THE WALL STREET JOURNAL 26-GEN-2016

Europe's Lingering Banking Disunion

The Single Resolution Board simplifies rules for failed banks, but confusing national rules persist.

By Marcello Minenna

With the new year, the eurozone has acquired a new banking regulator, as the Single Resolution Board is now open for business. Along with new capital requirements that are supposed to cement the concept of "bail-ins"—the capacity of creditors and investors to absorb losses at a struggling bank before taxpayers step in—this new resolution board is supposed to boost financial stability by clarifying the rules for failed banks. If only it were that easy.

The problem is twofold. Eurozone banks face the daunting task of cataloging liabilities that can be written down in a crisis. The resolution board intends to set minimum requirements for such liabilities, known by the acronym MREL, by the end of the year.

But with the financial system still under distress in some eurozone countries, identifying bail-in liabilities is a fraught task. Banks are waiting for a detailed, invasive regulation that has the potential to impose structural changes of their balance sheets. For instance, in order to comply with MREL standards, eurozone banks can be forced to issue classes of instruments unfamiliar to their management, such as junior or subordinated debt tranches with differentiated yields. The adjustments are neither simple nor immediate.

While the resolution board's chief, Elke König, hopes such rules will mean her board will "not have to resolve any bank" because institutions will be healthier, it seems that they have already had a harsh impact on peripheral banks.

Serious problems have arisen from the set of complex "reorganization schemes" that some national central banks have put in place for regional banks in order to anticipate and possibly avert the most negative consequences of the bail-in mechanism. The idea is that if regulators can force small- or medium-size banks to revamp their balance sheets before they reach a level of distress so severe as to trigger the Single Resolution Board's involvement, they can avoid the consequences of a full bail-in. Italy and Portugal are the primary movers here, and their experiences show the potential for confusion.

In some ways, these two countries have adopted similar procedures. Both have created bad banks to take on the nonperforming loans of struggling institutions, with write-downs that on average have exceeded 80%. They have then endowed new banks with higher-quality assets in the expectation of privatizing the good banks. So far so good. But the other common feature here has been an asymmetrical burden-sharing. This has penalized the banks' shareholders and some creditors far beyond the losses they would have suffered before the introduction of the eurozone's uniform rules. Shareholders and some creditors who might have suffered losses of 60% to 80% on their stakes or bonds in restructured banks under previous rules have now suffered losses of 100%.

Italy's central bank has let the ax drop on shares and subordinated bonds, while preserving senior bondholders and large depositors. Forcing those bondholders to take the heaviest losses might appear to spread the costs of bank resolution toward the more risk-seeking classes of investors. But policy makers have not taken well into account the wide diffusion of subordinated debt among retail investors and small savers. The individuals involved often were unaware of the risks they took on when they held those assets. Those savers may have been missold their assets by institutions that shaded the truth about the risks. So Rome has had to establish an indemnity fund to reimburse some of the losses, although the €100 million ($108 million) earmarked for this is less than 10% of the total losses suffered by this class of creditor.

Portugal has gone the other way, shifting losses disproportionately onto foreign investors in order to protect domestic savers. Some 52 senior bond issues, mostly held by foreigners, have been transferred to the bad bank after write-downs that amount to a whopping 80% off the value at which the bonds traded the day before this resolution was implemented. Other senior debt held domestically has been spared.

This avoids the political problem the Italians have suffered, but creates a legal headache. Foreign investment funds complain, with good cause, that this violates the *pari passu* principle under which all holders of a similar type of debt have the right to be treated equally in case of forced liquidation. Litigation is almost certain to come, even if it now appears that Lisbon has agreed in principle to reimburse at least partially the involved investors.

The new Single Resolution Board will help solve some of these problems as the room for pre-emptive actions by national central banks is quickly reduced, but those central banks will still have some limited scope to craft their own rules for unhealthy banks. Meanwhile, European banks still face a difficult year or two as they adapt to new eurozone-level regulations while national governments cope with the economic and legal fallout of their own varied rules.

Mr. Minenna is a doctoral lecturer at the London Graduate School of Mathematical Finance.