Boštjan Jazbec: The bail-in tool and the challenges to its smooth implementation

Address given by Mr Boštjan Jazbec, Governor of the Bank of Slovenia at the Executive Seminar on Banking Resolution, Florence, on 14 July 2016.

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It is a pleasure to be invited to talk on banking resolution to this distinguished gathering of bank regulators, supervisors, central bank officials, bankers, and academics. The timing could not be more opportune.

Banking resolution can be a messy business. Last week, criminal police from the Special Prosecutor's Office raided the Bank of Slovenia and seized documents and information related to banking resolution measures undertaken by the Bank of Slovenia and the government in December 2013. The main focus of the investigation is the decision taken at that time to use bail-in of subordinated instruments as one of the tools of banking resolution.

In 2014, the Slovenian Association of Small Shareholders filed several court cases against the Bank of Slovenia and local banks, claiming that the subordinated instruments in rescued banks should not have been erased. One of the cases has gone all the way to the European Court of Justice after Slovenia's Constitutional Court referred it to the EU tribunal for clarification. A ruling of the European Court on this case is expected early next week. The court ruling may have serious ramifications for the efforts under way to establish an effective Banking Union in Europe.

Considerable momentum has developed in favor of bail-in centered banking resolution. As Andrew Gracie of the Bank of England has noted in a recent speech, a bail-in transaction is at the heart of all the resolution plans drawn up in the Crisis Management Groups. In addition, the European Banking Authority (EBA) has set standards on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) that banks should have to ensure adequate loss absorbing capacity. The Slovene experience brings out the sensitivity of the bail-in tool and the challenges to its smooth implementation. It would be important for the resolution authorities to address these challenges upfront and find answers for them.

A key requirement would be to make bail-in legally enforceable by introducing all the necessary legislation, thereby minimizing the possibility of litigation. An important associated step is clear communication. Investors and shareholders will need to understand the risks to which they are exposed by holding subordinated instruments, and holders should have clarity on the order in which they would incur losses. However, it is doubtful if the ambiguities in the resolution framework can be fully eliminated. A major challenge with every resolution is to decide when to trigger resolution measures and what process of resolution to use. The criteria for bank resolution are relatively vague and there are no mechanical formulas that tell us exactly whether a bank needs to be resolved. Resolution frameworks (including the BRRD) typically do not define trigger thresholds and specify solutions.

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Let me now turn briefly to the developments in the banking sector in Slovenia during the financial crisis and the specifics of resolution measures undertaken in December 2013.

The business models of Slovene banks before the financial crisis were based on heavy funding on international financial market and aggressive lending to increase or retain market share. As a result, the onset of the global financial crisis hit Slovene banks particularly hard. The availability of foreign funding of Slovene banks shrank and funding costs increased. The resulting liquidity crunch put a strain on corporate operations and an increasing number of firms resorted to delayed or non-settlement of financial liabilities to banks. As the quality of their loan portfolios deteriorated, banks were faced with higher loan impairment and provisioning charges and a decline in capital adequacy relative to the requirements. Bank profitability began a downward slide and moved into negative territory in 2010. All the common bank profit indicators remained negative till 2014.

Matters came to a head in the second quarter of 2013 following the international bail-out of Cyprus by the European Commission (EC), **European Central Bank** (ECB) and **International Monetary Fund** (IMF). The contagion spread to Slovenia. Slovenia's sovereign long-term debt was downgraded and the availability and cost of funding for banks on wholesale markets came under further pressure. With the recognition that an international bailout was looming for Slovenia as well in the absence of urgent measures to rescue and restructure the banking system, a comprehensive review of the banking system encompassing an asset quality review and stress tests was initiated in August 2013. The review was conducted by four consulting firms under the supervision of a steering committee comprising representatives of the Bank of Slovenia and Ministry of Finance and observers from the European Commission (DG EcFin and DG Comp), European Central Bank and the European Banking Authority.

The resolution measures undertaken on the basis of the results of the review included: capital increases in three major banks with state aid and in five small banks via money from private investors; transfer of non-performing claims to a special bank asset management company; bail-in of subordinated instruments; and reorganization of activities to core business with the aim of improving governance structure and risk management. In addition, two small banks were put in the process of an orderly wind-down involving asset divestment and phasing out of portfolios and activities over a three-year period. The total cost of the rehabilitation of the banking system is estimated at around 8 to 10 percent of GDP. The share of bail-in instruments in the total cost is close to 2 percent of GDP.

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What can be said about the banking resolution process in Slovenia?

Like elsewhere in Europe, Slovenia did not have an effective banking resolution framework during the crisis period. Response to the deteriorating health of the banks during the crisis period was delayed, thereby increasing capital risk and the need for additional capital. On occasions, in state-owned banks funding guarantees were provided by the government in lieu of actual capital.

At the time of the banking resolution in Slovenia in December 2013, the BRRD was not in effect and the decision on the establishment of a Single Resolution Mechanism was being finalized. Still, the EC, ECB, and EBA did exercise considerable influence on the resolution package. The national resolution authority and the three European institutions did not always agree on the preliminary findings of the review. This gap had to be closed before the final package could be crafted, since DG Comp is mandated with assessing the viability and the restructuring plans of banks to which state aid is granted. It is therefore ironical that the Bank of Slovenia is being investigated for alleged mishandling of data and inaccurate calculations and the European Court is to issue a ruling on a case referred to it.

The legislation on many aspects of the resolution package, including the bail-in on subordinated instruments, were in existence but were not consolidated. However, it would be wrong to construe that holders of subordinated instruments did not know the risks that they were exposed to.

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What are the challenges looking ahead?

The world of Slovene banks is changing on account of institutional and regulatory changes and the prevailing macroeconomic environment. In November 2014, the European Central Bank assumed responsibility under the Single Supervisory Mechanism for supervising 8 banks in Slovenia accounting for more than two-thirds of the market share. The supervisory culture will change under the new regime. The ECB will also inspect the business models of banks. It is reasonable to expect that under the new supervisory regime the ECB will trigger any decision on the need for banking resolution. Thereafter the decision to place a bank in resolution would involve the SSM Board, the ECB Governing Council, possibly the SSM Mediation Panel and the Board of the SRM. I apologize to those institutions that I forgot to mention. Given the high political sensitivity of the elements to be included in a resolution scheme, it is hard to contemplate how a binding decision on banking resolution could be reached over a weekend.

In addition, prudential rules have been established for European banks that require putting in place by specific dates new requirements on, among other things, quality and quantity of capital (in the form of several layers of capital buffers), liquidity, leverage, and counterparty risk. Building up capital buffers and meeting the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) will be challenging in an environment of low bank profitability. If only for this reason, harmonization and transparency of resolution standards would help.

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To conclude, I will finish with the same thought that I started my speech. Banking resolution is a messy business.