Supervision-to-Resolution Scenarios: From the Plausible to the Implausible

The adoption in Europe of the resolution and recovery regime for the banking industry has led to a structural shift in the way the market assesses large banks. We have been focusing on this aspect for some time, pioneering a resolution-based approach in our bank rating methodology even before the official adoption of the EU Bank Resolution and Recovery Directive (BRRD) more than two years ago.

European supervisors consider resolution as the final step in a sequence of supervisory actions, generally following early intervention. It can occur when and where (i) an institution is failing or likely to fail, (ii) private-sector or supervisory steps are not likely to prevent the failure, and (iii) normal insolvency is not in the public interest. One area that remains relatively blurred for market participants is the specific process of handling the boundary between supervision and resolution by the respective regulatory authorities. This concern has been heightened in the market by the uncertainties and fears related to bail-in scenarios for MREL/TLAC-eligible senior unsecured debt.

One reason for the uncertainty is the fact that swinging a bank into resolution according to BRRD has not yet taken place, and a specific scenario analysis of the process has not been put forward by the competent authorities.

In this report we refer to three likely scenarios for a large euro area (EA) bank supervised by the ECB which deteriorates financially towards the danger zone of failing or likely to fail: two that are plausible – early supervisory intervention, without and with state aid following up -- and one that is less plausible – placing into resolution without going through these phases. We also mention a more extreme phase in the resolution process, what we call latter-stage bail-in, which we find implausible. The diagram at the end of the report highlights the sequence and correlation of these scenarios.

We highlight that, for the purpose of this report, the main thrust of early intervention is on the conversion of capital securities, and of resolution on eligible liabilities' bail-in – as this scenario analysis aims to address specifically investors' concerns.

We present a hypothetical situation of a large bank in a EA country going through the supervision-to-resolution process, starting in 2017. Importantly, the subsequent deterioration in that bank's creditworthiness is not the result of any legacies of the 2008-13 crises (as is for example the current situation with some Italian banks). For this scenario analysis, we refer to the fictional Principality of Slobozia. One of the largest banks in that country is Principality Banking Group of Slobozia (PBGS), with ca. EUR 70 billion in total assets. While not a G-SIB, PBGS is considered a Significant Institution (SI) and as such is directly supervised by the ECB.

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Figure 1: PBGS – Simplified balance sheet
(in EUR billion)

Total assets	70
Risk-weighted assets	42

Assets		Liabilities and Capital	
Interbank / Reverse repos	20	Interbank / Repos	20
Loans and investments	45	Deposits	33
Other	5	Covered bonds	5
		Long-term debt	4.8
		MREL senior debt	2
		Tier 2	0.5
		AT1	0.5
		Equity	4.2
Total Assets	**70**	**Total Liabilities and Capital**	**70**

Source: Scope Ratings

A. The plausible and less plausible

PBGS is on a 12-month supervisory cycle. The Joint Supervisory Team (JST) is responsible for the bank's day-to-day supervision. The ECB is also the host supervisor in a College of Supervisors – as the institution has two subsidiaries outside the EA.

PBGS's business model is a mix of (i) domestic retail banking (mortgages, business loans and consumer/credit card loans) and financial services (asset management, insurance), (ii) some foreign retail, and (iii) wholesale (loans to large corporates, investments, and a relatively sizeable trading book).

At EUR 42 billion, risk-weighted assets (RWA) represent 60% of total assets. With EUR 4.2 billion of CET1, the ratio is 10%. In addition, the bank has issued EUR 500 million of AT1 and EUR 500 million of Tier 2. Its combined buffers amount to EUR 1.85 billion. The bank already complies with the new MREL requirement (based on RWA[1]), as in addition to equity and capital securities it has issued EUR 2 billion of MREL-eligible senior debt, bringing the MREL ratio to 17.1% of RWAs.

