EU Directive

BANK RESOLUTION – PART 2

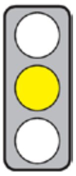
cep**PolicyBrief** No. 2013-11 of 18 March 2013

Centrum für Europäische Politik

KEY ISSUES

Objective of the Directive: The Commission is seeking to prevent banking crises, strengthen financial stability and ensure that taxpayers do not shoulder the burden of future banking crises.

Parties affected: Banks and investment firms, its owners and creditors, and resolution authorities



Pros: (1) Resolution tools for banks and investment firms strengthen market discipline and lower the exposure of public funds. Interference with property rights is justified.

(2) A bail-in strengthens market discipline and reduces moral hazard.

(3) Resolution funds minimise taxpayer exposure.

Cons: (1) Setting up a bad bank ensures short-term recapitalization, but will prove problematic in the long-term.

(2) Committing resolution funds to lending to other member states' resolution funds could worsen banking crises.

CONTENT

Title

Proposal COM(2012) 280 dated 6. June 2012 for a **Directive** of the European Parliament and of the Council **establishing a framework for the recovery and resolution of credit institutions and investment firms.**

Brief Summary

Part 1 of the CEP Policy Brief deals with recovery and resolution plans and with crisis prevention measures; Part 2 deals with resolution tools and resolution funds.

► **Context and resolution objectives**
- The Commission finds fault with the lack of „adequate" rules for the recovery and resoultion of banks and investments firms (hereinafter: institutions), as an alternative to insolvency proceedings (recital 1). This shortfall is meant to be mended with this Directive.
- Resolution objectives are (Art. 26 (2))
  - preserving „critical functions" of institutions,
  - avoiding adverse effects on financial stability,
  - minimising the exposure of public funds,
  - the protection of depositors, investors and clients.

► **Resolution conditions**
- Resolution action by appointed authorities can be taken only, if (Art. 27 (1))
  - an institution is failing or likely to fail,
  - failure cannot be prevented by other action within a reasonable timeframe,
  - a resolution is in "public interest", i.e. necessary and proportionate in achieving one or more resolution objective (Art. 26 (2)).
- An Institution is considered failing, if (Art. 27 (2))
  - capital requirements have been breached in a way that justifies the withdrawal of its authorisation,
  - its assets are less than its liabilities,
  - due obligations cannot be paid,
  - „extraordinary public financial support" is required.

► **Resolution principles**
- Action by appointed authorities is to be taken in accordance with the following principles (Art. 29 (1)):
  - Shareholders of the institution in resolution bear losses first.
  - Subsequently, losses are borne in accordance to the order of claims of creditors.
  - Creditors should not incur losses greater than under normal insolvency proceedings. Accordingly, compensation payments are intended (Art. 65).
- Resolutions must comply with the Union State aid framework (Art. 29 (3)).

► **Resorting to equity before the actual resolution**
- By the resolution authority, the concerned institution has to commit to (Art. 52)
  - writing down Common Equity Tier 1 capital (e.g. common shares),
  - writing down additional Tier 1 (e.g. preference shares) and Tier 2 (e.g. hybrid capital as a mix of debt and equity capital) capital; the resolution authority can require a conversion to Common Equity Tier 1 capital.

Authors: Anne-Kathrin Baran and Philipp Eckhardt | baran@cep.eu
CEP | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-105 | www.cep.eu

– Requirement for the write down or conversion is the „non-viability" of an institution, which demands that the resolutions authority finds that the institution (recital 51, Art. 51 (1)),
  - fulfils the conditions for resolution,
  - is no longer viable without a write down or conversion of additional Tier 1 and Tier 2 capital, or
  - is receiving „extraordinary public support" to remain viable.

► **Resolution tools**

– Resolution is then carried out by means of (Art. 31 (2) (a)-(d)):
  - the sale of business,
  - the establishment of a bridge institution,
  - the separation of assets into an asset management vehicle („bad bank"),
  - a bail-in.
– The separation of assets can be applied only in conjunction with another resolution tool. (Art. 31 (4)). Other tools can be applied singly or in conjunction (Art. 31 (3)).

► **Sale of business**

The resolution authority can transfer instruments of ownership, assets, rights and liabilities of an institution without the consent of shareholders or third parties to a purchaser that is not a bridge institution (Art. 32 (1)).

► **Establishment of a bridge institution**

– The resolution authority may transfer assets, rights and liabilities of an institution under resolution to a bridge institution without the consent of shareholders or any third party. Transferred liabilities should not exceed the total value of transferred rights and assets. The bridge institution is to be monitored by the resolution or a public authority (Art. 34 (1)-(3)).
– The bridge institution must be authorised (Art. 35 (1) (c)).
– The institution must be sold within a five year period to a private sector purchaser, or else its operation is to be terminated (Art. 35 (2)-(7)).

