SRB Bi-annual reporting note to Eurogroup

This note is aimed at reporting to the Eurogroup of 8 November 2023 on: 1) the Single Resolution Board's (SRB) views on CMDI; 2) Lessons learned from the recent crisis cases and liquidity in resolution; 3) Resolvability progress of SRB banks; 4) Progress made on resolvability of less significant institutions and 5) Single Resolution Fund activities.

1. SRB's views on CMDI

One of the objectives of the Crisis Management and Deposit Insurance proposal (CMDI) is to facilitate transfer strategies in resolution in order to deal with mid-sized and smaller banks which are systemic at regional level. CMDI - that is currently being negotiated by the co-legislators - is key to strengthen the crisis management toolset, particularly to facilitate the resolution of failed banks through the transfer of deposits and the exit from the market of failing banks via the implementation of resolution transfer tools. As the lessons learned from the recent crisis cases show (see Section 2), the implementation of transfer tools in resolution offers an effective way to cope with the situation of a failing bank. The SRB is very supportive of this reform.

CMDI is not a response to the recent crises. However, these events support the approach taken in this reform, i.e. enhancing the resolution toolkit and enabling a broader use of tools to transfer the deposits book. In fact, the US crises have shown once again that if depositors start fearing for their savings, financial stability may be in danger. Indeed, CMDI provides for enhanced depositor safeguards.

Some mid-sized and smaller banks would currently go into liquidation but resolution has the advantage, when compared to liquidation, that customers would have access to their deposits without any interruption. Furthermore, CMDI would minimize losses to depositors (via DGS interventions) whilst avoiding piecemeal liquidations. As such, in the SRB's view, CMDI helps by preventing contagion and reducing financial stability risks, whilst avoiding the use of public funds.

Upon request of the legislators, the SRB worked to quantify the main impacts of CMDI. The SRB presented these findings to the relevant Council Working Party - on 20 July and 9 October 2023 - and to the public in a seminar together with the SSM on 16 October 2023. Three key findings of the SRB study are:

- Subject to a case-by-case analysis, based on the sample of banks (Sis and LSIs) available to the SRB, CMDI would expand the scope of resolution in a moderate way, i.e. the strategy could change from liquidation to resolution for about 30 banks (mostly less significant institutions), while noting that this is clearly expected to remain at the discretion of resolution authorities.
- CMDI would have a limited impact on the finances of national Deposit Guarantee Schemes (DGS) and of the Single Resolution Fund when compared to their available resources and to the costs of piecemeal liquidation in several countries.
- In order to achieve its objectives, CMDI modifies the creditor hierarchy position of the DGS by putting it to the same level of uncovered depositors. This necessary amendment has worried DGS that fear greater losses in liquidation cases. However, according to the SRB study, the incremental cost for a DGS in a post-CMDI liquidation would appear to be manageable.

The analysis utilised conservative assumptions and concluded that CMDI is a very useful addition to the resolution authorities' toolkit (the presentation is available here). It is a much-needed evolution of the framework, with the potential to increase the firepower of resolution authorities to deal with banks' crises.

This analysis supports the Eurogroup statement of June 2022 which called for a completion of the CMDI legislative work by early-2024. The final compromise text the co-legislators will eventually agree, e.g. on the creditors' hierarchy and the least cost test, should unlock sufficient funding to potentially support the resolution of mid-size banks. The alternative, of not moving ahead with the proposal, carries the risk of reverting to the use of public funds, if public authorities view this as necessary to protect depositors in future crisis cases.

CMDI has plenty of positive novelties that go beyond the dual proposal of expanded PIA and funding. But there is no doubt that the funding aspects are the most controversial and so are the subject of particular attention in the co-legislation process. CMDI should be seen as a coherent package and the SRB thoroughly supports it. The technical solutions provided by CMDI are particularly necessary at the shortest term possible.

2. Lessons learned from the recent crisis cases and liquidity in resolution

In the past months, the SRB, within the Financial Stability Board (FSB), has been working on a report on the lessons learnt from the US and Swiss events of earlier this year. This report has been recently published. One overarching lesson learnt is that the FSB key attributes on resolution remain valid. In that sense, the framework, needs only limited evolution, not profound changes.

