Speech

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INDISPENSABLE ELEMENTS FOR THE BANKING UNION: OBSERVATIONS ON THE US EXPERIENCE

Speech by Pentti Hakkarainen, former Deputy Governor of the Bank of Finland and Supervisory Board member of the European Central Bank, currently Chair of the Administrative Board of Review, ECB, at the International Capital Markets Conference 2023. The event is organized by Deutsche Bundesbank, KfW, the Official Monetary and Financial Institutions Forum (OMFIF) and DZ Bank on 9 May, 2023 in Frankfurt.

INTRODUCTION

Thank you for inviting me to deliver this keynote speech at this event. This is really an honour recognizing that the conference brings together a wide range of actors in the financial world representing central and commercial banking, regulators, politics and think tank organizations.

Versatile participants bring valuable insights into discussions about how to keep the financial markets safe and sound.

I start with a disclaimer that a speak today in a personal capacity about subjects not related to the ECB's Administrative Board of Review, which I chair. The views expressed today do not necessarily reflect those of the ECB.

The recent events of First Republic, Silicon Valley Bank, Signature Bank, Credit Suisse etc have once again brought the stability of the financial system into the headlines. Beyond occasional news headlines, financial stability is an important objective for many authorities around the globe, which constantly work to maintain it. As Larry Summers has said about market disturbances: "These are things like forest fires, it is much easier to prevent them than it is to contain them after they start to spread".

Financial stability requires that three main elements are in place.

First, a detailed set of regulatory requirements, with which the participants in the system comply. These aim to ensure a safe and sound financial system.

Second, effective supervision of compliance with such requirements and of the management of the risks that arise for individual participants and in the system. Such supervision must be comprehensive and efficient.

Third, understanding that even comprehensive regulatory and supervisory frameworks cannot prevent all banking failures and crises – it is necessary to have a cleaning system to deal with such failures. And by cleaning system I mean prompt, corrective actions that ensure that swift and robust solutions are implemented. Be it resolution or liquidation, this cleaning system ensures that inefficient market participants may fail in a controlled manner, while limiting contagion and maintaining the trust in the whole financial system.

Such a cleaning system is an indispensable part of financial stability. Weak regulation requires a strong supervision and the other way round, a strong supervision may fix some weaknesses of regulation. However, banking crises cannot be prevented entirely, regardless of how strict regulation or supervision is. All these elements – regulation, supervision and cleaning system- are needed and are linked to each other.

In the recent cases we have seen all three elements at play, and failures in regulation and/or in supervision. It was however remarkable how swiftly authorities were able to implement the solution, indeed "Chapeau" to both US and Swiss authorities! The global contagion may not be likely as problems were contained quickly, but having major central banks keeping interest rates high to fight inflation, some instability in financial markets seems very possible.

I will focus my talk today on this third element – a cleaning system.

In the European Union, where I have had the opportunity to be closely involved in the work of the ECB over the last two decades, we have developed a very detailed cleaning solution – the Banking Union bank resolution framework. This solution was in part inspired by the US solution, informed by the detailed prescriptions of the Financial Stability Board and is soon to celebrate its 10th birthday. So one can say the Banking Union bank resolution system is still young, even if quite comprehensive, and it has been tested a couple of times already albeit not in very explosive situations.

Still the question is: Could we, in the European Banking Union, learn more from the US experiences of devising and implementing an effective cleaning system? And what do we need to do to complement the Banking Union, what is flawed or still missing? What does it aim to achieve, how is it structured, what are the best practices? What we need to improve?

I shall be comparing the US and the Banking Union solutions for resolving failing banks and present to you 3 observations – first about the speed, secondly about consistency and predictability and thirdly about the interaction between resolution and deposit insurance.

1. Speed

Let me start with a bird's eye view – the architecture of the resolution systems.

The bank resolution system in the US is centralised. The FDIC has in addition to supervisory powers an autonomous authority to manage bank failures. It can manage both the transfer of a going concern business as well as the liquidation of assets.

In the European Union the bank failure management landscape is shared by many authorities. First there is a distinction between Banking Union and non-Banking Union Member States and authorities. In the Banking Union, the Single Resolution Board is responsible for only the biggest banks, national resolution authorities remain responsible for smaller banks. The SRB's decisions are endorsed by the European Commission and the Council and are implemented by national resolution authorities. Where the SRB finds no public interest in resolution, failing banks are left to a national solution, they may be put into insolvency or into a liquidation. If the SRB needs to have recourse to deposit guarantee funds, it needs to coordinate with the relevant authorities. If funding from the Single Resolution Fund is to be used, the approval by the European Commission from a competition perspective is also required.

