A EUROPEAN FRAMEWORK FOR BANK RECOVERY AND RESOLUTION

Silvia Scatizzi
Legal officer - Unit Financial Stability
European Commission

BASILEA 3 - RISK & SUPERVISION 2014-
Roma 16-17 June 2014

Disclaimer: this presentation only reflects the views of its author. It does not present an official position of the European Commission

Recall – Why we need a resolution framework

€ 591.9 billion (4.6 % of EU 2012 GDP) = aid used for capital support between 2008-2012. Guarantees and other form of liquidity supports peaked in 2009 at € 906 billion (7.7 % of EU 2012 GDP)

EU banking sector is highly integrated, but systems to deal with bank crises have been national

Many national legal systems are inadequate for winding down banks in a way to preserve financial stability and protect taxpayers' money. Lack of suitable procedures for cross-border situations.

EU framework required to ensure effectiveness and coherence in how MS deal with failing banks, in particular cross-border; to strengthen the single market

BRRD's objectives

- **Maintain financial stability** by ensuring the continuity of critical banking functions which are in the public interest
- **Minimise costs for taxpayers** and ensure losses borne by bank shareholders and creditors – legal certainty
- **Avoid disorderly insolvency** (e.g. Lehman Brothers)
- Implement the G20 endorsed **FSB key attributes** to effective resolution regimes within the EU

BRRD's main features

- Provide supervisors and resolution authorities with:
  - tools to **strengthen their grasp of the structure of all banks** operating within their jurisdictions
  - ability to **plan and respond to the failure of these banks**, including where necessary making structural, operational and legal changes
  - powers to **return a bank in financial distress back to viability**
  - ability, where in the ***public interest*** to do so, to **resolve a non-viable bank** with credible and effective tools
- **Cross-border cooperation and coordination**: resolution colleges, strong role for EBA & third country arrangements
- **Financing arrangements** to facilitate a resolution

19 months of negotiations...delicate balances

- Treatment of **home and host** authorities when agreeing actions relating to planning, prevention, intervention and resolution of banks operating cross-border
- Possibility of **precautionary recapitalisation of solvent banks**
- Developing parameters of a **credible and usable bail-in tool: protecting public funds**, while minimising the risk of contagion and providing adequate safeguards to those affected during the use of the tool
- Securing sufficient commitments to ensure that **industry finances resolution**

What was achieved: a comprehensive and flexible framework

- **Scope**: all banks and large investment firms
- **Comprehensive**: 4 pillars
  - *Planning & prevention* – banks and authorities to anticipate problems before they occur
  - *Early intervention* – authorities to act before problems compromise bank's viability
  - *Resolution* – authorities to restructure failing banks and preserve critical functions through the use of 4 main tools & financing means to facilitate resolutions
  - *Cooperation and coordination* – within the EU & with third countries
- **Flexibility**: national resolution authorities to use a range of tools and powers in a proportionate manner based on an institution's business model, risk and size and different type of crises.

Planning and Prevention

Business as usual | Financial distress | Failing or likely to fail

- **Recovery plans**: banks outline viable options and realistic timeframes to overcome financial distress and regain long-term viability
- **Resolution plans**: authorities to split up entities and secure continuity of critical functions
- **Resolvability assessments**: removal of any significant impediments (including legal or operational) to resolution
- Removing barriers for **intra-group financial support**: group entities can enter into agreements with each other to provide financial support should one party face financial distress

Planning and Prevention

Business as usual | Financial distress | Failing or likely to fail

- **Precautionary recapitalisation**: a solvent bank receiving public injections of capital to address weaknesses identified by stress tests and severe disturbances in funding conditions will not trigger a resolution of the bank
- This use of public funds will be **subject to State aid rules** and will be **reviewed in 2016**

Early Intervention

Business as usual → Financial distress → Failing or likely to fail

- A bank breaches any prudential requirement, authorities can:
  - require an **action program** and a timetable for its implementation
  - require the management to convene, or convene directly, the **shareholders' meeting**, to adopt vital decisions
  - require the institution to draw up a **plan for restructuring of debt with its creditors**
  - appoint a **temporary administrator** to restore the financial situation, stop mismanagement and avoid further decline e.g. by implementing the recovery plan or preparing the institution for resolution

European Commission

Resolution: trigger

Business as usual → Financial distress → Failing or likely to fail

- Authorities determine:
  - the bank is **failing or likely to fail** because it is or will in the near future no longer be viable or solvent
  - there is <u>no</u> reasonable prospect that any **alternative private sector or supervisory action** would prevent the failure within reasonable timeframe
  - resolution is necessary in the **public interest** to preserve financial stability
- Authorities need to balance between public and private interests, as well as financial stability and the rights of bank shareholders & creditors

Resolution – Four main tools

Business as usual | Financial distress | Failing or likely to fail

1. **Sale of business** : total or partial sale to another commercial entity
2. **Bridge bank** : transfer all or part of the business to a publicly controlled temporary entity
3. **Asset separation** : transfer of assets whose liquidation could cause market disruption to an asset management vehicle
4. **Bail-in:** write-down or conversion of liabilities to absorb losses

Effective bail-in tool: purpose

- **Recapitalise and restructure a failing institution, by writing down or converting the failed bank's liabilities**, increasing the options for authorities to respond to failure of large, complex financial institutions
- **Set-up a new institution** (e.g. a bridge bank) to harbour essential functions by capitalising it via converting the claims of transferred creditors to equity
- But **should not be used to recapitalise inefficient banks** at the cost of debt-holders but to maintain essential functions

Effective bail-in tool: scope and features

- **Powers to write down claims of unsecured creditors** of a failing institution and/or convert debt claims to equity
- **Exempted liabilities** include: those backed by assets or collateral, covered deposits, client assets, short-term debt (<7 days), or liabilities such as salaries or taxes
- **Follows hierarchy of claims** according to seniority - equity, then equity-like and convertible instruments, subordinated debt, and finally senior debt
- **Deposit Guarantee Scheme** to contribute but ***as a preferred creditor*** for the amount of losses that it would have had to bear if the institution had been wound up under normal insolvency proceedings
- All banks need to hold sufficient "bail-in-able" liabilities, to be determined by authorities, to ensure effectiveness of the tool

European Commission

Bail-in: thresholds during normal bank failure

3. Alternative financing sources

Only after 5% of the financing arrangement's cap has been reached, and all unsecured and non-preferred liabilities other than eligible deposits have been bail-in

2. 5% Resolution financing arrangement

Resolution financing arrangement may provide loss absorption or capital injection of up to 5% of total liabilities

1. 8% internal loss absorbtion

8% of total liabilities or 20% of RWAs to be absorbed by shareholders and creditors before the use of the resolution financing arrangement

DGS (covered deposits)	**More bail-in or eventually alternative financing sources (private, public/ ESM)**
Households, micro, SMEs > €100,000	
Senior debt & corporate deposits >100,000	**Resolution financing arrangement 5% of liabilities**
Subordinated debt	**Internal absorbtion 8% of liabilities or 20% of RWAs (in order of hierarchy)***
AT1 & T2	
CET1	

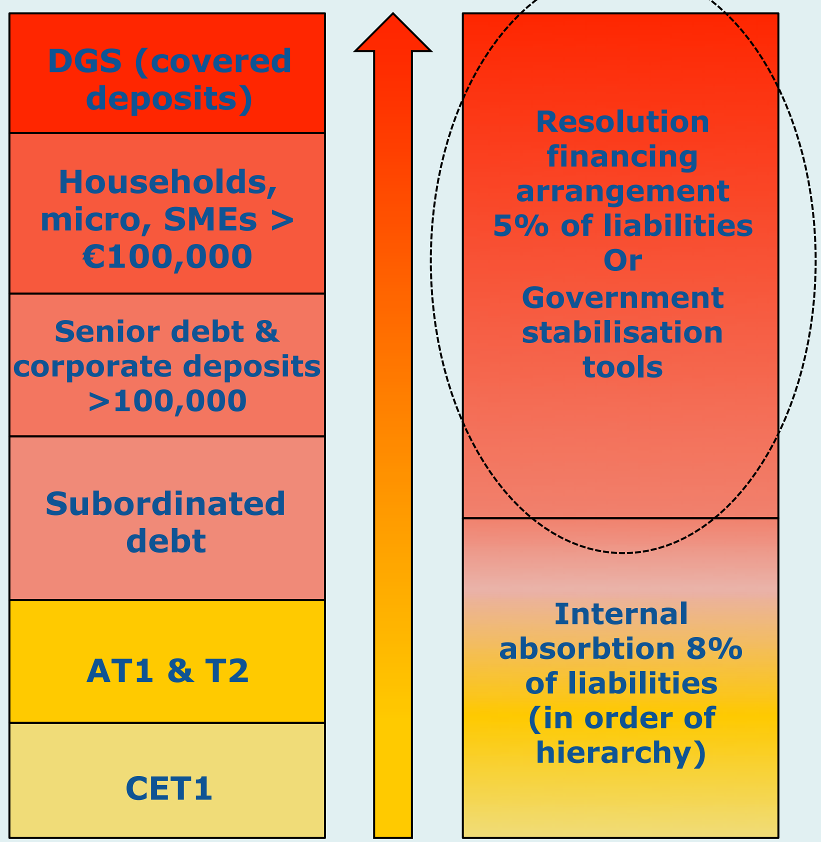
* Flexibility to depart from creditor hierarchy if not possible to bail-in the liability during the timeframe, would create contagion risks, lead to destruction in value, necessary to ensure continuity of critical functions.

