Swinging a Euro Area Bank into Resolution: If, When and How

In recent months there has been renewed market scepticism regarding the commitment of banking authorities in the euro area (EA) – primarily the ECB and the Single Resolution Board (SRB) – to adhere to the resolution channel for failing banks, in accordance with BRRD. Such scepticism is not surprising in light of the efferent socio-political dynamics across Europe and the new winds of change from the US in general, and the handling of the Banca Monte dei Paschi di Siena (Monte) situation in particular. It comes after several years of market participants gradually becoming convinced that, going forward, resolution will be the sine qua non scenario for large banks in distress.

The market debate is now more intense due to the introduction of the new class of MREL/TLAC-eligible senior unsecured debt ('non-preferred' senior) through last November's proposed European Commission (EC) directive to amend Article 108 of the BRRD. Properly assessing the risk of these instruments, and thus being able to price them accordingly, is a primary concern for bank-debt investors, underpinned by the if-when-how assumptions related to resolution.

We summarise our view as follows:

1. Resolution is a reality for European banks, and very likely to remain so for the foreseeable future. There has been enormous investment by EU politicians, policymakers and regulators in replacing the old bail-out regime, which cost European taxpayers dearly during the crisis, with the new resolution/bail-in structure. While 'never say never' cannot be the wisest approach, basing investment decisions for bank debt on the off possibility of bail-outs would be unadvisable to the extreme.

   In the past Scope has written extensively about resolution, and in fact its bank rating methodology has been taking it into account since the beginning (our first public draft was published in September 2013). In May 2016 we updated our methodology to create new space for the rating of MREL/TLAC-eligible senior unsecured debt.

2. While the official line is that EA supervisors consider resolution as the final step in a sequence of supervisory actions, we believe that in real life the Frankfurt-based ECB (primary supervisor for large banks) will do everything in its powers – which happen to be very substantial – to avoid the scenario of swinging a distressed bank into resolution, thus 'passing the baton' to the Brussels-based SRB. Many across Europe and beyond – not least the euro-sceptic politicians – would plausibly view such a step as proof of the pan-EA supervisor's inability to handle a bank crisis on its own, thus potentially dealing it a reputational blow. Such a view would be significantly amplified if a second large EA bank ended up in resolution. In a Europe fraught with growing uncertainties regarding its cohesiveness, claims at the national level would most probably be raised about the wisdom of relying on a cross-border bank supervisor displaying questionable effectiveness.

   In contrast to the EA, resolution could be more naturally viewed as the final step in a sequence of supervisory actions (thus being a less remotely implausible scenario) in countries like the UK or Switzerland, where one single body – Bank of England and FINMA, respectively – is both supervisory and resolution authority.

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3. The Monte scenario cannot be assumed as the future template for the 'resolution vs bail-out' debate across the EA. First, the BRRD addresses the banking world after the crisis – thus not dealing with the stresses preceding or developing during the crisis, which is Monte's case. Second, we could consider that if Monte's subordinated securities were not held directly by domestic retail investors, the actions chosen by the Italian authorities would have been different. Indeed, recapitalising a bank to protect supposedly knowledgeable international institutional investors in subordinated securities would be politically unpalatable.

This report[1] presents four scenarios of what may happen when a relatively large EA bank supervised by the ECB deteriorates financially towards the danger zone of failing or likely to fail. Two that are plausible – early supervisory intervention, without and with subsequent state aid – and one that is less plausible – being placed into resolution without going through the early-intervention phases. We also highlight a fourth, more extreme outcome in the resolution process, that of latter stage bail-in, which we consider relatively implausible. The diagram at the end of the report highlights the sequence and correlation of these scenarios.

For the purpose of this report, the main thrust in early intervention is on the conversion of capital securities, and in resolution on the bail-in of MREL-eligible debt – as this aims to address investors' concerns.

We present a hypothetical situation of a large bank in an EA country moving through the supervision-to-resolution process, starting in 2018. Importantly, the subsequent deterioration in that bank's creditworthiness is not the result of any legacies of the 2008-13 crises. 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 70bn in total assets. While not a global systemically important bank, PBGS is considered a significant institution and as such is directly supervised by the ECB.

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

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

[1] This report is an updated and partially redrafted version of an earlier report published by Scope and titled '*Supervision-to-Resolution Scenarios: from the Plausible to the Implausible*' (27 July 2016).

Marching towards distress

PBGS is on a 12-month supervisory cycle. The Joint Supervisory Team 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, investment banking, and a relatively sizeable trading book).