The ECB's Supervisory Board agreed with the assignment of a combined SREP score of 2 for the institution (1 is the highest and 4 the lowest), namely: 2 for business model, 3 for governance and controls, 2 for capital adequacy, and 2 for liquidity adequacy. Based on this score and on other considerations (e.g. the country's macro dynamics) the total SREP capital requirement (TSCR) is 10.5%.

During the following supervisory cycle, PBGS's asset quality worsens considerably, with increasing levels of non-performing loans triggering higher provisions. A mix of difficult market conditions, poor internal governance and inadequate risk controls also leads to a marked deterioration of the trading book. The consequence is a sizeable EUR 700 million net loss that impacts the CET1 ratio – which falls below the combined buffer requirements (CBR). The materially deteriorating financials lead to more market funding

Table of Content

[1] This report assumes that the EBA's recent proposal (July 2016) to adopt RWA as reference base for MREL will be adopted, to bring it in line with the existing reference base for TLAC.

difficulties, and to a downgrade of the external ratings from low A to high BBB and soon thereafter to low BBB (borderline investment grade). The institution is now under heightened supervision. The new combined SREP score is 3, which is worse than the 2 assigned at the end of the previous supervisory cycle. A top-management change is forced on the bank, as well as a requirement to re-focus the business, deleverage and de-risk. The bank is no longer allowed to pay dividends and management bonuses are curtailed until the amount of the combined buffers strengthens. It continues however to pay coupons on the outstanding AT1 securities, as the ECB considers that the negative impact on financial stability of prohibiting it at this time (the AT1 market being forcefully re-priced, thus hurting the AT1 issuance capacity of the rest of European banks and marginally their cost of funding as well) would exceed the positive effect of helping PBGS shore up its capital position. Practically, the EUR 45 million coupon payments are not materially significant in this broader scheme of things.

The supervisors urge PBGS to raise more equity, but the attempt fails, given its difficult situation. They also actively encourage consolidation into a domestic or foreign bank, but no transaction goes through, as there are no takers with funds to commit. There is thus no private-sector solution on the horizon to PBGS's worsening situation.

Moving forward, the loan and investment portfolios continue to deteriorate, the trading book remains crippled, and the bank has to report another EUR 700 million net loss. Based on an earlier submitted recovery plan, the institution creates a loan-workout subsidiary and another top-management change is requested by the supervisors. The external ratings are now in the BB range (non-investment grade), market funding is no longer available to refinance the bank's long-term assets, and consequently the ECB/Eurosystem agrees to start supplying liquidity – against heavily-haircut collateral – as the bank remains solvent, albeit barely.

Aiming to address the challenge of the borderline prudential capitalization, the competent authorities – in the shape of a decision of the Supervisory Board, adopted by the ECB's Governing Council -- authorize more drastic steps as part of an early supervisory intervention. A bridge-bank subsidiary for PBGS is established, housing activities and assets pending future sale to a third party. The bank's wholesale banking activities which were not pursued as a core business are stopped and discontinued. The institution's recovery and resolution plans are reviewed one more time and the Single Resolution Board (SRB)/national resolution authority are brought into the assessment process by the ECB/national competent authority.

At this time, three different scenarios are likely to develop: the first two well within the realm of the plausible, the third less so.

Scenario 1 (plausible): early intervention and no state aid

Hoping to avoid a situation where placing the bank in resolution is the only option, the supervisors will make maximum use of the early-intervention tools at their disposal. The prohibition to pay coupons on the AT1 securities follows the earlier interdiction on dividends and management bonuses. However, as noted above, the annual EUR 45 million coupon payment is nothing more than a drop in the bucket for the recapitalization of the ailing bank. It nonetheless represents a sine qua non step before the implementation of the ensuing, more relevant early-intervention actions.

