EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB contribution to the European Commission's targeted consultation on the evaluation of State aid rules for banks in difficulty

The European Central Bank (ECB) welcomes the European Commission's evaluation of State aid rules.[1] *Public support to banks should be minimised. At the same time, the State aid framework needs to continue to be able to deal with failing banks and systemic shocks and facilitate timely exit of unsound banks from the market. State aid rules closely interact with the EU crisis management framework for banks; this contribution offers suggestions for enhancing the level playing field between banks in resolution and liquidation. First, this requires improving access to the Single Resolution Fund (SRF), so it can support resolutions more effectively in a systemic crisis and for a broader set of banks – for example by allowing national deposit guarantee schemes (DGSs) to extend funding in order to unlock access to the SRF. Second, the need for liquidation aid could be further limited by giving all EU DGSs the ability to support the sale of a failed bank to an acquirer. Finally, in cases where the option of liquidation aid is nevertheless being examined, the Commission could consider a wider scope for burden sharing – going beyond subordinated creditors but excluding depositors – on a case-by-case basis where the financial stability risks of bailing in senior creditors (excluding depositors) are limited. Given the strong interlinkages between State aid rules and the crisis management and deposit insurance (CMDI) framework, the review of both regimes should go hand in hand. Changes to State-aid rules should therefore only be considered after access to the SRF has been improved. Aligning State aid rules with the current inflexible conditions for accessing the SRF, notably the minimum bail-in of 8% total liabilities and own funds, should definitely be avoided.*

The ECB welcomes the Commission's targeted consultation on State aid rules for banks in difficulty. State aid rules are a key tool for minimising the use of public funds in bank failures while still providing flexibility for circumstances where State aid is in the public interest. This review provides an opportunity to take stock of the experience gained with State aid rules. It is also a chance to revisit the way these interact with the legislative framework for banks in difficulty, which has changed since the 2013 Banking Communication, and account for evolving market conditions.

From the ECB's perspective, the 2013 Banking Communication identified the right principles for guiding the Commission's assessment of State aid in support of banks. These include the need to ensure financial stability, maintain a level playing field, mitigate moral hazard and minimise recourse to State aid by requiring that shareholders and creditors bear the costs of a bank failure in the first

[1] References to State aid rules in this contribution should be understood as referring to State aid rules for banks in difficulty.

instance. Overall, the Commission's State aid framework has contributed to upholding these principles and striking an appropriate balance between them.

Despite the improvement in the market environment for banks, the State aid framework still needs to be able to deal with failing banks and systemic shocks. Since the 2013 Banking Communication was adopted, banks have strengthened their capital and liquidity buffers, built up gone-concern loss absorption capacity and improved the average quality of their asset portfolios as a result of strong regulatory and supervisory action. This renewed strength, together with fiscal support for the real economy and regulatory and supervisory action, allowed them to weather the coronavirus (COVID-19) pandemic and the direct fallout from the Russian war on Ukraine.[2] However, further steps are required to put our banking system on an even stronger footing. In particular, there is a need for further efforts to enhance the regulatory framework, e.g. by implementing the Basel III reforms timely, fully and faithfully. The banking union also still has to be completed. This includes reforming its crisis management toolkit before the end of the current legislative cycle and, in the medium term, putting the European Deposit Insurance Scheme (EDIS) in place. Where public support for banks was necessary to preserve financial stability in the past, State aid rules left sufficient room for intervention in specific cases. This should be preserved in the framework going forward. At the same time, the ECB sees room for further reducing the need for government support in liquidation, for example by relying more strongly on DGSs and by widening the scope for burden-sharing requirements in liquidation.

