EU Communication

RESOLUTION OF FINANCIAL INSTITUTIONS

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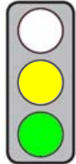
MAIN ISSUES

Objective of the Communication: The Commission presents for discussion a "European resolution framework", with which in future insolvent financial institutions are to be resolved without recourse to taxpayers' money.

Parties affected: Banks, investment firms, insurance companies, investment funds, central counterparties and their creditors, supervisory authorities.



Pros: The Commission's plans could discipline market participants and reduce the moral hazard problem.

Cons: Without the harmonisation of national bank insolvency rules, the resolution colleges responsible for conducting cross-border resolutions remain to a large extent powerless.

CONTENT

Title

Communication COM(2010) 579 of 20 October 2010: **An EU Framework for Crisis Management in the Financial Sector**

Brief Summary

► **Aims and scope**

– In Spring 2011, the Commission will be publishing a legislative proposal for a "European resolution framework". This framework is to allow credit institutions to fail whilst avoiding costs to taxpayers and without endangering financial stability.

– The European resolution framework is to apply to all banks and systemically important investment firms ("financial institutions"). By the end of 2011, the Commission will decide whether or not it should be further extended to include insurance companies, investment funds or central counterparties (CCP).

– In the current Communication, the Commission presents its regulatory proposals regarding the following areas:
  - strengthening preventative measures of the competent authorities,
  - resolution vs. bail out of insolvent financial institutions and
  - coordination of cross-border resolutions.

► **Strengthening preventative measures of the competent authorities**

– The Commission intends to reinforce the supervisory regime of financial institutions by having competent supervisory authorities:
  - prepare an "annual supervisory programme for each institution on the basis of a risk assessment"
  - use greater and more systematic on-site supervisory examinations and "more intrusive and forward-looking supervisory assessment",
  - apply "more robust standards",
  - exchange the management and prohibit dividend payments as soon as possible infringements of the Capital Requirements Directive occur (Directive 2006/48/EC; cp. CEP Policy Brief)
  - appoint a special manager in the case of actual infringements.

– Currently, the Commission is considering rules which would specify when and how financial institutions which operate across borders could transfer assets within a group, even if group entities are experiencing liquidity stress.

– Each financial institution must – "in close cooperation" with both the supervisory authority and the resolution authority – draw up a "resolution plan". This must outline how the business of the institutions can be "transferred or wound down in an orderly manner" if necessary.

– Each financial institution must prepare a "recovery plan", though this must be "applied proportionately", reflecting the size of the financial institution and the nature of its sources of funding. This plan must show with different scenarios how the institution intends to solve liquidity problems or to raise new capital. The supervisory authority assesses whether or not a plan is complete and appropriate.

– The supervisory authority may require change regarding the "legal structure, business arrangements and group structures" of financial institutions if the resolution authority deems it necessary in order to be able to resolve the institution.

► **Priority of resolution over bailing out insolvent financial institutions**

– Where possible, insolvent financial institutions should be wound up under ordinary insolvency proceedings. The Commission intends to explore what reforms of bank insolvency law is necessary to do

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so. By the end of 2012, it will publish a report on the further harmonisation of bank insolvency law. The aim is to create administrative procedures for the liquidation of banks as an alternative to court proceedings.

– However, should "ordinary insolvency proceedings" for financial institutions threaten the stability of the financial system, an "orderly wind down" – of the entire financial institution or parts thereof – may be "necessary" in the "public interest".
– Only as a "last resort" should bail-out measures be taken in order to actually maintain the insolvent financial institution as a going concern.

► **Resolution: Instruments**
– Each Member State must nominate an authority to be responsible for the resolution of financial institutions. This might be a ministry of finance, the central bank or the deposit guarantee scheme. The supervisory authority should not be in charge.
– In order to carry out a resolution, the resolution authority should be enabled to:
  - sell a financial institution wholly or partially without the prior approval of the owner;
  - cleanse the balance sheet of a financial institution by transferring "underperforming" or "toxic" assets to a "bad bank";
  - transfer some or all of a financial institution to a "bridge bank" with the aim of "onward sale to the private sector when market conditions stabilise".
– "Safeguards" and "mechanisms for compensation" should ensure that shareholders and creditors of a wound up financial institution do not suffer any greater losses than would be the case with ordinary insolvency proceedings.

► **Resolution: Financing**
– The costs of winding up financial institutions should preferably be borne by the shareholders and creditors.
– The Commission also proposes national bank resolution funds which, at a later time, would be transferred into a "single EU fund".
  - The funds should be financed by banks subject to the crisis management framework: through contributions
    - in the run-up to possible crises ("ex ante funds") and
    - in the aftermath of a crisis ("ex post financing"); these payments should be low at first and then increase "as the economy recovers".
  - The EU-wide basis for contribution levels should be the liabilities of financial institutions. To the extent that this is politically not feasible, Member States might be enabled to fix the basis for contributions themselves. However, that must not "distort the internal market".
  - Money from the resolution funds may only be used for resolving financial institutions. It may be used for the bail out of institutions if combined with "measures to restructure the entity", such as removing culpable management, or with measures to "dilute or write off the claims" of shareholders.
  - The Commission wishes to determine a "target size of funds" for resolution funds. In so doing, it intends to use the costs from recent bail-out actions as a basis and to take into account that accomplished reforms reduce the likelihood of a future crisis.

