



DOES BANK RESOLUTION RULE OUT THE USE OF PUBLIC FUNDS? THE CASE OF THE PODKARPACKI BANK SPÓŁDZIELCZY

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Abstract

On 15 January 2020 Polish resolution authority made a decision to launch the resolution of a regional cooperative bank. The aim of the resolution was to maintain the service of local government units, considered as the critical function of the bank. The tool used was a bridge bank combined with bail-in to subordinated bonds and unguaranteed deposits, including deposits from local government units. The author is of the opinion that the write-off deposits from public entities was a substitute of the insufficient amount of liabilities contractually eligible for bail-in, served as the instrument enhancing credibility of resolution as well as protecting other creditors from excessive losses (i.e. mitigating contagion risk). The presented case of bank resolution, has been assessed as an example of intentionally bending of the stiff BRRD rules to an unusual case to find the practical, socially acceptable solution. By comparing this case with resolution of other small banks in the EU, the author argues that national authorities seek to limit the scope for bail-in and try to use the financial arrangements within the resolution of small local banks as more secure for the banking sector and socially acceptable manner.

Keywords: bail-in, bank insolvency costs, bank resolution, bridge bank, BRRD, cooperative bank.

JEL Class: G21, G28, H12, R11.

INTRODUCTION

On January 15th 2020, the Polish resolution authority Bankowy Fundusz Gwarancyjny (Bank Guarantee Fund – BFG) made a decision to launch resolution of the regional cooperative bank – Podkarpacki Bank Spółdzielczy in Sanok (PBS). The BFG considered service of local government units as a critical function provided by the bank, and thus as a resolution objective. The process began two days later with the use of the bridge bank combined with bail-in, as the resolution tool. Major parts of credits and deposits were moved to the bridge institution Bank Nowy BFG SA. Client services were restored on January 21, after the move had been completed, The BFG stated that due to the huge negative equity (PLN 182 million) was forced to apply the bail-in to both subordinated bonds (100%) and uninsured deposits (43%), to get the bank's net asset value (NAV) equal zero. A significant share of depositors whose funds were written off were local governments and their units (public hospitals and schools), which may be surprising in view of the resolution's objective.

This article is related to a number of previous papers focusing on the bank resolution and the use of bail-in. The resolution of PBS can be compared to similar actions taken with respect to four small banks in Italy, in November 2015, as well as to two savings banks (Andelskassen) in Denmark, in 2016 and 2018, where bridge banks (combined with bail-in) were selected as the appropriate resolution tools [Lintne and Lincoln 2016]. A description of the resolution framework and tools is presented in the „Key Attributes” issued by the Financial Stability Board [FSB, 2014] and in Directive 2014/59/EU of the European Parliament and of the Council of May 15, 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms [BRRD, 2014]. Acharya and Yorulmazer [2007] described the impact of a bank's asset specificity on the resolution costs (misallocation costs) that could occur if a bank is liquidated or its assets are transferred to another entity in the course of resolution. Avgouleas and Goodhart [2015] conducted an extended critical, legal, and economic analysis of the key potential risks connected to a bail in. They pointed out that bail-in incentivizes certain creditors to enhance their responsibility for the bank, thus reinforcing market discipline, but it implies a higher contagion risk, and its use is limited, suggesting a combination of bail in and bailout. Geithner [2014] discussed the bail-in to deposits. He pointed out is that depositors by choosing the bank (which is not done by taxpayers), can theoretically monitor its condition and, when the risk of the bank increases, make a timely decision to withdraw funds, increasing the bank's incentives to reduce risk (market discipline). However, he presented an immediate counter-argument that certain groups of unguaranteed depositors (e.g. the above mentioned schools, libraries and clinics) are not able (due to information asymmetry and insufficient preparation) to monitor effectively the

bank condition. Similarly, Bernard et al. [2017] and Benink [2018] argued that unexpected losses may not be absorbed by unsecured debt holders. Boccuzzi and De Lisa [2017] identified the emergence of uncertainty about the bail-in scale as the main reason for the potential outflow of deposits, (due to fear of a wide range of write-offs involving non-guaranteed deposits and other liabilities). The question of choosing when to launch a resolution, was examined by Dewatripont [2014], who states that too late start of resolution can be more costly for taxpayers than using public funds earlier. Pandolfi [2018] proposed a model that showed that the assumption that all losses will be covered by bail-in leads to the risk of a credit crunch. In order to reduce that risk, the regulator should declare the use of the bail-in together with the bail-out but not replace the bail-out with the bail-in. Miklaszewska [2017] noted that the resolution scheme described in the BRRD had been designed for large systemically important banks. Rigid application of this scheme to small entities, like cooperative banks, may create political and social problems. The goal of this paper is to assess the bail-in to deposits from public entities (and its scale) as the factor enchainning credibility of the resolution. The author argues that the write-off deposits from public entities may in certain situations be necessary to ensure the credibility of the resolution and mitigate the risk of contagion. In the presented case those deposits played the role liabilities contractually eligible for bail-in substituting insufficient amount of MREL¹.

The research methods used in the paper are:

- analysis of the bank’s financial data and public estimation of the value by estimating the value of the bank drawn up for the resolution,
- comparative analysis of PBS resolution and similar cases in Europe.

The paper is organized as follows: Section 1 presents the concept of the bank resolution and its possible consequences, especially focused on the small banks, Section 2 presents the cases in EU, similar to the PBS case, Section 3 presents the background and objectives of the PBS resolution as well as controversies and potential consequences, Section 4 concludes and summarizes the main results of this study, showing some important policy implications.

