity.

The European Resolution Framework:
The Resolution Decision Process

Single Rulebook (2013): "*unified framework for the EU financial sector that would complete the single market in financial services*" (EP, 2019)

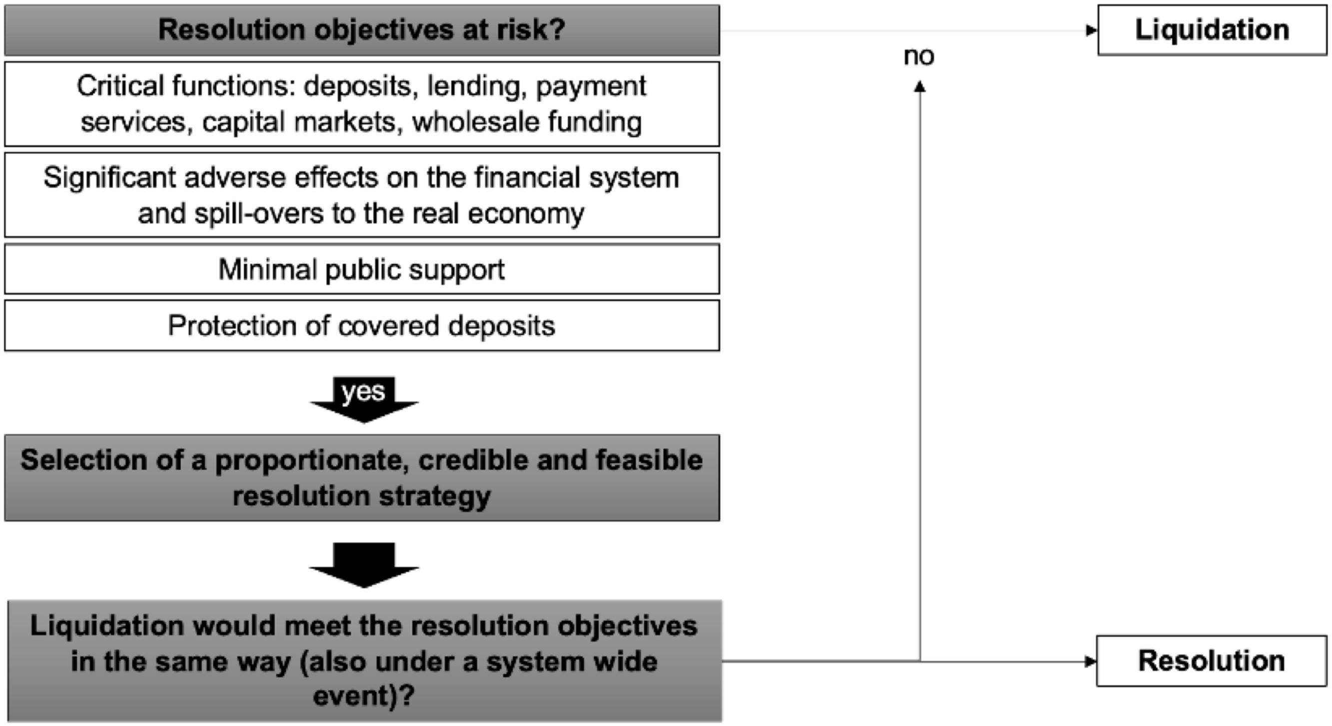
Three pillars:

- Single Supervisory Mechanism (SSM) | CRD/Capital Requirements Regulation
- Single **Resolution Mechanism** (SRM) (SSM) | **Banking Recovery and Resolution**
- **Directive**~~European Deposit Insurance Scheme (EDIS)~~

The European Resolution Framework:
The Resolution Decision Process

1. Assessment of Resolvability: liquidated or, **if not,** resolved under toolkit
   - SRB: establishment of minimum requirements for own funds and eligible liabilities (MREL)
2. *Failing or likely to fail* (FOLTF) declaration by the ECB (Art 32.4 BRRD):
   - Charter at risk
   - Balance sheet insolvency (or at risk of)
   - Liquidity insolvency (or at risk of)
   - Extraordinary public support (exc. Art 34 for solvent institutions)
3. Public Interest Assessment
   - Can the resolution meet the overall resolution objectives better than liquidation?

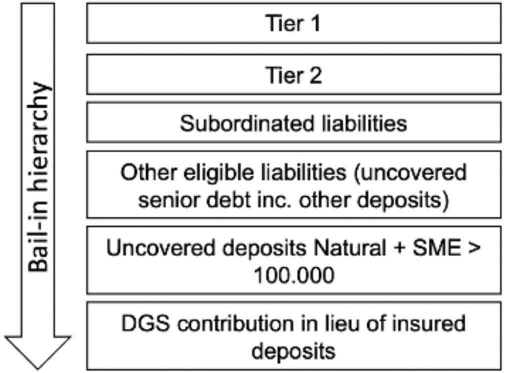
Public Interest Assessment



The European Resolution Framework

The Resolution Mechanism:

1. Mandatory Bail-in



The European Resolution Framework

the Resolution Mechanism

2. Transfer tools:

- Sale of business (Art 38, 39 BRRD)

"The bidding can be **restricted to pre-selected potential purchasers considered more likely to ensure financial stability due to their market size, structure, business model** etc. than others. Incentivizing purchasers and limiting their risk, for example by providing guarantees (via the resolution fund) should also be considered to help achieve a timely transaction." (FinSac guidebook, 123)

- Separations of assets (Art 42 BRRD)
- Bridge bank (Art 40 BRRD)

Termination *"as soon as possible and in any event two years after"* its creation