State aid rules interact closely with the European CMDI framework established following the global financial crisis. This established resolution authorities, introduced a toolkit for bank recovery and resolution and regulates key features of DGSs in the EU. It also requires resolution funds and other sources of publicly administered funding in support of the banking sector to be available as a last resort when needed to safeguard financial stability. In the banking union, the CMDI framework laid the groundwork for establishing the SRF. This is being built up from bank contributions and can be used by the Single Resolution Board (SRB) to ensure resolution tools are applied efficiently and subject to a number of conditions, including compliance with State aid rules.[3] It will be complemented by a common backstop as soon as the reformed European Stability Mechanism (ESM) Treaty is ratified. Finally, the CMDI framework imposes additional restrictions on the provision of State aid to banks, in particular by making the need for extraordinary public

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2 At the onset of the pandemic, the ECB announced a number of measures to ensure that directly supervised banks could continue to fulfil their role in funding the real economy as the economic effects of COVID-19 became apparent. These included the ability for banks to fully use capital and liquidity buffers, including Pillar 2 Guidance, relief in the composition of capital for Pillar 2 Requirements, and operational flexibility in the implementation of bank-specific supervisory measures.

3 National resolution funds are available to national resolution authorities outside the banking union, subject to the same conditions.

financial support (including State aid) a trigger for declaring a bank failing or likely to fail (FOLTF), unless a number of stringent requirements are met.[4]

This close interaction means State aid rules and the CMDI framework need to be viewed in a holistic manner to ensure they are consistent with each other and operate together smoothly. The two frameworks share many key objectives, such as safeguarding financial stability, mitigating moral hazard and minimising the use of taxpayers' money. At the same time, they differ in terms of the requirements they impose, their scope of application and their ability to respond to unforeseen circumstances through built-in exceptions. Three types of State aid can be distinguished and analysed in this respect: liquidity aid, restructuring aid and liquidation aid. These are subject to different requirements under the State aid rules, depending on the degree to which they distort competition. The CMDI framework has its own approach to managing public aid which also differentiates between various forms of State aid, but does not necessarily follow the same distinctions or requirements defined by the State aid rules. The differences between the two frameworks warrant careful further consideration to avoid any negative side-effects.

The current restrictions under State aid rules and the CMDI framework for liquidity aid to solvent banks are well balanced.[5] Temporary liquidity support to solvent banks should in principle neither strongly distort competition nor impose a lasting burden on taxpayers. Accordingly, State aid rules and the CMDI framework impose less stringent restrictions on liquidity aid compared to other forms of aid. Qualifying liquidity aid does not trigger FOLTF and does not require shareholders or creditors to absorb losses. The requirements nevertheless imposed by State aid rules and the CMDI framework primarily aim to ensure the support remains temporary and will be repaid. The ECB considers the current approaches to be balanced. When assessing the option of providing liquidity support to going-concern banks, close interaction between the Commission and the relevant supervisor – based on a solid legal basis for exchanging information – are key to ensuring the beneficiary bank is viable and repayment is likely.

Restructuring aid to a going concern provided by national governments has been significantly curtailed by the CMDI framework. The options still remaining, which are rightly subject to strict conditions limiting them to extraordinary circumstances, should be preserved. Access to preventive measures by DGSs is uneven across the EU and conditions could be further clarified. In particular it should be possible to use them in a preventive manner in a way compatible with competition law, similar to institutional protection schemes (IPSs). Without safeguards, restructuring aid to going concern banks can distort competition, raise serious moral hazard concerns and be costly for taxpayers. Limiting this type of aid to extraordinary circumstances is therefore justified. The

4 Article 32(4)d of the Bank Recovery and Resolution Directive (BRRD) (Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p.190).

5 Central bank liquidity provision is typically not considered State aid and is therefore not discussed in this contribution.

current framework, which includes strict conditions for the use of restructuring aid in the form of precautionary recapitalisation, has only been used a few times since it was adopted.[6] The ECB considers that, in extraordinary circumstances, restructuring aid in the form of a precautionary recapitalisation can be a powerful tool for limiting severe harm to the stability of the financial system and the broader economy. This option – and the current conditionality for using it – should therefore be maintained. In addition, experience over recent years has shown that preventive intervention by a DGS can be a useful crisis management tool. Currently, the practical use of preventive measures is likely to be limited to private DGSs and IPSs, as any use by public ones would qualify as State aid and the beneficiary bank would therefore need to be declared FOLTF. As this distinction is currently primarily based on case law, some uncertainty remains over the types of DGS that can take a preventive measure without triggering the need to declare a bank FOLTF. The framework for preventive interventions, including the criteria for defining interventions by private and public DGSs, could therefore be further clarified. This would ensure market participants have correct expectations.