1. THE IDEA OF RESOLUTION

The sources of the resolution concept can be found in the so-called Too Big To Fail (TBTF) doctrine and the resulting need to prevent the collapse of large banks. This doctrine was later modified to some extent, due to the adoption of other

¹ Resolution authorities can impose a minimum requirement for own funds and eligible liabilities (MREL) on European banks. The MREL consists of own funds and part of a bank’s liabilities. If a bank fails and goes into resolution, the MREL acts as a buffer to absorb losses and to provide new capital to the bank.

criteria that would qualify a bank as an institution whose failure would pose a threat justifying state intervention (financial support). Such banks were described as „too important”, „too unique” or „too complex” and where there are significant links to other financial institutions or to the economy of the country as „too interconnected”². During the recent crisis, the only way to avoid the threats arising from the failure of a large bank was to provide public financial support. This situation gave rise to Key Attributes, published in 2011 by the Financial Stability Board [FSB, 2011] and modified in 2014 [FSB, 2014a]. These principles described the treatment of banks whose failure could cause a disturbance in the economy, emphasizing the need to act in a way that does not expose taxpayers to the risk of losses. The costs of winding up (or restructuring) such a bank should be covered first by the bank’s shareholders and then by the bank’s creditors (more precisely: entities with respect to which the bank has uninsured or unsecured liabilities). Creditors’ share of these costs is expected to enhance the bank’s internal loss absorbing capacity [FSB, 2014b]. The FSB principles have been introduced in many countries. Besides the European Commission has since 2010 proposed nearly 30 sets of rules to ensure a safer, sounder and more stable EU financial sector³. In 2014 the European Parliament adopted the Bank Recovery and Resolution Directive [BRRD, 2014]. According to that regulation, resolution means the use of a so-called resolution tool by a designated state or supranational institution (resolution authority – RA), consisting of sale of the business, establishment of a bridge bank, separation of assets or recapitalization of the bank. The RA also prepares a resolution plan for each bank⁴, i.e. a comprehensive document detailing the bank’s characteristics and preferred path if the institution is failing, indicating the tools to be used.

² Acharya and Yorulmazer [2007] have shown that a similar problem occurs when there is a threat of bankruptcy of many banks, which also creates pressure on state authorities to provide similar support (too many to fail). Such an „implied guarantee” by the State may create an incentive for so-called herd behavior, in the form of banks building portfolios of assets with a similar risk profile, resulting in a lack of risk diversification in the banking sector.

³ In June 2012, EU Heads of State and Government agreed to create a Banking Union, completing the European Monetary Union by providing for the centralized application of EU-wide rules for banks in the euro area. The Banking Union guarantees the harmonized application of European regulation through the creation of centralized Supervision and Resolution Powers (Single Supervisory Mechanism and Single Resolution Mechanism).

⁴ The plan also includes an assessment of the bank’s resolution plan usually expressed in two aspects [EBA, 2014; FSB, 2014a] of credibility and feasibility. Feasibility means that the resolution authority has the necessary powers to carry out the planned strategy, and credibility means that there are no unacceptable negative consequences for the financial system and the economy with the chosen course of action.

According to the BRRD Directive, a resolution can be carried out when:

- a) the bank is failing or likely to fail;
- b) action by supervisory authorities or private parties will not restore the normal functioning of the bank within a short time;
- c) the resolution is in the public interest, in order to:
 - ensure the continuation of critical functions,
 - avoid a negative impact of a bank failure on the stability of the financial system (in particular to prevent the effect of contagion),
 - prevent overcompensation of public funds,
 - reduce losses for depositors and investors,
 - protect (sufficiently) client funds and assets.

The resolution process may result in the closure of the bank, i.e. its disappearance from the market as a separate entity (closed resolution strategy) through liquidation or sale of its assets and liabilities to another institution. In the case of difficulties to find a buyer, it is assumed that the existing bank or part of it will be maintained (open resolution strategy) through recapitalization, transfer to another entity or (ultimately) to a bridge bank. The latter solution (bridge bank) is in fact a postponement of another tool, e.g. until there is a buyer, ready to buy all or part of the failing bank. The goal of bank resolution is to prevent its failure from devolving into a systemic banking crisis and to minimize the cost to taxpayers. The bank creditors (including uninsured depositors) are imposed to participate in covering the excessive losses of a bank. This concept considers measures that make it less likely that banks will fail and that limit losses to taxpayers in the event of a bank failure⁵. The possibility of witting-off the bank's liabilities to its creditors, commonly called as bail-in, made in order to cover losses or restore bank's equity is a precondition for bank resolution in the European Union (EU). The authorities cannot use public funds⁶, before the initial losses are covered by bank shareholders and creditors. Adopting the rule that, no creditor should be worse off than in liquidation (NCWOL), the BRRD ensures that no creditor incurs a loss greater than if the institutions had gone into liquidation. Bail-in facilitates both a smooth resolution process and its completion within a short time, which makes this mechanism popular among regulators. Moreover, bail-in incentivizes certain creditors to enhance their responsibility for the bank, thus

⁵ However, implementing this resolution framework efficiently requires that financial markets perceive it as credible. This credibility depends on predictability and the public acceptance of bail-in rules for creditors (priority and extent), prevention of contagion, and the feasibility of resolution in accordance with these rules. The feasibility of resolution is strictly connected with ensuring that financial institutions have sufficient loss-absorbing capacity (LAC) built up from equity, contingent convertibles (CoCos), and liabilities available for the bail in. Fear of contagion, a lack of public acceptance, and insufficient capacity by the bank to cover losses (or, alternatively, to restore equity) undermine the credibility of the resolution framework.

⁶ BRRD, Arts 44(5)&(7), 37(10)(a), Rec. 73.

reinforcing market discipline [Avgouleas and Goodhart 2015]. However, bail-in is not a tool without weaknesses. Some authors point out that in case of unexpected losses, the coverage of the losses in the bail-in process will encounter significant difficulties [Benink 2018; Bernard et al. 2017], and the only way to increase the bank's ability to absorb losses is to increase its capital buffers. In addition, charging the bank's creditors with insolvency costs increases the risk of contagion to other financial institutions, if the bank (the subject to the resolution) had liabilities to them. Bail-in without action to protect the rest of the financial system, in particular in the absence of public support (fiscal backstop), may cause creditors to run away from other banks. This may extend the disruption to the system as a whole, even if those banks manage to maintain sufficient debt levels to allow for full cancellation or conversion [Avgouleas and Goodhart 2015]. When considering the use of bail-in, it is necessary to pay attention to the structure of liabilities within a bank and in particular to differentiate them according to the creditor-bank relationship. In general, three types of bank creditors can be distinguished:

- depositors and entities using the bank's intermediation in the transfer of payments and custody services,
- counterparties in market operations, exchanges and clearing houses,
- holders of the bank's bonds and other forms of unguaranteed debt (including subordinated debt and contingent capital, i.e. debt instruments subject to conversion at an early stage of the bank's problems).