That materially more severe step that the supervisors then undertake -- as the authorities (the ECB's Supervisory Board and Governing Council, etc.) concluded had to be taken -- is forcing the conversion to equity of the bank's outstanding EUR 500 million AT1. Because this transaction is not sufficient, the supervisors pursue their early intervention by also imposing the conversion of the outstanding EUR 500 million Tier 2 securities into equity. As this conversion occurs at a moment when the bank's equity trades at a very significant discount compared to book value, the AT1 and Tier 2 investors are taking material losses on the principal. Nevertheless, the forced conversion brings nearly EUR 1 billion to PBGS's CET1 position – helping to refill the buffers.

Although these measures directly affect the market for bank capital securities and the bank equity market as well, they are nonetheless avoiding the even more drastic resolution and bail-in steps that could threaten senior unsecured creditors. On the positive side, PBGS, with almost EUR 1 billion of new equity, significantly restructured and on its way towards deleverage and de-risking, as well as continuing to benefit from central-bank liquidity assistance, survives as a going concern without being placed into resolution.

Under this scenario, even though the state-aid option was available and the amount to be injected in PBGS was not overwhelming in the broader scheme of things (a relative small price to pay for preserving systemic stability), the government took the decision to avoid it, as long as it was not the only avenue to further recapitalise, short of resolution and bail-in.. After all, the post-crisis resolution framework was put in place precisely to prevent bailing out banks with taxpayer funds, so the idea of a state contribution may have run against public opinion's expectations and tolerance – especially if elections are around the corner. Besides, were the bank's troubles mostly the result of mismanagement and reckless risk-taking (let alone fraud), the very suggestion of any state injection of capital would have been perceived very negatively, even if the proposed amount were less significant.

This process suggests that, while resolution indeed represents a powerful regulatory step to avoid an outright taxpayer bailout of a large bank, the supervisors have at their disposal an array of potentially effective tools to try to do the job themselves and thus stopping at the water's edge before resolution. In the EA, we assume that the ECB will invariably try to shoulder the problem itself to avoid passing the decision-making baton to the SRB, as it is understandably keen to preserve its institutional reputation in shape. One large EA bank being placed into resolution on the ECB's watch and subsequently handled by the SRB would probably dent to some extent the ECB's image as powerful and effective supervisor – especially in light of the ECB's relatively recent experience as bank supervisor. A second such occurrence could plausibly deal a heavier blow still to this image.

As another powerful argument for avoiding resolution for as long as the supervisors can deal with the stressed bank themselves, they are likely to choose "the lesser evil" of upsetting the market for bank capital securities rather than the much larger and deeper market for senior unsecured bonds.

Scenario 2 (plausible): early intervention and state aid

If the perception existed that the supervisory action, including the launching of early intervention, would not be sufficient to prevent a further erosion of PBGS's capital base, Slobozia's government, fearing the negative impact of the institution's problems on the financial stability of the country, would be assessing the possibility of a precautionary recapitalization of the ailing bank (allowed by Article 32(4)(d)(iii) of BRRD). According to EU state-aid rules, such extraordinary public support has to be preceded by burden-sharing by shareholders and subordinated creditors[2].

[2] Despite a ruling in July 2016 by the Court of Justice of the European Union (CJEU) that the EC's burden-sharing rule as precondition for state aid is not binding for EU states, we believe that it will be applied strictly as long as there is no significant amount of subordinated paper (such as capital securities) that had been sold by the bank to retail customers (as is the case in Italy).

As the bank's situation keeps deteriorating and another sizeable loss looms on the horizon, both the ECB and the government of Slobozia are seriously concerned about it getting closer to failing or likely to fail, which would necessitate it being placed in resolution and thus materially heighten systemic fears both in the country and across the EU at a time when other financially stronger European banks can ill afford to get hit by negative market sentiment.

At this time, the supervisory authority, as in scenario 1 (above), prohibits PBGS from making coupon payments on AT1 securities (as reminder the bank was already under interdiction to pay dividends and bonuses). The next step, again like in scenario 1, is the conversion of the EUR 500 million AT1 securities, and subsequently the EUR 500 million Tier 2 securities, into equity.

