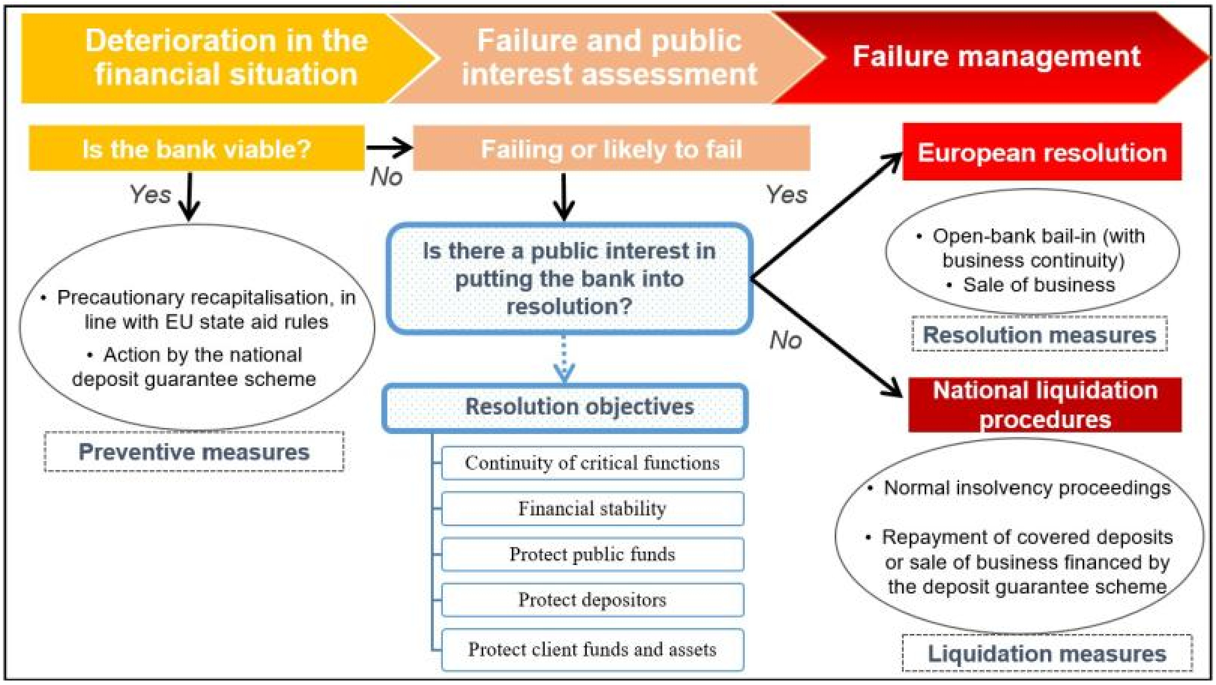
Resolution of banking crises: lessons from Europe and beyond

By Riad Benahmed

Following the 2008 financial crisis, the authorities developed a method for managing banking crises that limits the use of public funds: resolution. This blog post presents the European resolution regime and takes stock of the situation ten years after its creation. While this mechanism has already proved its worth, Europe can learn some lessons from the 2023 banking turmoil.

Chart 1: Resolution, the only harmonised method of managing banking crises in Europe



Sources: ACPR, BDF

Note: When a bank's financial situation deteriorates, the authorities have three options for managing the crisis: (i) prevent the bank's failure through financial support from the state or the national deposit guarantee scheme; (ii) if failure is unavoidable, liquidate the bank in accordance with the national insolvency procedure; or (iii) place the bank in resolution, a crisis management procedure harmonised at European level, to achieve certain objectives that are consistent with the public interest.

Note: A bank's critical functions may include the management of customer deposits and means of payment, the distribution of credit and its market activities.

Following the 2008 crisis, bank resolution regimes were set up in some G20 countries

During the financial crisis of 2008, the authorities had only one choice: save the ailing banks at the taxpayer's expense or let them fail (Lehman Brothers) at the risk of compromising financial stability. To avoid this, in 2011 the Financial Stability Board established an international standard for so-called bank resolution regimes, endorsed by the G20. These regimes give the authorities exceptional powers to manage bank failures in the public interest.