It may seem that only the bank's liabilities to the last group of creditors should be written off (or converted into capital) within the resolution process, but the scope of bail-in in the BRRD is wider and concerns all the bank liabilities that are not explicitly excluded⁷. In order to make the resolution effective the BRRD provides that banks must comply with a minimum requirement of own funds and liabilities eligible (contractually) to bail-in (MREL)⁸. However the Article 46(3)(c) gives resolution authorities the power to exclude (in exceptional circumstances) the liabilities of individuals (above the guarantee limit) and small and medium-sized enterprises. The main reason for leaving this possibility in the hands of national resolution authorities is the fear of contagion⁹. The optional exclusions leave an important discretionary power in the hand of a local resolution authority. That power may be used when exceptional circumstances occur, in

⁷ BRRD, Article 44(1).

⁸ The concern about the possibility of extending that scope during the resolution process may result in a withdrawal of funds from the bank and, as a consequence, the need for significant liquidity support for the bank during the resolution [Tröger 2017]. A consequence of the increased liability of creditors could therefore increase the cost of financing for banks and worsen conditions for borrowers.

⁹ BRRD, Article 46(3)(c), (d).

particular when the bail-in is not applicable within a reasonable timescale or there is concern that the bail-in may have negative impacts on the continuity of critical functions or may cause destruction in value or, finally, when there is a risk of generating widespread contagion which could cause serious disruption to the economy. The wider application of such an exemption allows for the protection of „vulnerable” segments of depositors with no guarantee. Such protection allows to strengthen the trust of these social groups both in the bank and in state institutions (supervision, resolution authority)¹⁰. In such a case bank’s losses must be transferred to other creditors, before the financial arrangements (the resolution fund) can provide a contribution to the bank in order to cover losses not absorbed through the bail-in. The BRRD allows, in such a case, for the use of financial arrangements only where bail-in has been applied to an amount of not less than 8% of the bank’s total liabilities (including own funds). Moreover, a cap on the use of the resolution fund is established, corresponding to 5% of the total liabilities of the bank under resolution. The scale of the bail-in required for a credible resolution is determined on the basis of a bank valuation. To ensure that authorities exercise these powers in ways those: reduce the risk of costs falling on the taxpayer, preserve value (where possible) and respect the property rights of affected shareholders and creditors, the BRRD requires independent valuations (3 types of valuation) carried out by independent experts. Those valuations are critical to resolution execution as far as the purposes of the resolution, selected tool and compliance with NCWOL rule are concerned [EBA 2019].

- Valuation 1 (prior to resolution): valuation required to inform the determination of whether the conditions for resolution or the write-down or conversion of capital instruments are met¹¹.
- Valuation 2 (prior to resolution): valuation required to inform the choice of resolution action to be adopted, the extent of any eventual write-down or conversion of capital instruments and other decisions on the implementation of resolution tools¹².
- Valuation 3 (after resolution): valuation required to determine whether an entity’s shareholders and/or creditors would have received better treatment if the entity had entered into normal insolvency proceedings and could therefore claim under the „no creditor worse off” rule¹³.

¹⁰ When announcing a policy of mandatory bail-in in case of bank failure, the authorities cannot ignore the consequences for bank financing and the functioning of the credit market. In other words, bail-in cannot be seen as a panacea for the problem of „banks too big to fail” and „too many to fail” and should be used together with other available tools, including the use of public funds (bail out).

¹¹ Under Article 36(4) of the BRRD.

¹² Ibid.

¹³ Under Article 74 of the BRRD.

In principle, the resolution process can start while the bank is still „technically solvent”¹⁴. The formal justification for such a decision before the NAV becomes negative (setting up the point of non-viability – PONV) may be the long-term inability of the bank to comply with prudential standards (e.g. capital requirement). An early decision increases the chances of a successful resolution and can therefore reduce uncertainty for the bank’s creditors and financial institutions and thus contribute positively to the stability of the financial sector [Dewatripont 2014]. However, such a decision should be the subject to claims by the bank’s existing shareholders, who may sue the supervisory authorities for deliberate action to take away the „solvent bank” and transfer it to new owners. For this reason, it is important to develop legal solutions that allow competent authorities to act in economically justified cases without having to wait for the technical insolvency of the bank.

2. THE PREVIOUS EXPERIENCE

According to the Single Resolution Board (SRB), the Directive’s regime has involved the resolution of four banks, based in different EU countries: Spain, Italy and Latvia¹⁵. However, given the size of these banks, their specificities and the resolution tools used, these cases are not a good benchmark. The resolution of PBS seems to be comparable to the cases of two savings banks (Andelskassen) in Denmark¹⁶ as well as to four small banks in Italy (Banca Marche, Banca Popolare dell’Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio di Chieti)¹⁷. In all those cases bridge banks (combined with bail-in) were selected as the appropriate resolution tools [Lintner and Lincoln 2016].

On 22 November 2015, Banca d’Italia as the Italian resolution authority and the Government of the Italian Republic decided to launch the resolution process in four banks: Banca Marche, Banca Popolare dell’Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio di Chieti. The market share of these four banks did not exceed 1% in loans and 2% in guaranteed deposits. Any of the four banks were split into a „good” bridge bank each and into one single „bad” bank. That „bad” bank was the vehicle set up for the transfer of all of the problem assets (especially NPLs) and liabilities. Please note that the application of the bail-in was not yet in force, since Italian government has tried to postpone the full entry into force of the bail-in provision in order to avoid mandatory write-off

¹⁴ NAV is still positive.

¹⁵ Banco Popular (Spain), Banca Popolare di Vicenza and Veneto Banca (Italy), ABLV (Latvia).

