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Welcome to video 3 on Banking Union in the EU. This video is on bank resolution and the Single Resolution Mechanism. Before watching it you should have done the prior reading and you should have looked at video 1 and video 2. Video 1 is on the single rulebook, and video 2 is on the single supervisory mechanism. What we had in the case of the single rulebook was that everybody should be singing from the same hymn sheet. The problem which we have beyond that is that the various parts need to work together, the various countries, the various authorities need to work together if you are going to be able to cover financial institutions which operate in more than one country. And that is really what the Single Supervisory Mechanism is designed to do, and indeed the Single Resolution Mechanism later on.

So the easiest way to do this is to have a hierarchy, so that somebody at the EU level is responsible and then they are able to tell the people at the national level what to do. Otherwise what you have is that the national authorities all have to try and work together and since you have problems of secrecy between them you don't even manage to get enough information. So that the lead authority, which is the home country, knows what is going on in the host countries where the bank is also operating. So you don't have enough information, and most certainly you don't have enough power because you can’t force anybody to do anything in another country. So this is really why we want this system, or rather why we see this system in Europe where somebody has to be responsible.

So let us look then at resolution, and resolution for banks of course is a very specific idea. And you will see that this is incorporated by two things in the Banking Union, the first is a Directive, the Bank Recovery and Resolution Directive. And the second is a Regulation setting up the Single Resolution Mechanism. But if we look at this in a little bit more detail I think it would be possible to understand it better. The problem which the authorities are trying to deal with, is what should they do if a bank starts getting into difficulty. And they have divided the Directive into two parts, recovery and resolution. Because recovery is something which the bank can manage to do on its own.

So what it should be doing is if things start going sufficiently badly that people start getting worried, then it has to put this mechanism into force. So there is going to be some sort of early warning threshold at which point people leap into action. But it’s then up to the bank itself to try and do this with the help of the supervisor. And it has to have a plan for doing this, and this recovery plan has to be agreed by the supervisor. But if things are much worse then the bank is not just going to be in difficulty, it is going to be breaching the rules of permitted size of capital. So it will go through the minimums permitted., At that stage it is then going to be up to the authorities to do something, and that is where resolution comes in. So if the bank actually breaches the conditions for being a bank, then the authorities take over. If things get really bad then of course the bank may very well become insolvent.

But in this second case of resolution it is the authorities who run the game and it is they who decide what is going to be done and they will be replacing the management of the bank. So let us go back to the picture as a whole. This Bank Recovery and Resolution Directive applies to the whole of the European Union, and indeed to the European Economic Area. So it is not just something for the SSM countries, the euro area countries, but something for everybody. So the first thing which the Directive does is it sets up all of the tools which you need - all the powers for trying to resolve insolvency problems. And what they found in the previous cases in the global financial crisis is that without these tools and powers, the only thing that they could do, was just let the taxpayer bail out the bank if they didn't want it to stop operating.

So these essential functions which we talked about before, for them to keep going, if you can't intervene in the way which is described here, then the only thing you can do is give money for the bank and it will keep going. So the first intervention power is simply that the authorities can step in and run the bank. So they can appoint some sort of special manager to run that bank. In the case of New Zealand that is described as a statutory manager, so it is exactly the same sort of idea in the EU countries. And what can that statutory or special manager do once they've taken over the bank?

Well the first thing they can do is simply divide it up, and they can separate it out into the bits which will continue to run alright, and the bits where there are the problems. This is often described as a bad bank. So that is the first tool they have [the second in overall list], they can chop the bank into a number of pieces and make sure that the good bits can then be running on their own or sold to somebody else. So that is the third tool - that you can sell the bank to somebody else, or sell the parts of it to somebody else. And all of this can be done without involving the shareholders, because it is now the authorities who are running the bank. But maybe they can't do this fast enough, because all of this has got to be done without the bank stopping operating.

So all of these tools have to be used overnight, although you will notice the banks tend to fail on Fridays, so that you have got the whole of Saturday and Sunday to conduct this resolution process. But nevertheless you have got to be able to do it in about 60 hours. So maybe you can't do it fast enough, in which case they can transfer the business of the bank to a bank run by the authorities and owned by them. And this is described as a bridge bank, this is purely temporary until the other characteristics of the change can be put in place. So in most cases bridge banks can only run for a year, or possibly two years. Otherwise you could just end up with nationalising the bank and that is something which you would want to do outright, and that would be the sale of business to the government.

The last of the aspects and perhaps the most controversial one is the bail in tool. And the idea of a bail in, is that the creditors of the bank take a hit. That what is happening if a bank is failing is the value of its assets have become quite a lot less than the value of its liabilities. So for the bank to return to solvency something has got to change. Either the assets have got to increase, or the liabilities have got to run down, or some combination of them. And what the bail in tool does, is it runs down the liabilities. And you can do this in two ways. One of them is simply to write them down in order of priority, and the other one is to swap debt for equity, so that you're doing 2 things at once. If you are swapping debt for equity, the people who own the debt are now becoming the owners of the bank, so you have created new owners of the bank. If you simply write them down then somebody else has got to step in with some capital and become the owner of the bank.

