BRIEFING

Hearing with Mrs Elke König, Chair of the Single Resolution Board

ECON, 11 July 2017

This briefing presents the state of play regarding the work of the SRB as well as a summary of several resolution or State aid cases. It also includes an updated analysis of the weakest banks under the direct remit of the SRB. It is published in advance of the Hearing with Mrs Elke König, Chair of the SRB, in ECON on 11 July 2017 in accordance with Article 45.4 of Regulation (EU) 806/2014.

Main achievements in 2016

On 11 July 2017 the Chair of the SRB will present the 2016 annual report to the ECON committee. SRB took had taken over full responsibility for the resolution of significant banks and cross-border groups on 1 January 2016. In 2016 the SRB developed its policy in the main areas: resolution planning (including setting MREL requirements), crisis management, contributions and cooperation with national authorities, European institutions and international counterparts.

The SRB has established working arrangements with national resolution authorities, through the signature of cooperation framework agreements. Internal Resolution Teams and dedicated committees were established to develop common methodologies and policies in the main areas of activity. The SRB also started to cooperate closely with resolution and competent authorities within and outside the Banking Union (Resolution colleges) and outside the EU (crisis management groups).

Regarding contributions to the Single resolution Fund, in 2016 the SRB collected more than EUR 10 billion. This amount includes both the 2015 contributions transferred from national resolution funds and the 2016 contributions raised by national resolution authorities. In January 2016 NRAs thereby transferred EUR 4.3 billion to the SRF in ex-ante contributions for 2015, and transferred another EUR 6.4 billion for 2016 at the end of June. The SRB expects that the 2017 contributions will amount to about EUR 6.5 billion. The transfer was supposed to take place on 30 June 2017. For the breakdown of 2016 contribution, see EGOV briefing PE 587.403. In addition the SRB completed the signature of the Loan Facility Agreements with all 19 participating Member states. Those LFAs provide the SRB with an aggregate bridge financing of EUR 55 bn, in the form of credit lines between each national compartment and the respective Member State.

The resolution planning activity of the SRB is still in the early phase. The SRM Regulation provides that "*The Board shall determine the date by which the first resolution plans shall be drawn up. Resolution plans group resolution plans shall be reviewed, and where appropriate updated, at least annually...*" (article 8(12) SRMR). Mrs König indicated in its 11 January press conference that about 70 resolution plans and 30 transitional resolution plans had been developed in 2016. The decisions on the 2016 resolution plans were to be submitted to banks in January 2017.

Those decisions do not yet include binding MREL requirements, but an "informative MREL target", applicable at consolidated level only, which is not binding, not enforceable and not challengeable. In addition, the methodology for setting this informative target is simplified, as the SRB has mechanically applied its methodology without considering bank-specific adjustments linked to the resolution strategy or their risk profile. The SRB published on 17 February 2017 its guidelines on the approach taken in 2016 and the next steps regarding MREL requirements. For more details on the methodology, see EGOV briefing PE 587.403.

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The resolution of Banco Popular on 7 June 2017

The capital position of Banco Popular had been under pressure for months. In June 2016 the bank completed a capital increase of EUR 2.5 billion, in view of the results of the stress test carried out by the EBA and disclosed on 29 July 2016. Those stress tests determined that under the adverse scenario, the CET1 of the bank would reach 7.01% in 2018. The bank booked large losses in 2016 on its portfolio of real estate, resulting in net loss of EUR 3.5 billion for the exercise. As a consequence, the management of the bank was reshuffled and the new banks attempted to define a new strategy by raising capital or merging with a competitor.

The sale process was ongoing when a sudden deterioration of the liquidity of the bank forced the supervisor to determine the bank was failing or likely to fail. On 31 May 2017 Reuters reported that Mrs E. König, chair of the SRB, warned EU officials that Banco Popular "*may need to be wound down if it fails to find a buyer*". It seems that on 3 June 2017 an extended executive session of the SRB planned the resolution of Banco Popular. According to the FROB, the SRB decision taken that day provided that the tender should comply with a number of conditions. In particular, "*the SRB decision explicitly considered the possibility of the sale process being undertaken regardless of whether the final resolution scheme included the sale of the business or any other tool (...)*". This underlines that a draft resolution scheme was already being discussed four days prior to the actual resolution decision.

