



Finance Watch

September 2014

TOO-BIG-TO-FAIL (TBTF) IN THE EU

WHICH PIECES OF LEGISLATION AIM AT TACKLING
THE TBTF ISSUE, AND WITH WHAT RESULTS SO FAR?

An assessment of EU 2009-2014 legislative work on banking

ASSETS OF THE 15 EU'S LARGEST BANKS

x3

2000
€7000^{BN}

2011
€20,000^{BN}





Perhaps the most severe blow to public trust was the revelation that there were scores of too-big-to-fail institutions operating at the heart of finance. Bankers made enormous sums in the run-up to the crisis and were often well compensated after it hit. In turn, taxpayers picked up the tab for their failures. That unjust sharing of risk and reward contributed directly to inequality but – more importantly – has had a corrosive effect on the broader social fabric of which finance is part and on which it relies. [...]

By replacing such implicit privilege with the full discipline of the market, social capital can be rebuilt and economic dynamism increased. [...]

This is the year to complete that job.

Mark Carney, Governor of the Bank of England and Chairman of the G20's Financial Stability Board - 27 May 2014

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The Global Economic Outlook: Mark J. Carney.

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Finance Watch has received funding from the European Union to implement its work programme. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch.



TOO-BIG-TO-FAIL (TBTF) IN THE EU

An assessment of EU 2009-2014 legislative work on banking

Banks perform vital functions in the economy: they take deposits, create and allocate credit and maintain the payments system. However, in the past 15-25 years some banks have grown out of all proportion to the economy, mainly by increasing the amount of financial trading they do with other financial firms. **They are now too-big or too-important-to-fail (TBTF)**, forcing taxpayers to rescue them in case of failure because there is a necessity to protect core banking functions to keep the economy going. These very large banks are also **too-interconnected-to-fail**: the possibility that a bank's failure will spread to other banks or even to the whole banking system leads authorities to come to their rescue with taxpayers' money in order to avoid a systemic crisis.

Public money therefore provides a safety net for large banks, which artificially lowers their funding costs and encourages them to take risks they would not otherwise take. They grow bigger as a result, which increases the value of the safety net even more. **It's a vicious circle** that hurts the market in good times and in bad: in good times it subsidises financial trading, distorts competition and keeps large banks away from their core function, financing the real economy; in bad times it causes financial crises and recessions.

WHAT HAS BEEN DONE IN THE PAST 5 YEARS TO ADDRESS TOO-BIG-TO-FAIL BANKING?

This document provides an overview of the corresponding EU financial regulations (passed or still in discussion) and an assessment of what remains to be done, in light of three major questions:

- **Has the loss-absorbency capacity of banks been improved and is it enough to protect taxpayer money?**
- **Is the current regulatory framework credible in the face of a major crisis?**
- **Are public institutions well equipped to deal with future financial crises and has the supervision of TBTF banks been improved?**

NB: Words with an * are defined in the 'jargon-buster' on p.14 of the Finance Watch report [Basel 3 in 5 questions](#).



IN SHORT: WHICH PIECES OF EU LEGISLATION ATTEMPT TO ADDRESS THE TBTF ISSUE?

In the past five years, the European Commission has published an unprecedented number of proposals to re-regulate the banking sector, and to tackle TBTF. However, a lot remains to be done.

On this page we list the five most significant pieces of legislation concerning TBTF, some of which are still being negotiated. On subsequent pages we give a short overview of each legislative text, together with a summary of Finance Watch's assessment and recommendations to improve them.

The present document refers extensively to Finance Watch reports published between 2012 and 2014, in which the reader will be able to find much more information and details.

Banks need to be able to withstand difficult times (losses) on their own, without requiring public intervention. For that to happen, they need to increase their loss absorption capacity. It is in the first place the role played by capital: the higher the capital of a bank, the higher its ability to absorb losses on its own.

- The **Capital Requirements Directive (CRD IV)** and the **Capital Requirements Regulation (CRR)** (further referred to as 'CRD IV') raise capital requirements and introduce the objective of a cap on leverage for European banks. CRD IV is a transposition of the Basel III accord into the European Union.

When a bank does face failure (which means that capital is not enough), there need to be enough additional lines of absorption to prevent a systemic crisis (during which a problem at one bank can affect the rest of the financial system, and in the end the economy as a whole), and ultimately to avoid the use of taxpayers' money.

- The **Bank Recovery and Resolution Directive (BRRD)** strengthens national resolution systems in Member States by providing several prevention and resolution tools, including the possibility to force creditors to take losses (bail-in mechanism).
- The **Single Resolution Mechanism (SRM)** is the crisis-management branch of the Banking Union (the supervisory branch being the SSM, see below). It mirrors BRRD in countries participating in the Banking Union (thus providing for the same bail-in tools) and provides for the creation of a Single Resolution Fund.