The last tool which they require is all of this is going to cost some money. It may very well be that it's very difficult to get that out of the creditors. That is what is intended in New Zealand. In the New Zealand case it will be the creditors who provide money for the costs. In the European case there are going to be some resolution funds which amount to one percent of covered deposits. So it is not one percent of covered deposits in this bank which is in trouble, it is one percent of covered deposits in the system.

There are two remaining elements in the Directive, one of which we have talked about before in the directive, which is that there need to be recovery and resolution plans, but the remaining one is depositor preference. In other words in this process of bailing in, depositors are the last people who are bailed in before the secured creditors. So if we look at the creditor hierarchy you get the shareholders bailed in first, then the subordinated debt-holders, then the junior unsecured debt-holders, and then the senior unsecured debt-holders. If you hadn't got depositor preference, and we don't have it in this country, then the depositors would be bailed in as soon as we've finished with the subordinated debt-holders. And that means that in most cases where there is a severe problem depositors would be bailed in. In the European case this is not going to happen, and the depositors will be last in line, and therefore it is going to be very unlikely that they will actually get bailed in, so that is the first side.

The second side is that there's going to be a Single Resolution Mechanism and this is going to match the Single Supervisory Mechanism. So it will cover the euro area countries compulsorily, and it will also cover all those who join into the Single Supervisory Mechanism as well. Here they have needed to create a new institution and what they have created is a Single Resolution Board. And that has been done by the Single Resolution Regulation. The Single Resolution Board is in effect part of the European Commission although it is set up as being completely independent. And as I say this will be in Brussels and it will work with national resolution authorities. So each country has to have its own resolution authority. But the Single Resolution Board is going to decide how all of those tools which exist under the Bank Recovery and Resolution Directive, are actually going to be used in the case of the failure of a particular bank. Also as a further side of the Single Resolution Regulation they are creating a Single Resolution Fund. And this is a separate inter-governmental agreement because not everybody is going to be party to it and this is going to be a constraint on governments.

So whereas each country under the Resolution and Recovery Directive had to have its own resolution fund, what they're doing for the countries who have joined the SRM, is mutualise those funds. So they're going to be able to add them together, and that process will occur over the first 8 years in which this operates. So I will start in 2016 and progressively, up to 2024, those funds will be mutualised. So by the end of 2024 if a bank which runs across the whole of these countries gets into difficulty, then they can use these funds wherever in the bank the problems occur. So it may be that all of the money goes to one country, but nevertheless they can use those funds. But, these funds only amount to one percent of the covered deposits, and in the case of, of the euro area, this is going to be just 55 billion euro. And that in the context of the size of these banks is really quite a small sum.

So where does this leave us in terms of what we should be looking at? The first question to ask is: does the Bank Recovery and Resolution Directive give the resolution authorities enough tools? Well, since this seems to cover most of the area previously I suspect the answer is going to be yes. What else do you want to do which you will be unable to do without these tools? But there are some more difficult problems. , Can you really have recovery plans which are realistic? Can you actually plan in advance and say I can set up exactly what we will do in the event of a crisis? When markets are shut, this is something which we can manage to operate even though we can't get any more capital out of people. Is it going to be the case that the authorities intervene early enough? Because forbearance has been something which has characterised previous crises. We always hope that perhaps the problem will go away before you have to act. It may be that just you can't recognize it and the indicators you are using are not enough.

Even if you can manage to intervene early enough can you actually manage to do enough that you could absorb all the losses which have been made and still have a bank which is adequately capitalised? And that is something which we'll see when we get to resolutions as well.

One of the problems here is that we'll be using the new bail in tool. With a recovery the bail in is voluntary. It is purely that these are instruments which exist already which can be bailed in so it is part of the contract. And these are normally called contingent convertible securities. It says if things get adequately bad, then the debt will be converted into equity. So there will be some level which is independent of the authorities and independent of the bank in trouble will just be a statistical trigger which means that debt gets converted into equity. If that sort of thing happens, is this going to result in a general collapse in confidence and in fact will generate a crisis just because we start having a recovery process occurring?

Then perhaps, one should ask the question is the Single Resolution Board actually going to be able to work properly? Will we find that it can actually impose its will? Will the national governments in fact still be rather panicked about what is going to go on and decide that they would rather use taxpayer funds than have the bailing in process and the other tools being used. Because it is still an area of national sovereignty where they can do that.

And lastly, are the resolution funds going to be large enough? Is that 55 billion euro going to be enough? Perhaps, one should move on and use the European Stability Mechanism and a much larger, nearly a trillion euro, funding in that to help the process.

What we're going to do after this video is try and look at the problems which are posed and what might be done in the future for a better arrangement for a proper Banking Union, and that is video 4.

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