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

During the following supervisory cycle (2019), 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 700m net loss that impacts the CET1 ratio and creates a shortage to meet the combined buffer requirement**.** Deteriorating financials lead to more market funding 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 to pay coupons on the outstanding AT1 securities, as such coupon payments have a priority claim over management bonuses and dividends.

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 700m 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 capitalisation, the competent authorities – in the shape of a decision of the Supervisory Board, adopted by the ECB's Governing Council – authorise 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 that are not considered as a core business are stopped and discontinued. The institution's recovery and resolution plans are reviewed once more, and the SRB/national resolution authority is 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, the annual EUR 45m coupon payment is nothing more than a drop in the bucket for the recapitalisation of the ailing bank; it nonetheless represents a sine qua non step before the implementation of the ensuing, more relevant supervisory early-intervention actions.

Noting that, unlike Monte and other EA banks, PBGS never sold its capital securities directly to retail investors; the next more severe supervisory step is forcing the conversion into equity of the bank's outstanding EUR 500m AT1. Because this transaction is not sufficient, the supervisors then pursue early intervention by also forcing the conversion of the outstanding EUR 500m Tier 2 securities into equity – a highly severe step but nevertheless within the realm of possibility. As this conversion occurs at a moment when the bank's equity is trading 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 1bn to PBGS's CET1 position – helping to refill the buffers.

Although these measures directly affect the markets for bank capital securities and bank equity, they nonetheless avoid the even more drastic resolution and bail-in steps that could threaten investors in senior debt eligible for MREL. On the positive side, PBGS – with almost EUR 1bn of new equity, significantly restructured, and on its way towards deleveraging 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 into PBGS was not overwhelming in the broader scheme of things (a relatively small price to pay for preserving systemic stability), the government took the decision to avoid giving it, as long as it was not the only avenue to further recapitalise, short of resolution and bail-in. Again, this was politically easier as the bank never sold its junior securities directly to domestic retail customers. 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 the public's expectations and tolerance. Besides, were the bank's troubles mostly the result of mismanagement and reckless risk-taking (let alone fraud), the very suggestion of any state aid would have been perceived very negatively, even if the proposed recapitalisation amount were less significant.

This process suggests that, while resolution indeed represents a powerful regulatory step to avoid an outright taxpayer bail-out 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 stop at the water's edge before resolution.

Scenario 2 (plausible): early intervention and state aid

If the perception existed that the supervisory action, including early intervention, would be insufficient to prevent a further erosion of PBGS's capital base, Slobozia's government, fearing a negative impact of the institution's problems on the financial stability of the country, would be assessing the possibility of a precautionary recapitalisation 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].

As the bank's situation keeps deteriorating and another sizeable loss looms on the horizon, both the ECB and the Slobozia government are seriously concerned about the bank getting closer to failing or likely to fail, which would necessitate it being placed into resolution, and thus materially heighten systemic fears, both in the country and across the EU, at a time when other 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 a 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 500m AT1 securities, and subsequently the EUR 500m 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 recapitalising PBGS with another EUR 1.5bn (it was determined that more was unnecessary), with the EC's 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 the conversion of capital securities and the injection of state aid, as well as being also significantly restructured, de-risked and recapitalised, combined with 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 Joint Supervisory Team considers that pursuing early-intervention steps – including the conversion into equity of the institution's AT1 and Tier 2 securities – could help stabilise the bank as a going concern, the decision is nonetheless taken by both the ECB's Supervisory Board and the SRB to directly place the bank into resolution.

Upon this action being taken, the SRB and the national resolution authority proceed to implement resolution measures for the ailing institution, which has already undertaken drastic remedial actions (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 1bn, are converted into equity. Because this step does not restore the institution's recapitalisation to a reassuring level, the next bail-in occurs for the MREL-eligible senior unsecured debt aggregating to EUR 2bn. At this time, the bank in resolution has been deeply restructured, with a new top management in place and a scaled-back business model, and is in the process of being deleveraged and de-risked. An additional EUR 3bn (the aggregate of MREL-eligible EUR 500m AT1, EUR 500m Tier

[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 was the case in Italy).

2 and EUR 2bn senior) has boosted CET1 to a more acceptable level, making it also possible to continue liquidity support from the ECB/Eurosystem.

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

Again, while scenario 3 – the placing of the bank directly into resolution – is possible, it nevertheless represents a far less plausible outcome than scenarios 1 or 2 for the reasons highlighted above.