► **Separation of assets into an asset management vehicle („bad bank")**

– The resolution authority may transfer assets, rights and liabilities of an institution under resolution to an asset management vehicle („bad bank"), which is monitored by the resolution or a public authority (Art. 36 (1)-(2)).
– The goal of the bad bank that manages transferred assets is the maximization of the value of assets by sale (Art. 36 (3)).
– Assets should only be transferred, if the liquidation of those assets under normal insolvency proceedings could have an adverse effect on the financial market (Art. 36 (4)).
– The consideration for which assets are transferred to the bad bank, is determined by the resolution agency in accordance with the „fair and realistic" valuation of assets by an „independent" person and with the Union State aid framework (Art. 36 (5) in conjunction with Art. 30 (1)).

► **Bail-in**

– A bail-in requires that the resolution authority demands that the creditors are to write down their claims against the institution under resolution, or is to convert the institutions liabilities into equity (Art. 2 (49)).
– A bail-in allows for the recapitalisation of an institution under resolution or for providing capital to a bridge institution (Art. 37 (2)). The former must contribute to the long-term viability of the concerned institution (Art. 37 (3)).
– In using a bail-in, Common Equity Tier 1 capital is written down first, followed by additional Tier 1 and Tier 2 capital (Art. 43 (1) (a)-(b)).
– All liabilities of an institution are subject to the bail-in (Art. 38 (1)). Exempt are notably (Art. 38 (2)):
  - deposits guaranteed for,
  - secured liabilities and
  - liabilities with an original maturity of less than one month.
– National resolution authorities determine the aggregate amount of own funds and eligible liabilities each institution has to maintain (Art. 39 (1)). The size, the business model, the risk profile and relevance to the system of the institution should thereby be criteria. The Commission can, by means of delegated acts, determine the aggregate amounts with different ranges to categories of institutions (Art. 39 (3)-(7)).

► **National resolution funds**

– Member States must establish resolution funds for the financing of resolutions (Art. 91 (1)), to which each institution contributes in accordance to its liabilities (Art. 94). National deposit guarantee schemes may serve as such funds (Art. 99 (5) and (7)).
– After ten years, the resolution funds must include at least 1% of the amount of deposits guaranteed for by deposit guarantee schemes (Art. 93 (1)).
– The resolution authority may use the fund's resources to provide security for the assets and liabilities of an institution under resolution, a private sector purchaser, a bridge institution or a „bad bank" (Art. 92 (1)).

– The insufficiency of a fund, obliges other Member States' funds to lend to, given its resources are sufficient. The amount lent should not exceed half of the funds resources. The Commission will specify interest rates through delegated legal acts (Art. 97 (2) and (3)).
– The deposit guarantee scheme to which an institution under resolution is affiliated, is liable up to the amount of covered deposits, for the amount of losses that it would have had to bear if the institution had been wound down under normal insolvency proceedings (Art. 99 (1)).

► **Transposition**
– Member Countries have to implement the Directive until the 1st of January 2015 (Art. 115 (1)).
– The bail-in tool has to be applicable from 1st of January 2018 latest (Art. 115 (1)).

Statement on Subsidiarity by the Commission
The Union banking sector is largely integrated, making divergent national law unapt for crisis management. It jeopardizes effective resolution of cross-border groups of institutions and harbours risks to financial stability.

Policy Context
The Commission intends to propose the establishment of a homogenous resolution framework, thus likely a homogenous resolution fund and a homogenous resolution authority for institutions of Member States that take part in the common banking supervisory body, before the 2013 summer recess.

Legislative Procedure

12 June 2012	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal market
Committee of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur: Gunnar Hökmark (EPP-Group, Sweden)
Leading German Federal Ministry:	Ministry of Finance
Committee of the German Bundestag:	Finance (in charge)
Decision mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