Under this scenario, these radical early-intervention steps replenish PBGS's CET1 position, but are not sufficient. They are however able to clear the way for the government to proceed with recapitalizing PBGS with another EUR 1.5 billion (it was determined that more than that was not necessary), with the European Commission's (EC) accord. Aside from the normative aspect – abiding by the EC's state-aid rules – the Slobozia government can plausibly claim that the bank's junior creditors were not getting a free ride at taxpayers' expense.

Following the recapitalisation from both capital securities' conversion and injection of state aid, and also significantly restructured, de-risked and recapitalized, as well as continuing to benefit from central-bank liquidity assistance, the intervened institution is able to survive as a going concern and in time restore its business and financial fundamentals, without ever being placed into resolution.

Scenario 3 (less plausible): moving straight into resolution

Following the exchange of information based on the evolving SREP outcomes between ECB supervisors and SRB representatives, the latter determine that the institution is failing or about to fail. Indeed, the latest SREP scores for PBGS are 3 for business model, governance/controls, and liquidity adequacy, but 4 for capital adequacy. The possibility of state aid is not considered as likely or even suitable. While the JST considers that pursuing early intervention steps – including the conversion to equity of the institution's AT1 and Tier 2 securities – could help stabilize the bank as a going concern, the decision is ultimately taken by the ECB's Supervisory Board and by the SRB to place the bank into resolution.

Upon this action being taken, the SRB and the national resolution authority proceed to implementing the resolution measures for the ailing institution, which has been already undertaking drastic remedial action (as highlighted above). In addition, the resolution authorities apply bail-in to the liabilities eligible for MREL. First, the AT1 and Tier 2 outstanding securities, aggregating EUR 1 billion, are converted into equity. Because this step does not restore the institution's recapitalization at a reassuring level, the next bail-in occurs for the MREL-eligible senior unsecured debt aggregating EUR 2 billion. At this time, the bank in resolution has been deeply restructured, with a new top management in place, a scaled-back business model, and in the process of being deleveraged and de-risked. An additional EUR 3 billion (the aggregate of MREL-eligible EUR 500 million AT1, EUR 500 million Tier 2 and EUR 2 billion senior) has boosted CET1 to a more acceptable level, making also possible the continuing liquidity support by the ECB/Eurosystem.

Were these additional MREL-eligible funds not sufficient for the institution to restore acceptable capitalization, outside resolution funds may be used to supplement them[3]. In our example the fictional PBGS does not need additional funds, but they should normally be available if the resolution authorities determine that they are necessary.

Again, while scenario 3 -- the placing of the bank into resolution -- is both possible and positive, it may nevertheless represent a less plausible outcome than scenarios 1 or 2 for the reasons highlighted above.

B. The implausible

The BRRD establishes that all long-term unsecured liabilities of a bank placed in resolution are bail-in-able. That would include senior unsecured debt that is not specifically eligible for MREL (such as senior debt issued by the operating bank of a group with a holding company structure), non-preferred (corporate) deposits, preferred deposits (above EUR 100,000 from SMEs and individuals) and even the Deposit Guarantee Scheme (but not the covered deposits themselves).

