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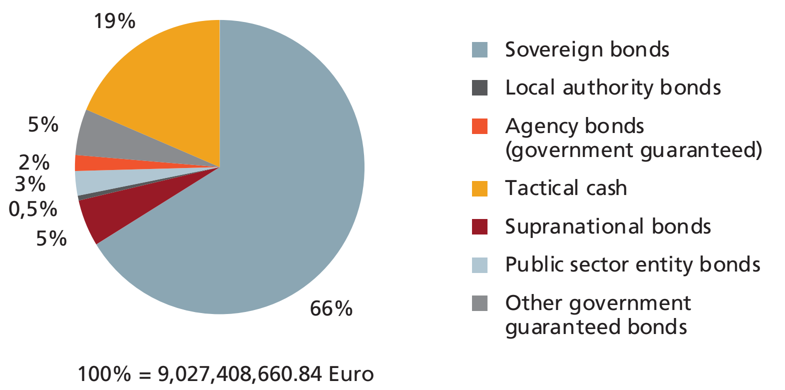
The Single Resolution Fund as a safety net for the Banking Union

Following the economic crash of 2008, European leaders took a decision to protect the taxpayer and shore up financial stability. They wanted to replace the concept of bail-out with bail-in, thus making banks' management, shareholders and bondholders more responsible. Europe's political masters wanted to end the notion of a bank being 'too big to fail', and so the decision was taken to create the Banking Union – a new regulatory architecture for the financial sector. Under the Banking Union, the Single Resolution Mechanism was born, and the Single Resolution Board (SRB) was created.[1] The SRB is the owner of the Single Resolution Fund (SRF, the Fund). The SRF is one key element in the safety net for the Banking Union.

The SRF exists to provide stability and confidence to the market in a time of crisis and, if required, it can be used to support the use of resolution tools in a resolution case. It is a fund of last resort and is paid for by banks and credit institutions operating in the Banking Union in the form of ex-ante contributions. At present, the Banking Union consists of the 19 countries that make up the eurozone. The taxpayer does not contribute anything to the Fund.

At the moment, the Single Resolution Board is working to build up the SRF, between the years 2016 to 2023, as laid down in EU law.[2] In 2019, in total, 3,186 institutions injected €7.8 billion into the Fund, bringing the present size of the fund to €33 billion. The goal is to have a fund that is worth at least 1 percent of the amount of covered deposits of all credit institutions within the Banking Union by 31 December 2023. In simple terms, that means roughly €60 billion, although that is not a precise figure, since the amount of covered deposits is always fluctuating.

Figure 1: SRF investment portfolio by counterparty type (excluding Strategic Cash reserves)



Quelle: Single Resolution Board

The SRB is responsible for the investment of the money in the SRF. If we take a look at the situation at the end of December 2018, the amounts held in the SRF totalled €24.9 billion, composed of the investment portfolio worth €22.1 billion and Irrevocable Payment Commitments[3] or IPCs worth €2.8 billion. The subsequent graphs are based on these end of 2018 figures. Since then, the size of the portfolio has risen to €33 billion after new contributions from financial institutions were paid in June 2019.

How is the SRF invested?

The SRB is allowed to make investments of the financial means collected and held in current accounts taking into account both the financial capacity of the Fund and the expected disbursements. Since the decision to resolve a bank can happen in a matter of hours or days, the Fund's assets must be accessible at very short notice. The investment objective is to satisfy the liquidity needs and to protect the capital of the SRF in order to support the efficient application of resolution tools. Satisfying the liquidity means that the SRF must be able to provide the required amount of liquidity at any time on short notice. To this end, to support this objective, the SRB endeavours to invest the amounts held in the SRF in liquid assets.

The Delegated Regulation 2016/451 (DR) also states that the Board shall have a prudent and safe investment strategy. The SRB can invest the amounts held in the Fund in various asset classes subject to certain restrictions.[4]

The DR sets out the general principles for investments including eligible assets, portfolio composition, diversification requirements, risk management and possible outsourcing. Based on these, the SRB has selected a subset of the safest and most liquid assets from the eligible universe which form the annual strategic asset allocation.

The asset classes currently selected originate from the list of eligible assets (Article 4 of DR). The actual assets to be invested in will depend on their ability to contribute to the objectives of satisfying liquidity needs and protecting the value of the SRF.

Article 3(3) of DR requires that the amounts referred to in Article 1(1) of DR shall be invested altogether as a single pool of resources. The portfolio management style is passive, following a benchmark, which leads in principle to low portfolio activity.

