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European Commission

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Banking Union: Review of the crisis management and deposit insurance framework (BRRD review)

The proposal contains good suggestions but must be developed further

Finance Finland (FFI) welcomes the efforts to improve the Banking Union's crisis management tools. The Commission's proposal has many good suggestions which help improve crisis resolution, such as increasing information exchange between supervisory and resolution authorities. Timely intervention by the authorities is of essence to avoid the depletion of capital buffers in banks that are failing or likely to fail (FOLF). The buffers are meant to absorb losses not only in going concern but also in gone concern situations. Therefore, it is essential that own funds are not depleted before resolution or liquidation is commenced. The Banking Union's core principle of no bail-out must be respected, and investors of the failing bank, not outsiders, should bear the losses in full.

That being said, FFI is worried about certain elements of the proposal which abandon the no bail-out principle. The elements once again introduce the practice of bail-out and hence render the whole proposal flawed and dysfunctional. While the Banking Union was supposed to alleviate or even abolish the problem of moral hazard, the Commission's proposal contains elements which in fact reinforce it. The main one of these is the use of Deposit Guarantee Schemes (DGSs) as a bail-out instrument to cover losses investors have taken to make profit.

The need to use DGSs as a bail-out instrument arises from the Commission's assumption that some banks cannot raise enough loss absorption capital to be eligible for the Single Resolution Fund. It seems to imply that the banks in question do not have viable businesses: a viable bank would be able to gather enough loss absorption capital by itself, and thus the DGS would not be needed to cover investors' losses.

The crisis intervention and DGS framework could, however, be built so as not to contain moral hazard or the element of bail-out. In fact, the current proposal contains elements that are headed in the right direction to make the framework workable. The development of the framework should focus on placing the losses fully on investors, which can be done by the timely launch of resolution or liquidation measures. This requires sufficiently clear supervisory powers and obligations so that the asset quality and the true amount of own funds of a FOLF bank can be ascertained early enough before the bank breaches the minimum capital requirement. The calculation rules for FOLF assessment should be drafted. The final moment for the FOLF decision should be when the minimum capital requirement is breached based on the materially ascertained balance sheet values.

Fire sales of bank assets should be avoided: they destroy asset value and cause unnecessary losses to the FOLF bank. One way to avoid this is to transfer the covered deposits and a corresponding amount of assets to a healthy bank. The remainder of the bank can be liquidated in due course if a suitable buyer is not found. The failed bank then exits the market. To facilitate this kind of semiprivate solution, the acquiring bank should be allowed to use the franchise of the failed bank for a limited period to avoid unnecessary turmoil and uncertainty in the market and to give the acquiring bank time to absorb the acquired assets into its existing business.

There is a risk that, after the transfer of assets and covered deposits, some of the customers may want to withdraw their deposits from the acquiring bank. Since the transferred assets may be impossible to liquidate in a short time without material haircuts, the DGS could offer the acquiring bank temporary liquidity support in the form of a repayable loan to pay for the withdrawals and thus mitigate the liquidity risk the acquiring bank could face.

For these measures to work it is necessary that DGSs do not guarantee other deposits than those now covered by deposit insurance. In general, FFI opposes any extensions to the scope of deposit protection since this would weaken the DGS framework instead of making it stronger.

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