Scenario 4 (implausible): bailing in non MREL-eligible liabilities

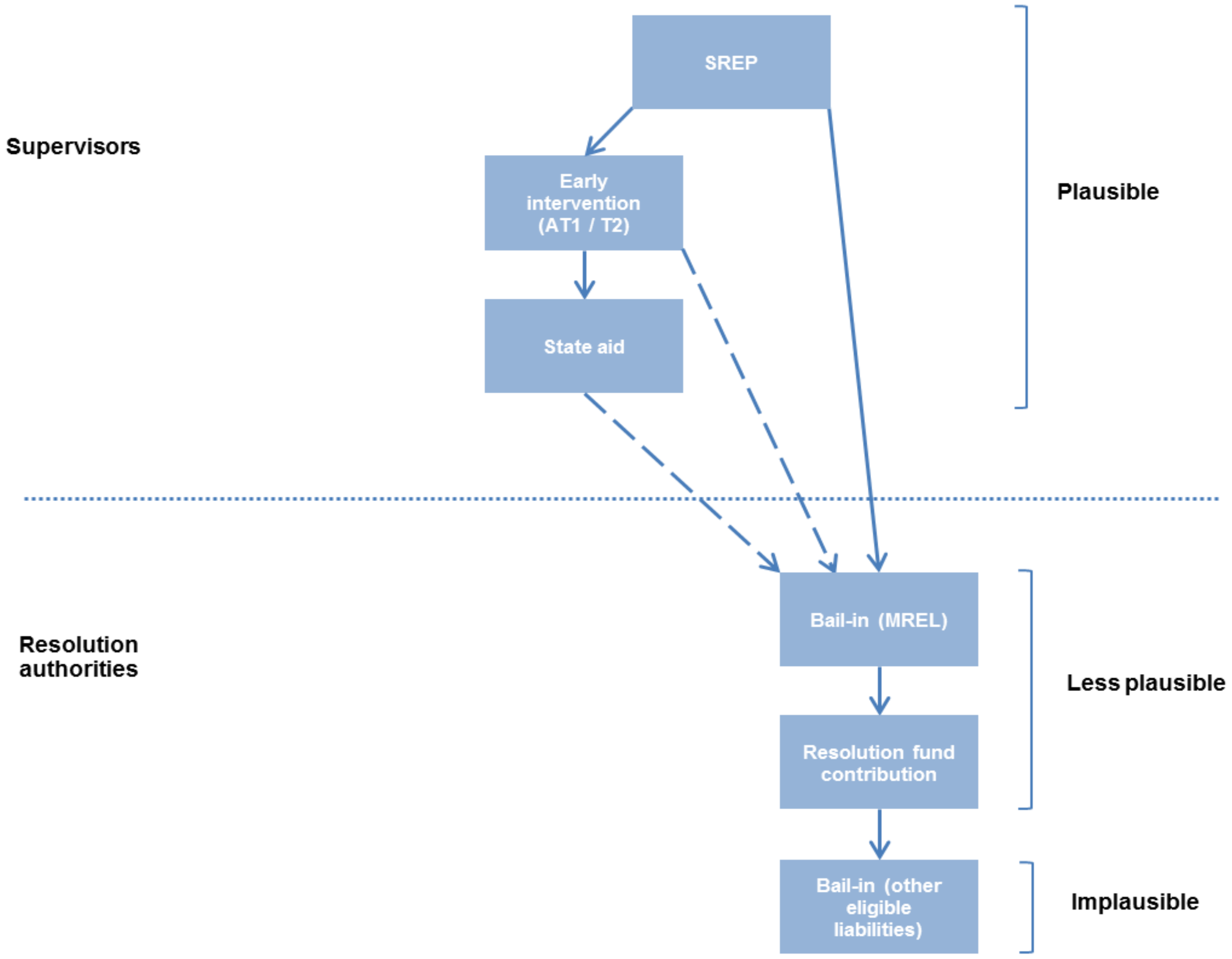
The BRRD establishes that all long-term unsecured liabilities of a bank placed in resolution are bail-in-able. That would include senior unsecured debt that is not specifically eligible for MREL (such as senior debt issued by the operating bank of a group with a holding company structure); non-preferred (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 definitely implausible. First, the meltdown in resolution would 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 bail-outs for collapsing banks in the new world of resolution – letting uncovered depositors lose their funds could be political suicide.

This is why we consider what we may call the latter-stage bail-in (e.g. bailing in long-term unsecured liabilities beyond those which are MREL-eligible) as highly improbable in real life, even under BRRD.

We also question the applicability of a ‘going concern’ definition to a bank in this advanced state of meltdown, and thus the use of resolution pushed to such an extreme.

Figure 2: Supervision-to-resolution scenarios



Source: Scope Ratings

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