¹⁶ Resolution of Andelskassen took place in 2016 and 2018.

¹⁷ Resolution of four small Italian banks has been launched in November 2015.

subordinated bonds held by individuals¹⁸. In order to ensure that public funds are not (at least formally) used to cover losses incurred by these banks, the three largest Italian banks (Unicredit, Intesa and UBI), put in advance the money to the resolution fund¹⁹. The operation to resolve the four banks without a haircut to senior bondholders required the three biggest Italian banks to advance money to the resolution fund and was only possible because the small market share of the failing banks. The total contribution of the resolution fund [Banca d'Italia 2017] amounted to about 3.6 billion: (1.7 billion to absorb losses in the original banks, 1.8 billion to recapitalize the bridge banks and 140 million to inject the minimum capital in the bad bank). Those measures were designed to protect retail bond holders. For this purpose, the resolution fund supported by the money borrowed from the three biggest Italian banks was used in the manner that did not meet the target required under the BRRD. Although the protection of retail debt holders is not a resolution objective, unless regarded as a critical function, an exposure of such bank creditors to losses may have contagion effects (for example, resulting in a bank run) or be politically sensitive. In that case the Italian Government intentionally postponed the full implementation of the BRRD Directive and set up a resolution fund to absorb losses (at that time without the prior 8% bail-in requirement) by collecting ad hoc ex post bank contributions.

By October 5, 2015, the Danish Financial Supervisory Authority²⁰, acting also as the resolution authority concluded that attempts to meet the solvency requirement set out in the recovery plan had failed. The savings bank Andelskassen J.A.K Slagelse was likely to fail, and no alternative measures were available within a reasonable time to prevent the failure. The authority considered that the conditions for resolution were fulfilled, including that resolution was in the public interest, however resolution objectives were not clearly presented. The Danish resolution authority, determined that the resolution of then was in the public interest to allow its critical functions to continue, and protect depositors and client funds. A bridge bank²¹ has been established to take over ownership of the failing bank. The bridge bank was wholly owned and capitalized by the Danish financing arrangements (resolution fund). The authority decided to cancel all the contributed capital, write down relevant capital instruments and bail-in for loss absorption all the subordinated and certain senior bank liabilities. The same form of decision and the same measures were taken on September 13, 2018 with respect to Københavns Andelskasse. Both resolved entities were small local savings

¹⁸ The resolution process was carried out under intense scrutiny by the media, which placed negative emphasis on the banks and highlighted the issues affecting subordinated retail bondholders.

¹⁹ The resolution of the four banks was launched before full implementation of BRRD in Italy. That procedure could not be applied in case of PBS.

²⁰ Finansiel Stabilitet.

²¹ Broinstitut I A/S.

banks with the amount of total assets on the level of EUR 50 million (Andelskassen J.A.K Slagelse – DKK 306,41 million, and Københavns Andelskasse – DKK 411 million) with market share about 0.01% in the Danish banking sector. In contrast to the Italian case, the resolution of both banks in Denmark were arranged under the fully implemented BRRD but also conducted through the application of the bail-in tool in conjunction with the bridge bank tool. As a consequence, some of the unguaranteed deposits (senior debt) were written off.

Table 1. Comparison of the small, local banks resolved in the EU

Category	Banca delle Marche	Banca Popolare dell'Etruria e del Lazio	Cassa di Risparmio di Ferrara	Cassa di Risparmio della Provincia di Chieti	Andelskassen J.A.K. Slagelse	Københavns Andelskasse	Podkarpacki Bank Spółdzielczy w Sanku
1	2	3	4	5	6	7	8
The date of launching resolution	November 22, 2015	November 22, 2015	November 22, 2015	November 22, 2015	October 5, 2015	September 13, 2018	January 15, 2020
Total assets (EUR bn)	22.7	12.3	6.9	4.7	0.04	0.05	0.68
Loans (EUR bn)	17.3	6.1	4.6	2.1	0.02	0.02	0.32
Deposits (EUR bn)	7.2	6.4	3.4	2.5	0.03	0.04	0.62
Number of branches (EUR bn)	308	175	106		0	0	78
Market share (within the banking sector)	0.37%	0.33%	0.17%	0.13%	0.01%	0.01%	0.18%
Market share (among cooperative banks)	n/a	n/a	n/a	n/a	1.93%	2.42%	2.2%
The resolution regime	pre-BRRD	pre-BRRD	pre-BRRD	pre-BRRD	full-BRRD	full-BRRD	full-BRRD

1	2	3	4	5	6	7	8
The objection	Protection of all senior creditors and individuals holding subordinated debt	Protection of all senior creditors and individuals holding subordinated debt	Protection of all senior creditors and individuals holding subordinated debt	Protection of all senior creditors and individuals holding subordinated debt	Not clearly stated*.	Not clearly stated.	Continuation of the critical function – servicing local government units
The tool	a bridge bank combined with bail-in and a bad bank	a bridge bank combined with bail-in and a bad bank	a bridge bank combined with bail-in and a bad bank	a bridge bank combined with bail-in and a bad bank	a bridge bank combined with bail-in	a bridge bank combined with bail-in	a bridge bank combined with bail-in and a bad bank
The scale of bail-in	Write-off capital owners and subordinated creditors (individuals, who held subordinated bonds were fully compensated)	Write-off capital owners and subordinated creditors (individuals, who held subordinated bonds were fully compensated)	Write-off capital owners and subordinated creditors (individuals, who held subordinated bonds were fully compensated)	Write-off capital owners and subordinated creditors (individuals, who held subordinated bonds were fully compensated)	Write-off capital owners and full bail-in to subordinated and senior creditors (including not-covered deposits and DGS)	Write off capital owners, and full bail-in of subordinated and senior creditors (including not-covered deposits and DGS)	Write-off capital owners, and full bail-in to subordinated and partial (43%) of senior creditors
The use of financial arrangements	Capitalization of the bridge and the bad bank as well as partial covering losses	Capitalization of the bridge and the bad bank as well as partial covering losses	Capitalization of the bridge and the bad bank as well as partial covering losses	Capitalization of the bridge and the bad bank as well as partial covering losses	Capitalization of the bridge bank	Capitalization of the bridge bank	Capitalization of the bridge and the bad bank
Remarks					Some creditors received compensation under the NCWOL principle		

* Notwithstanding the bank's small relative size, the Finansielt Stabilitet, as the Danish resolution authority, determined that the resolution of the bank was in the public interest to allow its critical functions to continue, which will not be met if the Institution is subject to bankruptcy proceedings.