Bail-in: thresholds during a systemic crisis

3. Alternative financing sources — Government stabilisation tools with Commission approval

2. 5% Resolution financing arrangement — Resolution financing arrangement may provide loss absorption or capital injection of up to 5% of total liabilities

1. 8% internal loss absorbtion — 8% of total liabilities to be absorbed by shareholders and creditors before the use of the resolution financing arrangement



* Flexibility to depart from creditor hierarchy if not possible to bail-in the liability during the timeframe, would create contagion risks, lead to destruction in value, necessary to ensure continuity of critical functions.

Resolution financing arrangements

- Short-term financial assistance **from industry contributions** to **ensure successful outcome to resolution**- i.e. guarantees, loans, payment of compensation, loss absorbency in conjunction with bail-in.
- Overall **target level** of 1% of covered deposits within10 years
- Risk adjusted **ex-ante contributions** and ability to raise **ex-post contributions.**
- MS can **operate the fund through a system of bank levies.**
- **DGS**, which are now **preferred** in the hierarchy, can contribute up to the amount they would have contributed in insolvency and up to 50% of the fund's target level.

Resolution financing arrangements

- A bail-in of 8% of total liabilities is the condition for the use of the financing arrangements.
- **8% bail-in** of total liabilities **is substantial** compared to the losses banks faced in the crisis.
- Between 2008 and 2010 only one bank's losses exceeded 8%, the average for all other banks was slightly less than 3%.

Treatment of deposits

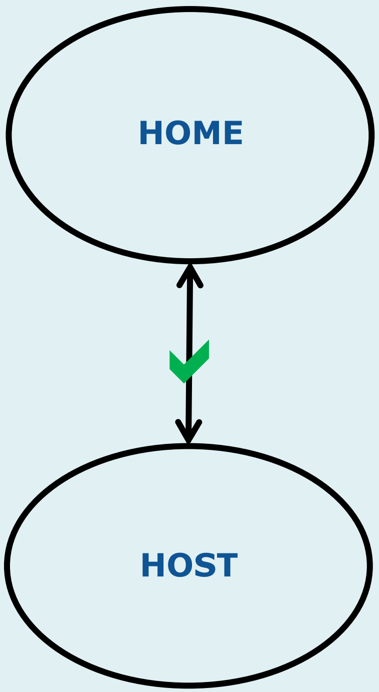
- **Creditor hierarchy**:
  - *eligible deposits* of households and micro, small and medium enterprises to be preferred
  - *deposits covered* by a deposit guarantee scheme (DGS) (i.e. those up to €100,000) to be super-preferred
- **Bail-in** – should authorities, for loss absorbency purposes, bail-in depositors:
  - *covered deposits* will not be affected, as exempted from bail-in and the DGS will step in their shoes
  - *eligible deposits* of those mentioned above, unlikely to be affected as the resolution fund can step in their shoes provided 8% of liabilities of the failed bank have absorbed losses

European Commission

Cross-border cooperation: within the EU

- Establishment of **resolution colleges** to facilitate cooperation and coordination amongst authorities for banks that operate cross-border
- Framework to come to **joint decisions** throughout the BRRD from a group perspective
- **EBA to mediate** should authorities not come to a joint decision in matters in line with CRD/R (mainly capital and liquidity), but not regarding resolution due to urgency, possible fiscal consequences
- Detailed **principles on cross-border resolution :**
  - cooperation and coordination
  - transparent, efficient and timely action
  - assessment of impact on financial stability, fiscal resources, resolution fund and DGS of affected Member States

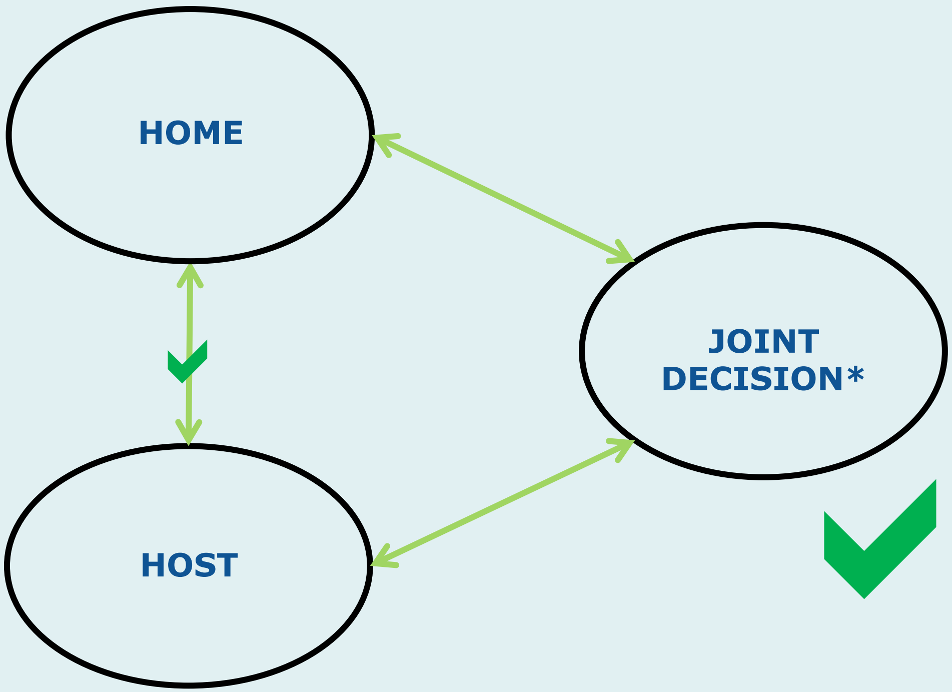
Joint decision making process



Provisions relating to:

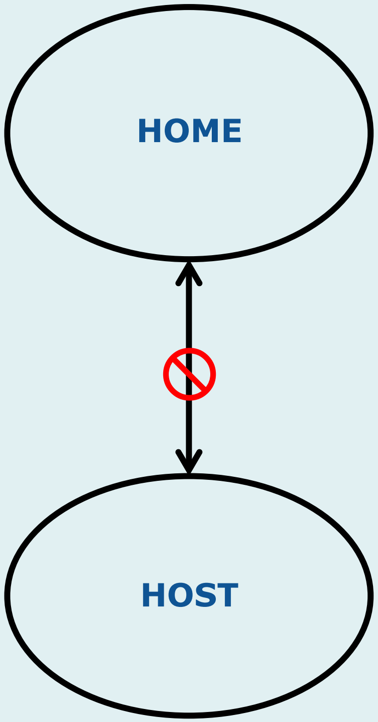
- Group recovery plans (A 8)
- Group resolution plans (A 12)
- Removing impediments to resolution in groups (A 15)
- Reviewing intra-group financial support arrangements (A 19)
- Use of early intervention measures (A 25)
- MREL at consolidated basis (A 39)
- Resolution (A 83 & A 83a)

Joint decision making process



* EBA may facilitate a joint decision through the process of EBA non-binding mediation