The following Monday and Tuesday, important deposit outflows were observed, and it was confirmed that a number of local authorities participated in this development. On Tuesday 6 June at 15.30, the bank ran out of liquidity and notified the Spanish supervisor. By 21.30 the ECB concluded that the bank was failing or likely to fail. According to the Spanish press, the negotiation with Mrs Botín, president of Santander, was led by Spanish authorities (Bank of Spain, FROB, Ministry of Finance). Santander was notified on 6.00 on Wednesday 7 June that its offer was accepted and the signature took place at 7.00. The banks had to secure a capital increase and several regulatory approvals overnight.

The bank had not benefited from State guarantees, and it was reported in the press that the bank ran short of eligible collateral for central bank refinancing. However contradicting rumours were reported in the Spanish press on this issue, some claiming the ECB had imposed haircuts of up to 90% on the eligible collateral, others claiming the bank had not presented all its eligible collateral at the refinancing desk of the ECB. It was confirmed by the Spanish Minister of Finance that a number of local authorities were involved in the deposit outflows preceding the failure of the bank.

On 6 June 2017, the ECB announced that Banco Popular was "failing or likely to fail". The ECB indicated that "*the significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due*". Therefore, in line with Article 32(4)(c), the ECB determined that the bank was failing or likely to fail and communicated its decision to the SRB.

On the following day, the Single Resolution Board (SRB) adopted a resolution decision, transferring all shares and capital instruments of Banco Popular Español S.A. (Banco Popular) to Banco Santander S.A (Santander) for one euro, under the new framework for the recovery and resolution of credit institutions and investment firms (Directive 2014/59/EU and Regulation 806/2014/EU). On the basis of valuation carried out in line with Article 20 SRMR, the SRB wrote down, prior to the transfer of the shares to the purchaser, the ordinary shares and additional tier one instruments and the banks, and converted tier 2 instruments into shares which were subsequently transferred to the purchaser. The resolution decision was addressed to the Spanish resolution authority (the FROB) for implementation.

On the same day (7 June 2017), the European Commission approved the resolution scheme of Banco Popular under the "*EU's bank recovery and resolution rules*", noting that the scheme involved no State aid nor aid from the Single Resolution Fund. In particular, the Commission noted that the three conditions for resolution were met (the bank was failing or likely to fail, there was no

alternative private measure nor supervisory action which could have prevented the failure, and it was necessary in the public interest).

The SRB decided to apply two resolution tools: the sale of assets tool and the bail-in tool. No use of the Single resolution Fund was needed. The provisional valuation carried out by an independent expert estimated that the value of the bank was negative and would range from EUR [-8.2] billion in an adverse scenario to EUR [-2] billion in the baseline scenario, according to the FROB. Therefore the SRB wrote down the equity and additional tier one instruments, while the tier two instruments were converted into shares before the transfer of the shares to Santander. Additional tier one and tier two instruments amounted to EUR 2 billion in total.

The use of sale of business tool was facilitated by the fact that the Bank had been attempting to find a buyer in the preceding weeks. Indeed, the potential purchasers had already had the opportunity to analyse the books of Banco Popular. In addition the SRB indeed decided on 3 June 2017 in an extended executive session that the FROB should begin an open tender process to sell the bank. The FROB contacted interested parties and once the tender closed the SRB acknowledged that the marketing requirements and commercial terms set out in Article 24.2 SRMR had been complied with. The FROB indicates that Santander was the only purchaser to fulfil the requirements for acceptance.

For more details on the resolution of Banco Popular, see EGOV briefing PE 602.093.

The decision on Veneto Banca and Banca Popolare di Vicenza on 23 June 2017

On Friday 23 June 2017, the European Central Bank (ECB) declared the two Veneto banks "failing or likely to fail". The ECB press release indicates that the decision results from capital shortfalls as "*the two banks repeatedly breached supervisory capital requirements*". For more details about the roots of those failures, see below.

On the same day the Single Resolution Board (SRB) assessed that the conditions for resolution as per BRRD were not met. According to the SRB, while the two banks were failing or likely to fail and no private solution could be implemented to prevent their failure, there was no public interest justifying resolution action. The SRB defends that "*neither of these banks provide critical functions, and their failure is not expected to have significant adverse impact on financial stability*". As a consequence, the two Veneto banks had to be wound down under normal insolvency proceedings at national level, under the responsibility of Banca d'Italia, in its capacity as National Resolution Authority.