A preventive approach is also needed if we want to limit the potential size and impact of banking crises, which is about limiting the ability of deposit-taking banks to engage in trading activities and therefore decreasing the implicit guarantee that trading activities today benefit from.

- The European Commission's proposal for a **Structural Reform of Banks** aims at stopping the biggest banks from engaging in the risky activities of proprietary trading. It also aims at giving supervisors the power to require those banks to separate certain potentially risky trading activities from their deposit-taking businesses if the pursuit of such activities compromises financial stability.

Finally, supervision needs to be improved at the European level to deal with the issues facing large / Europe-wide banks.

- The **Single Supervisory Mechanism (SSM)**, also part of the Banking Union, is set to centralise key competences and resources for the supervision of Euro area banks, and banks of other Member States that decide to enter into close cooperation agreements with the SSM.

1. IMPROVING THE LOSS ABSORBING CAPACITY OF BANKS

Problem statement:

Banks are not robust enough to withstand losses*. In the financial crisis, many banks had insufficient capital to cover their losses, creditors were not requested to take losses, and banks had to be rescued with taxpayers' money.

Banks need to increase their loss absorption capacity so they can be more resilient on a standalone basis and withstand bigger losses before getting into trouble. This reduces the incidence of failure in the first place, and increases the likelihood of a successful bail-in if a bank does fail: the losses can be allocated to shareholders and creditors and not to taxpayers. And since banks are often highly interconnected with other banks, having bigger shock absorbers would make the whole system stronger.

What has been achieved?

A. Capital Requirements Directive IV package

The CRD IV package entered into force on 27 June (the Regulation) and 17 July 2013 (the Directive) ([publication in the Official Journal](#)), but full implementation is due 1 January 2019. Member States have to transpose the Directive into national law, and the European Banking Authority (EBA) is producing Binding Technical Standards (i.e. Regulatory and Implementing Technical Standards) for the implementation of particular aspects of the CRD IV package ("Level 2").

Two key provisions in CRD IV are:

- **Higher capital requirements**

The Tier 1 capital requirement* was increased to 6% of risk weighted assets* (RWA) (from 4% under Basel II)

FW ANALYSIS & RECOMMENDATION: The new Tier 1 Capital requirement remains extremely low¹ and leaves the financial system still significantly exposed to small declines in asset* values / losses.

More importantly, the package keeps the same methodology as before for the calculation of risk weighted assets: an overly complex, opaque and self-calibrating methodology. Indeed, by enabling banks to use their own internal models, the internal ratings-based (IRB) approach allows the industry to "self-calibrate" its regulatory capital. This became an incentive for aggressive institutions to use overly optimistic assumptions, and led to a related decline in the consistency of the risk weights. The same approach is maintained in CRD IV. This raises questions regarding its robustness and does not contribute to restoring confidence.

Finance Watch recommends the implementation of a simpler, shorter and more transparent regulation, which would give more prominence to a simplified standardised approach over the IRB / self-calibrating approach.

¹ In 2012, FW recommended an increase of Tier 1 capital to 10% of RWA*, including a common equity Tier 1 (or Core Tier 1) of 7.5% of RWA. Including the capital conservation buffer, this translates respectively into 17.5% (Total capital), 12.5% (Tier 1 capital) and 10% (Common equity Tier 1) of RWA.

- **Increased leverage ratio**

Basel III postponed the introduction of a minimum leverage* ratio of 3%, which means that a bank's gross borrowings could not be more than 33.3 times its Tier 1 capital. It would decrease large banks' leverage while having very little or no impact on small banks.

The introduction of this minimum leverage ratio (or leverage cap) in EU law has been left to later decision by the Commission. Its implementation would be gradual and would follow an observation period: banks will publicly disclose their ratios from 2015, and the Commission will prepare a report by the end of 2016 including, where appropriate, a legislative proposal to introduce the minimum leverage ratio as a binding measure as of 2018.

FW ANALYSIS & RECOMMENDATION: The absence of a binding leverage cap in CRD IV is a missed opportunity, as this was the key innovation of Basel III. Excessive leverage has been identified as one of the key causes of the current crisis. The introduction of a leverage ratio is therefore needed to improve banks' robustness. Finance Watch suggests a flexible leverage ratio of 5%-3% (5% for normal times and 3% in downturns) – or 20x to 33x. This would mean that in normal times, a bank's gross borrowings could not be more than 20x its Tier 1 capital.