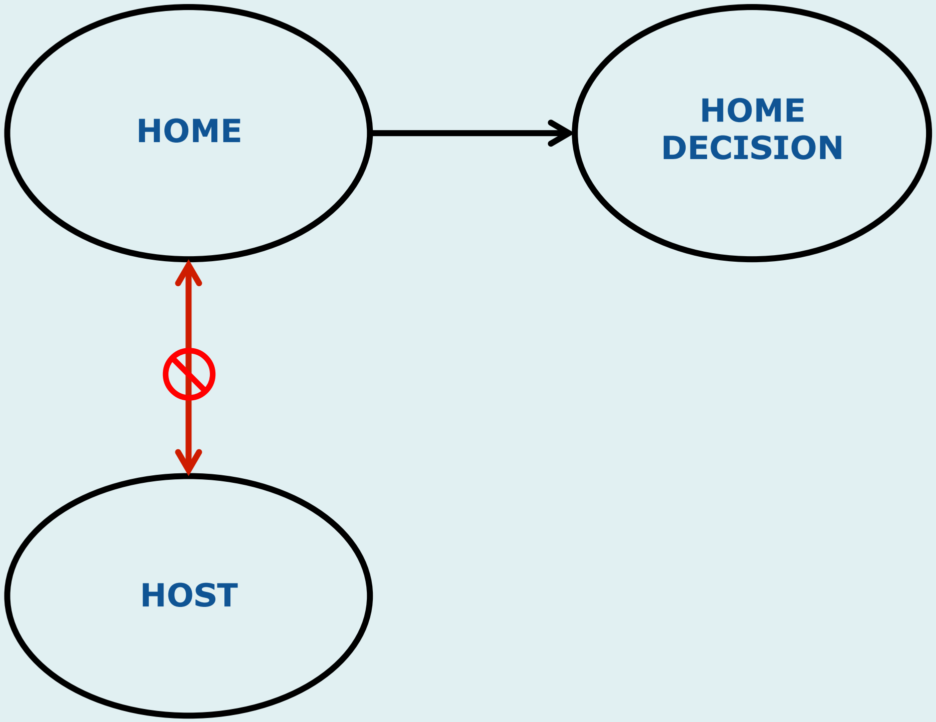
No joint agreement – role of EBA



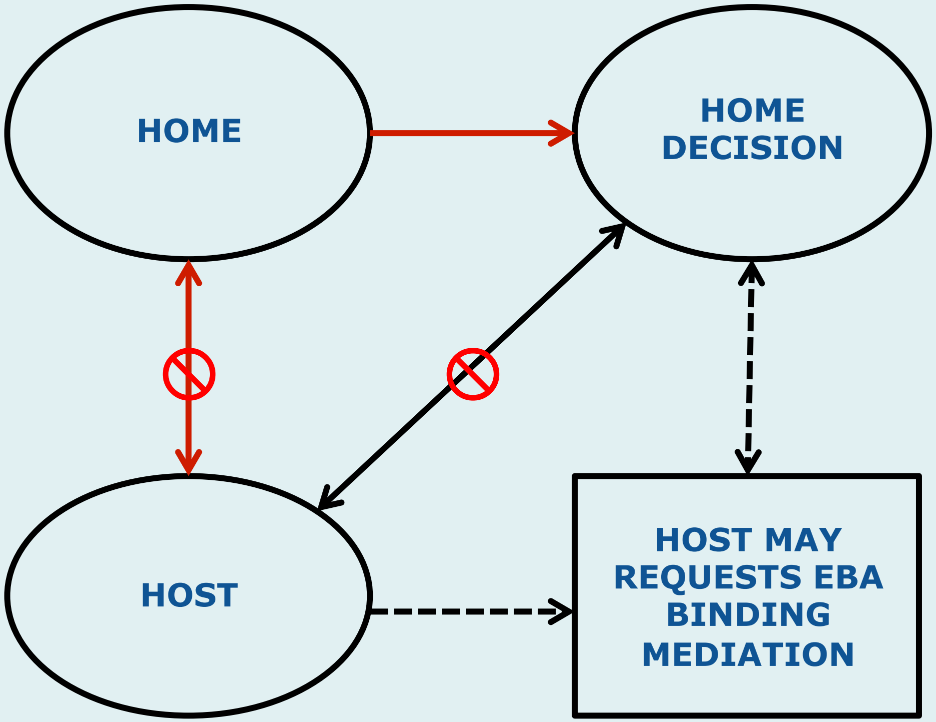
At the request of the relevant authority, EBA may mediate and provide a binding outcome in relation to:

- Recovery plans A6(4)(a), (b) or (d)
- Resolution plans – areas that have no impingement on MS fiscal responsibility
- Removing impediments to resolution A14(4)(g), (h) or (j)
- Reviewing intra-group financial support arrangements
- Use of early intervention measures A23(1)(a), (e) or (eb)
- MREL at consolidated basis
- BUT **not** in relation to resolution decisions