On 25 June 2017 the two banks were wound down with the transfer of the performing business (performing loans, financial assets, deposits and senior debt) to Intesa San Paolo (ISP) subject to the injection of cash and the provision of guarantees by the Italian government (see below), the transfer of the non-performing portfolio to SGA, the vehicle formerly used for the liquidation of Banco di Napoli, and the bail-in of equity and subordinated shareholders, which remain in the entity into liquidation.

On 25 June 2017, the European Commission approved the aid measures taken by Italy to facilitate the liquidation of the Veneto Banks. Those measures include:
(1) the sale of the good business of the bank to Intesa San Paolo, which entails a transfer of all performing loans, financial assets, senior bonds, and deposits, as well as branches and employees; Intesa San Paolo paid a consideration of one euro and received, in addition to the good business of the bank, a cash injection of EUR 4.785 billion by the State and State guarantees amounting to up to EUR 12 billion, covering the financing of the liquidation (EUR 5.3 billion, up to EUR 6.3 billion), the perimeter of the good business (EUR 4 billion) and legal risks (up to EUR 1.5 billion) (see below figure 1);
(2) a transfer of the other assets, mainly non-performing loans, to SGA, the vehicle used for the liquidation of Banco di Napoli, in view of their gradual disposal over time aiming at maximising the

recovery on those assets; those assets were transferred at book value against a claim of the entity in liquidation on the future proceeds of the liquidation;
(3) the bail-in of shareholders and subordinated creditors;
(4) a cash injection by the Italian Treasury into Intesa San Paolo, amounting to 4.785 billion;
(5) a financing of the entity in liquidation by Intesa San Paolo, covered by a State guarantee for an amount of EUR 5.3 billion, up to EUR 6.3 billion;
(6) a guarantee granted by the State to Intesa San Paolo on legal risks for an amount of up to EUR 1.5 billion.

The orderly liquidation of the Veneto banks seems to constitute, prima facie, a case of resolution as per EU law, since the national resolution authority, Banca d'Italia, has exercised resolution powers to apply a resolution tool: the sale of part of the assets and liabilities of the failing bank and their transfer on commercial terms to a purchaser without the consent of the shareholders fully complies with the definition of the sale of business tool as per Article 38 BRRD. For a detailed descriptions of legal definitions of resolution and normal insolvency proceedings under the BRRD, see EGOV briefing PE 602.094.

However, the competent resolution authority in the case at hand is the Single Resolution Board, and by its decision of 23 June 2017 it assessed that there was no public interest in resolving the Veneto banks and that the banks would be wound down "*under normal Italian insolvency proceedings*". Indeed the SRB concluded that (i) neither Veneto Banca nor Banca Popolare di Vicenza provided critical functions, (ii) their failure was not expected to have significant adverse impact on financial stability and (iii) their orderly liquidation under normal Italian insolvency proceedings would ensure the same level of protection for depositors, investors, customers and clients 'assets and clients' funds. It is not clear whether the SRB, to come to the latter conclusion (point (iii)), assumed that the liquidation under "normal Italian insolvency proceeding" would entail the provision of State aid as provided in the Italian decree law and as approved by the Commission.

The Commission concurred with the SRB that the measures implemented by Italy do not qualify as resolution action since the presence of public interest was dismissed by the SRB. The European Commission has approved the measures as liquidation aid under Italian national insolvency procedures (see EGOV briefing PE 602.094 for more details on the assessment under State aid rules). In the case at hand, albeit the SRB had concluded that the resolution was not warranted in the public interest, the Commission indicated that EU rules foresee the possibility to grant State aid to mitigate economic disturbance at regional level. Therefore as noted by Andrea Enria "*two different definitions of "public interest" have been applied, one at the EU level and another one by national authorities*", which may undermine the consistent application of the EU framework for resolution.