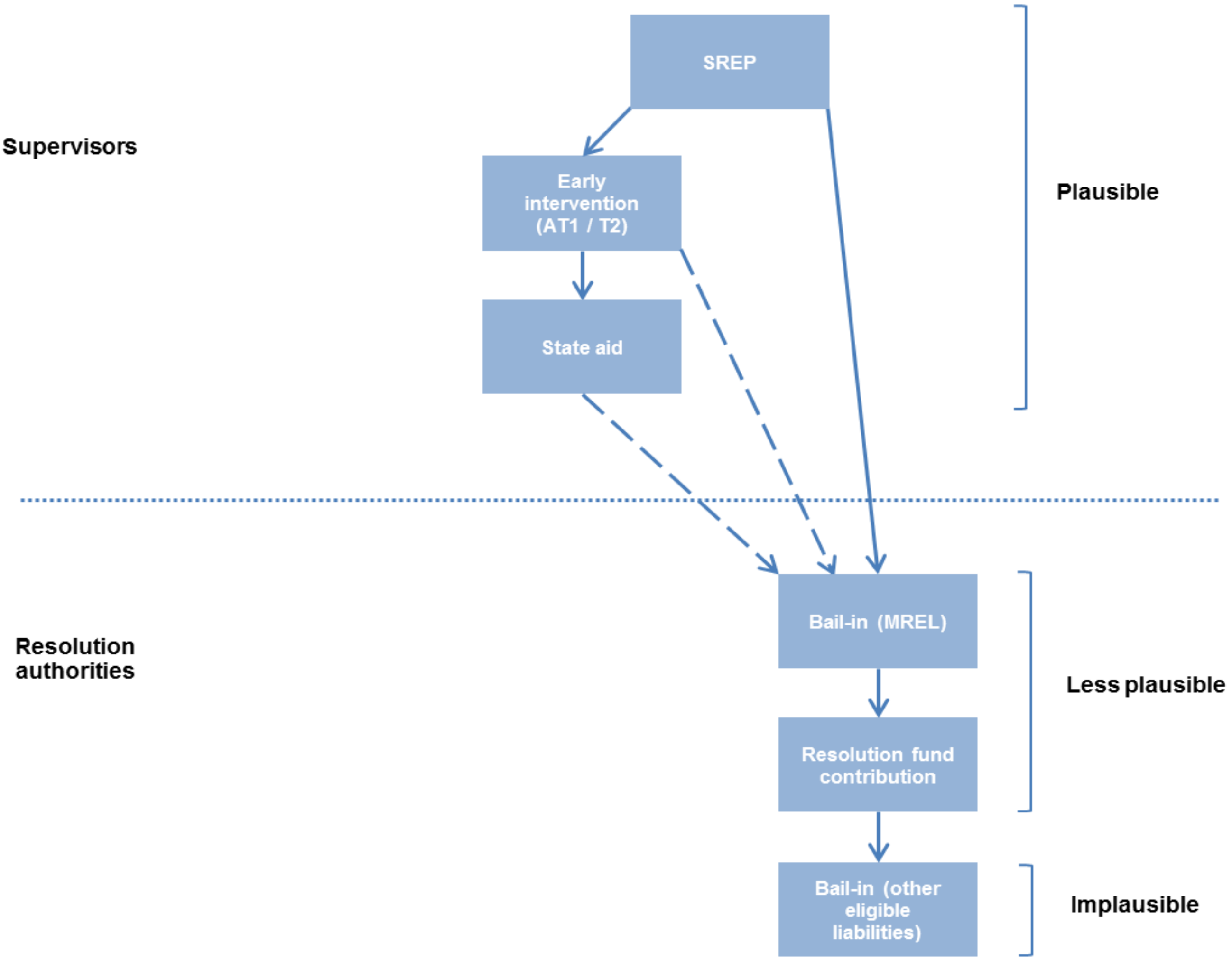
That said we consider such a scenario as implausible. First of all, the bank-in-resolution's meltdown should be on a truly gargantuan scale – to eat up equity, capital securities, senior MREL debt, and the proceeds from the resolution fund and still leave a hole. Second, we believe that, as much as governments will not be expected to provide classic taxpayer bailouts for collapsing banks in the new world of resolution, letting uncovered depositors lose their funds would be socio-politically unacceptable.

This is the reason why we consider what we may call the latter-stage bail-in (e.g. bailing in liabilities beyond the MREL eligibility) as highly improbable in real life, even under BRRD.

We would also question the applicability of a "going-concern" definition to a bank in this advanced state of meltdown, and thus of the credibility of resolution pushed to such extreme.

3 Currently capped by BRRD at 5% of nominal liabilities and own funds. However if the EBA's proposal to change the MREL reference base to RWA is adopted (as this report assumes) it is possible that the reference base for the resolution fund contribution could also be adjusted to RWA.

Figure 2: Supervision-to-resolution scenarios



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