Wunderkind is Walking? The Resolution of Banco Popular as a First Test for the Single Resolution Mechanism

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It had been hailed as the advent of a brighter future: When the Single Resolution Mechanism – the second pillar of the European Banking Union – became operational from 2015, the expectation was that it would ‘bolster the [European] Union, restore financial stability and lay the basis for economic recovery’ (to borrow from the SRM Regulation, or ‘SRMR’); in order words: accomplish no less than recovery from the economic crisis that has plagued the Eurozone for almost a decade now. Under the new framework, complementing the centralisation of
banking supervision within the Single Supervisory Mechanism, the power to initiate resolution proceedings for ailing banks has been transferred from national bodies to the Single Resolution Board (‘the Board’) under the auspices of the European Commission. The Board has since been in charge of placing large Eurozone banks under resolution, determining the application of the innovative resolution tools available under the SRMR. It also decides on the use of the Single Resolution Fund, which has been established as a source of funding for resolution action under the new regime.

In view of the massive impact of taxpayer-funded bail-outs during the global financial crisis and the Eurozone crisis that continue to be visible in public budgets across Europe,[1] the new regime has been perceived as no less than a genuine game-changer—a true Wunderkind indeed: If successful, it would not just do away with the need to resort to costly, and morally hazardous, bail-outs in order to prevent the systemic fallout from large bank insolvencies; it would also balance out residual national biases in the process, which previously had stood in the way not just of incentive compatible resolution actions in cross-border-settings, but also of deeper integration of the European banking markets.

Against this backdrop, policymakers as well as regulators across the Eurozone understandably will have sighed with much relief at the news that the Single Resolution Mechanism has passed muster in its first real-world test. Having invested considerable political clout into the new framework (not least by giving away national powers to a newly created European body), most Eurozone governments will regard the Board’s decision, published on 7 June 2016, to formally place the Spanish lender Banco Popular S.A. under resolution and have its shares transferred to competitor Banco Santander SA, as a vindication of what initially appeared to be a bold, indeed risky, move into entirely uncharted territory. After all, it was one thing to cede powers for the day-to-day supervision to a network of national agencies under the helm of an experienced European Central Bank, and quite another thing to centralize resolution powers – the powers to deal with, and control, financial meltdowns taking place in highly dynamic markets, with a vast array of financial, economic, social and political interests at stake – within the hands of a supra-national body created from scratch for that purpose.

More broadly, the successful resolution of the Spanish lender seems to provide a welcome counterexample to the on-going rescue operations adopted by the government of Italy with regard to a number of ailing Italian banks which, given the deviation from the standard procedures and the involvement of public funds, and despite the fact that the European Commission has rubber-stamped the strategy, may well be perceived to be an untimely reminder of an ugly past,
rather than a state-of-the-art-approach.\[2\] Last but not least, the resolution of Banco Popular, at least at first sight, testifies not just to the institutional viability of the decision-making arrangements within the Single Resolution Mechanism, but also to the practicability of the innovative ‘resolution tools’ made available under the SRMR. As these have been modeled after the 2014 Bank Recovery and Resolution Directive (the ‘BRRD’), which applies across the European Union as a whole, this is of significance far beyond the Eurozone.

So, is Wunderkind being seen walking, only a little over a year after its birth? Both political parents and bureaucratic midwives may be forgiven for pausing with awe and admiration at the swift implementation of the share deal, accomplished by making use of the ‘sale of business tool’ prescribed by Articles 22(2)(a) and 24 of the SRMR. Should academic observers, in particular those who – like this author[3] – have remained skeptical about the merits of both the new institutional framework and the resolution toolbox, follow suit, fall silent, repent and lick their wounds?

To be sure, the successful implementation of the Board’s first ever resolution action should be welcomed across the board. If the proof of the pudding is in the eating, it is reassuring to watch the meal going well. First and foremost, the institutional arrangements of the Banking Union, involving not just the decision-making procedures between the Single Resolution Board, the Commission, the Council, and national resolution authorities in the participating Member States and other jurisdictions, but also the cooperation with the ECB as supervisory authority, appear to have worked out as intended – perhaps surprisingly so, given the considerable complexity of the relevant arrangements and the potential for political interference from national governments.

In this context, it is worth noting that the Board’s decision followed directly upon the assessment by the European Central Bank, as competent supervisory authority, that Banco Popular was ‘likely to fail’ within the meaning of Art. 18(1) SRMR, and, therefore, qualified for resolution action. Undoubtedly, the formal coordination between the ECB’s assessment and the adoption of a resolution scheme by the Board (as well as its immediate endorsement by the EU Commission) will have been preceded by informal negotiations between the different actors over a period considerably longer than the less than 24 hours it took from the start of the auction to the close of the deal.