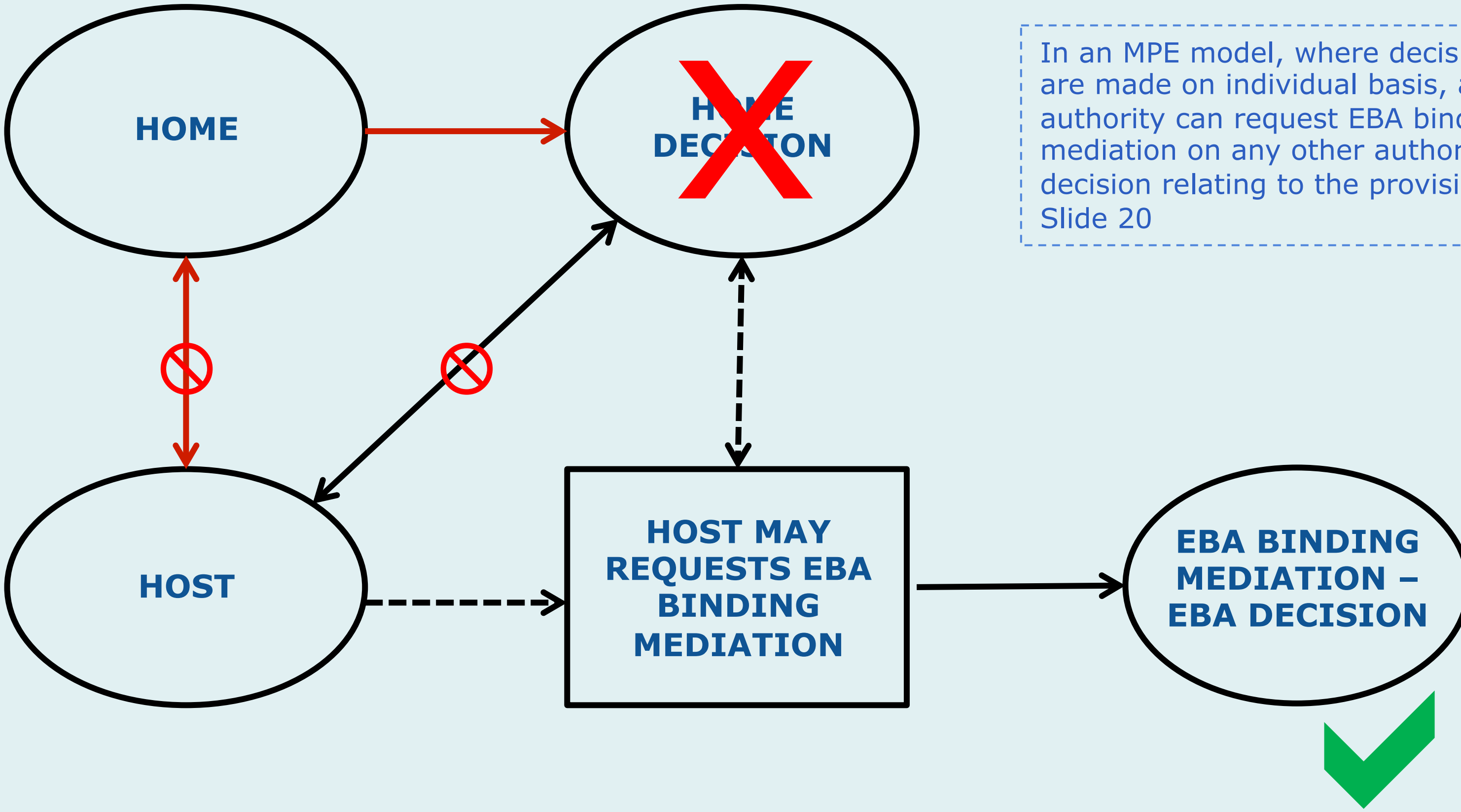
No joint agreement – role of EBA



No joint agreement – role of EBA

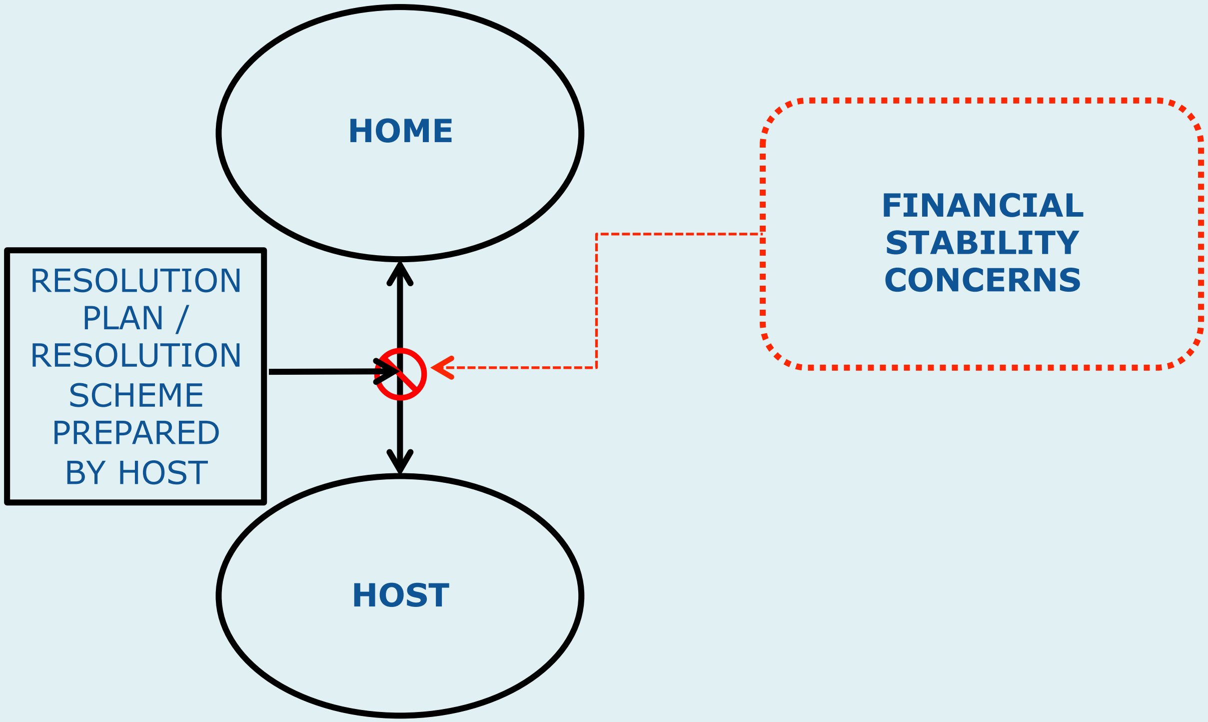


No joint agreement – role of EBA

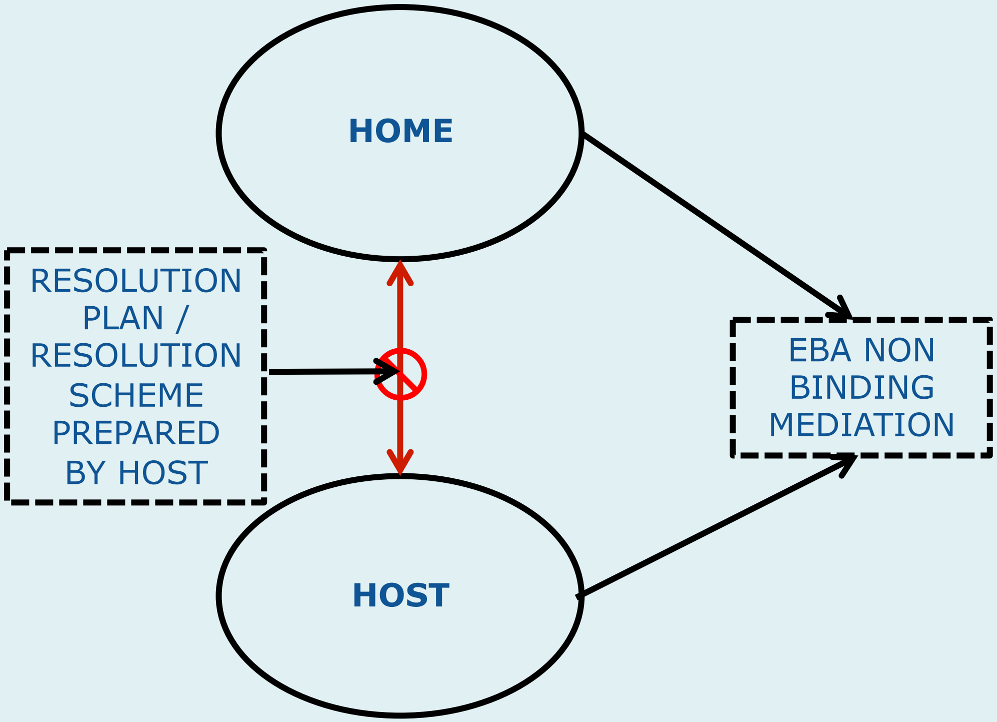


In an MPE model, where decisions are made on individual basis, any authority can request EBA binding mediation on any other authority decision relating to the provisions in Slide 20

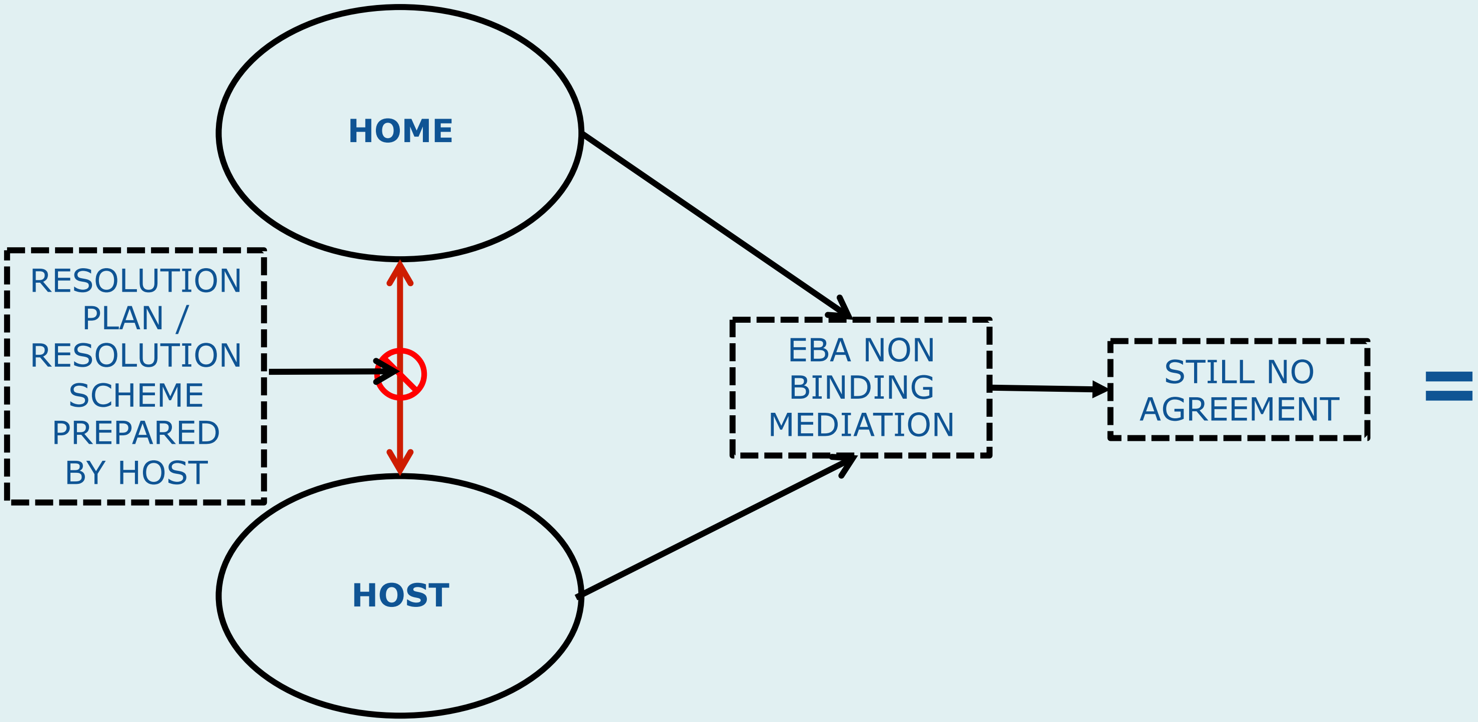
Resolution - no joint agreement – what happens...