The European Resolution Framework
Financing arrangements

- Extraordinary public support to an insolvent bank ⍰ FOLTF
- Primary sources of funding: bail-in and contribution by national deposit guarantee schemes
  - Exclusion of liabilities:
    - ➢ Financial support < 5% total liabilities
    - ➢ Bail in of 8% of all liabilities
- Additional funds from resolution funds after all eligible liabilities were absorbed
- Temporary public intervention only in a systemic crisis after other tools have been “assessed and exploited to the maximum extent practicable”
- Always subject to **State Aid rules**

		Situation	Means	Specific Conditions	Source
Solvent		Extraordinary public support as precautionary capitalisation EC: to cover capital shortfall under adverse scenario of stress test	State guarantee to back liquidity facilities by CB or issued liabilities Injection of own funds or purchase of capital instruments	BRRD: Temporary nature Before the point of WDCC Market prices Not of offset losses **State Aid Approval:** Burden-sharing Restructuring plan	State Funds State funds
FOLTF	Public interest	Resolution BRRD 37	Bail–in DGS		Shareholders and creditors
FOLTF	Public interest	Resolution with exceptions to bail-in BRRD 44 (4,5)	Contribution to absorb losses Purchase shares or capital instruments	>8% liabilities absorbed Contribution <5% of total liabilities **State Aid approval**	Resolution fund Ex-post contributions (3 years) Alternative financing sources ESM Backstop
FOLTF	Public interest	Resolution in extraordinary circumstances BRRD 44 (7)	Contribution to absorb losses Purchase shares or capital instruments	Contribution > 5% of total liabilities 100% of unsecured, non-preferred liabilities, other than eligible deposits absorbed **State Aid Approval**	Alternative financing sources Non-used funds of the NRF/SRF ESM Backstop
FOLTF	Public interest	Resolution in the context of a systemic crisis Governemnte Stabilisation Tools BRRD 37(10), 56, 58	Temporary public ownership Public equity support	>8% liabilities absorbed **State Aid approval**	Shareholders and creditors Resolution Fund (NRF/SRF) ESM Backstop / State Funds
FOLTF	Liquidation	Liquidation Aid	Liquidation aid	**State Aid approval**	State funds

Alternative funding means

Member States shall ensure that financing arrangements under their jurisdiction are enabled to contract borrowings or other forms of support from institutions, financial institutions or other third parties

State Aid Framework

1. Articles 107–109 of the Treaty on the Functioning of the European Union (TFEU):

*Save as otherwise provided in the Treaties, **any aid granted by a Member State** or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, **be incompatible with the internal market**.*

2. Banking Communication 2013:
   - No recapitalization or asset protection without previous authorization of (draconian) restructuring plan
   - Other principles:
     - Burden sharing
     - Minimum support - competition
     - Return to viability

Issues with the European Resolution Framework: Limited toolkit

- Prohibition of public intervention limits interventions towards private market solutions and concentration of banking capital
- "One-size-fits-all" bail-in may have asymmetric effects in different national and banking environments

It seems clear that the BRRD creates a comparative advantage for larger banks
(Costa, 2018)

Issues with the European Resolution framework : Discritionarity

- Regulatory requirements: P2R, MREL, NPLs reduction targets and level of forbearance
  - MREL: preference for market instruments (subordinated debt) hurts ”middle class banks” (Restoy,2018)
- Point of failure (FOLTF):
  - Prospective losses or infringements of capital or liquidity requirements
  - Exclusion from Eurosystem’s liquidity assistance
- Public interest assessment
  - National vs regional stability
  - Contradictions between national authorities, the SRF and DGComp
- State Aid compliance

Issues with the European Resolution Framework: Discritionarity

Political elements are outside of my remit. But I think that the euro area has to be and has to see itself as a single jurisdiction. That is why, in my opinion, cross-border mergers within the euro area are the way forward and I doubt that politicians would have a negative view of such developments (...) It is important to complete banking union so that it can be viewed as a single jurisdiction... And it will allow more cross-border mergers. (Daniele Nouy, Chair of Supervisory Board of ECB, 2017a)

*And I am not just talking about domestic mergers. The European banking union sets the scene for banks to merge across borders. It has opened up a large pool of potential partners.Cross-border mergers would do more than just help the banking sector to shrink. They would also deepen integration. And this would take us closer to our goal of a truly European banking sector. (*Daniele Nouy, 2017b)

Sustainable consolidation projects have the potential to create economies of scale across the European banking sector. This would help banks become more cost-efficient and better able to invest in large-scale digitalisation, and spark the transformation of their business models while also opening the door to diversifying their products and therefore their revenue sources. (Edouard Fernandez-Bollo, Member of the Supervisory Board of the ECB, 2021)

Concluding Remarks

For the most part, the Comission's narrative has excluded critical concerns about the pro-cyclicality and fragility of market-based finance, so starkly on display during the Global Financial Crisis (Braun et al. 2018)

Transfer of discretionary powers to SRB, ECB and DgComp and **limited resolution toolkit** promote a regulatory driven consolidation through:

- Elimination of smaller banks with tradtional business models
- Transformation of business models towards risk-driven profitability and market integration
- Absorption of liquidated and resolved banks by larger financial units

SRM process can be understood in the context of an aliance between the Comission, financial interests and technocracies to shape economic governance at the European level (Gabor and Ban 2016)

This process of financialization of economic governance uses market-based statecraft for na integration agenda that implies a puzzling return to known instability drivers in a post-crisis context:

- Resilience of market-based finance
- Too Big To Fail Institutions
- Regional assymetries between Member-States