The cash collected from contributions for the SRF is deposited in cash accounts the SRB holds with selected central banks from Banking Union Member countries and is remunerated at the ECB deposit facility rate. In May 2018, the implementation of the SRB's investment strategy commenced with a total of €9 billion invested in two mandates in the course of 2018. The non-invested amounts at the end of 2018 of €13 billion (Strategic Cash reserve) were held in the cash accounts mentioned above.

Such mandates were constructed based on the strategic asset allocation set out in the SRB's 2018 Investment Plan. The mandates include securities investments as well as a cash position resulting from the fact that securities having a yield below the ECB deposit facility rate are not purchased. In total, as of the end of 2018, the two mandates contained €7.3 billion of securities and €1.7 billion of cash. The currency of the investments is the euro. Although the SRB has, in principle, the intention to hold securities until maturity, the ability to do so is constrained by the purpose of the SRF, i.e. to have amounts available at short notice to support resolution needs. Apart from cash, the following asset classes are invested in as part of the Investment Plan:

– Government bonds from 19 Member States of the Banking Union and other EU states;

– Supranational bonds (multilateral development banks and international organisations);

– Government-related bonds (agency bonds, regional and local authority bonds and bonds from Government-Development banks).

In early 2019, a third mandate was introduced which contained non-financial corporate bonds. Environmental, Social and Governance considerations are taken into account for these investments for which an exclusion list of issuers is maintained.

The total return of the SRB portfolio for 2018 was -0.16 percent with the negative return on cash of -0.40 percent being partially offset by a positive return on securities and the cumulative return since the start of securities investments (in May 2018) has been 0.72 percent until September 2019.

Risk Management Governance in three lines of defence

The SRF successfully implemented its 2018 investment strategy with the selected outsourcing partner for portfolio management and custody services and started investing in securities and the operationalisation of the SRF was further carried forward. Decisions on in-house versus outsourcing were based on strategic importance, efficiency, security and costs. These criteria were applied in determining which activities of the investment management process to outsource.

Further portfolio managers may be added in the future. The outsourcing of investment tasks may only be made to bodies governed by public law, eurozone central banks, international institutions established under public international law or Union law institutions.

Like all investors prolonged period of ultra-low and negative interest rates puts pressure on investment returns. In this current environment, it is therefore extremely challenging on a sustained basis to invest in high quality liquid assets without being subject to negative returns. Indeed, the Delegated Regulation states that "due to the intrinsic nature of investments, changing market conditions

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Der Single Resolution Board (SRB) wurde gegründet, um dem Finanzmarkt in Zeiten einer Krise Stabilität zu verleihen. Der SRB wiederum baut seit 2016 den Single Resolution Fund (SRF) auf, um Banken abwickeln zu können. Der SRF soll bis zum Jahr 2023 mit 60 Milliarden Euro komplett aufgefüllt sein. Doch so viel Geld sollte natürlich auch investiert werden. Dabei hat der SRF besondere Anforderungen. Über allem steht die Liquiditätsfrage. Eine Abwicklung kann im Ernstfall innerhalb von Stunden anstehen. Dementsprechend schnell muss investiertes Geld liquidierbar sein. Daher hat der SRF auch eine recht hohe Cash-Komponente, die allerdings zur negativen Einlagefazilität bei der EZB geparkt werden muss. Trotzdem ist auch der Werterhalt eine Priorität bei den Investmentgrundsätzen. Das führt zu sehr strengen Vorgaben. Daher hat der SRB für den SRF eine Risikomanagement mit drei Verteidigungslinien aufgebaut. Seit Mai 2018 hat der SRF damit insgesamt eine Rendite von 0,72 Prozent erzielt. (Red.)

and interest rate environment, even the safest and most liquid assets may entail negative returns. In this respect, a loss on the portfolio should not imply per se a violation of the investment objectives."

The Board has adopted a Governance Framework as part of its investment strategy, detailing the division of tasks and responsibilities between the Board in its Plenary Session and its Executive Session. One of the elements of the Governance Framework is that the Board approves an internal governance structure for investments. In early 2018 the SRB adopted a risk governance framework based on the three lines of defence model.

1. First line of defence Risk Management – Single Resolution Fund Unit (SRF Unit)

The SRF Unit is responsible for the development and implementation of the investment strategy of the SRB. As certain portfolio management activities, in particular transaction execution, are outsourced to a portfolio manager service provider, the main role of the Unit is to advise the Board in its Executive Session on the investment strategy, on its implementation as well as the compliance monitoring of outsourcing partners. The key instrument in the management of the investments is the composition of the benchmark which is to large extent designed by the SRF Unit with the quantitative input from an outsourced service provider. The SRF Unit reports to the Vice Chair of the SRB.