Resolution - no joint agreement – what happens…

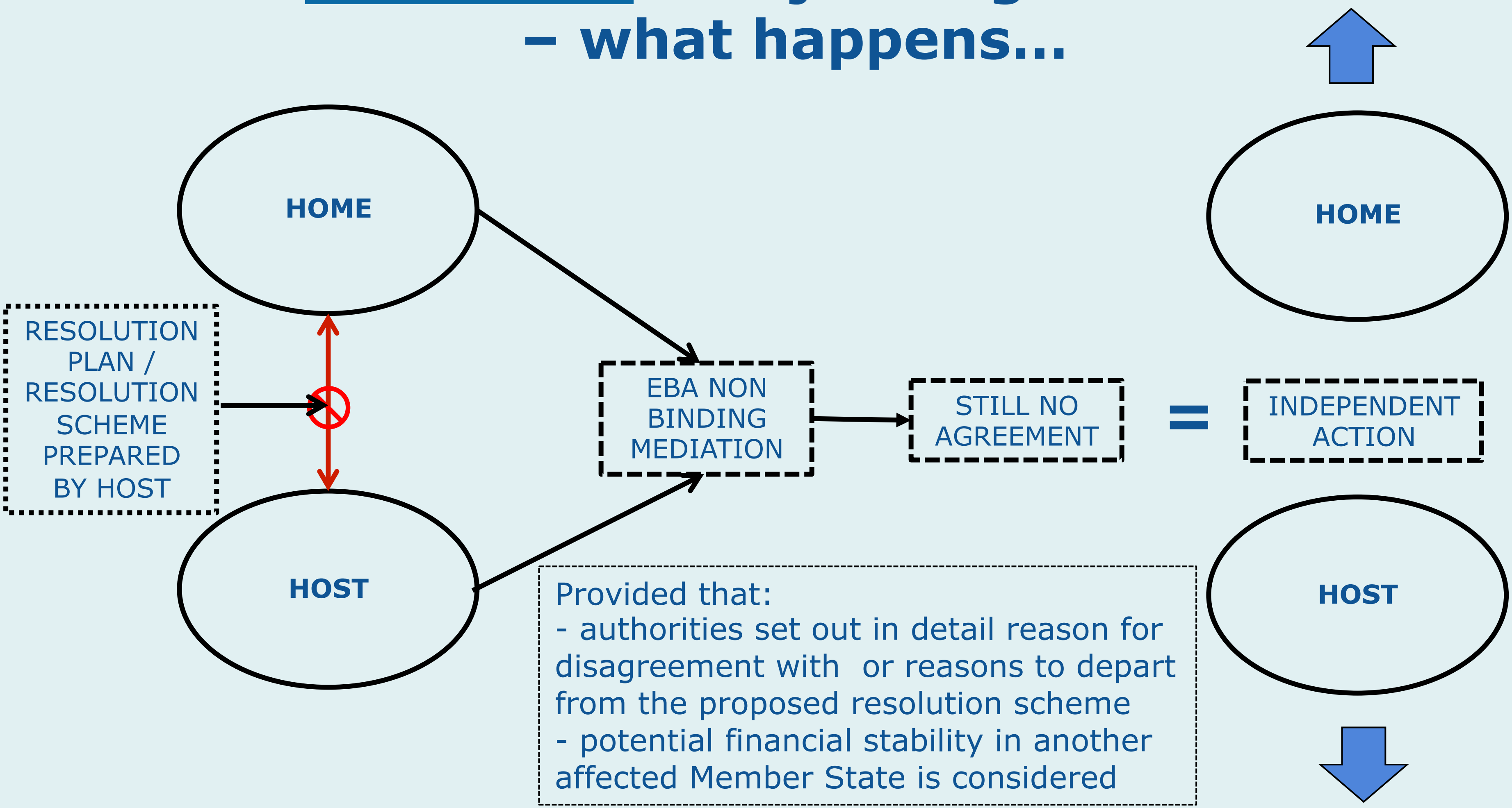


Resolution - no joint agreement – what happens...



European Commission

Resolution - no joint agreement – what happens…



Provided that:
- authorities set out in detail reason for disagreement with or reasons to depart from the proposed resolution scheme
- potential financial stability in another affected Member State is considered

Cross-border cooperation: with third countries

- Most large banks that operate in the EU are global:
  - **Commission** able to negotiate **binding agreements with third countries** on recovery and resolution to complement a non-binding framework that EBA may conclude.
  - Prior to these, **Member States can enter into bi-lateral arrangements** with third countries.
  - Separately, **Member State authorities able to recognise or refuse the recognition of third countries resolution proceedings**. Refusal may be based on, for example, unequal treatment of creditors in that Member State.