Restructuring aid in resolution provided by the resolution fund is constrained by the CMDI framework. The framework could be further improved to make resolution a suitable option for a broader range of banks and thereby avoid possible recourse to government support. The principle that losses after a bank failure should first and foremost fall on shareholders and creditors is a cornerstone of the CMDI framework which the ECB supports. If, as a last resort, support from the resolution fund is necessary in resolution, the requirements imposed by the CMDI framework and State aid rules diverge. While the latter typically require shareholders and subordinated creditors to absorb losses before restructuring aid (including support from the resolution fund) can be provided, under the former a contribution from the resolution fund in lieu of bail-in is only possible once 8% of total liabilities and own funds (TLOF) have been bailed in. Depending on the specificities of the failing bank, the 8% requirement may make it necessary for senior liabilities and deposits to be bailed in, i.e. going beyond the burden-sharing requirement up to subordinated creditors under State aid rules. The 8% requirement may raise financial stability concerns if deposits have to be bailed in. This may be the case for smaller banks which rely more heavily on deposits and have less access to capital markets; large banks typically have a stronger, dedicated loss-absorption capacity that shields deposits. Furthermore, in a systemic crisis, bailing in 8% of TLOF in one or more bank resolutions could unintentionally worsen the situation due to spill-over effects. In its contribution to the Commission's targeted consultation on the review of the CMDI framework,[7] the ECB therefore suggested that work should be done to investigate whether the conditions for accessing resolution funds could be revised to allow for addressing exceptional circumstances where financial stability would otherwise be threatened. The following principles could guide this investigation. Use

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[6] In 2020 the Commission further clarified the potential use of precautionary recapitalisations in its Communication on tackling non-performing loans in the aftermath of the COVID-19 pandemic, recalling that the amount of any support measure should be determined on the basis of a stress test or equivalent exercise, and that the Commission may request further verifications on a case-by-case basis to confirm the absence of hidden likely or incurred losses.

[7] ECB contribution to the European Commission's targeted consultation on the review of the crisis management and deposit insurance framework

of public funds should: (i) remain a last resort; (ii) allow for an approach which safeguards financial stability; and (iii) be proportionate to the moral hazard implied by an intervention. On this basis, consideration could be given to lowering the requirements for accessing resolution funds based on objective criteria in cases where this is in the public interest, e.g. in a systemic crisis, where the bail-in of uncovered depositors threatens to seriously undermine financial stability or where a failed bank is exiting the market through the use of the sale of business tool. Consideration could for example be given to the idea of allowing national DGSs to extend funding to unlock access to the SRF by helping to finance a possible remaining shortfall below the 8% threshold. This would avoid the need to bail in deposits in resolution where doing so would raise financial stability concerns. These proposals would allow the SRF to support resolutions more effectively in a systemic crisis and for a broader set of banks. Nevertheless, this should not limit efforts by regulators, supervisors and resolution authorities to minimise the need for using the SRF where possible, for example by requiring banks to build up and maintain a strong capacity to absorb losses.