In the two summaries of its decisions on Veneto Banca and Banca Popolare di Vicenza, the SRB explains why it dismissed the existence of any public interest. In particular, the SRB argues that:
(i) the deposit taking and lending activities of the bank do not constitute "critical functions" in the meaning of Article 2(1)(35) BRRD, since they are "*provided to a limited number of third parties and can be replaced in an acceptable manner and within a reasonable timeframe*";
(ii) there is no risk to financial stability given the low interconnectedness of the bank with other financial institutions;
(iii) normal insolvency proceedings would offer the same level of protection to depositors, investors, other customers as well as to clients' funds and assets.

Box 1: The definition of critical functions in Article 2 BRRD

"*(35) 'critical functions' means activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross border activities of an institution or group, with particular regard to the sustainability of those activities, services or operations*"

This decision means that deposit taking activities and lending activities are not considered critical per se, since competitors would be able to provide similar services relatively easily ("*in an acceptable manner within a reasonable timeframe*"). However it is to be noted that the SRB considered on 7 June, in its decision to put Banco Popular in resolution[1], that the deposit taking activities of the Spanish bank and its lending to SMEs constituted critical functions. The SRB also considers that the liquidation, under normal insolvency proceedings, of a traditional bank with a combined balance sheet of EUR 62.5 billion does not undermine financial stability insofar as the bank has few interconnections with other financial institutions. This suggests that a number of institutions under the direct remits of the SRB may not be eligible for resolution action given their small size and low interconnectedness with other financial institutions. Andrea Enria, Head of the EBA, has declared in an interview: "*a very high bar for resolution has been set. The decision that there was no EU public interest at stake in the crises of two ECB-supervised banks that were hoping to merge and operate in the same region with combined activities of around €60 billion sets the bar for resolution very high*".

The SRB also dismissed the risk of deposit run, claiming that normal insolvency proceedings offer the same level of protection to depositors. However the press release of the SRB does not clarify whether the SRB, to come to this conclusion, assumes that the liquidation of the Veneto banks under normal insolvency proceedings necessarily involves the recourse to public funds to protect unsecured senior creditors which are not covered by deposit guarantee schemes. This was also highlighted by Andrea Enria, who stresses out that some investors were better off in liquidation than in resolution, which, according to him, should not be possible.

The precautionary recapitalisation of Monte dei Paschi di Siena

On 4 July 2017 the European Commission announced the approval of the precautionary recapitalisation of MPS for a total amount of EUR 8.1 billion. This amount includes the conversion of junior bondholders for EUR 4.3 billion, and a capital injection of EUR 3.9 billion by Italy. In addition, Italy will inject EUR 1.5 billion to compensate the retail investors who were victims of misselling. In addition, MPS will divest a EUR 26.1 billion portfolio of non-performing loans (NPLs) to a private securitization vehicle. 95% of the junior and mezzanine tranches of this securitisation vehicle will be purchased by the fund Atlante II. The deal was signed on 26 June 2017, one day after the Commission approved the measures taken in relation to Veneto Banca and Banca Popolare di Vicenza. For more details on the precautionary recapitalisation of MPS and the previous State aid measures granted to MPS, see EGOV briefing PE 587.392.

The State aid amounts to EUR 5.4 billion, and was approved as precautionary recapitalisation by the Commission, meaning the bank was not deemed failing or likely to fail under Article 32 BRRD (for more details on the conditionality attached to precautionary recapitalisations, see EGOV briefing PE 602.084). It is to be noted that a key difference between MPS and Banco Popular was the provision of State guarantees by Italy to MPS, which enabled the bank to use government guaranteed bonds as collateral for ECB refinancing. Conversely, when Banco Popular ran out of eligible collateral, it could not avoid resolution.

[1] *"The SRB concluded that resolution action would be necessary to achieve the following resolution objectives outlined in Article 14 SRMR: to ensure the continuity of critical functions, namely: deposit taking from households and non-financial corporations (small and medium sized enterprises - "SMEs" - and non SMEs); lending to SMEs, and payment and cash services"*