Source: Author's elaboration based on Banca d'Italia, 2017; BFG, 2020; Finansielt Stabilitet, 2015; 2018.

3. THE RESOLUTION OF THE PBS

3.1. The background

In recent years, Podkarpacki Bank Spółdzielczy w Sanoku (PBS) was the second largest cooperative bank in Poland. At end-June, 2019, its total assets were equal PLN 2.8 billion. The Bank operated in the Podkarpackie Province through a network of 78 bank outlets. The Bank did not belong to any association of cooperative banks and was not a member of the institutional protection system (IPS). The roots of the bank date back to 1871. On 9 April 1871, the District Advance Society in Sanok was established under the Act on Cooperatives. The bank was established in its current form in 1997 through the merger of local smaller cooperative banks. In 2000, the Cooperative Bank in Sanok changed its name to – Podkarpacki Bank Spółdzielczy in Sanok. The Bank's offer included a full range of services: accounts, card loans payment insurance and capital funds. The Bank's clients were farmers individual small and medium-sized enterprises as well as large enterprises and local governments. The Bank built the image of an institution very positively assessed by customers, which was to be proved by numerous awards and distinctions it won. Moreover, the bank was very innovative by introducing modern technologies to the cooperative sector, including: biometric ATMs, mobile applications and coin-operated cash machines. In the annual report for 2015, the bank reported a net profit of PLN 30 million (despite the worsening financial condition), thanks to an unusual operation. It consisted in transferring the trademark to a subsidiary and granted it the right to use it, and then started using the trademark on the basis of an operating lease agreement. This allowed, as noted by the auditor examining the bank's report, to show a profit of PLN 47.4 million on this operation but at the beginning of July 2016, the bank published an adjustment to the annual report (carried out at the request of the Polish Financial Supervision Authority), which changed the manner of recognising the impact of the mark's valuation on the results and created additional provisions for credit exposures and write-downs on the value of financial fixed assets, which had a negative impact on the balance of provisions. As a result, the bank reported a loss of PLN 48.3 million for 2015 and was obliged by the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego – KNF) to work out and implement the recovery plan²².

²² On 7 October, 2016, the KNF approved the recovery plan of Podkarpacki Bank Spółdzielczy for the years 2016 to 2020, submitted by the bank on 19 September 2016.

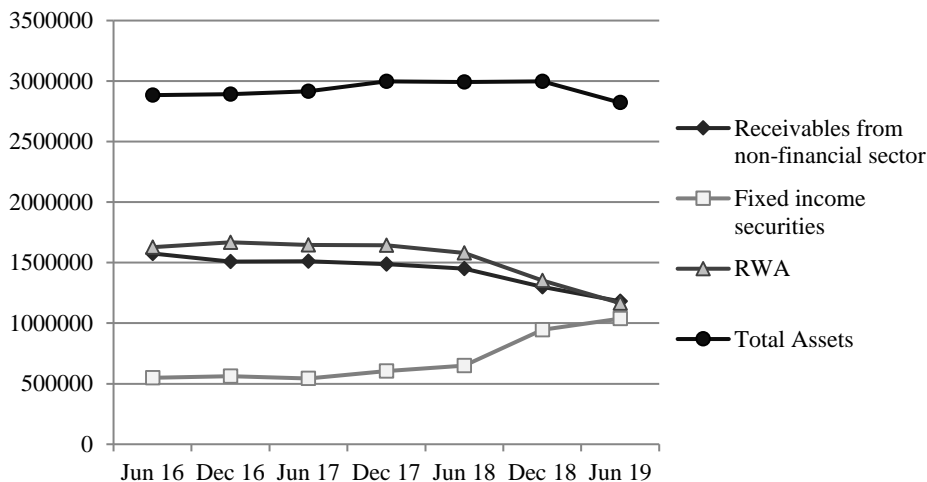


Figure 1. Selected asset categories (PLN thousand)

Source: Author's calculations based on PBS, 2016a; 2016b; 2017a; 2017b; 2017c; 2018a; 2018b; 2019a.

On 10 March 2017 the bank submitted a membership declaration to the Institutional Protection System (IPS), established by the Bank Polskiej Spółdzielczosci Group (BPS), on joining this Cooperative, and also a declaration with attachments, on expressing willingness to join the IPS. By the letter dated 4 September 2017, but the Management Board of the Cooperative refused to give the consent to the accession. Since mid-2017, bank's capital adequacy ratios have been systematically decreasing and according to the data at the end of 2018, the bank no longer met the supervisory standards. In the first half of 2019, its financial condition deteriorated dramatically. The main reason for the rapid decrease in capitals was the loss from previous years. In the amendment to the financial report [PBS 2019b] the bank stated that as a consequence of the current capital situation of the bank, the KNF may apply measures implying the possibility for the Bank Guarantee Fund to launch resolution²³.

²³ Explanation of why market discipline proved to be ineffective in this case and unguaranteed deposits remaining in the bank will be the subject of a separate article.

