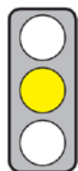
BANK RESOLUTION – PART 1

CEP Policy Brief No. 2013-10 of 18 March 2013

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, supervisory and resolution authorities, taxpayers



Pros: (1) The creation of a resolution and recovery regime is absolutely essential.
(2) Recovery plans can help to prevent crises.
(3) Resolution plans are imperative, as is the ability of the authorities to order an institution to implement any of a wide range of measures to achieve resolvability.

Cons: (1) Recovery and resolution plans should not be allowed to factor in ESM funds.
(2) If an institution can be wound down without state financial support, the authority should not be allowed to appoint a special manager or to order remedies when recovery plans are being drawn up.

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.

► **Background, objectives and scope**
– According to the Commission, during the financial crisis the supervisory authorities lacked "adequate tools" and powers to deal with financial institutions that were at risk of failing (recital 1).
– The Commission proposes a Union-level framework for the recovery and resolution of banks and investment firms. The objectives of the Directive are (Explanatory Memorandum, p. 2)
  - to tackle bank crises "pre-emptively",
  - to maintain the stability of the financial market and
  - to reduce taxpayer exposure to bank losses.
– Resolution of a bank or investment firm constitutes an alternative to normal insolvency procedures and involves its 'restructuring' with the objective of (Art. 2 (1))
  - ensuring the continuity of the essential functions of the institution,
  - restoring the viability of all or part of that institution and
  - safeguarding financial stability.
– The Directive applies to the following "institutions" (Art. 1):
  - credit institutions and investment firms and their subsidiaries,
  - branches of credit institutions and investment firms which have their head office outside the EU,
  - financial institutions whose subsidiaries are "exclusively or predominantly" credit institutions, investment firms or other financial institutions ("financial holding companies") and their subsidiaries.

► **Designation of authorities responsible for resolution**
Each member state will designate one or several national authorities which are responsible for resolution. Resolution authorities may be the national authority responsible for banking supervision, the national central bank, a government ministry or another authority. (Art. 3 (1)-(3)

► **Recovery planning**
– Each institution must draw up a recovery plan setting out which measures it intends to take to restore its financial stability in the event of a "significant deterioration" in its financial situation (Art. 5 (1)).
– The recovery plan shall not assume any access to or receipt of state aid ("extraordinary public financial
– support"). However, the use of secured central bank facilities such as marginal lending is generally permitted. (Art. 5 (2) and (3))
– The recovery plan must be stress-tested. The European Banking Authority (EBA) shall specify various scenarios for such a stress test in the form of technical standards. (Art. 5 (5) and (6))
– The national banking regulatory authority (competent authority) will review the recovery plan (Art. 6 (1)).
– If the competent authority finds the recovery plan is deficient, the institution must revise the plan within three months (Art. 6 (3). If the competent authority still regards the plan as deficient, it may require the institution to take measures (Art. 6 (4)), such as
  - higher capital adequacy requirements,
  - a reduction in its risk profile or
  - a change to the firm's strategy.

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► **Resolution planning**

– The resolution authority shall, in consultation with the competent authority, draw up a resolution plan for each institution. The plan shall provide for the resolution actions which the authorities may take where the institution meets the conditions for resolution (Art. 9 (1)).
– The plan shall include, in particular, explanations (Art. 9 (4))
  - of how "critical functions and core business lines" could be legally and economically separated,
  - of how various resolution options could be financed and
  - of "critical interdependencies".
– The resolution plan shall not assume any access to or receipt of state aid ("extraordinary public financial support"). Assistance from resolution funds is permitted, however. (Art. 9 (2) and (3))

► **Other provisions governing recovery and resolution plans**

– The competent authority and the resolution authority may provide simplified recovery and resolution plans for certain institutions. This will depend on the nature of the institution's business, its size and its systemic importance. (Art. 4 (1))
– Recovery and resolution plans must be updated annually (Art. 5 (2), Art. 9 (3)).
– Parent companies and their subsidiaries ("groups") must submit recovery plans for the group as a whole and for the individual institutions. The resolution authority must submit resolution plans for the group as a whole and for the individual institutions. (Art. 7, Art. 11 (1))

► **Assessment of resolvability of an institution and consequences**

– Based on the resolution plan, the resolution authority assesses the extent to which the institution is resolvable. The institution is "resolvable" if, without use of extraordinary public financial support (Art. 13 (1))
  - it is "feasible and credible" to liquidate it under normal insolvency proceedings or
  - it can be resolved without giving rise to "significant adverse consequences" for the stability of the financial market.
– If an institution is deemed not to be resolvable, it must propose measures to address the deficiency and become resolvable within four months (Art. 14 (1) and (2)). If the resolution authority still regards the institution as not resolvable, it may require the institution (Art. 14 (3) and (4)), to
  - draw up service agreements within the group or with third parties to cover the provision of critical functions of the institution,
  - divest assets,
  - limit or cease specific activities or
  - change its legal or operational structure.

