Bank resolution no longer a dreaded scenario for credit investors

“Pour ne jamais finir, une banque doit être toujours prête à finir[1]” *(To forever avoid its end, a bank needs to always be ready to end)*

Count Mollien, Napoleon’s Finance Minister

Resolution has been the ultimate bugbear of many credit investors and analysts since the last financial crisis. At least from 2014, when the BRRD was adopted in the EU. The likelihood of a bank getting closer to the dreaded ‘failing or likely to fail’ threshold has been a key driver of bank debt prices, especially debt in bail-in-able buckets. And not just for firms on shakier financial foundations; banks that are safely away from that threshold are also affected. At every sign of a marginally weakened prudential metric for a bank – say, a capital ratio down 30bp albeit still safely above requirements – analysts will often suggest scenarios around how close the bank is to being pushed into resolution by unbending regulators.

While such scenarios continue to drive market prices on banks’ capital structure, the likelihood of a large European bank ending up in resolution is more remote than at any time since the last crisis. This is true not only in the middle of the pandemic, where regulators will be loath to initiate such a radical step even if a large bank were a candidate, but it will persist into the post-pandemic years, when banks will be expected to play a central role in the economic rebuild.

As investors readjust their analytical lenses to assess bank creditworthiness, they will likely start de-emphasising the threat of resolution as the lodestar of danger. And they will be right to do so. In the case of banks with passable-to-good financial and business strength, there shouldn’t be much of a difference in the realistic credit risk of non-preferred senior debt (part of the MREL/TLAC bucket) compared to preferred senior. Market pricing will probably start reflecting this as investors become more convinced that for most banks, ending up in resolution – and thus activating a bail-in of MREL liabilities – is an unlikely scenario.

On the other hand, resolution planning remains an effective supervisory tool which helps the banks clarify their own trajectory and enables regulators to understand it and, if necessary, to steer it. But the market should be gratified that bank resolution, like wars, is likely to remain a planning tool that won’t turn into real action.

Large-scale misconduct (e.g. money laundering) will be the main risk potentially triggering resolution

A key takeaway from the Q1 results season has been the market’s keen focus on signs of asset-quality deterioration – higher provisions and NPL pick-ups. With one eye on how it affects the bottom line; the other on any stresses building around capital levels.

But this time is different, as European supervisors have not ceased stating since the Covid-19 crisis erupted. The severe financial distress stemming from the pandemic and the lockdowns was not triggered by the banking sector. Furthermore, banks, especially the larger players in each European country, are expected to help shoulder the financial impact through loans, guarantees, or borrower repayment moratoria.

[1] Mollien is quoted by Ludwig von Mises in “The Theory of Money and Credit” (1912).

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But why is it different this time? First, as long as banks' asset-quality positions deteriorate mostly from the impact of the Covid-19 crisis – through a worsening of credit quality to affected sectors of the economy – supervisors have been encouraging banks to use their excess liquidity and capital, and to dip into their regulatory liquidity and capital buffers. It is extremely improbable that, were a bank to do just that to help customers affected by the pandemic, the regulators later turn around and threaten it with early intervention or resolution.

Second, if a bank takes unnecessary risks to boost profits by engaging in risky transactions or activities, supervisors will not be shy to take action; especially if the Supervisory Review and Evaluation Process (SREP) parameters weaken markedly. But, again, this is unlikely in the pandemic and post-pandemic years when most banks will have to play it safe and remain heavily invested in handling the impact of the crisis on their own business and on individual clients, and in general on the economies they finance (often based on government priorities).

Third and more than ever, cyber risk remains at the top of the risk hierarchy for financial institutions. Senior bankers, regulators and government officials are rightly concerned about the nefarious impact of a successful cyberattack on a large institution by a hostile government or criminal organisation. The affected institution's prudential and financial metrics might suffer and failing to address the sudden weakness could trigger a run on the bank. It is extremely unlikely that a bank in such a difficult situation would be ushered into resolution by its regulators. The far likelier rescue avenue in these circumstances would be support from the government or from the industry at-large, or a combination of the two.

There is, however, one scenario which could lead to supervisory intervention and eventually resolution even in the post-pandemic years: that of large-scale misconduct, either through gross negligence or, worse, through deliberate action. Such misconduct could relate to money laundering, terrorism finance, market abuse (e.g. interest-rate or exchange-rate rigging), widespread customer mis-selling, or even blatant improprieties related to the distribution of public-sector credit to virus-affected businesses.

Misconduct, however, is not a parameter directly affecting a bank's capital and liquidity under SREP. Within the euro area (EA), conduct supervision is pursued mostly by national authorities, not the Single Supervisory Mechanism, in many instances with insufficient tools and using a box-ticking and backward-looking approach. Gross misconduct would affect a bank's prudential metrics only if it resulted in substantial regulatory or legal fines hitting profitability and regulatory capital. That said if this is the factor materially affecting a bank's loss-absorbing capacity and capital levels, it is likely that it would trigger early supervisory intervention followed by resolution if necessary.

This is the reason why the market focus on bank risk needs to be increasingly on areas of potential gross misconduct, not just mostly on asset-quality metrics. Unfortunately, these aspects provide very limited visibility on a forward-looking basis.

Resolution planning: a useful and effective exercise for banks and regulators

However, the improbable scenario of a large European bank being placed into resolution post-pandemic cannot negate the real benefits of the discipline in resolution planning – for both banks and their regulators (supervisors and resolution authorities alike).

It is more than 200 years ago that Napoleon's respected Finance Minister, Count Mollien, noted the importance of a bank's survival plan. Last March, the EA's Single Resolution Board (SRB) published comprehensive guidance[2] on what is expected from banks to achieve resolvability. These expectations are structured along seven dimensions: governance, loss absorption/recapitalisation capacity, liquidity/funding in resolution, operational continuity/access to Financial Market Infrastructure services, information systems/data requirements, communications, and separability/restructuring.

The SRB, and resolution authorities in general across Europe, demand that banks update their resolution plans annually to account for changes in the market and in their own operations. These plans are discussed and challenged in joint supervisory/resolution colleges in which banks present and participate. Like stress testing and other processes that occur periodically, resolution planning exercises are effective supervisory tools helping banks steer their trajectories. And helping regulators understand them and, when necessary, steer them.

[2] https://srb.europa.eu/sites/srbsite/files/efb_main_doc_final_web_0.pdf

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