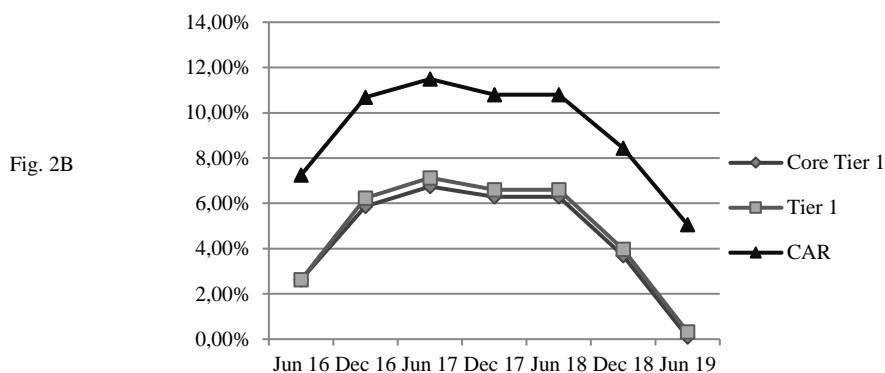
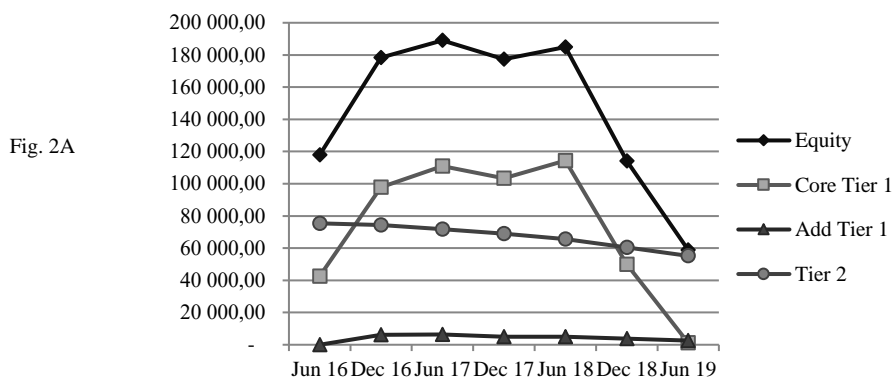


Figure 2. Capital components (Fig. 2A, in PLN thousand) and capital adequacy ratio (Fig. 2B)

Source: Author's calculations based on PBS, 2016a; 2016b; 2017a; 2017b; 2017c; 2018a; 2018b; 2019a.

3.2. The resolution process

During the preparative stage, the BFG carried out an initial valuation (Valuation 1) determining the preliminary difference in the value of the transferred assets and liabilities (the preliminary funding gap) based on limited, supervisory data published ones. This valuation prepared by an independent expert (Pricewaterhousecoopers Polska sp. z o.o. – PwC) as at 28 February 2020 presented a much worse picture of the bank, with a negative capital value of PLN –52 million.

The BFG considered that the PBS was threatened with bankruptcy and conditions for resolution were fulfilled, including that resolution was in the public interest. On 15 January 2020 the BFG made a decision to launch the resolution. According to that decision there were no indications that possible supervisory or the PBS actions would remove the risk of bankruptcy in due course. The BFG considered that the protection of liabilities to the local governments is in the public interest and in consequence is the objective to launch the resolution. All functions of the bank were suspended on January 17th and resumed on January 21st by the bridge bank²⁴ to which a major part of the PBS has been transferred. Based on the interim valuation (Valuation 2), also prepared by the PwC as the disposal value, the NAV was equal about PLN –180 million (finally –182.8 PLN million). The BFG decided to cancel all contributed capital, write down relevant capital instruments and apply bail-in to all the subordinated liabilities and certain non-subordinated debt (including uninsured deposits) – in the part resulting from the ratio of the estimated amount of negative equity of PLN 182.8 million less the amount of capital instruments and subordinated bonds.

The range of the bail-in was as follows:

- member shares and subordinated bonds in full,
- non-capitalised interest on amounts of funds exceeding the guarantee limit – in full,
- uninsured deposits (local government units, small and medium enterprises and other entities) – partial (42.57%).

For the purpose of verifying the NCWOL principle, a preliminary simulation of the insolvency scenario was also conducted. The difference between the losses under resolution (Valuation 2) and the hypothetical insolvency losses were calculated with PLN 413 million which means that the losses (estimated by the external expert PwC) would be about 125 % higher under hypothetical liquidation.

The application of the bridge bank in the resolution process required the use of public funds due to the need to set up its capital. Pursuant to Article 274(1)(2) of the BFG Act, BFG support cannot exceed 5% of bank's total liabilities and equities i.e. PLN 141 million. Moreover, pursuant to Article 44(4)(a) and 44(5)(a) BRRD and Article 274(1)(1) of the BFG act, in the case of discretionary exclusions of selected classes of creditors from write-offs/conversions, the use of public funds requires the write-off/conversion of 8% of the bank's own funds and liabilities i.e. PLN 227 million. The latter rule had a very serious impact on the resolution process and the bail-in scale of certain groups of depositors, which will be discussed later on. As in previous cases, the resolution tool was a bridge bank in combination with a partial bail-in. However, unlike in the Italian case, the liabilities to subordinated bond holders, including individuals, were written off in full.

²⁴ Bank Nowy BFG SA.

Table 2. Comparison of the balance sheet items (provided by bank and results of PwC valuations) as at February 28th 2020 (PLN million)

Specification	Data provided by the bank	Valuation 1	Valuation 2
Cash	66.6	66.6	65.6
Receivables from the Central Bank	212.1	212.1	208.6
Receivables from financial sector	160.7	157.3	154.8
Receivables from non-financial sector	1277.4	1209.0	1159.4
Receivables from government and local government entities	57.2	57.2	55.0
Securities	111.9	997.6	989.5
Fixed assets	61.1	67.6	55.7
Other assets	57.3	69.7	24.5
Total assets	2904.3	2037.1	2713.0
Liabilities to the Central Bank	0.0	0.0	0.0
Liabilities to financial sector	1.6	1.6	1.6
Liabilities to non-financial sector	2541.1	2541.1	2540.1
Liabilities to government and local government entities	203.7	203.7	203.7
Own issued securities	100.7	100.3	100.3
Other liabilities	38.0	38.0	23.6
Provisions	2.5	4.6	1.2
Equity	16.8	-52.1	-179.9
Total liabilities and equities	2904.3	2837.1	2 713.0

Source: BFG, 2020.