In the euro area, a resolution mechanism was put in place in 2014-2015. Under the aegis of the Single Resolution Board, it is one of the three pillars of the Banking Union, alongside the single supervisory mechanism and European harmonisation of deposit guarantee schemes. It is in the public interest to preserve financial stability and protect depositors and public funds during banking crises (see Chart 1). To achieve these objectives, the European authorities have the power to restructure or dismantle a failing institution using specific resolution tools:

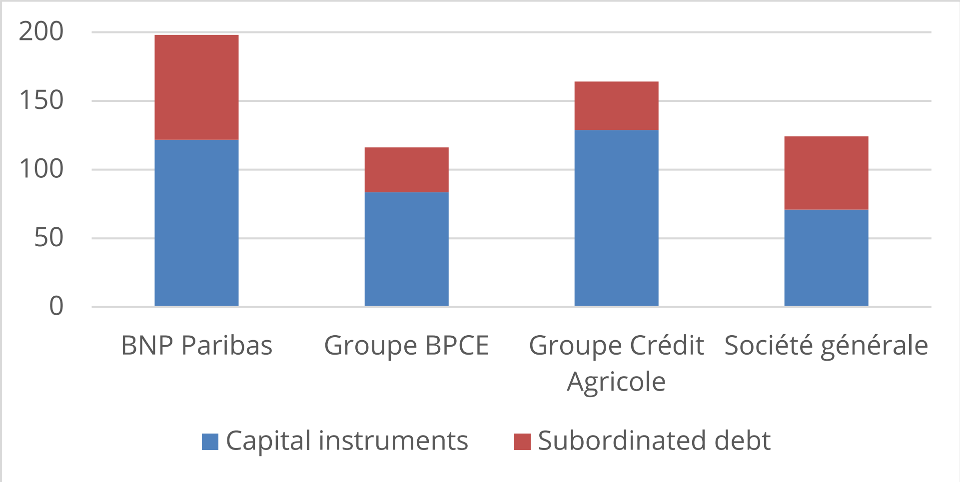
(i) bail-in: shareholders, then creditors, are called upon to absorb losses or recapitalise the bank;
(ii) transfer transactions, i.e. the sale of its business lines, assets or liabilities to an acquirer, a bridge bank or an asset management company (bad bank).

Funding resolution is a major challenge

To successfully implement a resolution procedure, it is essential to have the necessary funding. This funding is used to absorb the losses of a failing bank, to recapitalise it or to compensate an acquirer that would accept its deposits. There are three main sources of funding: (i) the shareholders and creditors of the failing bank; (ii) a resolution fund, financed by contributions from the banking sector; (iii) the State (bail-out). Deposits from households and businesses are protected by law up to the amount of the deposit guarantee (EUR 100,000 in Europe, USD 250,000 in the United States).

Resolution regimes around the world are based on the principle that shareholders and creditors are the first to be called on, with public funds only mobilised as a last resort. To this end, the authorities require systemically important banks (FSB, 2023) to hold a sufficient amount of capital and subordinated debt, in line with the international standard for total loss-absorbing capacity (TLAC). The authorities have the power to write down or convert these instruments into equity to finance a resolution procedure. At the end of 2023, these instruments represented around EUR 600 billion in the balance sheets of the four French systemically important banks, with two-thirds of capital instruments and one-third of subordinated debt (see Chart 2).

Chart 2: Capital and subordinated debt instruments (TLAC) of French systemically important banks at end-2023



Note: capital and subordinated debt instruments in EUR billions.