Legal competence:	Art. 114 TFEU
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment
Institutions that cannot survive in a market should have to exit. Such fundamental principle of regulatory policy has to apply to banks and investment firms as well. Banks and investment firms prevalent classification as systemic, and the unforeseeable implications on third parties of an exit by regular insolvency proceedings has prompted countries to take up the bill, undermining market discipline. **Resolution tools for banks and investment firms strengthen market discipline and lower the exposure of public funds**, thus being appropriate.
The legal establishment of when a resolution and when an insolvency proceeding be applied is for its different implications necessary. However, achieving a sole resolution objective should not be reason enough for a resolution. That way, the Commission considers preserving „critical functions" of an institution as reason enough for a resolution over insolvency proceedings.
The resolution tools substantially intervene with property rights of creditors and shareholders. As a last resort such is justified. Otherwise systemic institutions had an incentive to confide in public financial aid.
The sale of business and the establishment of bridge institutions apply only to institutions little complex, where the separation in parts worthy of saving and those not to can be taken easily and promptly. The rules for bridge institutions are flawed as missing the limitation to transferring only systemic parts potentially worthy of protection. Second, the obligatory authorisation is hindering any resolution, being a timely procedure. In contrast, the limitation of the existence of bridge institutions to five years is justified. Refraining from such would make this tool noncredible.
The separation of assets at risk of default into a publicly controlled asset management vehicle, so called **„bad bank", increases the stability of concerned institutions short-term** and contributes to its recapitalisation. **A dilemma arises when a „bad banks'" consideration does not balance the value of transferred assets. Should the consideration exceed the value of transferred assets, then such separation would distort incentives and competition** as countries bear the losses that the owners of the institution would have been liable to. In contrast, **transferred assets in excess of a consideration would endanger the long-term**

solvency of the institution. How the valuation of assets through an „independent person" and the reference to the Union State aid framework resolute this dilemma remains to be seen.

The bail-in is central to the strengthening of market discipline and to the prevention of moral hazard behaviour. First, it holds owners of an institution liable for losses they are responsible for. Second, creditors will have to consider potential participation in losses when making decisions on investment. **This will lead to risk-adequate pricing of refinancing costs of banks.** Including a broad range of liabilities into the bail-in, assures that sufficient funds are available for the stabilisation of the institution in crisis. To not draw on short-term liabilities of creditors, encourages to concentrate investment in those liabilities, but is necessary to ensure the short-term refinancing of institutions in crisis.

The demanded write downs and conversions before a resolution are in fact a bail-in, leading to a „bail-in before the bail-in". This is, as the order of claims for the bail-in comes to nothing, if no additional Tier 1 and Tier 2 capital stands by, because it has already been written down or converted. This is in need of correction.

The establishment of resolutions funds lowers taxpayers' exposure. The contribution of institutions to the funds in advance of crises prevents moral hazard behaviour and boosts the credibility of funds. However, the volume of the funds is too little for a simultaneous, orderly wind-down of several institutions within a banking crisis without stressing taxpayers' money. **Obligating national funds to lend to one another given one's funds means prove insufficient can cause domino effects that worsen banking crises**. Such credits weaken the stability of lending funds, the higher the amount lent, leaving too little resources for its use in national bank resolutions. The upper limit of 50% of lending capacity is therefore clearly too high. Moreover will such obligation create incentives for lax national supervision, since external funds must stand in, so that an inadequate redistribution of responsibility and burden occurs.

Legal Assessment

Competence

The Directive is correctly based on Art. 114 TFEU (internal market), as different treatment of failing systemic banks in different member states can damage the internal market.

Subsidiarity

Unproblematic

Proportionality

Depends on how the delegated acts are actually shaped.

Compatibility with EU Law

The power of resolution authorities, to transfer an institution or its parts without the consent of shareholders marks an interference with property (Art. 17 EU Charter of Fundamental Rights). Such intervention can be justified only for the safeguarding of financial stability without placing a burden on taxpayers.

Compatibility with German Law

Germany already has legislation on the establishment of bridge institutions (§§ 48a ff. German Banking Act (KWG)), although there is no limitation to the duration of such institution. Necessary funds come from the restructuring fund financed through an imposed banking levy (§ 3 Act establishing a restructuring fund RStructFG). Further, there is legislation on the separation of assets into a bad bank. One way is to establish a special purpose vehicle, where securities bound to hedging transactions, acquired inclusive of the 30th of September 2012 can be transferred too. [§§ 6a to 6d The Financial Market Stabilization Fund Act (FMStFG)]. Another option is the establishment of a deconsolidated environment (e.g. FMS Wertmanagement) to which acquired risk positions and non-strategic businesses can be transferred (§ 8a FMStFG). The financing is done publicly by the Financial Market Stabilization Fund (SoFFin). Losses after resolution have to be balanced by the restructuring fund (§ 13 FMStFG).

Conclusion

Tools for the resolution of banks and investment firms strengthen market discipline and lower the exposure of public funds. The resulting interference with property rights is justified. Setting up a bad bank ensures short-term recapitalisation, but will prove problematic in the long-term. A bail-in strengthens market discipline and lessens moral hazard behaviour. Resolutions funds lower taxpayer exposure. Obligating national funds to lend to each can worsen banking crises.

Authors: Anne-Kathrin Baran and Philipp Eckhardt| Telephone +49 (0)761 38693-105 | baran@cep.eu