The three largest components of the PBS deposit base (representing a total of more than 90 % – see Figure 3) were deposits from individuals (virtually entirely excluded from bail-in), deposits from private companies and cooperatives and deposits from local governments and their units. It is worth recalling that the resolution objective was considering the service of local governments and their units as the critical function of the bank, due to the high value of deposits belonging to those entities. In this situation, it seemed natural to exclude these deposits from bail-in, under Article 46(3)(c) of BRRD. At that time, however, under Article 44(4)(a) and 44(5)(a) BRRD, the bail-in of the remaining available liabilities at 8% of the bank's total liabilities and own funds is a condition for using the bridging bank with capital from public funds.

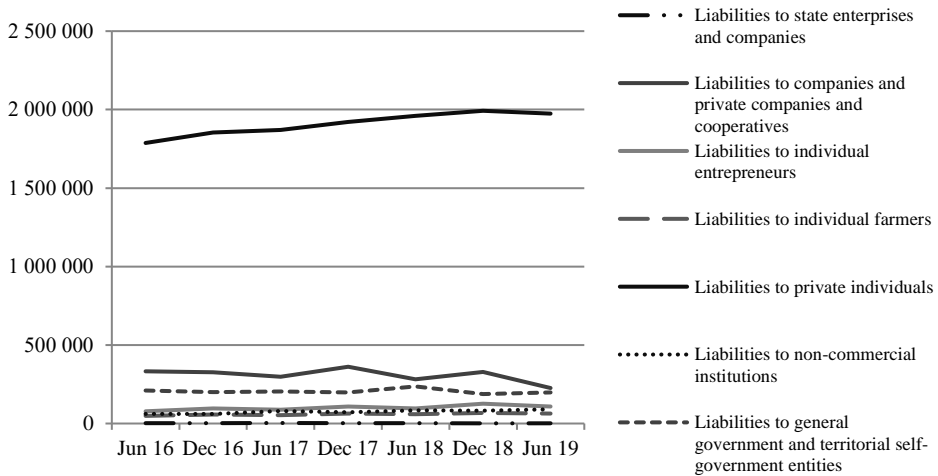


Figure 3. The deposit base (PLN thousand)

Source: Author's calculations based on PBS, 2016a; 2016b; 2017a; 2017b; 2017c; 2018a; 2018b; 2019a.

According to the information provided by the BFG [2020], that would force the write off all deposits from small and medium enterprises as well as from individuals (above guaranteed amount) for the total amount of 80 min PLN. It is highly probable that companies whose accounts would have been completely written off would have suffered a significant loss and, in addition, would have problems with liquidity, loan repayments and payment handling. This would have a strong negative impact on the region's economy. It would be also difficult to reconcile those measures with the NCWOL principle. It cannot be omitted that the loss of all funds deposited in the bank by enterprises, while fully protecting the deposits of local government units would be socially unacceptable. However in the context of the last conclusion, it is still possible to justify the adopted resolution objective. Considering that:

- in the absence of an entity willing to purchase PBS, the bridge bank combined with bail-in allowed for credible resolution using a bridge bank,
- the write-off of local government funds was aimed at reducing the scale of bail-in (both in full and in relation to the bank's other creditors)²⁵,
- the used funds from the from the financial arrangements (for the purpose of capitalisation of the bridge bank) will be returned after an unforced sale of the bridge bank's assets,

²⁵ Owners of a cooperative bank and subordinated bond holders (including individuals) lose all their investments. The other bank's creditors have been treated equally, whoever they are.

- a potential subsidy for local governments²⁶ from the state budget may significantly compensate for the losses incurred by local governments, leaving the state budget formally outside the formal support of the resolution,

it seems to make it likely that (as in the case of four small Italian banks and partially in case of Andelkassen), the Polish RA found a certain compromise that may be socially acceptable, by intentional bending the provisions of the BRRD, leading up to a hidden bailout by the state treasury. Apart from subordinated bonds, the bank had no other liabilities, contractually eligible for bail-in. It is likely that if 8 % of the total amount of the bank's liabilities had not had to be written off, the bail-in range applied by RA would have been significantly lower. All the cases compared indicate a discrepancy between the BRRD framework and the optimal (according to the national authority) way for a resolution of a small bank. Moreover, in each of these cases, the BRRD records were bent to justify a resolution of a very small bank (Denmark) or a reduction in bail-in (Italy, Poland). This calls for consideration to be given to whether the BRRD in its current form really facilitates the handling of all cases of failing banks. However, any protest by local governments or other creditors of the bank should lead to a formal reduction of the bail-in scale. A change in the adopted rules as a result of pressure from creditor groups may undermine the credibility of this tool in the future. The effectiveness of bail-in will collapse if creditors are able to force state intervention. Therefore, the determination of state authorities to resist this pressure is necessary [Stopczyński 2020].

3.3. Consequences and controversy

The resolution of the PBS aroused a lot of controversy and questions about the consequences of this decision. The author limited the discussion in this publication to issues closely related to the thesis presented in this article: the moment the resolution was launched, the used tool and, the problem of individuals as subordinated bonds holders.

The value of the bank's NAV calculated as at 28 February 2019 on the basis of data provided by the bank (not to mention Valuation 1) amounted to PLN 16.9 million (see Table 1) is significantly lower than that presented in the bank's financial statements for 2018 (PLN 114 million) and for the first half of 2019 (PLN 59 million). This immediately raises the question of how the KNF assessed the bank's situation at the time and why it did not decide to launch the resolution

²⁶ In practice, however, this means unequal treatment of clients, as other entities cannot count on such a refund: individuals, companies and, for example, which in some sense also have public funds at their disposal (collected for church renovation).

earlier²⁷. In the period preceding the resolution, the bank was very active in sponsoring cultural and sports events in the region. The bank's management had to be aware of the actual financial condition of the bank, and such behaviour has the characteristics of siphoning money out of the bank. Representatives of local governments complained about the moment of launching the resolution [Nowiny 2020]. In their opinion, in January 2020 their account balances were higher than in December 2019. The truthfulness of this information would be a significant argument for the thesis adopted by the author.