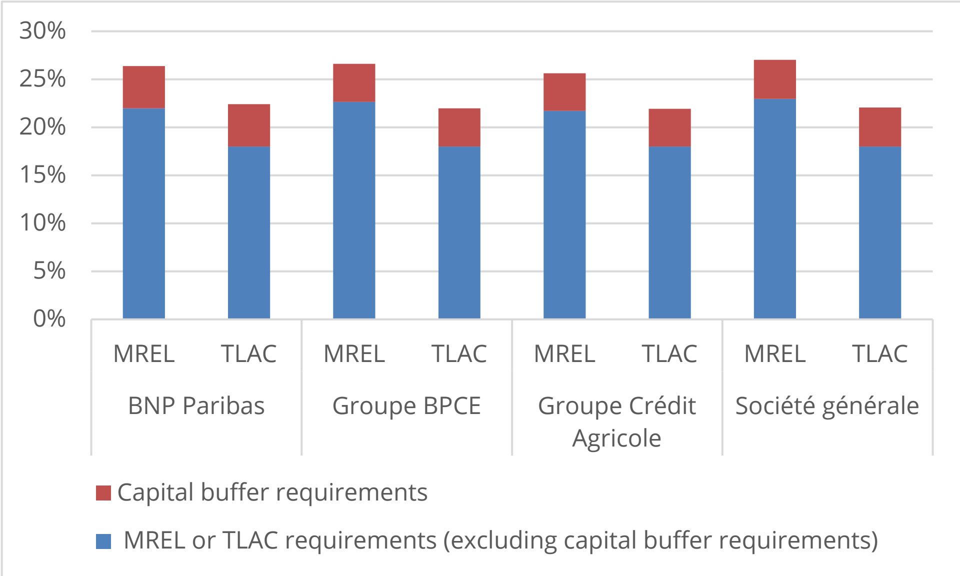
Source: ACPR

In the Banque de France Bulletin, we compare the sources of funding for resolution in Europe and the United States (Benahmed, 2024). The European model is characterised by the absence of a federal budget and the objective of breaking the bank-sovereign nexus. In the euro area, the Single Resolution Fund pools contributions from national banking sectors. In order to limit the sharing of cross-border losses, its use is only authorised after shareholders and creditors have been called on to contribute up to 8% of the failing bank's balance sheet.

The minimum requirement for own funds and eligible liabilities (MREL), i.e. financial instruments that can be mobilised in the event of a failure, therefore anchors the funding of the European resolution regime. The European MREL standard and the international TLAC standard have the same purpose, but they do not measure exactly the same things: some eligibility criteria are different. Furthermore, the MREL, which is specific to the European Union, is set higher than the international TLAC standard (see Chart 3) and applies to more than 300 European institutions, both systemically and non-systemically important.

Conversely, the United States offers a financing model backed by the full faith and credit of a federal treasury: only the eight systemically important US banks are subject to TLAC requirements and the Federal Deposit Insurance Corporation is free to mobilise the resources of the resolution fund in the event of a crisis.

Chart 3: MREL and TLAC requirements for French systemically important banks at end-2023



Note: as a % of risk-weighted assets. Capital buffer requirements apply in addition to the minimum amount of capital and debt required under the MREL and TLAC requirements.

Source: ACPR

The 2023 banking turmoil confirmed the need for these resolution regimes

The European resolution mechanism has proved its worth since 2014, as evidenced by the review (Benahmed and Houarner, 2024) of the main resolution cases in the euro area (Sberbank, Banco Popular), Poland and Denmark. We can see that the European authorities have preferred to transfer activities to acquirers rather than maintaining them through open-bank bail-in. The former is effective in managing liquidity and confidence crises, while the latter addresses solvency problems.

In the United States and Switzerland, the banking turmoil in 2023 was not managed in accordance with the best standards for resolution or its funding arrangements (FSB, 2023). The takeover of Credit Suisse by UBS was organised outside the resolution framework, without shareholders losing their entire stake. Moreover, the authorities had to resort to exceptional measures, which posed a risk to public finances: guarantees offered to the buyers, protection of all deposits (including uninsured deposits) of Silicon Valley Bank and Signature Bank and extraordinary loans from central banks in the face of unprecedentedly rapid deposit runs.

Only by activating the resolution mechanisms would it have been possible to preserve both financial stability and market discipline. If the US regional banks had been subject to loss-absorbing capacity requirements such as TLAC or MREL, their failure would have been less costly for the banking industry and guaranteeing all uninsured deposits might not have been necessary. As regards emergency takeovers such as that of Credit Suisse by UBS, they could be replicated during resolution with less risk for taxpayers, by combining them with bail-in.

The 2023 banking turmoil, like the European experience, shows that resolution regimes can nevertheless be bolstered by a combination of three elements:

(i) resolution standards, in particular sufficient loss-absorbing capacity, which apply not only to large institutions but also to some small and medium-sized banks;

(ii) greater readiness on the part of the authorities to use all the instruments at their disposal, not just bail-in;

(iii) an exceptional liquidity provision mechanism, in particular to guard against the possibility of large deposit outflows in the digital age.

The last two elements of this combination are still missing from the European resolution regime.

Firstly, Europe's crisis management policy lacks flexibility, as it only tends to favour bail-in for large banks. And yet, banking crises cannot be reduced to traditional solvency problems, especially given the emergence of new risks (climate, geopolitics, cyber, new technologies). The authorities must therefore be prepared to use innovative combinations of resolution tools (Benahmed and Houarner, 2023): for example, the disposal of subsidiaries or of impaired assets in addition to bail-in.

Secondly, unlike their British, American and Japanese counterparts, the major European banks do not have access to exceptional liquidity facilities in the event of failure. A framework for the European Central Bank to provide "Eurosystem resolution liquidity" could fill this gap (Villeroy de Galhau, 2023) and consolidate the Banking Union.