Then let me examine the speed of the initiation of resolution procedures. On this aspect triggers for resolution are of key importance.

In the US, once a bank is critically undercapitalised, then its chartering authority, together with the FDIC engage with the bank's management and have a time-limit by law – the Prompt Corrective Action provision. The authorities have then 90 days to appoint a receiver. If a chartering authority does not appoint a receiver, the FDIC may also do it. However, there are also a number of other grounds for appointment of a receiver, including balance sheet insolvency and illiquidity. Once receivership starts, many of the assets can be marketed to potential purchasers, even if the resolution of the entity has not yet been announced to the public.

In the European Union and in the Banking Union in particular, where decision-making for significant banks is relatively centralised, the initiation of resolution follows a similar path. There are 4 different broad circumstances that lead to a conclusion of failure. Breaches or likely breaches that justify withdrawal of the licence, actual or likely illiquidity or actual or likely balance sheet insolvency. Also, the provision of most types of State aid is a trigger for resolution. The ECB has the primary responsibility to determine significant banks to be failing or likely to fail, but so can the SRB. In principle the SRB can contact potential purchasers even before the bank is declared as failing.

Regarding the speed, my first observation is that decision-making in the European Union requires more coordination between several authorities. The process is complex in particular in cases where national authorities are involved. A second observation is that the triggers for resolution are pretty similar, but in the Banking Union we do not have a precise equivalent of the prompt corrective action clause, with its precise deadline. These two facts may slow down the process. The US system is putting pressure on the authorities to avoid risks from inaction. It's obvious that the speed can be improved by strengthening the coordination and clarifying the roles of authorities, and by inserting triggering indicators with timelines for action.

2. Consistency and predictability

Next, let me observe that practice with real resolution case matters. Learning by doing is an important mechanism to further improve the effectiveness and efficiency of the resolution system.

The FDIC has been in place since 1934, soon it will be celebrating 90 years. FDIC has resolved a bank a week on average in recent decades. It has practiced the work from small to big medium sized banks. In the active period of 2008 to 2013 the FDIC closed 489 banks with close to USD 700 bln of assets. Of these 489 banks most were resolved through various types of asset acquisitions and assumption of liabilities by other banks, and only 24 were liquidated with deposit pay-outs.

The Single Resolution Mechanism is almost 10 years old, created in 2014. During this time the system has been tested less often. While a few banks have failed during this period, only two resolutions of significant banks took place – the one of Banco Popular Espanol and that of Sberbank. In both cases the SRB decided to sell the relevant banks to a new owner. In the other cases where public interest in resolution was not found, the failing banks followed different solutions. Veneto and Vicenza were liquidated, using liquidation aid, ABLV Latvia's shareholders decided to voluntarily liquidate the bank, while the search for a buyer for its subsidiary was unsuccessful for one year and then the

Luxembourgish court started its liquidation. PNB Banka entered into insolvency shortly after its failure. And Sberbank Austria disposed of all its banking business and its licence lapsed.

Two things become apparent in this presentation. One, compared to the FDIC there have not been that many resolutions of significant banks in the Banking Union and many of the resolution tools have not yet been tested, beyond the sale of business. And two, in Europe - when SRB resolution is not implemented - national solutions vary greatly. The outcome of the process is difficult to anticipate. Whereas in the US, the FDIC is also in charge of these liquidation solutions. The recent European Commission proposal of a crisis management framework would extend the harmonized treatment on small and medium-sized banks in the Banking Union, which should enhance consistency also in the case of application of national systems.

3. Funding and interaction with deposit insurance

Let me turn next to the funding in resolution and what is the interaction with the deposit insurance systems.

In the US, the FDIC doesn't only manage bank failures, but it also operates a deposit insurance fund and can have recourse to it. It can also borrow from the Treasury. So far, the FDIC's funding has been sufficient. In the years 2008 to 2013 the FDIC needed around USD 68 bln to resolve banks with total assets of close to USD 700 bln. Certainly, recourse to its resolution tools, rather than straight liquidation of assets and depositor pay-out have led to this manageable cost.