The key objectives of a bridge bank are to maintain critical financial services, ensure deposits are protected, and continue operations that are important for financial stability, minimizing disruption to the financial system [Sarra 2018]. Good practice dictates that a bridge transaction be utilized rarely and only as a short term measure to a pre-planned permanent solution for the troubled bank. In some jurisdictions the bridge bank option is reserved for systemically important banks [McGuire 2012]. In this context, the choice of a bridge bank as a resolution tool for small banks is somewhat surprising, but the previous experience in EU shows that a bridge bank has been predominantly used as the resolution tool, especially in case of small banks. It indicates, the difficulty in finding an entity willing to take over the bank in its entirety or even after partial bail-in. On the other hand, recapitalisation or liquidation would lead to significantly higher costs²⁸. The use of a bridge bank requires less bail-in compared to a recapitalisation and allows for an earlier use of public funds²⁹. The financial arrangements are used here to create the bridge bank capital and are expected to be returned after the end of its operations. In addition, full ownership control by the state institutions provides a greater guarantee of the bank's survival than when existing creditors become bank's owners (not necessarily willing or prepared to do so). It seems also probable that the central bank will be more willing to provide liquidity support to an entity belonging to a safety net institution than to a private acquiring entity³⁰.

The data presented by the internet services [www1; www2] indicate that 10.6 million of the subordinated bonds issued by the bank were in the portfolios of assets

²⁷ Crucial is the answer to the question whether the sharp deterioration of the bank's condition actually took place in the first half of the year or whether it was only a matter of making corrections to earlier unreliable accounting records.

²⁸ Recapitalisation might be difficult from the legal point of view because of the need to transform the cooperative bank into a commercial bank.

²⁹ In the absence of any potential buyers of a failing bank (wholly or partly), the RA will choose between recapitalisation and the bridge bank. The lack of an adequate amount of liabilities eligible for write-offs or conversions to capital (MREL) is likely to impose a deep bail-in to non-guaranteed deposits.

³⁰ The establishment by the BFG of two other banks, predestined to play the role of bridge banks in resolution processes may indicate that the bridge bank will become the primary resolution tool in Poland.

of open-ended investment funds, of which 3.7 million in the BPS Towarzystwo Funduszy Inwestycyjnych S.A (BPS TFI) funds³¹. Although the write-off these bonds, and consequently incurring a loss by holders (or holders of TFI participation units) seems indisputable³², it is worth posing the question whether offering such bonds to individuals was not a misselling. At present, the contagion effect in the form of lower prices of subordinated bonds issued by other cooperative banks should also be taken into account.

One of the most important is the problem of market discipline and in particular the impact of its increase (by sensitizing market participants to the situation of banks in a weaker financial condition) on the credibility of bank resolutions in the future. In the author's opinion this subject deserves a separate publication.

CONCLUSIONS AND POLICY IMPLICATIONS

One month after the launch of the PBS resolution, it is not yet possible to fully assess this process and its effects. In particular, the identification of possible contagion scale requires more time and data from other entities. However, a preliminary assessment of the presence of the public interest and the resolution mechanism used may be provided. As in Italy and Denmark, the real justification for a resolution such a small bank is to limit the losses of the bank's clients that they would suffer in the event of its bankruptcy, but the protection of retail debt holders is not a resolution objective, unless regarded as a critical function. It is likely that for this reason the formal justification is the continuation of the service of local government units, considered a critical function of the bank.

The information presented by the BFG [2020] indicates that the decision to launch resolution was made too late (what raises the issue of setting up PONV triggers by the authorities) and the process of making this decision by supervisory authority was not transparent. Actions taken sufficiently early and can ensure the continuity of critical functions, while minimizing the impact of an institution's failure on the economy and wider financial system. The information presented by the KNF [2020] is very poor and does not allow to verify which factor decided to consider that possible supervisory activities were exhausted.

The rationale for choosing bridge bank combined with the partial bail-in as the resolution tool seems to have the same basis as in other cases. The resolution authority seeks to use the resolution fund as early as possible, hoping that the unforced future sale will allow the recovery of the fund and possibly partial

³¹ BPS Towarzystwo Funduszy Inwestycyjnych SA is part of the BPS Group, the largest association of Cooperative Banks in Poland. Bank Polskiej Spółdzielczości SA is 100% shareholder.

³² However some investors were probably largely unaware of the true risk associated with these products, not even being aware of their bondholder status.

recompense of the creditors whose liabilities have been written off. In this context, the bail-in of deposits from local government units has served as an instrument to protect other creditors of the bank from excessive losses. However, the reaction of the local governments indicates that they were unaware of the role assigned to them. It is not excluded that their losses will be compensated by the State budget (in the manner that does not allow to recognize a direct link with PBS resolution).

The concept of bank resolution was designed as an attempt to find an antidote to the Too Big To Fail bank problem. This concept was later extended as a way of dealing with all failing banks. The previous cases of resolution of small banks in the EU indicate that national resolution authorities, fearing the effects of a potential contagion (or protecting the finances of the local community), see the need to avoid the bankruptcy of small, local banks, and made a decision to trigger resolution when such banks become insolvent. At the same time, resolution authorities seek to limit the scope for bail-in and try to use the financial arrangements (resolution fund), facing the dilemma of following the BRRD provisions or bending the rigid rules of the Directive to use public funds at an early stage. In this context the resolution of PBS seems to be credible however not an example of good practice described by BRRD and other EU regulations³³. It is rather an illustration of bending existing regulations in order to resolve banks in a socially accepted manner. This raises the issue whether the current regulations are not too rigid and may in the future impose ineffective or socially unacceptable solutions and the need of empirically monitoring bail-in, and more general, the application of the BRRD.

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³³ On the basis of these regulations, we are still in a transitional period and it is only when banks have sufficient loss absorbing capacity (sufficient amount of liabilities contractually eligible for bail-in) that the uncertainties with regard to the potential bail-in scale will be removed. On the other hand the evidence of „unusual cases” shows the necessity to introduce other measures to deal with the failing banks and practical challenges encountered when applying bail-in.

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