2. Second line of defence Risk Management – Investment Risk Manager

The responsibility of the second line risk manager is to ensure that all risks are adequately identified, measured, assessed and managed by the SRF Unit as well as ensuring compliance with risk processes. The second line Investment Risk Manager operates outside the SRF Unit, providing an independent judgement. The Risk Manager reports to the Vice Chair.

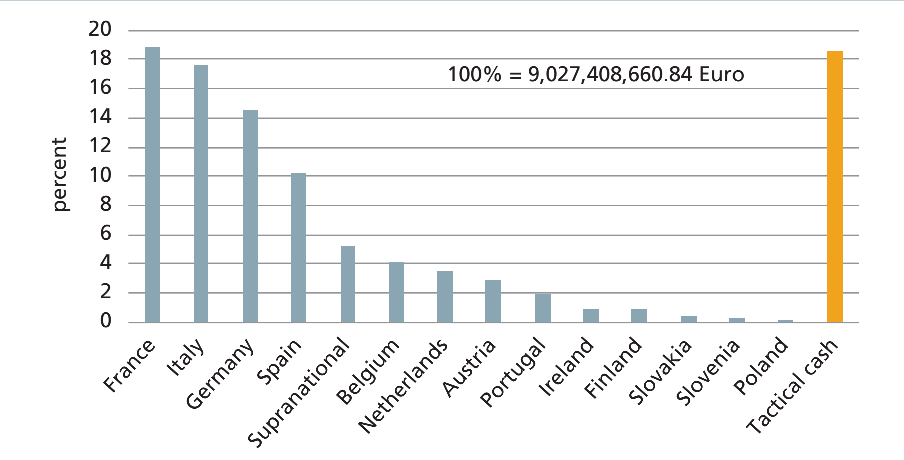
3. Third line Risk Management – Internal audit

The third line of defence is the internal audit function. The role of internal audit is to provide independent assurance on the quality and effectiveness of the investment processes including risk management. The internal auditor reports to the SRB Board in its Executive Session and upon request to its Plenary Session.

A Fund Committee in its Investment Composition (FCIC) prepares decisions to be taken by the Board in its Plenary Session pertaining to investments. The FCIC is composed of experts from the 19 National Resolution Authorities (usually part of the national central bank), the European Commission, the European Banking Authority (EBA) and European Central Bank.

An Investment Committee advises the Board in its Executive Session on all investment related topics and is composed of one Board Member and the Vice Chair as Members as well as head of the SRF Unit. The Investment Risk Manager and the Head of Unit of the Contributions and Financing Unit participate in the meetings.

Figure 2: SRF investment portfolio by geographical region (excluding Strategic Cash reserves)



Quelle: Single Resolution Board

Risks overview

Financial risks are the risks linked to the investments of ex-ante contributions in the financial markets. We can further divide them into:

– Market risk

– Credit risk

– Liquidity risk

In relation to the current investments held by the SRB, the above types of financial risks are accepted to a certain extent. Other financial risk types, like for example currency risk are not currently accepted. Financial risks are defined in terms of quantitative or qualitative limits and guidelines in the SRB Risk Management Framework, which is updated on an annual basis and annexed to the SRB's investment strategy.

Market risk is the risk of loss arising from changes in the value of financial assets due to fluctuations of the price of securities. In the case of the investment portfolio held by the SRB, the main market risk is the interest rate risk as long as the currency risk is not relevant. The SRF's portfolio is exposed to an increase in interest rates. Credit risk is the risk of loss arising from the inability of a counterparty, issuer or other obligor to fulfil its contractual obligations. As at end of 2018, 39 percent of the securities portfolio (including cash in the mandates but excluding Strategic Cash reserves) was rated AAA with 69 percent being rated AA or higher (see figure 3).

The market liquidity risk is defined as the inability to sell a security or the risk of loss against the prevailing market value if position needs to be sold in a short timeframe. It is minimised by investing in high credit quality liquid assets and by adopting adequate measurements that allow the timely detection of deteriorations in the liquidity of the portfolio.

Is the Single Resolution Fund sufficient in size?

One question that is often asked, is whether or not the Fund would be enough in the case that a major bank required resolution. The simple answer is that, even when it is fully built up, €60 billion would not be enough. However, along with that €60 billion, there will be a backstop[5)] of an additional €60 billion. The other thing to bear in mind is that the Fund is not the only thing the EU has put in place since the crisis.