There is nothing wrong with that, however, and the very fact that the Board managed to carry out the operation in a very limited period of time should be praised as a considerable achievement, especially given that early leaks had already caused depositors and investors in the bank’s debt instruments to panic.
In terms of substantive outcomes, while the transfer of the shares appears to have been prepared as part of the ‘resolution scheme’ adopted by the Board under Article 23 SRMR, implementation remains with the Spanish resolution authority pursuant to Articles 18(9) and 28 SRMR, and problems may still occur during that process. Nonetheless, the resolution of Banco Popular illustrates that the relevant legal and commercial preparations can indeed be accomplished within a short period of time, which is laudable. Adding to the complexity of the transfer as such, the resolution action, according to information published by the Board, also provided for the write-down of existing Common Equity Tier 1 and Additional Tier 1 instruments, while Tier 2 instruments were converted into new shares, which have been transferred to Banco Santander for the price of 1 euro. The ‘sale of business’, as such, has thus been complemented with elements of a bail-in (in technical terms, a combination of the write-down and conversion of capital instruments under Article 21 SRMR and the bail-in tool under Articles 22(2)(d) and 27 SRMR, jointly designed to ensure that losses are borne exclusively by shareholders and creditors rather than the taxpayers). Given the substantial uncertainties associated with these new and innovative powers, this should also be regarded as a considerable success, although it remains to be seen whether and to what extent the underlying assumptions will successfully be challenged in litigation. All in all, the resolution of Banco Popular, from an outsider’s perspective and based on the limited information available shortly after its publication, should indeed be considered a success story.

Whatever its merits, however, observers should take care not to read too much into the resolution of Banco Popular. First, it is important to bear in mind that, although Banco Popular is reportedly Spain’s six largest lender, with subsidiaries in Spain and Portugal and operations also in the United States, it does not even come close to global significance, and both its corporate structure and business model appear to be relatively simple. Against this backdrop, the lessons potentially to be learnt from this case for application in future resolutions of large, globally active banking groups, involving not just thousands of legal entities, but also highly complex interrelationships with customers, other market participants and market infrastructures around the globe, are likely to be limited.

Secondly, it is quite essential that, in this particular case, resolution action could rely on rival institutions willing to take over the failing bank. Santander assuming the whole business in the form of a share deal is, at the same time, the simplest possible form of a successful resolution, and the safest scenario in terms of implications for financial stability, as all business operations can continue without any interruption whatsoever. To be sure, we do not know about Banco Popular’s positions in derivatives transactions (if any), but even if counterparties...
had been exposed, they would probably survive the transfer without any knock-on effects. Had it not been possible to structure the resolution action in this way – for example, because no competitor had been willing to assume the ailing bank due to uncertainty about its real value and hidden risks –, resolution would have had to rely entirely on a bail-in, with or without the transfer to a bridge institution, which would have been far more complicated to design and implement.

And, thirdly, it is important to note that the resolution, in this case, takes place within a market environment that has gone some way to recover from the systemic crisis. In particular, there are reasons to doubt that the SRB, or, indeed, the Italian authorities, could follow the same recipe with regard to the current problems affecting a number of Italian lenders whose problems (and funding patterns) appear to differ significantly from Banco Popular’s.

Again – is Wunderkind being seen walking? For sure, judging from publicly available information, the Banco Popular case is a great achievement for which the Board deserves unmitigated applause. Given the nature of that case, however, there are reasons to remain cautious about the prospects for larger, more complex cases in the future. Instead of the Wunderkind simile, it may be more appropriate to compare this case to a first trial of a modern ship in coastal waters. The trial having been completed successfully, there are reasons to be reassured about the vessel’s capacity to master these waters, especially in fairly sound weather conditions. The master and crew impressively have proven up to their task, and the vessel’s structure seems sound. It is not just the Spanish taxpayer, who went off the hook with zero losses this time round, who will congratulate master and crew (and the shipbuilders). Yet, it remains to be seen how this will work out at open sea, let alone amid a hurricane. To acknowledge this should by no means be interpreted as an attempt to belittle what has been achieved. But, just as the Board’s management and staff (who will know anyway), all stakeholders involved, including governments and the general public, will benefit from as much realism as can possibly be mustered in a venture as risky as the resolution of globally active, systemically important financial institutions.

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[2] See Jim Brunsden ‘Decisive Madrid shows edge over sluggish Italians’, Financial Times (8 June 2017) (reporting the views of policymakers and academic observers to that effect). And see also Martin Arnold, Tobias Buck, and Rachel Sanderson ‘Why Santander rescue of Banco Popular is a European test case’ Financial Times (8 June 2017).

Introduction On 1 June 2017 the European Commission and Italy reached an agreement ‘in principle’ on the recapitalization of Banca Monte dei Paschi di Siena (MPS). A mere week later,...

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