For more detail see Finance Watch's [position paper on CRD IV](#) and a shorter explanatory version '[Basel 3 in 5 questions](#)' (also available in [French](#) and [German](#)).

B. Bank Resolution & Recovery

The [Bank Recovery and Resolution Directive \(BRRD\)](#) will enter into force on 1 January 2015. Bail-in provisions will enter into force in January 2016.

The key provision in BRRD is related to the bail-in tool.

BRRD allows national resolution authorities to **allocate losses, with an order of seniority, on unsecured creditors** by writing down or converting into equity* their claims, hence protecting taxpayers.

A minimum level of losses equal to **8% of total liabilities (including own funds)** will have to be imposed on an institution's shareholders (capital) and creditors (debt) before access can be granted to a resolution fund (either a national resolution fund or the Single Resolution Fund in the Banking Union, see below).

Liabilities* that are not permanently excluded will be bailed-in in a pre-defined pecking order: Capital comes first (shareholders' claims), followed by subordinated debt, unsecured claims and finally uncovered deposits above EUR 100,000.

FW ANALYSIS & RECOMMENDATIONS: The objective (creating bail-in mechanisms) is the right one but several issues undermine its realisation.

- First, **many categories of debt are exempted from bail-in, which reduces the loss absorbing capacity of this tool**. See [here \(page 2\)](#) the list of bank liabilities (such as very short term liabilities) that are permanently exempted from bail-in.

- Second, **too much is left to the discretion of national authorities.** National resolution authorities have the possibility to “exclude, or partially exclude, liabilities on a discretionary basis if they cannot be bailed-in within a reasonable time; to ensure continuity of critical functions; to avoid contagion or to avoid value destruction that would raise losses borne by other creditors”. As a result, if a major banking institution failed, it could be expected that resolution authorities would not impose enough losses on creditors because they would fear a contagion effect, e.g. they could exclude derivatives that are a major source of interconnection between large financial institutions.
- This makes the bail-in tool less credible, which, in turn, feeds the too-big-to-fail problem: the belief that authorities will not pass on losses to creditors but rather to taxpayers will provide a funding subsidy to the very activities that make resolution impossible and bail-out inevitable.

See Finance Watch's [report on the Bank Resolution and Recovery proposal of the EC](#) and Finance Watch's [report on Banking Union and bank structure reform](#), “Europe’s Banking Trilemma”.

C. Resolution Fund / Single Resolution Mechanism

The European Parliament and the Council reached a [political agreement on the Single Resolution Mechanism](#) on 20 March 2014.

The Single Resolution Mechanism (SRM) regulation sets up a centralised authority (the Single Resolution Board) which deals with the resolution of banks in the Banking Union, using the tools provided for by BRRD. The SRM regulation also includes a **Single Resolution Fund (SRF)** aimed at providing an additional backstop before taxpayers are called in, which mirrors the national resolution funds. The Single Resolution Fund will be established at a level equal to 1% of insured deposits in the Banking Union, ca. EUR 55bn. It will be built up by bank contributions over the course of eight years, with 60% of the funds in national compartments to be mutualised within two years.

The Fund will be allowed to intervene only after at least 8% of the failing bank’s liabilities have been exhausted through shareholders’ and creditors’ contribution (bail-in) to loss absorption and recapitalisation, as provided for by the bail-in mechanism in BRRD.

FW ANALYSIS & RECOMMENDATION: The resolution fund is intended primarily for resolution but transforms into a loss absorption fund if needed. However, it will be of limited effect given that it may be too small to cope with the failure of the largest banks, especially if nothing is done before then to tackle excessive bank size, complexity and interconnectedness (as an illustration, each of the top 15 European banks have assets on average of EUR 1,300bn). The danger is therefore that Europe creates a paper tiger – an SRM that delays reform of the banks because it appears capable of handling bank failure, but which in a crisis actually cannot.

2. MAKING CRISIS MANAGEMENT TOOLS CREDIBLE

Problem statement:

As explained above, crisis management tools introduced in BRRD and SRM are not robust enough to be credible in case of a major crisis or failure of a large bank. Attempts to pass the losses of too-big and too-connected-to-fail banks elsewhere in the system are likely to increase rather than absorb systemic risk. This would force authorities to make a difficult choice: saving the bank including creditors' and depositors' money (bail-out) or protecting taxpayers' money (no bail-out). This will, in turn, feed the too-big-to-fail problem: the belief that authorities will not pass on losses to creditors but rather to taxpayers will provide a funding subsidy to the very activities which make resolution impossible and bail-out inevitable.