Eurozone and Banking Union

Single Currency

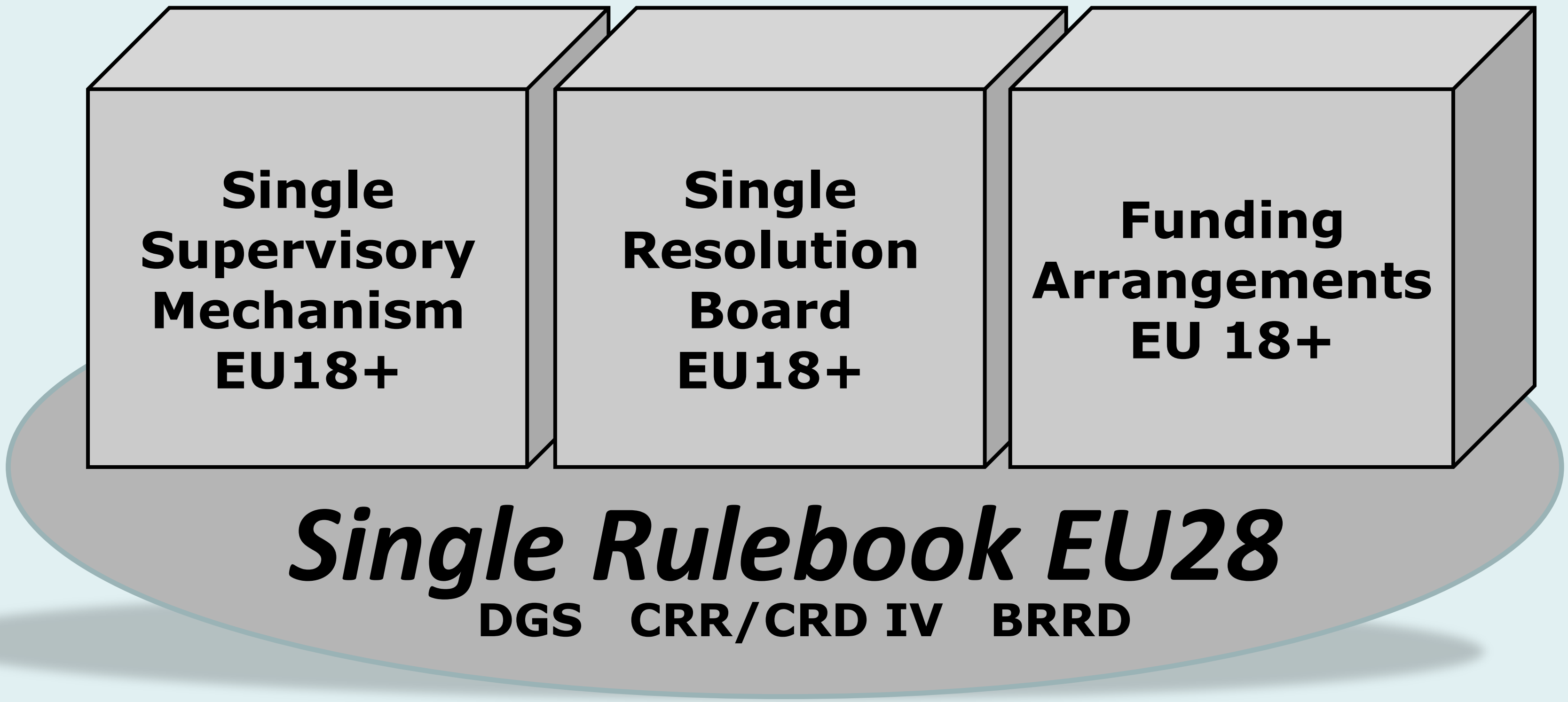
↓

Single Supervisor

↓

Single Resolution Mechanism

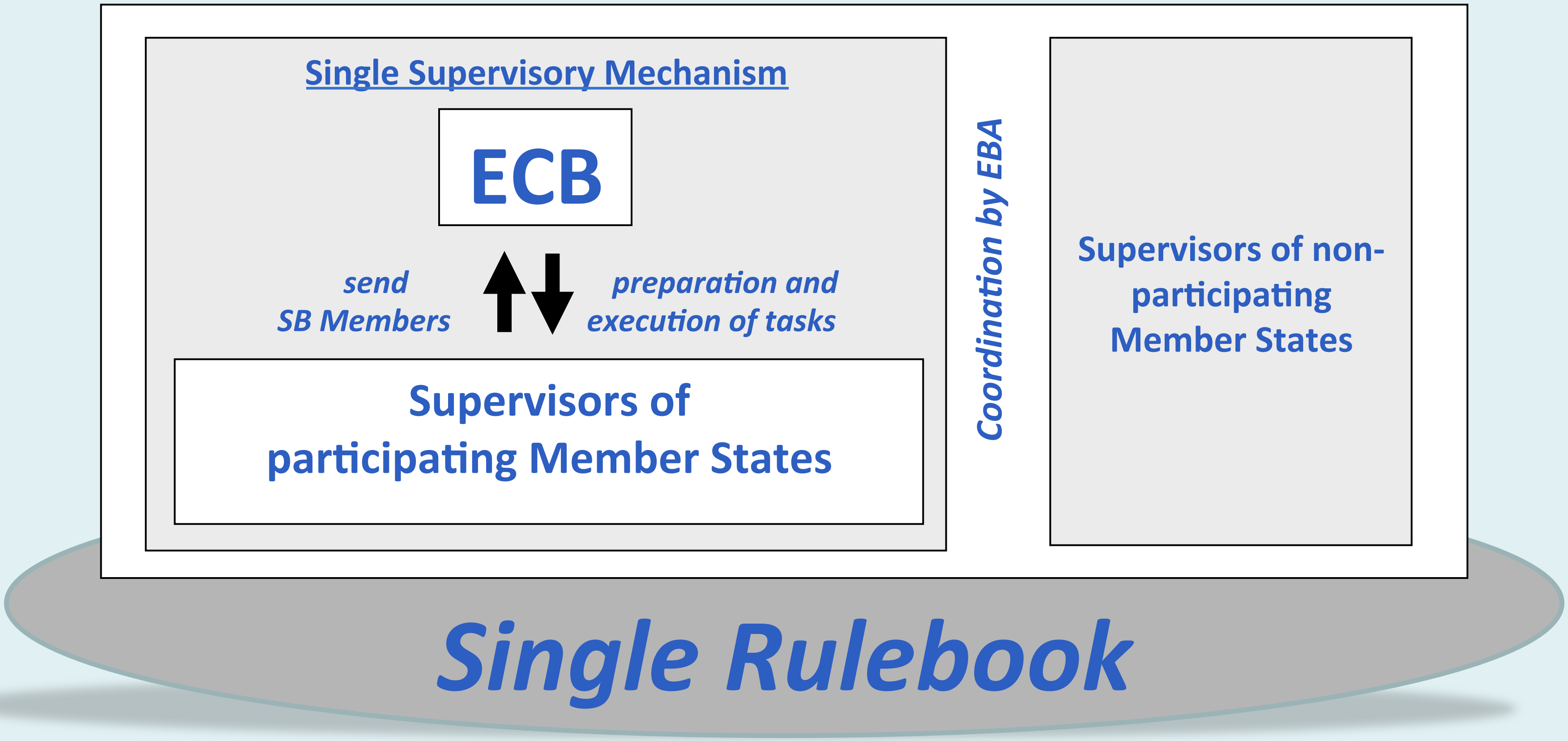
Key elements of the Banking Union



Recall – Why we need a Banking Union

- Restore confidence
- Strengthen financial stability
- Achieve a genuine EMU
- Break sovereign-bank link
- Consolidate the Single Market

Overview of the Single Supervisory Mechanism



SSM - Key steps

Entry into force – 4 Nov 13

Comprehensive assessment

Start supervision – 4 Nov 14

Key tasks conferred on the ECB

- Authorization and withdrawal of licence.
- Ensure compliance with requirements on capital, leverage, liquidity, and governance.
- Supervisory review (Pillar 2).
- Consolidated supervision and supervision of conglomerates.
- Early intervention measures where a bank breaches requirements (coordinating with resolution authorities).
- Macroprudential tasks.
- Structural reforms: Mandate separation of trading activities
- All tasks not explicitly conferred on the ECB are exercised by national supervisors.

Distribution of work between ECB and national supervisors (1)

- SSM composed of **ECB & national supervisors**.
- National supervisors **assist** ECB with **preparation and implementation** of its tasks.

– For less significant banks national supervisors take most supervisory decisions.

  – Definition based on size (< 30 Bn assets), importance for national economy (<20% national GDP; in any case 3 most important banks), significance of cross-border activites.

– ECB framework regulation on practical modalities.

Challenges: Comprehensive assessment

- **The SSM Regulation requires the ECB to carry out a comprehensive assessment of banks' balance sheets.**
- **Three elements:**
  - Supervisory risk assessment;
  - Asset quality review;
  - Stress test (coordinated by EBA).
- **Challenges:**
  - Restore credibility of the EU banking system and market confidence.
  - Establish a sound reputation of the ECB in it new role as banking supervisor.
  - Ensure appropriate backstop arrangements are in place.
  - Preserve balance between ECB and EBA and home and host authorities.

European Commission

For the Eurozone
Single Resolution Mechanism

- SRM is the institutional set up to apply the BRRD within the eurozone.
- A more integrated system was necessary for those Member States that share the euro.
- Voted in EP plenary on 15 April (same day as BRRD and DGS)
- Publication in the Official Journal foreseen this summer.
- Ensures that potential future bank failures in the banking union are managed efficiently, with **minimal costs to taxpayers** and the real economy.

European Commission

Key principles of the SRM

- Decisions are European, but involve NRAs in view of significance of bank resolution for national economies

- Responsibility for supervision, resolution and funding is aligned at EU level

- Funding arrangements are not funded by taxpayer:
  - Break the link between banks and sovereigns
  - Reduce the link of the cost of funding of banks and sovereigns

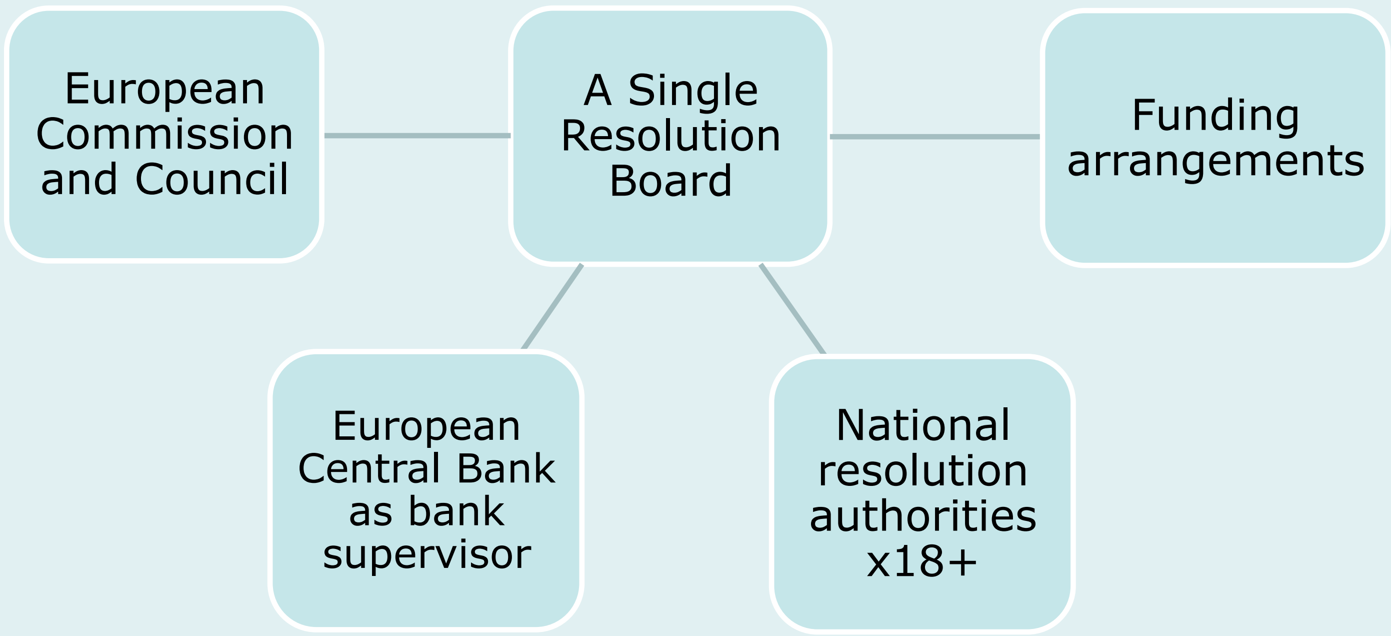
Scope of Single Resolution Mechanism

- **Mirrors the SSM:** all banks established in the Euro Area and other participating Member States

- As for the SSM, there is a **distribution of tasks between the Board and the NRAs**:
  - Board is directly responsible for cross-border and significant banks (›30bn)- about 200 banks
  - NRAs are responsible for all other banks (*also to adopt resolution decisions, provided no use of the Fund is required*).