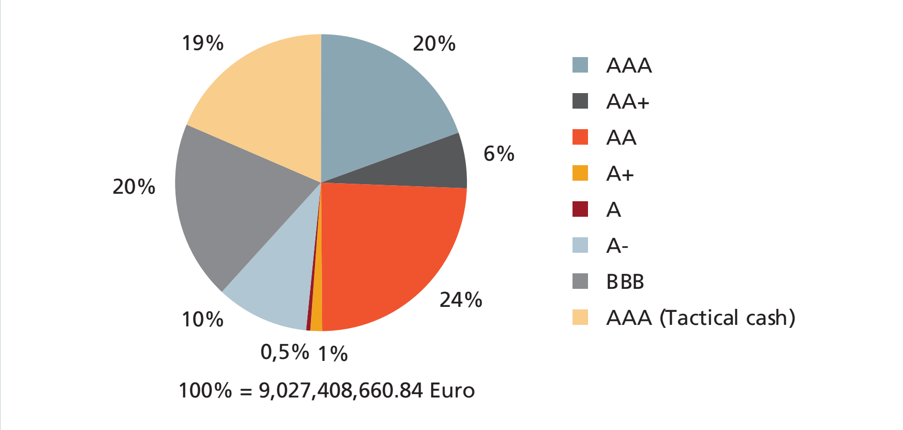
In a new crisis situation of a similar size, needs are expected to be lower due to capital and liquidity requirements which were introduced as post-crisis measures including the Liquidity Coverage Ratio, Net Stable Funding Ratio, Minimum Requirement for own funds and Eligible Liabilities (MREL) and Total Loss Absorption Capacity (TLAC).

We now also have stronger supervision of the banking sector at EU level – something pretty much non-existent before the crash.

Providing Confidence to the Market

Now, shareholders and certain bondholders will be first in line to lose their investment value if a bank enters into resolution and burden sharing is required. Therefore, banks now have an incentive to be more cautious, since the governments will no longer come to the rescue and cover the losses. Nevertheless, in economic terms, confidence is everything, and having the Fund and its backstop in place will provide credibility and confidence to the market should the economy and some banks take a turn for the worse.

Figure 3: SRF investment portfolio by credit rating (S&P) (excluding Strategic Cash reserves)



Quelle: Single Resolution Board

The SRF is one of the key elements in the design of the Banking Union safety net. Within the resolution scheme, the SRF may be used for capital or liquidity support only to the extent necessary to ensure the effective application of the resolution tools available. This need for support in resolution sets high requirements for the liquidity of the SRF. The funds need to available at the time of resolution. At the same time, the value of the Fund must be preserved. These two goals may be from time-to-time be conflicting and the investment strategy set by the Board aims to balance these. However, the liquidity goal is considered to be the primary goal due to the purpose of the Fund.

The SRF's investment strategy is based on the diversification concept. This will be ensured through asset class, security and sectoral diversification, in addition to investments across maturities and ratings in order to achieve the optimal risk-return ratio. The investments in securities have helped to enhance the returns compared to investments in deposits with negative ECB deposit rate. Liquidity of the portfolio is also ensured when implementing the investment strategy.

The SRF is expected to grow to €60 billion in size by the end of 2023. One could question the adequacy of the size for various banking failure scenarios. In addition to the planned Fund size there is a current and planned backstop arrangement by the Member States which is fiscally-neutral. The resolution framework relies primarily on the use of resolution tools without the use of the Fund. However, the Fund as the safety net for the Banking Union is able to support the efficient application of the resolution tools and exercise of the resolution powers.

Footnotes

1) Regulation (EU) No 806/2014 (SRMR) governs the Single Resolution Fund owned by the Single Resolution Board.
2) Calculation, collection and transfer of contributions is governed by Implementing Regulation, Delegated Regulation and Intergovernmental Agreement between Member States. Commission Delegated Regulation (EU) No 2016/451 governs the investment strategy and administration of the SRF.
3) The IPC agreements are currently backed by cash collateral. The purpose of the cash collateral is to secure the full and punctual payment of the contribution when called by the SRB. In case an institution fails to pay the full amount when IPC is called, the SRB is entitled to seize and apply the cash collateral in discharge of the commitment undertaken under the IPC framework.
4) DR 2016/451 referring to DR 2015/61 articles 10(1) 11(1) 12(1) (a) (b) (c) (d) (e) 15(1)]: Central banks (ECB, Member State Central Bank, Central Banks of third country), government bonds or regional government and public sector, covered bonds, development banks and international organisations, corporate bonds, asset-backed securities, shares and collective investment undertakings. Investments shall be sufficiently sectorally, geographically and proportionally diversified.
5) The Member States in the Banking Union have committed to develop a public common backstop for the steady state. As an interim solution the SRB has signed a Loan Facility Agreement bilaterally with all Participating Member States with a combined value of €55 billion which is in place until 2023. Both arrangements are fiscally neutral and can only be accessed as the last resort. The backstop will be repaid by raising ex-post contributions collected from the financial institutions.