► **Bail-out measures**
– The resolution of large, complex financial institutions (LCFI) can put the stability of the financial system at risk. Therefore, the Commission is considering how the business activities of such financial institutions can be ensured temporarily.
– One option is the conversion of debt to equity. The Commission will:
  - analyse whether the resolution authorities should be statutorily empowered to accomplish such conversions or whether they should be based on contractual agreements between financial institutions and creditors;
  - determine the nature of the liabilities to which these options are applied;
  - explore how conversions would affect the financing costs of financial institutions.

► **Coordination of cross-border resolutions**
– The Commission deems the establishment of a "single European body" appropriate to resolve cross-border financial institutions. Due to a lack of support for this idea, it strives to harmonise the "resolution tools" and to introduce an obligation for competent authorities to cooperate in case of cross-border resolutions.
– In order to achieve the coordination of cross-border resolutions, the Commission presents two reforms:
  - Resolution colleges would – analogous to the supervisory colleges for cross-border banks – develop group resolution plans and coordinate the according resolutions;
  - The resolution authority of the Member State in which the parent institution is seated is to decide as the "group level resolution authority" whether or not an insolvent institution is to be resolved as a group or each subsidiary separately in its respective Member State.
– For the coordination of resolutions with third countries, the Commission strives for international cooperation agreements. To this end, it supports the G20 work.

Changes Compared to the Status Quo

To date, there are no European rules on how to resolve insolvent financial institutions in a controlled way. Such institutions have been maintained by state aid.

Statement on Subsidiarity by the Commission

The Commission does not address the subject of subsidiarity.

Policy Background

The Commission has been working on better organizing crisis management and the resolution of financial institutions for quite some time now. In October 2009, it published a Communication on cross-border crisis management in the banking sector [COM(2009) 561] and a Communication on bank resolution funds [COM(2010) 254] in May 2010.
On 17 November 2010, the Council adopted the Regulation on the European Banking Authority (EBA). At the beginning of 2011, it will commence activities and may, in the event of a crisis – to be defined by the Council of Ministers – oblige national supervisory authorities to take measures contributing to stability and an orderly functioning of the financial markets. It remains to be seen whether or not this will include resolution measures.
On 1 December 2010, the Commission outlined in a Communication how it will extend the crisis-related special rules for state aid for banks [SEC (2010) 1462]. According to these rules, all banks in the EU receiving state aid will have to submit a restructuring plan as of 1 January 2011. To date, this has applied only to certain banks in distress. The Commission's aim is to gradually phase out these special rules.
During the G20 summit in Toronto in June 2010, it was agreed that national authorities should be provided with sufficient instruments to ensure a restructuring or resolution of financial institutions without recourse to tax payers' money. During the G20 summit in Seoul in November 2010, this agreement regarding "systemically important financial institutions" (SIFIs) was confirmed.
The Basle Committee for banking supervision of the Bank for International Settlements (BIS) on 19 August 2010 proposed in an consultation paper that subordinate liabilities of financial institutions can be converted into own capital. The Commission wishes to match future EU rules with possible new rules of the Basle Committee.

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Consultation procedure:	The Commission announces a consultation on „technical details" for December 2010.

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

A legal provision that makes possible also at a practical level the insolvency of financial institutions is long overdue. This applies in particular to financial institutions whose insolvency has until now been deemed too risky due to their size and complexity or their interconnectedness with other financial institutions.
The proposed "orderly winding down" of "systemic financial institutions", and in particular the explicit participation of shareholders and creditors, reduces unacceptable incentive distortions ("moral hazard"): financial institutions tend to take too many risks if they do not have to fear insolvency. The same applies to the investors of these financial institutions – whether shareholders, bond buyers or other creditors. Until now, all of these parties could rely on the state to use taxpayers' money to protect financial institutions from insolvency, as otherwise a chain reaction could threaten the stability of the entire financial system.
The Commission should assess specifically if a minimum amount of the financial institutions' own capital should consist of convertible bonds ("CoCo-Bonds"). When necessary, these corporate bonds are automatically converted into shares and can discipline both creditors and the management of institutions.
What continues to be problematic, however, is the fact that there is still no consent as to **how to determine "systemic relevance"**. Since this means for financial institutions substantial costs**, objective and comprehensible criteria which are internationally applicable are urgently needed** for the classification of "systemic".
Supervisory authorities should not be responsible for the resolution of financial institutions. Otherwise there is the danger that supervisors might delay a resolution because it could be interpreted as a failure on the part of the supervision.
Essentially, the Commission's plans provide for five concrete measures, which all seriously interfere with the entrepreneurial freedom of systemic banks.
The first two measures, according to which systemic financial institutions must draw up **resolution plans** ("living will") **and recovery plans** already in the run-up to a crisis, **are indispensable for the credibility of a potential orderly resolution** – usually accomplished under great time pressure.
Thirdly, **the fact that authorities may request financial institutions to amend their legal or corporate structure** constitutes an especially severe intrusion into entrepreneurial freedom. However, since only credible resolution scenarios can create real incentive effects, such intrusion– if convincingly and sufficiently proven and approved by court – **must be possible**. **However, this power is not a universal remedy**: in certain cases