Some of the lessons go in the same direction as the work carried out in recent years within the Single Resolution Mechanism (SRM) e.g. ensuring all resolution banks have a substantial minimum requirement for own funds and eligible liabilities (MREL) capacity, work on liquidity in crisis for the banks.

However, other lessons will require some additional work. It is relevant to consider how communications by home and host authorities and firms could support restoring confidence of markets and depositors. The recent crises have shown that even one non-coordinated comment can have far-reaching, unintended, consequences. It is therefore critical that not only resolution authorities, supervisors and banks, but also relevant governments, coordinate their communication.

Another important lesson is that we need optionality for resolution strategies and tools. In the US and Switzerland, transfers proved to be effective even for larger banks. This, however, does not make bail-in less of a priority. Rather, it shows that we need to be nimble, with variant options for our resolution strategies. We should be able to switch or combine tools to respond effectively to each situation.

The FSB report also indicates as an area of interest the availability of a public liquidity backstop - a key missing in piece in our framework.

Liquidity in resolution

Liquidity is central to a successful crisis management. Banks depend on trust. If customers lack confidence that their funds will be available on demand, a spiralling liquidity crisis may develop. Such a crisis can potentially drive fire sales of assets to meet increasing liquidity demands, putting at risk the viability of the bank, the feasibility of resolution and possibly spreading panic across the banking sector and beyond.

The SRB resolution toolkit is strong but must be backed up by effective liquidity provisions to ensure the successful resolution of any crisis. In fact, the SRB has now built up a Single Resolution Fund (SRF), which stands at almost EUR 80 billion (section 5 for more information on this) and is requiring banks to work on their capabilities to generate liquidity in resolution (see section 4 for more information). However, the liquidity firepower in resolution could be boosted in two ways:

- **Common Backstop:** while the ratification process of the ESM Treaty reform is still ongoing, the SRB continues its work on the operationalisation of the Common Backstop to the SRF. In this context, the SRB developed a Collateral Policy and the joint SRB-ESM team elaborated a common methodology for the Repayment Capacity Assessment. The Repayment Capacity Assessment is used to determine the SRB's ability to repay the loan(s) received under the Common Backstop facility, by levying ex-post contributions from Institutions in the Banking Union and thus ensuring compliance with the fiscal neutrality criterion of repayment within the medium-term. On the basis of several tests, the SRB is confident that the amounts granted by the ESM would be effectively repaid on time.
- **Liquidity in resolution beyond the common backstop:** Liquidity in resolution was identified by the

FSB as an outstanding issue to be addressed and the Eurogroup also shared "*the assessment of the institutions [i.e. ECB, SRB and Commission] that there are limitations in the current framework for liquidity provision in resolution which may hamper its effectiveness*". However, the toolbox given to resolution authorities in the Banking Union is still mainly equipped to solve a solvency-driven crisis rather than a liquidity one. Available studies and the evidence from recent crisis cases in the US and Switzerland have shown how available resolution liquidity facilities (i.e. the SRF and the ESM backstop when it is in place) may not be sufficient in the case of the failure of a global bank (G-SIB) or of several medium-sized banks failing at the same time. This is a tail-risk but should not be ignored.

It is key to understand, that if the ESM treaty is not eventually ratified, the tail-risk of not having enough liquidity firepower for a resolution increases and may become relevant even for banks smaller than GSIBs.

3. Resolvability progress of SRB banks

Resolution planning

On 1 April 2023, the SRB started the 2023 Resolution Planning Cycle (RPC) – which is the annual process for the updating and reviewing of all resolution plans, as required by law, in cooperation with the National Resolution Authorities.

Currently, the 2023 RPC is on-track according to the plan and timeline as communicated externally (RPC Booklet 2023). Concretely, the SRB has finalised the update and enhancement of the 97[1] resolution plans for the 2023 RPC, some of these are under review by the SRB's horizontal functions and the ECB while others are already in the approval phase.