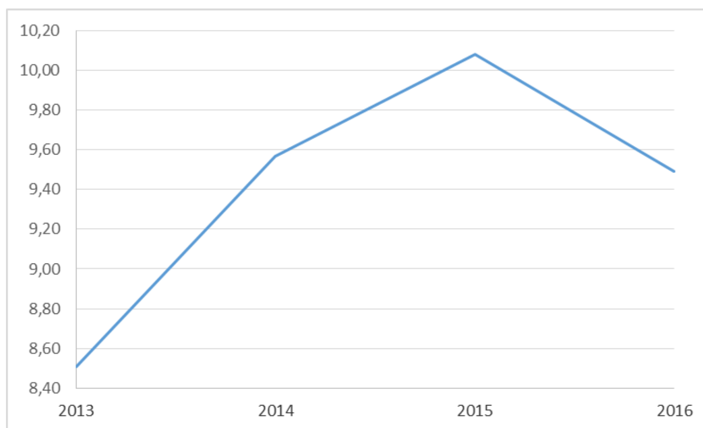
The evolution of vulnerable SSM banks since 2013

This section briefly discusses whether the financial position of the weakest banks directly supervised by the SSM has improved since the crisis. The analysis focusses separately on 5 indicators, and, for each of them, describes how the 10 weakest performances observed at each reporting date have evolved from December 2013 to June 2016.

Methodology: The sample includes, for each indicator, 103 to 120 banks directly supervised by the SSM for which the indicator is available in Orbis Bank for all or all but 1 reporting dates. Banks are sorted from the weakest to the strongest, and the average of the 10 weakest performances is then calculated for each period and reported in the graph.

NB: the list of the 10 worst performing banks is different for each reporting date: there is no homogeneity across the period. For example, after a recapitalisation a bank may no longer belong to the group of the "10 worst performers".

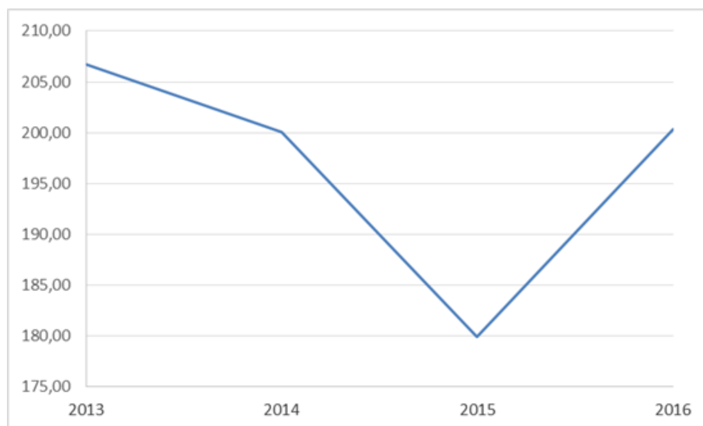
Figure 1: SSM banks: Average of the 10 lowest Tier 1 ratios since 2013



Source : EGOV based on Bankscope®

The capital positions of the 10 worst performing SSM banks have improved steadily in 2014 and 2015 but deteriorated again in 2016, due in particular to three banks which booked significant net losses over the period: MPS (IT), Unicredit (IT) and CGD (PT). However those three banks raised significant amounts of capital in the first half of 2017 and two other Italian banks were liquidated at the end of June. Those five banks were the only ones with Tier 1 ratios below 10% as of 31 December 2016.

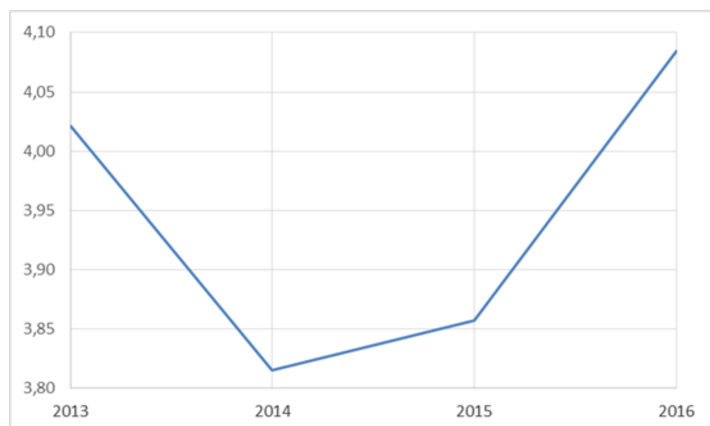
Figure 2: SSM banks: average of the 10 highest capital impairment ratio since 2013



Source : EGOV based on Bankscope®

The asset quality of the worst performing banks has significantly deteriorated in 2016. The capital impairment ratio compares the amount of non-performing loans (net of loan loss provisions) to the amount of equity of the bank. A high ratio means that the capital position is vulnerable to further provisioning of non-performing loans by the bank. Figure 2 shows that the average had improved in 2014 and 2015. In 2016 the big impairments booked in Italy (MPS, Veneto Banca, Banca Popolare di Vicenza and Banca Carige) explain the deteriation of the ratio. But MPS and Carige have raised significant amounts of capital in the first half of 2017 and their capital impairment ratio should decrease accordingly, while Veneto Banca and Banca Popolare di Vicenza have exited the market.