a (complete) resolution will not be possible even after (and despite) the enforcement of these measures and a (partial) recovery of financial institutions will be indispensable.

The forced sale or forced transfer **of** (parts of) **systemic financial institutions** as a fourth measure is a similarly rigorous intrusion tool that **is** also **justifiable as an ultima ratio**. Without this option, such institutions could abuse their systemic relevance by rejecting a voluntary sale and thus provoking recovery through taxes or monies from the resolution funds.

The fifth measure, namely **the establishment of a bank resolution fund**, which is to be used for funding the resolution of financial institutions, **is appropriate** in view of the fact that Member States supported banks to the sum of 2,300 billion Euros in 2008 and 2009 (source: State Aid Scoreboard by the EU Commission, SEC (2010) 1462 of 1 December 2010, p. 50). **This measure will** also **not be able to prevent** in future certain **financial institutions from being** resolved, or at least **supported**, fully or partially **through tax payers' money**.

An EU resolution fund reduces the probability that tax money is used, but substantial risks arise where the national banking supervision is too lax due to political pressure. In such a case the resulting costs of a bad national supervision must be borne by participants in the whole European Union.

The resolution of financial institutions operating across the border through resolution colleges is consistent and better than a decentralised resolution through national resolution authorities, as supervision a well already takes place in supervisory colleges. **However, without harmonising national bank insolvency rules, the efficacy of resolution colleges will be limited**. For then the resolution plans will remain without any binding effect to national authorities and the resolution scenario will not really be credible.

Impact on Efficiency and Individual Freedom of Choice

It is an advantage for overall economic efficiency if both shareholders and creditors carry the risks of their own investment decisions. Only then are risks fully taken account of and does capital flow towards the highest profit. The lack of such an "internationalisation" of risks (e.g. through the lack of conditional convertible bonds) is the equivalent of a discrimination against those economic participants not profiting from this implicit state guarantee. The impact on these companies, for instance, results in higher financing costs.

Impact on Growth and Employment

The planned own capital requirements, compulsory contributions to resolution funds and to (increased) deposit guarantee funds burden financial institutions, which can have a negative effect on the granting of credits and thereby on growth. On the other hand, these measures would lead to savings in the public budgets and would thus reduce taxes, which in turn would increase available incomes.

Legal Assessment

Legislative Competence

The EU is empowered by Art. 114 TFEU to take legislative measures in the field of financial market supervision. Whether or not this applies to the announced proposals will depend on how they will be designed.

Subsidiarity

Systemic financial institutions normally operate in several Member States at the same time. Therefore, such financial institutions cannot be resolved in a satisfactorily orderly manner purely through national action.

Proportionality

Some of the Commission's proposed measures (e.g. compulsory sale) intrude deeply into entrepreneurial freedom. They will meet the principle of proportionality only if they are sufficiently substantiated.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

On 28 October 2010, the Bundestag approved the *Banken-Restrukturierungsgesetz* (bank restructuring act). In the event of a threat to the stability of the financial system, a restructuring procedure is carried out which – similar to the Commission's plans – intervenes in the rights of creditors and shareholders. Moreover, a *Restrukturierungsfond* (restructuring fund) will be established in which one billion Euros will be saved each year; the aim is to achieve a total volume of 70 billion Euros.

Possible Future EU Action

Apart from the announced legislative proposal in Spring 2011, further efforts can be expected, such as the establishment of a European resolution authority for cross-border banking groups and a EU- resolution fund.

Conclusion

A statutory provision which makes the resolution of insolvent financial institutions credible can discipline market participants and reduce the existing moral hazard problem. For that purpose, however, criteria for the definition of "systemic relevance" must be urgently agreed upon. Resolution and recovery plans, official orders to amend the corporate structure and the establishment of a banking resolution fund are necessary for the credibility of the resolution scenario. Compulsory sales are justifiable in terms of an *ultima ratio*. The establishment of resolution colleges is consistent; without a harmonisation of the national bank insolvency rules, however, they will remain a paper tiger.

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