The end of 2023 marks a key milestone for resolvability, as it is the deadline for banks to build up their capabilities for complying with the SRB Expectations for Banks (EfB) and the steady-state MREL targets, in accordance with the legal framework. As a result, as mentioned above, the SRB will shift the focus from resolution planning (focussed on updating/enhancing the resolution plans) to the operationalisation of resolution strategies and testing of banks' resolvability. In this vein, the working priorities for SRB banks in the 2024 RPC include the common request to conduct the first testing of banks' capabilities for the timely provision of high quality valuation data and a liquidity exercise applying the feedback from the 2023 joint SRB-ECB liquidity exercise.

Resolvability assessment

The results of the 2022 heat-map assessment[2] show that overall, banks have demonstrated the expected level of progress set by the SRB until the end of 2022. Two-thirds of the banks already reached their final MREL target for 2024, including the Combined Buffer Requirement (CBR). Banks have continued to enhance their preparedness to operationalise bail-in, an area in which smaller and less complex banks have caught-up with the larger banks compared to the previous resolvability assessment publication. In parallel, banks have developed capabilities in three new priorities introduced by the SRB, related to liquidity in resolution, separability and Management Information Systems (MIS).

In the coming months, banks are expected to close the main remaining gaps to support resolvability. This means that banks need to meet their final MREL target and demonstrate that they have developed the main remaining capabilities related to liquidity and funding in resolution, separability and restructuring. In 2024, the SRB will review whether any shortcomings remain and take remedial action where needed.

[1] The number of resolution plans updated in the 2023 RPC is different than the number of banks under SRB's remit (114 on 1 July 2023) since: (i) the number of resolution plans does not take into account the plans of EU hosted banks which are subject to final adoption by the respective group-level resolution authority (GLRA), (ii) there are banks under simplified obligations for which the resolution plan is updated every two years, (iii) there are some 3rd country hosted banks that have a single resolution plan bundling two entities under SRB's remit, (iv) there are recently on-boarded banks for which the first resolution plan is planned for the 2024 RPC.

[2] SRB 2022 Resolvability Assessment report.

Looking ahead, given the evolving nature of the risks banks have to face, the resolvability assessment has to adapt in order to provide an adequate response to crisis events at any time.

Banks will need to provide evidence that they update their resolvability capabilities over time. They will be requested to regularly test their capabilities according to a multiannual work programme and to make the necessary adjustments in order to make sure their resolution strategies are flexible enough to respond to a range of crisis scenarios, taking into account emerging risks and lessons learnt from real crisis cases. To this end, the SRB will continue engaging with banks to further operationalise resolution strategies and tools, with particular focus on transfer tools, liquidity in resolution and restructuring.

Resolvability, is not only a responsibility of the banks but also of the SRB and of the National Resolution Authorities (NRAs). National frameworks, insolvency procedures, national resolution handbooks need to be ready to be implemented and resolution authorities should be correctly staffed. The SRB, of course, contributes to this endeavour by strengthening protocols and capacities of the SRM to address potential crisis cases. For instance, this entails, among many other activities, executing dry-runs, supporting NRAs developing resolution handbooks, ensuring that the bail-in tool can be smoothly applied everywhere in the Banking Union.

MREL status and policy

To provide a stable regulatory environment in a phase where some banks are still building up their MREL stock to meet the final (2024) targets, the SRB has decided to maintain its policy on the calibration of MREL (total and subordinated component) with minimal changes in 2023. Going forward, as part of the SRB's ongoing strategic review, the SRB has announced the intention to launch a public consultation on MREL to gather views and reflections from stakeholders, informing the SRB's potential review of the MREL policy.

As regards the build-up of MREL, the latest available data show that the overall shortfall against the final (2024) targets for resolution entities reduced significantly in the second quarter of 2023. The shortfall reached EUR 4.4 bn (0.1% TREA), almost halving (down by EUR 3.7 bn) compared to the previous quarter and decreasing by around 76% year-on-year (EUR 13.9 bn). When considering the CBR, the MREL shortfall was equal to EUR 13.6 bn (0.2% TREA), down by 32% (EUR 6.5 bn) compared to the previous quarter, and by 57% year-on-year (EUR 18.4 bn).