The need for liquidation aid could be reduced by expanding resolution and using DGSs more effectively in liquidation; where financial stability risks are limited, recourse to government support in liquidation could be restrained further. To qualify for liquidation aid, a bank has to exit the market through an orderly liquidation of its banking activities. As a result, liquidation aid is considered less distortive to competition than restructuring aid, where the beneficiary bank remains active in the market. The possibility to provide liquidation aid was motivated by the absence of a resolution mechanism and the infeasibility of liquidating institutions under ordinary insolvency proceedings in specific cases. With the introduction of the resolution framework in the EU, the scope of institutions which could benefit from liquidation aid has been reduced. Larger banks with critical functions are now expected to be resolved and liquidation aid is not available in resolution. Liquidation aid is not subject to restrictions under the CMDI framework, such as the 8% threshold, and may therefore be more readily available than support from the resolution fund in resolution. This may, in some instances, create incentives to manage bank failures under the national liquidation framework. It would be desirable to mitigate these incentives, while maintaining the flexibility to address exceptional circumstances in the State aid framework. The scope for liquidation aid could be redefined accordingly by making the resolution framework applicable to a broader set of banks, as discussed above. In addition, the need for liquidation aid could be further reduced by making measures for managing bank failures other than through a depositor pay-out (i.e. alternative measures) more widely available to DGSs in liquidation.[8] Alternative measures could give DGSs the ability to support transfers of the assets and liabilities of a failed bank to an acquiring bank, provided it is less costly than a depositor pay-out (the “least cost” test). The use of alternative measures could also be promoted by clarifying that DGSs could support each other

[8] See the speech by Andrea Enria, Chair of the Supervisory Board of the ECB, at the Institut Montaigne, Paris, 17 May 2022. The ECB also supports the creation of a European administrative liquidation framework to harmonise and improve the effectiveness of the crisis management framework for banks where there is no public interest in resolution and which therefore go into liquidation. An administrative liquidation tool could be supported by EDIS, but would be useful even before this is set up.

to fund alternative measures or by enabling the SRF to provide liquidity support to this DGS funding. This would facilitate the use of an efficient crisis management tool for handling bank failures where resolution is not in the public interest without recourse to government support. Finally, in cases where liquidation aid is nevertheless an option being considered, the Commission could factor the desirability of a level playing field between resolution and liquidation into its decision on whether the aid is compatible with the internal market where it deems it relevant. Following an assessment of financial stability risks, this may lead to a wider scope of the burden-sharing requirement, going beyond subordinated creditors but excluding depositors. In specific cases where the financial stability risks of bailing in senior creditors (excluding depositors) are considered limited, the framework could foresee, based on a case-by-case assessment, to go beyond the starting point of the junior burden-sharing requirement for liquidation aid. However, the introduction of any condition similar to the 8% of TLOF condition to access the SRF should be avoided, as it limits the ability to take the specificities of an individual case into account. Financial stability risks should be assessed by the Commission, after consulting the ECB and the SRB, so the decision continues to factor in financial stability considerations and leaves flexibility to react to the circumstances of the case. Any such change to the Commission’s methodology should only be considered if the CMDI framework is first amended as referenced above to ensure that the preconditions for accessing resolution funds can be applied equally well across a wide range of scenarios. Finally, the proposed continued exclusion of depositors from the Commission’s burden-sharing requirement in liquidation does not rule out that uncovered depositors may have to absorb losses in a bank failure. The scenario in which no State aid is provided and where therefore also uncovered deposits may need to absorb losses remains the default. Covered deposits are and will remain protected by the DGS against having to absorb losses in all cases.

Generally, the ECB is of the view that European-wide industry-funded safety nets should be further developed, so as to minimise the need for national governments to use taxpayers’ money in banking crises in the banking union. Several State aid options currently still require the involvement of national governments. With the build-up of European safety nets funded by the banking sector, such as the SRF and, in future, EDIS, the need to rely on national governments in a banking crisis will recede. This will improve the level playing field and limit the risk of the bank-sovereign nexus re-emerging. The ECB therefore continues to see EDIS as a key priority, not only as an important shock absorber in the banking union, but also as a means to reduce the need for State aid and mitigate moral hazard concerns. The difference between the use of industry-funded safety nets and government funds should be factored into the Commission’s State aid assessments, so DGS/EDIS and SRF interventions can be used when these are the most economically efficient way to safeguard financial stability.