The Greens | European Free Alliance
in the European Parliament

The context: new rules for avoiding taxpayer bail-outs of banks

The final form of Banking Recovery and Resolution Directive (BRRD) was agreed after long negotiations between the European Parliament and the Finance Ministers of the Member States.

It sets out the rules, applicable in all Member States, for recovery actions to be carried out by bank management, under guidance from supervisors, to stave off bank failure as well as the rules for the resolution process, under the control of public resolution authorities aimed at reducing to zero (or at least minimising) the need for taxpayer bail outs.

For member States inside the Eurozone, a newly established Single Resolution Mechanism (SRM) will act as the resolution authority. However the rules enforced by the Board of the SRM and resolution authorities for member states outside the SRM will be the same ones as set out in the BRRD.

Banks must pay to clean up their own mess – in proportion to their riskiness

There are two principle mechanisms in the rules essential to achieving the overarching goal of shielding taxpayers from the costs of cleaning up behind failed banks:

- "bail-in" rules that ensure that a maximum amount of the losses incurred by banks is passed on to investors in the banks shares and bonds
- resolution funds, fed by contributions from the banks themselves, that will be used to cover the costs of restructuring and/or winding up the banks

Contributions to these resolution funds, which in essence represent a "third party insurance" against the costs of failure, should, as in the case of any insurance premium, be based on the likelihood and size of the payout.

Specifically, this "premium" must therefore accurately reflect, for each bank the following two elements

- the probability that the bank will enter resolution, and
- the expected cost of resolving the bank

Both of these elements are a function of the risk profile of a bank: the riskiness of its assets and how much of others people money is invested in those assets. The second element is also a function of the absolute size of a bank's balance sheet.

Obviously most small banks do not pose a systemic risk and would probably be allowed to be wound up under normal insolvency proceedings.

In a fair world, the most systemically risky banks (engaged in complex and speculative activities using unstable funding) will contribute the overwhelming proportion of the money required for resolution funds. Arguably, small banks, especially those engaged in "boring banking" (payment services, savings and loans) should not pay anything at all, unless they are part of a closely related group that is likely to fail together.

Systemically risky banks already get better interest rates from investors than their non-systemic peers, who assume that their losses will be limited if the bank fails, because governments will be obliged to step in to avoid a wider crisis.

Clearly, in a fair world, systemic banks' contributions to resolution funds should largely offset this "too big to fail" subsidy. This would have the benefit of promoting real competition between smaller safer banks and their bloated rivals.

The detail of how each bank's contributions are actually calculated will be set out in rules (EU-language „delegated act“) currently being drafted by the European Commission and which will be presented to the finance ministers and the European Parliament this Autumn.

However, this fair world is not one desired by many of the most systemically risky banks and they have successfully lobbied their governments to try to reduce the weight given to banks' risk profiles in the calculations of contributions to resolution funds. The biggest and riskiest banks, helped by their governments, want the smallest and less risky to pay more than they should. In particular the Italian and the Dutch government are active in this lobbying.

In fact the finance ministers tried to gain control of the whole calculation during the negotiations on the SRM but were stopped from doing by the European Parliament, led by the Greens.

Now some of them are trying again by exerting pressure on the European Commission as it consults about the rules. It has emerged that at least one Member State is seriously proposing that a bank's risk profile should only have an effect on 15% of its contributions!

Green comments on the Commission Services papers (15 May and 13 June 2014) focusing on banks´ contribution to the resolution fund

Note: we agree with the SSM-based approach to administrative fees for the SRM. The following concentrates on the common approach to the calculation of contributions to resolution funds in the BRRD delegated act discussed in the document.

Summary

- **We believe that banks that pose no systemic risk (individually or collectively) should be exempt from paying contributions, otherwise they would be effectively subsidising their systemic competitors**
- **We agree that the contributions should be based on the probability and extent of use of resolution funds**
- **We strongly disagree with the assertion that the non-risk-based component must have more emphasis than the risk based component This is not what the co-legislators intended in BRRD and it opens the door to politically motivated de-emphasis of the risk profile of a bank (apparently at least one MS would like the risk based component to count for just 15% of contributions!)**
- **We agree that the list of factors to be taken into account for the risk adjustment under BRRD Art 103 is non-exhaustive and some elements can be combined or added**
- **We believe that there should extra measures of risk exposure systemic risk, quality of the bank's risk management, capital excess relative to total supervisory requirement) and a lower emphasis on the "Risk Weighted Assets" measure which is easy for banks to manipulate We agree that high P&L can be both comforting and worrying - it depends on the trend and source**
- **We believe statistical and expert judgement approaches should be combined to assessing the relative importance of the risk adjustment factors**

Detailed comments

Proportionality

We are supportive of proportionality (e.g. a "lump-sum" allowance as suggested by Germany[1]) to ensure that the smallest and most "boring" business model banks (offering little more than payment services, loans and deposits) do not end up paying into a fund that will never be used for them and, hence, to effectively subsidize their systemic competitors.