Seven banks closed their MREL shortfall (including CBR) in the reporting quarter (2Q23). Eight banks were still in shortfall to their final target (around 10% of the entities in scope). The number increases to 18 banks (22% of sample) when considering the CBR. However, it is worth noting that all banks with a shortfall against their final targets, and 14 (out of 18 banks) when including the CBR, have a longer transitional period to meet their final targets - ending in 2024-2025. As such, if we exclude banks which are subject to transitional periods beyond 2024, only four banks in the SRB's remit remain in shortfall with respect to their full final 2024 target including the CBR. In addition, the shortfall of banks with longer transitional period accounted for 96% of the total shortfall (corresponding to around EUR 13 bn).

As regards banks' funding outlook, in mid-March, spreads experienced a violent increase, due to the SVB and Credit Suisse crises. Confidence resumed towards the end of the first quarter of 2023, which helped the reduction of spreads. After a short period of market volatility, spreads continued their tightening trends from May, which allowed banks to benefit from favourable issuance conditions. At the beginning of July, funding costs were close to their level ahead of SVB and Credit Suisse crises, showing that market confidence is being restored. In August, spreads experienced again a slight increase, providing attractive rates for investors. Supported by spreads tightening, the month of September started strong in terms of issuances, with a range of issuers being able to tap the market.

4. Progress made on resolvability of less significant institutions

The SRB has an oversight role for Less Significant Institutions (LSIs) and has recently published a report on the topic. The SRB, in fact, ensures an effective and consistent application of the European resolution framework and high standards in resolution planning and crisis management both horizontally – across the LSIs in the 21 participating Member States – and vertically – between the LSIs and SRB banks within these Member States. There are ca. 2000 LSIs of which three quarters belong to several cooperative and savings banking networks but are not prudentially consolidated. The remaining 500 banks are equally divided between traditional and specialised business models.

At the end of the 2022 resolution planning cycle (RPC), 25 of the 68 LSIs with the resolution strategy had a shortfall with respect to the final MREL targets. In addition, the NRAs' phasing in and proportionate implementation of the SRB's Expectations for Banks and the 'heatmap' approach is ongoing.

The NRAs and the SRB are jointly enhancing LSI crisis preparedness and management through discussion of the NRAs' best practices and enhancing SRB procedures.

5. Single Resolution Fund activities

Initial period

During the last eight years, the SRB has gradually built the SRF with the objective of reaching the target level of at least 1% of the amount of covered deposits of all credit institutions within the Banking Union by 31 December 2023 (end of the "initial period"). For the calendar year 2023, the SRB collected EUR 11.3 bn of ex-ante contributions from 2,777 institutions that are in the scope of the SRF, and the available financial means of the SRF amounted to EUR 77.6 bn.

Mutualisation

The SRF has 21 compartments. In October 2023, 98.3% of the compartments were mutualised. By the end of 2023, as foreseen under the regulation, available means in the SRF will be fully mutualised and national compartments will cease to exist.

Steady state

The dynamic nature of the target level implies that if after the initial period the available means diminish below the target level, the SRB shall collect contributions in order to reach again the 1% target. To that end, every year at the end of January, the SRB will receive data from the DGSs. In case there is a gap, the SRB will collect the amount of ex-ante contributions necessary to fill it in and reach the new target. If the SRF is equal to or above the target level, no collection of ex-ante contributions will take place.

The SRB will verify in the first months of 2024 whether the available financial means in the SRF is equal to at least 1% of covered deposits held in the BU. As the outcome of the verification exercise is unknown at this point, the SRB is obliged to take the same preparatory steps that it has taken in the previous contribution periods. This will ensure that, if required, it will be in a position to calculate and raise contributions to the SRF.

Investments

The SRF has a prudent and safe investment strategy for the investment of ex-ante contributions, the legal basis for which is provided in Article 75(3) SRM Regulation and Commission Delegated Regulation (EU) No 2016/451. The investment strategy is subject to annual review, and has the objectives of value preservation and satisfying the liquidity requirements of the Fund. Liquidity risk management is critical as the SRF should be prepared to provide liquidity at short notice for the total amount held in the Fund. The SRF ex-ante return object is to have a return above the risk-free rate, defined as the remuneration of cash balances held with National Central Banks (currently €STR minus 20bps).