► **Early intervention**

– Where an institution does not meet or is at risk of not meeting the capital adequacy requirements, the competent authorities must be able to require the institution (Art. 23)
  - to increase its reserves of own funds,
  - to implement the arrangements and measures set out in the recovery plan,
  - to convene the shareholders meeting,
  - to remove or replace board members or managing directors,
  - to draw up plans for negotiating the restructuring of debt with its creditors.

  The authority can also contact potential purchasers in order to prepare for the resolution of the institution.
– EBA shall develop draft implementing technical standards for these powers of intervention (Art. 23 (2)).
– The competent authorities may appoint a special manager if (Art. 24 (1))
  - the measures referred to above are not sufficient to meet the capital adequacy requirements,
  - the financial situation of the institution "significantly" deteriorates or
  - the institution commits a "serious" violation of law or serious administrative irregularities.
– The special manager shall take over the management of the institution and all the associated powers. However, only the competent authorities shall have the power to convene the shareholders meeting. The competent authorities may set limits on the action of a special manager. (Art. 24 (1), (2) and (4))
– Special management shall be limited to a maximum of two years, although may "exceptionally" be extended. The special manager is under a "statutory duty" to take all measures necessary to redress the financial situation of the institution. "In case of doubt", this duty overrides any other duty. (Art. 24 (3) and (6))

► **Intra-group financial support (group agreement)**

– The institutions within a group can enter into internal agreements to provide financial support to each other to prevent resolution (group agreement; (Art. 16 (1)). This may take the form of a loan, a guarantee or the provision of assets for use as collateral (Art. 16 (2) (b)).
– The Member States may require that any proposed agreement has to be approved by the shareholders meeting of every group entity that proposes to enter into the agreement (Art. 18 (1)).
– At the time the proposed agreement is made none of the institutions concerned must be in breach of any capital or liquidity requirement or at risk of insolvency. (Art. 16 (4))
– Group agreements require the consent of the supervising authority for the group ("consolidating supervisor") and that of the competent authority for each of the subsidiaries. If these authorities are unable to reach agreement within four months, the consolidating supervisor will make its own decision. The matter may be referred to the European Banking Authority (EBA) for mediation. (Art. 17)

– Approval of a group agreement shall require the following conditions to be met (Art. 19)
  - there must be a realistic prospect that the provision of support will resolve the financial difficulties of the institution receiving the support,
  - the financial stability of the whole group is not jeopardised, in particular the liquidity or solvency of the entity providing the support is not at risk, and this institution complies with the own funds requirements;
  - consideration is provided.
– The decision to provide financial support in a specific case must be made by the management body of the institution providing the support (Art. 20). The competent authority responsible for the entity providing the support may "prohibit or restrict" the provision of financial support. The consolidating supervisor or the competent authority responsible for the entity receiving support may object to the decision to restrict or prohibit financial support and may refer the matter to EBA for mediation. (Art. 21)

Statement on Subsidiarity by the Commission

According to the Commission, divergent national legislation is "ill-suited" to dealing adequately with the cross-border dimension of crises. This jeopardises financial stability and makes it more difficult to wind down cross-border groups.

Policy Context

In 2009 the G20 states called for a review of resolution regimes and bankruptcy laws. In 2010 the European Parliament produced an own-initiative report containing recommendations on crisis management in the banking sector and the Commission issued a Communication on the same subject [COM (2010) 579, see CEP Policy Brief]. Also in 2010, the Ecofin Council published its findings on bank recovery and resolution. In 2011 the G20 states approved a document published by the Financial Stability Board (FSB) setting out the core elements of an effective resolution regime. In November 2012 the Federal Financial Supervisory Authority (BaFin) held a consultation on its draft of a circular on minimum requirements for recovery plans. This Directive is part of the discussions on the creation of a banking union which also include the proposal to transfer banking supervision to the ECB (COM (2012) 511 and 512, see CEP Policy Briefs) and the reform of deposit guarantee schemes (COM (2010) 368, see CEP Policy Brief). The Commission intends to publish a further proposal on the creation of a European resolution authority and a European resolution fund in 2013.

Legislative Procedure

06 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

Ordoliberal Assessment

The absence of a credible recovery and resolution regime for banks and investment firms means that banks, particularly those considered to be systemically important, are de facto protected against failure by the state and by taxpayers' money. This creates considerable incentive distortions: An organisation that does not have to fear bankruptcy will have a tendency to take greater risks as it never has to fully bear the negative consequences of its actions, such as losses. Credible recovery and resolution regimes can counteract this moral-hazard behaviour, strengthen the principle of liability and ensure that the shareholders and creditors of the banks shoulder responsibility for the risks taken. **The creation of a resolution and recovery regime is** therefore **essential from an ordoliberal perspective**.

The requirement to draw up recovery plans is appropriate: such plans help both the regulatory authorities and institutions to identify risks and threats at an early stage and to respond appropriately. They are therefore **a suitable tool for crisis prevention.** Extending the requirement to cover all institutions without exception is also appropriate, particularly since exempting provisions are available for smaller institutions. Recovery plans are a good source of information for uncovering systemic risks which may also be present at smaller institutions.

The resolvability of an institution must be credible. Resolution plans are thus essential, as is the ability of the authorities to order an institution to implement any of a wide range of measures to achieve resolvability. Without these measures, it would not be possible to wind down institutions in a critical situation, and there would be no element of discipline. There is only a short window of time available for the business to be wound down in an orderly manner. It is therefore only possible if information is already available – before the crisis – about the structure of an institution, links with other financial market players, existing creditor and ownership structures and plans for how parts of the institution can be wound down. However, it is important to remember that banking crises are often unforeseeable and do not follow a particular pattern. There are limits to how much planning can be done for such a crisis in advance. For this reason, there is no guarantee that even a "resolvable" institution can in reality be resolved without help from the public purse.

It is crucial to have **a situation where recovery and resolution plans are not be allowed to anticipate** recourse to **public support**. This **makes the institutions more aware of the fact that they alone are responsible for the risks they take. Nor may funds from the** European Stability Mechanism (**ESM**), which in future will be allowed to recapitalise banks directly, **be factored into the recovery and resolution plans**. In this regard the Directive is insufficiently specific. The inclusion of central bank facilities in the recovery plans must also be spelled out in more detail. It is important to prevent the ECB from being unable to freely decide on the eligibility of assets to serve as collateral, because these are already provided for in recovery plans.

Since, according to the provisions of the Directive, **every institution must essentially be resolvable without recourse to state aid, it is an unjustifiable interference with commercial freedom to *generally* allow the regulatory authority to prescribe "remedies"** at the point when a **recovery plan is being drawn up** and **to appoint a special manager** when the institution has failed to comply with the capital adequacy requirements, for example ("early intervention"). These options should be strictly limited to cases in which, were they not invoked, it would only be possible to safeguard financial stability with the use of state aid.

Group agreements can strengthen the stability of a group. The requirements for one institution in the group supporting another – such as the duty to obtain the consent of the competent authority – are appropriate. After all, if it does not have sufficient financial strength, the supporting institution may itself get into difficulties. Intra-group financial support also increases mutual interdependencies, which makes any resolution more difficult.

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

Unproblematic

Compatibility with EU Law

The appointment of a special manager and "remedies" prescribed by authorities in the drawing up of a recovery plan constitute interference with commercial freedom (Art. 16 Charter of Fundamental Rights of the EU). Such interference can only be justified if it is essential to safeguard financial stability without burdening the taxpayer.

Compatibility with German Law

In early February 2013, the German government passed a bill requiring systemically important banks to draw up recovery plans. The Federal Financial Supervisory Authority (BaFin) is also required to prepare resolution plans for these institutions. To date there has been no special statutory provision. However, BaFin already requires systemically important banks to prepare recovery plans under section 25a German Banking Act (KWG). The current Bank Reorganisation *Act (Kreditinstitute-Reorganisationsgesetz)* provides for recovery and reorganisation procedures. Unlike in the Commission's proposal, however, the banks themselves determine how and when such a procedure should be initiated. This requires a notification to BaFin and the presentation of a recovery or a reorganisation plan. However, unlike the recovery and resolution plans provided for in the Directive, both these plans are based on a specific crisis situation. The recovery procedure can be applied to all banks in need of recovery whereas the reorganisation procedure can only be applied to those which are systemically important. BaFin can appoint a special manager (referred to in the German legislation as a special representative (*Sonderbeauftragter*) (section 45c KWG). The conditions under which such an appointment can be made are broader in scope than in the Directive.

Conclusion

The creation of a resolution and recovery regime is essential. Recovery plans contribute to crisis prevention. Resolution plans are imperative, as is the ability of the authorities to order an institution to implement any of a wide range of measures to achieve resolvability. Recovery and resolution plans must not be allowed to factor in ESM funds. Special managers and remedies prescribed as part of the recovery planning are only acceptable for institutions which cannot be resolved without state aid.