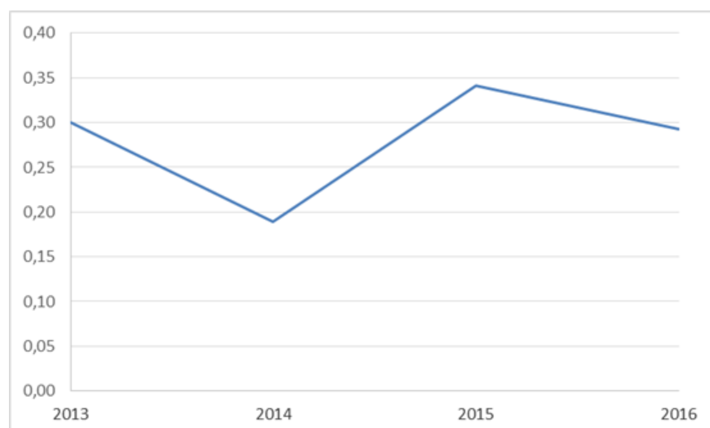
Figure 3: SSM banks: average of the 10 lowest liquidity ratio since 2013



Source : EGOV based on Bankscope®

The liquidity position of the SSM worst performing banks remained very low in 2016. The liquidity ratio reported in Figure 3 compares the amount of liquid assets to the amount of deposits and short term funding. Figure 3 shows that the lowest ratios among SSM banks remain very low at about 4% (for comparison, the median value in the full sample is 25%).

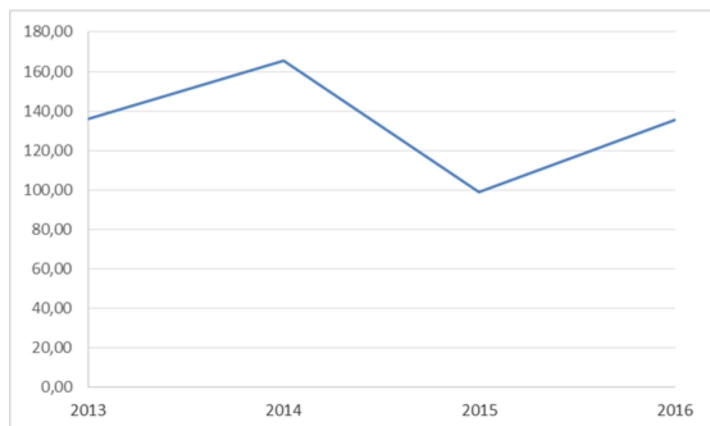
Figure 4: SSM banks: average of the 10 lowest operating income ratios since 2013



Source : EGOV based on Bankscope®

The average of the 10 lowest operating income ratio is deteriorating again in the 2016. The operating income ratio measures the operating revenues (interests, fees, trading) against average total assets. It does not factor in operating expenses, impairments, taxes nor other exceptional revenues. All 10 banks featuring the lowest ratio in June 2016 were already among the 10 worst performers in 2015. This suggests that their low profitability is structural and probably linked with their business models.

Figure 5: Weakest cost/income ratios of SSM banks since 2013



Source : EGOV based on Bankscope®

The weakest performances in terms of cost/income ratio deteriorate again. The overall trend is negative and stems from several banks such as the two Veneto banks which exited the market in June 2017. The cost/income ratio measures the difference between operating revenues (interest margin, fees, trading income) and operating expense (staff, buildings).

Conclusion: When looking at the worst performing banks across 5 financial indicators, it appears that the financial positions of the weakest banks have deteriorated in 2016. However for several banks, radical actions have been taken in 2017 to tackle the problems they faced at the end of 2016.

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