The threat of bail-in and resolution mechanisms must be made credible: investors must believe that in the heat of a major crisis bail-in will be applied, and authorities will have the means to avoid the call to taxpayer money – bail-out. Therefore, on top of higher loss absorbing capacity (see CRD IV) and better ability to impose losses on investors and stronger resolution mechanisms (see BRRD and SRM), a **structural reform of banks – tackling the form and activities of the largest banks – must be enacted.**

What has been achieved?

Bank structure reform

The Commission published a [proposal on bank structure reform on 29 January 2014](#). This proposal will be debated and amended by the European Parliament – elected on 25 May 2014.

The core objectives of the proposed regulation (Article 1) include: to avoid resource misallocation, encourage real economy lending, reduce conflicts of interest, reduce bank interconnectedness and **make bank resolution possible**. Proprietary trading (narrow definition) is prohibited in case of global systemically important institutions (G-SIIs). The decision to separate other trading activities is not automatic but is left to European and national competent authorities and will depend on a narrow test of whether there is a threat to financial stability.

FW ANALYSIS & RECOMMENDATION: The European Commission's proposal on bank structure sets the right objectives, but has little prospect of reducing the economic burden of too-big-to-fail banking on the EU's taxpayers and real economy for three main reasons. First, although the banning of proprietary trading is welcome, it will contribute only marginally to reducing too-big-to-fail banking and the harmful implicit subsidies that go with it. Second, since any decision to separate will not be automatic (but will be made on a discretionary basis by the competent authorities, based on a narrow test of whether there is a threat to financial stability), it is very difficult to predict whether separation of too-big-to-fail banks will actually be achieved. Finally, the text is further weakened by its high level of administrative complexity and numerous carve-outs.

- See FW's report [‘The importance of being separated’](#)
- See FW's [factsheet on the effects of bank separation](#)
- See FW's [press release on the Commission's bank structure proposal](#)

3. IMPROVING THE ABILITY TO ANTICIPATE AND DEAL WITH CRISES

Problem statement:

The European banking system is dominated by international banks (TBTF banks) operating in many European countries. In case of major difficulties facing a bank, national authorities can be conflicted with national interest and tempted to protect “national champions” against broader general interest, beyond their borders. It is therefore essential to shift the responsibility for both supervision (SSM) and resolution (SRM) of large banking groups to the EU level in order to make the system effective and avoid conflict of interests.

What has been achieved?

European Banking Union

In September 2012, the European Council issued a communication entitled “[Roadmap towards a Banking Union](#)”. The European Banking Union is a political vision for more EU integration with the objective to strengthen and extend the regulation of the banking sector in the Euro area¹. Its three pillars are

- a Deposit Guarantee Scheme (DGS)²,
- Single Resolution Mechanism (SRM) - crisis management tools for the Banking Union, mirroring those provided for by the Bank Recovery and Resolution Directive (BRRD) (see above),
- and a **Single Supervisory Mechanism (SSM)** centralising the supervision of Euro area banks.

One of the main objectives of the Banking Union (and the SSM in particular) is to build up common decision-making and to take collective responsibility for banks, primarily the largest ones.

The SSM is to ensure that the Single Rulebook (comprising of e.g. CRD IV) is applied consistently in the EU. Therefore the prudential supervision of around 130 Euro area banks, which represent almost 85% of total banking assets in the Euro area, will be performed by the European Central Bank in close cooperation with national competent authorities.

The ECB will become the Single Supervisor in November 2014. Prior to assuming the new responsibilities the ECB will finalise a comprehensive assessment comprising of two pillars: an Asset Quality Review (reviewing the quality of banks' assets) and Stress Tests (examining the resilience of banks' balance sheets to stress scenarios). The ECB is also granted the power to initiate the process of resolution within the SRM.

Regulations³ concerning the SSM were published in the [Official Journal in October 2013](#).

¹ Other EU countries (non-Euro area) can also join the Banking Union through a close cooperation agreement with the SSM.