- Board is ultimately responsible for **all banks**.

Components of the Single Resolution Mechanism



European Commission

The Single Board: Tasks of the Plenary and Executive Board

- As a rule, **Executive Board** decides in specific resolution cases
- **Plenary Board** decides:
  - *By silent procedure*, if specific resolution case requires more than 5bn from the Fund (10bn for liquidity support) – (*by simple majority representing 30% of contributions*)
  - On guidance to the Executive Board, if the net accumulated use of the Fund in the prior consecutive 12 months reaches 5bn (*by simple majority representing 30% of contributions*)
  - On ex-post contributions and borrowing of the Fund (by *2/3 majority representing 50% of contributions during the 8 year transitional period; 30% of contributions in the steady state*)
  - Each voting member has one vote

Triggering Resolution in practice

- Determination that the **(i) bank is failing/likely to fail** is generally made by ECB
  - Board may also if it has informed ECB, and the latter has not reacted within 3 days

- Board assesses if there is a **(ii) systemic threat** (public interest) and there is **(iii) no alternative private solution**

- If so, it adopts a **resolution scheme** in which it sets out the necessary resolution and funding measures

- Resolution scheme is submitted to **Commission** for endorsement or objection.

Role of the EU Institutions:
Commission and Council (Meroni functions)

- **Commission** is in most cases the last instance deciding on resolution on the basis of the resolution scheme adopted by the Board.

- **Council** is also involved in some cases.

- Within 24 hours, the Commission shall either **endorse** or **object** to the resolution scheme (except in the cases where Council is competent).

Role of the EU Institutions: *Commission and Council (Meroni functions)*

- The **Council** may approve or object to a resolution scheme, on a Commission proposal:
  - on the ground that the resolution scheme does not fulfil the criterion of public interest
  - where Commission proposes a material modification of the amount of the Fund (i.e. a change of 5% or more to the amount of Fund compared to the Board's proposal)
- Resolution scheme may enter into force only if **no objection** has been expressed by the Council or the Commission <u>within 24 hours</u>
- If Commission or Council objects, Board amends scheme within 8 hours.

European Commission

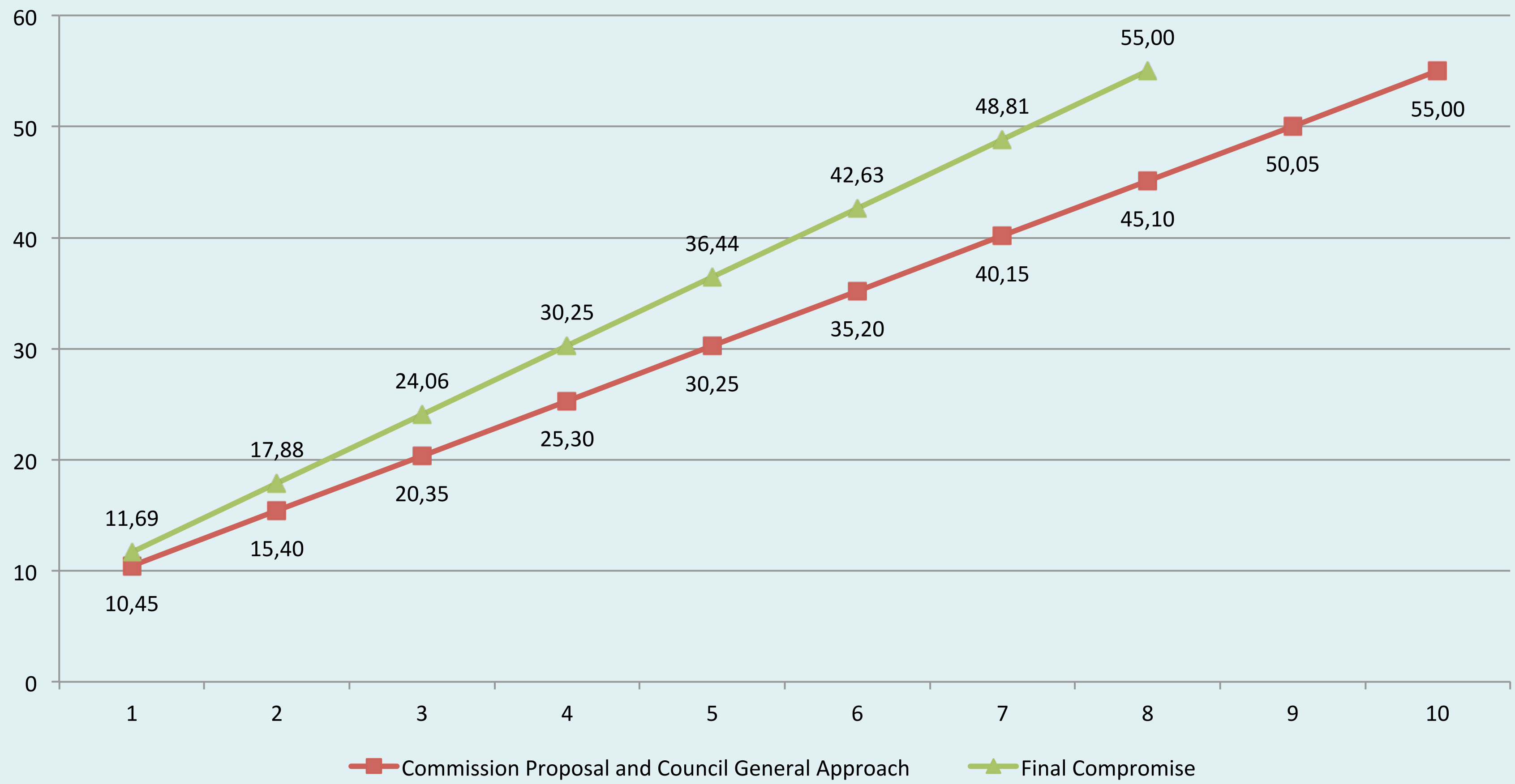
Resolution Scheme: Implementation

- Resolution scheme sets out the **resolution tools** and provides, where necessary, for the **use of a certain amount of the Fund**.
- Board **instructs** NRAs to implement the scheme.
- Board adopts guidelines and **general instructions** to the attention of NRAs.
- Board closely cooperates with the NRAs.