While the FDIC provided over USD trillion in guarantees during the last financial crisis, subsequent amendments to the relevant law have limited the FDIC's ability to provide emergency financial support to individual institutions, except as part of a liquidation process.

In the European Union, the funding means of the SRB may appear a bit more modest. The SRF's target level will be roughly EUR 80 bln. The national deposit insurance schemes have funds of EUR 37 bln. The amounts are not very far from the FDIC funds. The use of the fund is subject to strict conditions, in particular a bail in of 8% of total liabilities. In any event, none of the two resolution cases that we had in Europe so far made any recourse to the resolution fund.

In addition, the Member States have agreed that the European Stability Mechanism will provide a backstop to the SRF under certain conditions, but the agreement is not yet ratified. This bridge financing to the ESM should also aim to cover potential substantial liquidity needs for an SRB resolution. The SRB's recourse to deposit guarantee funds is at this stage limited. Such recourse is further limited by the size of the individual national funds.

It is indispensable to have a swift interaction of resolution with the deposit insurance system, not only for funding reasons but also for creating more feasible options for cleaning the mess. In this regard, the differences between the US and the Banking Union are particularly pronounced.

In the US the FDIC is responsible for deposit insurance. It takes into account all aspects of safeguarding depositors' rights. It has the power to transfer deposits to another institution. It can decide when to use the funds from the deposit insurance fund.

In Europe, the interaction with deposit insurance is more complicated. The resolution authority focuses on protecting depositors' interests, but a payout by DGS can also be deemed to satisfy this objective. Where the SRB does not find public interest in resolution, its tasks would stop there, and it would not be able to transfer the deposits to another legal entity. A strict least cost test and a tiered depositor preference also do not facilitate the broader use of the deposit guarantee funds, to limit the overall cost of failures. However, we have seen lately that the Commission is willing to change these elements to facilitate the use of DGS funding, in particular by expanding the cases where DGS can intervene to support a non-payout solution and by proposing a general depositor preference, which facilitates transfer strategies.

The US experience is not necessarily one where a big volume of funds from the industry has had to be used to cover the price tag of resolution. It is rather one where the use of the available funds has been very efficient. We can learn from that by making better use of the funding we have available in Europe.

My other observation relates to an efficient and seamless integration of deposit insurance in the resolution process, with the overall objective to facilitate resolution and reduce its overall cost. The creation of a European Deposit Insurance System (EDIS) therefore is a necessity, especially for managing failures of cross-border banking groups. The optimal solution would be, evidenced by the US experience, a single authority which takes care of both the resolution and a deposit insurance.

When contemplating the way forward, one proposal could be to expand the mandate of the SRB to act as a deposit insurance authority. The SRB has expertise, and it has to deal with deposits in resolution cases anyway. In addition, it already has financial capacity comparable to that of the FDIC.

As a practical solution the EDIS could cover only the bigger, significant banks which are already in the SRB's perimeter. Other banks would remain in their national deposit arrangement. The strong national deposit guarantee systems, like German Institutional Protection Schemes (IPS), could be integrated as complementary systems providing additional coverage to the banks in question. The SRB would then be a unitary authority like the FDIC in the US. The decision-making system would reflect to the current set up of the Banking Union resolution and supervision frameworks.

Conclusion

As I have alluded to in the beginning, regulation and supervision and resolution systems are complementary and necessary elements for financial stability. Where regulatory requirements are weak, the more effective supervision is needed. Accordingly, a detailed and strict regulation may give grounds for lighter supervision. Better to have both strong, but even in that case bank failures cannot be fully avoided. Thus, as a backstop, a robust resolution system is necessary.

A robust resolution system should be swift, predictable and credible. The recent events of bank-runs having exceeded all expectations of speed and amounts of liquidity outflows, have underscored the importance of authorities' ability to act quickly. Another elementary part has been fair treatment of depositors and other creditors.

The Banking Union has a framework for handling banking problems in place. However, efforts are needed first to simplify and speed up decision-making, secondly to strive at consistency and predictability, and thirdly to enhance interaction between resolution and deposit insurance.

Regarding the third above, it is important to unlock a stalemate of the Commission's EDIS proposal of 2017. One practical solution could be to entrust the role of deposit insurer to the SRB and cover only the big banks under its perimeter.

In conclusion, let me note that the US system will soon be celebrating 90 years of existence, while our European system is only 10 years old. This should not give us excuses to rest on our laurels. We must not stop improving our system, whenever and wherever we can.

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