[1] Expert Group Meeting of June 13. The UK seems to support the idea of a negative risk-adjustment for small non-systemic banks. This goes in the right direction but its calibration would be difficult and it would be simpler to simply exempt such banks as the UK infact already does with regard to its own bank levy

Due to their small size and not being part of a highly correlated group of banks who would all fail together, as well as their low risk business model, it would never be against the "public interest" to let them be wound up under normal insolvency proceedings.

Such banks should not be forced to pay insurance for a risk they do not pose.

Overall Approach to contributions

We strongly support the Commission services' view that the **BRRD delegated act should fully specify the relative contributions of** credit institutions paid into resolution funds **at national or SRM level**. This must include **how the "pro rata liabilities"**[2] **(or "flat") component and risk based component are combined**.

The Council Implementing Act in the **SRM regulation should only address the practical modalities of implementing the BRRD delegated act** in the specific SRM context.

We note with dismay that a minority of MS (BG, HU, PL, SE, DK, and UK) continue to press for only the risk adjustment to be dealt with in the DA and for the flat component, and its how the two are combined to be dealt with in the Council Implementing Act[3]. This would deprive the European Parliament of its democratic rights.

We believe that contributions should be approach as a form of insurance[4] and the "premia" paid by banks should depend on two factors:

- The probability of recourse to the fund
- The expectation for the amount of the fund that would be used in the event of such recourse

These factors are influenced by both the size the risk profile of the bank: the riskiness of the assets invested in, the stability of the funding sources and the extent to which shareholders and creditors can absorb losses. We therefore support the Commission services' view on the high level principles of the risk based approach.

"Pro rata" versus "risk-based" components of contributions

[2] i.e. the proportion of the liabilities (other own funds and covered deposits) of banks covered by the fund that a bank represents

[3] Expert Group Meeting of June 13

[4] More specifically a "third party liability" insurance taken out by the banks to cover "claims" from third parties (otherwise uninsured creditors, taxpayers and wider economic stakeholders) in the event of failure.

We do not agree, however, with the Commission services' view that the text of BRRD 103 implies that the risk adjustment factor must *necessarily* have a smaller effect on contributions than the "pro rata liabilities" component. Making this a requirement would potentially contradict the principles above.

Size comes into both of the factors mentioned above. Guaranteeing it a separate and more prominent role from risk profile is highly artificial and undermines an objective assessment of the likelihood of recourse to the resolution fund.

As a common sense rule of thumb, if bank A is half the size but twice as risky as bank B, it should pay the same contributions.

Again we note with consternation that the Commission's interpretation gets enthusiastic support from BE, EI, EL, ES, NL, PL, IT and LU and only the UK questions it directly. One can only conclude that those member states fear that "their" banks will contribute proportionally more if a proper account is taken of their risk profile and this would impinge on their competitively with member states with a larger proportion of less risky banks.

We believe that, if they prevail, the risks posed to the real economy and the tax payer by systemic banks will not only persist but *increase,* as safer banks are, in effect, forced to subsidise them[5].

To be consistent with the "insurance principle" we strongly advocate an interpretation of the BRRD 103.2 that makes relative contributions proportional to both the relative proportion of system liabilities and the relative riskiness.

We also saw no reason why the Commission services' first paper of 15 May 2014 dropped the "multiplicative" approach to combining the "pro rata liabilities" and risk factor components set out in the Commission's non-paper from February. We are pleased that the paper for the 13 June meeting rather supported the multiplicative approach. We favour that approach as it is closest to the way insurance premia are calculated.

We have not seen any convincing reasoning to back the additive approach, which allows for a quite arbitrary (and politically influenced) weighting of non-risk-based and risk-based components. Nevertheless a number of member states continue to insist on it offering as explanation only that it would be "simpler" - it is doubtful that they also would agree with us that making banks simpler would save a lot of worry about bank failure in the first place.

[5] See also our comments on proportionality

Assessment of the Risk-based component

The list of factors to be taken to account according to BRRD 103.7 points a to h are **not exhaustive and not independent** of each other.

We therefore believe that the Commission is empowered under the delegation **to select whatever it deems to be the most effective set of quantitative and qualitative indicators** that take those factors **and potentially other factors** into account.

Commission services would appear to have initially agreed as is evidenced by their interpretation of BRRD 103.7 point d and the addition of a point i) on taking in account bail-inable liabilities in excess of the MREL. However they seemed to have gone back on this position prior to the 13 June meeting of the Expert Group as they removed it from the list. We believe further thought to adding to the list of indicators in the text is required.

Risk exposure indicator (BRRD 103.7(a))
We would further recommend that the final approach to assessing and combining the different dimensions of assessment of the risk-based factor **be methodologically similar to the CAMELS approach used by the FDIC** to calculate deposit insurance contributions (as mentioned in the non-paper produced during the SRM negotiations[6]).

In our opinion, while it might be tempting to address the "probability of recourse" component using RWA (because these are calibrated to loss percentiles of a probability distribution), **it is important that RWAs not be given undue emphasis** and thus further increase the reliance on methodologies that have proven to be, at best, moderately correlated with the risk of failure of a bank and easy for banks to manipulate. An alternative to RWA/assets could be an expression of how "tightly a bank is capitalised relative to the *total* supervisory capital requirement (i.e. pillar 1, 2 and any other requirements resulting from e.g. stress tests).

We would therefore recommend that, in addition to RWA/assets and leverage ratio discussed in the paper, the **feasibility of an asset sensitivity measure (based on key risk factor shock scenarios) and a "distance to default" measure** (integrating *market* value and volatility of share prices) **should be explored**.

Some member states have indeed called for a measure of exposure to market risk, similar in spirit to the above to be included, but the Commission services apparently ignores this.[7]

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[6] "Non-Paper of the Commission's Services on the Adjustment of the Contributions to the Single Resolution Fund in proportion to the Risk Profile", 20.2.2014

[7] Annex to the 13 June 2014 paper covering risk indicators

In addition we are surprised by the lack of reference to systemic risk in the Commission services proposals despite some member states (e.g. FR, UK) being in favour. Under the new capital requirements Directive some banks will be classified as "global" or "other" Systemically Important Financial Institutions (G- and O-SIFIs) - surely these should be paying the highest level of contributions as should those banks deemed systemic enough to require direct supervision by the ECB under the SSM.

It would also seem sensible to use **past public financial support (point e)** as a (risk indicator increasing) **adjustment to the RWA factor**. This would reflect the fact that underestimation of RWAs, leading to undercapitalisation is strongly related to the need for such support.

Finally, we regret the absence from the current discussion of any reference to a measure of the **quality of the management (especially risk management) of the bank** used in the CAMELS approach- a factor that is surely extremely relevant. This should be closely related to the supervisory review process under CRD.

Financial Condition indicator (BRRD 103.7(c))

We welcome the fact that the Commission services' point out that the relationship between P&L measures and risk is ambiguous and that many member states have serious doubts about profitability equating to good health

We would welcome an explanation of what is meant by the qualification "from continuing operations". We assume that this would not include "extraordinary" profits (e.g. from sale of a business) or purely accounting profits, but more clarity is needed.

In general, we believe more (positive) emphasis should be given to earnings generated from business over which banks should have the most control (if well run).
Rapid increases in earnings due to expansion into new activities and earnings from exposure to market risks could indicate increased fragility rather than robustness.

There is also some evidence that return on assets (as required to be reported under CRD Art. 90) rather than return on equity may be a better indicator of financial strength.

Combining indicators

While recognising that it is more art than science to find a weighting scheme for the risk adjustment factors to arrive at a global indicator, an approach based on higher weights for "comprehensive" indicators and lower weights for "specific" ones, as mentioned in the paper is much too vague.

We are aware of a number of studies "back testing" a variety of indicators in terms of the degree to which they were predictive of banks getting into trouble during the crisis. While the weighting scheme should not be *solely* determined upon such statistical approaches, they should certainly be used in the process of determining weights.

They could be complemented by expert judgement - both in the assessment of their relative importance and in the assessment of the relative contributions for real banks that ensue - to arrive at the final scheme.

Membership of institutional protection schemes

An institutional protections scheme (IPS) is a private arrangement under which several banks sign enforceable agreements to come to the aid of a struggling member – e.g. by providing liquidity, capital or purchasing business lines, etc).

The new Deposit Guarantee Schemes Directive in combination with BRRD makes it very clear that the Resolution Authority will only step in once it is clear that such private recovery actions have failed. IPS membership should, therefore, significantly reduce the risk of a bank going into resolution and, hence, of resolution funds being needed.

Where the strength of the IPS can be demonstrated to the supervisory authorities, this should clearly lead to significantly lower contributions to resolution funds for member banks, compared to similar banks outside an IPS.

Article BRRD 103 explicitly requires membership of an IPS to be taken into account when "adjusting contributions in proportion to the risk profile" and we hope the Commission will make the quality of the IPS a significant factor in determining contributions.

Once again, the risk profile and the impact of various factors should be reflected in the whole contribution and not in a separate and lightly weighted risk adjustment component as suggested in the papers and minutes seen.