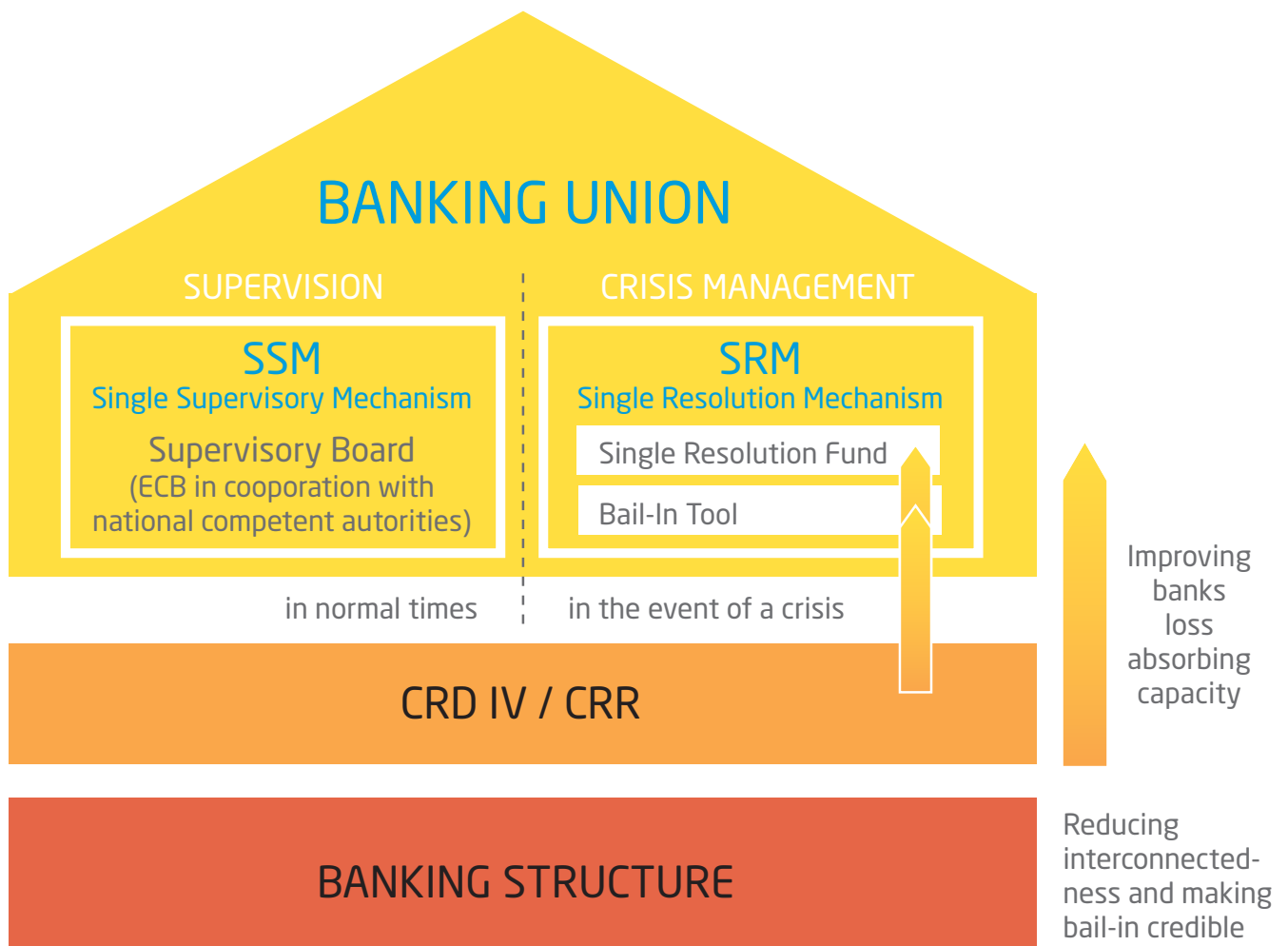
² Although Member States agreed on the harmonization of national Deposit Guarantee Schemes (in particular the application of the deposit guarantee on up to EUR 100,000), no agreement could be found on a shared and commonly-funded DGS. This pillar of the Banking Union has therefore been delayed.

³ SSM regulations also include EBA regulation, [to be found here](#).

FW ANALYSIS & RECOMMENDATION: The Banking Union may face its first test when the ECB carries out its comprehensive assessment of banks: what will happen if banks that need to raise capital after the assessment cannot do so in private markets?

- New rules (state aid and BRRD) aim to require existing investors to contribute to a bank's recapitalisation. However, a series of safeguards and escape clauses allow public authorities to let these private investors 'off the hook' especially if financial stability is at risk, in which case public money can be used to recapitalise the bank instead.
- High bank interconnectedness may pose a threat to financial stability: authorities will not want to risk a domino effect propagating one bank's losses to the whole system. This casts doubt on the credibility of the rest of the crisis management framework: if taxpayers cannot be protected after a round of stress tests, how could they be protected when exposed to a real financial crisis?
- FW argues that a structural reform of banks would reduce interconnectedness and improve the credibility of resolution.

See FW's report on Banking Union and bank structure reform, "[Europe's Banking Trilemma](#)"



NOTES

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org



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