Funding arrangements

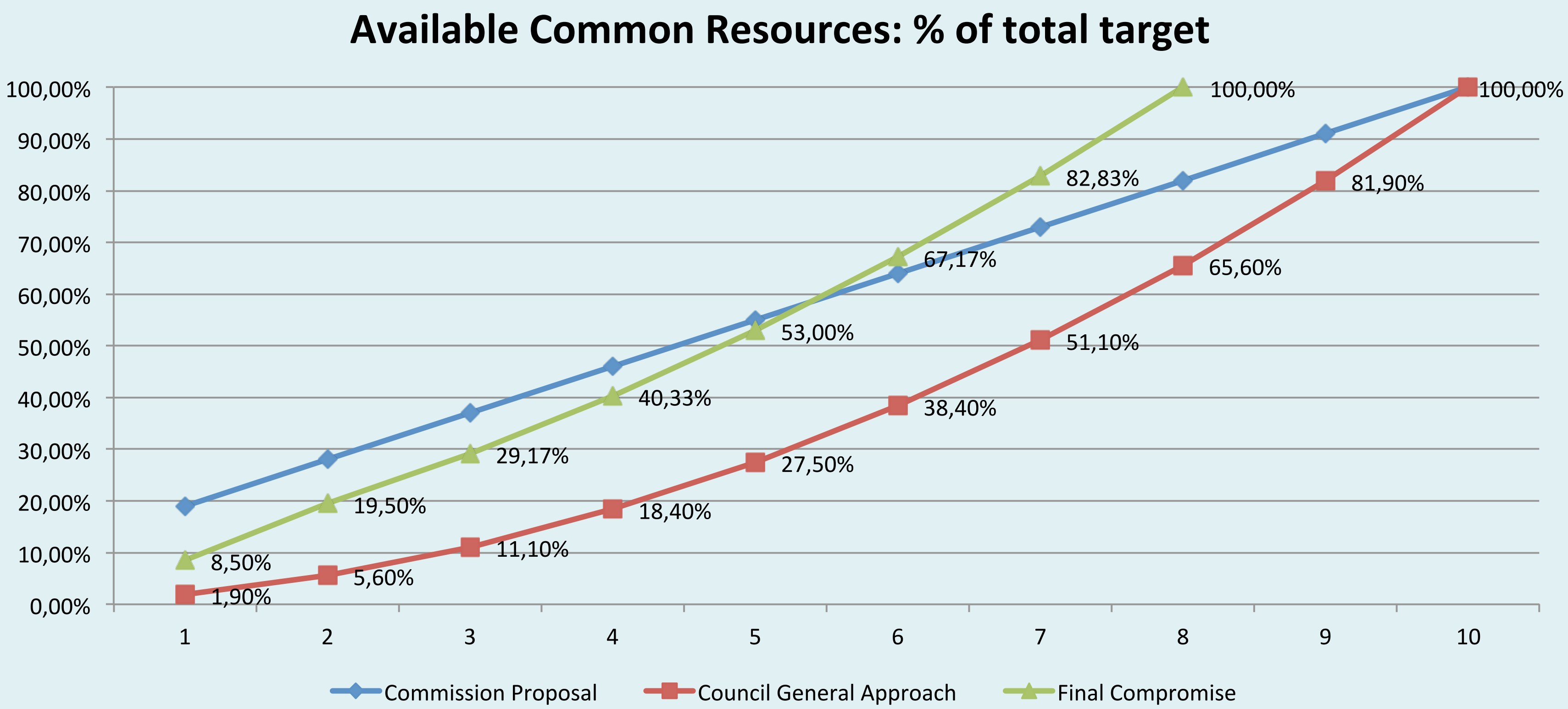
- A **Single Resolution Fund** sourced from the banking sector – not the taxpayer–can provide funding (principles set out in the BRRD apply, i.e. bail-in before any use of the Fund).
- A single fund creates **economies of scale**, boosts credibility, and is instrumental in breaking the sovereign-bank link.
- The fund could **borrow from the market.**
- Outside the EU budget.
- During a transitional period of 8 years, the Fund comprises **national compartments** corresponding to each participating MS in the SRM.

Total Fund Size: EUR billion



Internal Market and Services

Final compromise: accelerated, non-linear mutualization



Bank Contributions to the Fund:
Build-up period of 8 years

- **All banks** in the participating MSs contribute to the Fund
- **Target level** of the Fund is set at **European level**
- Individual contributions are calculated at European level but are **collected at national level under the IGA** and transferred to the Fund
- Contributions comprise a **flat part** and a **risk adjusted part**
- **2 COM acts to be adopted at the same time** as agreed during negotiations: **criteria for the risk adjustment of contributions** under the BRRD and **specification of the risk-based adjustment** for Banking Union.

Bridge financing

SRM foresees that the **Board shall contract for the Fund financial arrangements including, where possible, public financing arrangements**, regarding the immediate availability of additional financial means where the amounts in the Fund are not sufficient to meet the Fund's obligations.

SRM also foresees that the Board, together with the euro area MS **develops methods and modalities to enhance the borrowing capacity of the Fund**, immediately after the entry into force of the SRM.

European Commission

Agreement on the transfer and mutualisation of contributions to the Single Fund

- Complementary to the SRM.
- Binding only for the euro-area Member States. But the other MS were invited to sign and ratify.
- Signed on 21 May by all MS except for SE and UK.
- Governs the **transfer of contributions** raised at national level to the Single Fund and the **mutualisation** of the resources of the national compartments.
- Sets out the order in which financial resources are mobilised to cover resolution costs (resolution waterfall).

The resolution cost waterfall (after bail-in)

- **Step 1 National compartments of the Member States concerned up to the quarterly % threshold**
- **Step 2 If needed, all national compartments up to the quarterly % threshold**
- **Step 3 If needed, any remaining financial means within the national compartments of the Member States concerned**
- **Step 4 If needed, ex post contributions**
- **If needed, a loan from the Member State concerned, or a loan from the ESM in line with the agreed procedure**
- **Step 5 If needed, borrowing from other national compartments.**

Agreement on the transfer and mutualisation of contributions

- Governs **burden-sharing between national compartments** in group resolution (only if all group entities are in the euro area, if some are outside, BRRD applies):
  - costs distributed between compartments where parent and subsidiaries are established **in proportion to the relative amount of contributions that each entity** provided to its respective compartment with respect to the aggregate amount of contributions that all entities of group have provided to their national compartments.
- Possibility of **temporary lending among national compartments** if insufficient resources in a compartment.

Agreement on transfer and mutualisation of bank contributions

- Sets out **rules for non-euro Member States that wish to join** the Banking Union.
- **Entry into force:** after Member States representing 90% of the aggregate of the weighted votes of all MS participating in the Banking Union would have ratified it.
- **Application**: as of **1 January 2016** or as of the date of its entry into force if later than 1 January 2016 (once the conditions for the transfer of contributions to the Fund have been met).

Setting-up of the Resolution Board

- Board, as an EU agency, will be **legally established** once the SRM Regulation enters into force (**September 2014**).
- Board will start performing its duties in **resolution planning** as of **January 2015.**
- Board will be invested with its **full resolution authority** as of **January 2016** provided that the conditions for the transfer of contributions to the Fund are met by that date (i.e. the IGA is ratified and is applicable).

Setting-up of the Resolution Board

- The **Commission is responsible for setting-up and the initial operations of the Board** until it is fully autonomous and operational (January 2015).
- **Preparatory tasks will be carried out by Commission,** i.e. collection of bank contributions for the administrative expenditures of Board, recruitment of management and staff, determining the organizational structure of the Board.
- Commission official to be appointed as **interim Chair** until the Chair is appointed.
- **Task Force** created for the establishment of the Board in DG MARKT.

European Commission

Appointment of Board members

- Commission to submit to the EP a proposal for the appointment of the Chair, Vice-Chair and four 'permanent' members of the Board.
- EP to approve the candidates.
- Council to appoint them (by qualified majority) .
- 5 year term (not renewable). By derogation, term of office of first Chair is 3 years, renewable once for 5 years.
- In the steady state, Board may comprise between 240 and 309 staff members.

Conclusions

CRD/CRR+BRRD + SRM+DGS

Financial stability

Protect taxpayers and depositors

Help economies and foster growth

Timeline

2014

BRRD, SRM, DGS published in summer

Contributions: COM act under BRRD and COM proposal under SRM

ECB = supervisor

January 2015

BRRD will apply.

Resolution Board to be operational.

Some provisions in SRM will apply.

January 2016

Bail-in applies.

SRM applies if conditions transfer of contributions are met.

Agreement on the transfer should be ratified.

Before end of the transitional period

Arrangements for European backstop to be defined

European Commission

Convergence in the EU Single Rule Book

- Harmonized rules on banking supervision, resolution and deposit guarantee schemes
- Increased harmonization through directly applicable regulations (CRD 4, SRM), less national discretions
- SRM rules are the same as BRRD rules
- Commission Delegated Acts and EBA Technical standards and Guidelines will harmonize the details
- Top current priority are the criteria by which contributions to resolution funds will be set

International convergence
Key challenges of cross border resolution

- **FSB to develop initial policy proposals for the G20 meeting in Brisbane in November 2014 on:**
- 1) The development of **standards on loss absorbing capacity for G-SIBs,** when they fail ("gone concern loss absorbing capacity"**, G-LAC)**
- 2) The development of a **framework for cross-border recognition of resolution actions**.

European Commission

G-LAC

- G-LAC is fundamental for the application of the bail-in tool, as it will serves to identify liabilities to which it is most feasible and credible to apply bail in.
- Important to agree international standards on the nature, and calculation of the G-LAC
- Commission endeavours to promote a G-LAC design consistent with the MREL requirements in the BRRD

Thank you for your attention!

- **For more information:**

- *On BRRD*
- *http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm*

- *On Banking Union*
- http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm