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The progresses made on banking recovery and resolution; a new legislative and institutional framework since 2015

Maria Hormaeche Lazcano, Seconded National Expert, Single Resolution Board

The latest financial crisis underlined the need to develop a new and effective framework for resolution for entities operating in the European Union and beyond. In this context, the resolution regime has significantly advanced and resulted in the introduction of a new legislative package establishing the Single Resolution Mechanism (SRM), comprising the Single Resolution Board (SRB) and National Resolution Authorities (NRAs) , within the framework of the Banking Union. The SRM constitutes one of the pillars of the Banking Union. It complements the Single Supervisory Mechanism (SSM), the unified system of banking supervision in the Banking Union.

New legislative and institutional framework

The objective of the new regulation since 2008 has been to launch prudential rules for entities, increasing consumer protection, as well as setting rules for bank resolution. The Bank Recovery and Resolution Directive (2014/59/ EU -BRRD-), the Regulation 806/2014 -SRMR-, which establishes rules and a uniform procedure for the resolution of credit institutions and certain investment services

companies, the Deposit Guarantee Scheme Directive as well as, the European Commission Delegated Acts, formulated on the basis of the European Banking Authority's (EBA) technical standards and guidelines, form the set of rules for the whole of the European Union in terms of resolution planning and its implementation.

In Europe, the Bank Recovery and Resolution Directive and the Single Resolution Mechanism (SRM) entered fully into force in January 2016. One of the main objectives of this new banking resolution framework is to facilitate an orderly resolution of entities and investment services companies that are Failing or likely to Fail without causing a severe disruption to the availability of financing to the real economy.

In November 2014, the SSM (Single Supervisory Mechanism) was established, based in Frankfurt, nested in the European Central Bank and the national competent authorities (NCAs) - the national central banks-, as first pillar of the Banking Union. In force from January 2015, the Single Resolution Mechanism (SRM) is the new system of bank resolution comprising the Single Resolution Board (SRB) and National Resolution Authorities (NRAs) of the participating member States of the Banking Union, and forms the second pillar of the Banking Union. With a cross-border scope, the SRM grants the SRB sufficient powers and resolution tools to intervene when the conditions for resolution are met. And, at a preventive level, the SRB is required to prepare resolution plans, in order to make the banks resolvable, which detail how the entity will be resolved in such a way that the objectives of the resolution are met, without taxpayers' money.

The purpose of the creation and development of the Single Resolution Board (SRB) is to establish a strong, independent and centralized decision-making body to ensure that decisions on resolution are taken timely, effectively and rapidly throughout all Member States participating in the Banking Union while not only avoiding uncoordinated actions but also minimizing negative impact on financial stability, and limiting the need for support from public funds. This thus ensures the same rules of the game for all countries.

The SRB is responsible for exercising the powers of resolution of the most significant credit institutions, as well as for any cross-border group inside the Banking Union.

The SRB also works together with the National Resolution Authorities to design policies and standards in order to establish the existing legal framework, in particular the BRRD and SRMR.

Resolution planning and resolution plans

The role of the Single Resolution Mechanism is proactive. Indeed, the SRB, in cooperation with the National Resolution Authorities, focuses on resolution planning and its preparation to avoid potential negative effects that could result from a bankruptcy both on the economy and financial stability.

The SRM began its work on resolution planning since its inception in 2015. One of the key tasks of the SRB and the National Resolution Authorities (NRAs) is to design resolution plans. These plans are prepared within the Internal Resolution Teams (IRT). IRTs are staffed by SRB and NRA personnel.

The purpose in designing resolution plans is to determine the critical functions of the entity, identify and solve impediments to resolvability, and prepare the entity for possible resolution, where appropriate.

Critical functions are those provided by an institution to third parties not affiliated to the institution or group, whose sudden disruption would likely have a material negative impact on third parties, give rise to contagion or undermine the general confidence of market participants. And critical functions cannot be preserved without access to Financial Market Infrastructures (FMIs). The risk of losing access to FMIs is for sure a potential impediment to resolvability that will be examined closely in any resolution plan. Because critical functions cannot be preserved without access to FMIs, we must provide for continuity of access to avoid significant adverse effect on the financial system, and in particular prevent contagion to market infrastructures from the banks. SRB's work is forward-looking in this area; thanks to our planning, we can hopefully help prevent a bank from going into resolution.

The resolution plan reflects the characteristics of the entity and describes the preferred resolution strategy for it, including what tools would be used in case of resolution. Both the Directive (Art. 10) and the Regulation (Art. 8), as well as the technical standards of the European Banking Authority, contain the content of the resolution plans, which includes different chapters: a strategic business analysis; an overview that describes the bank's structure, financial position, business model, critical functions, core business lines, external and internal interdependencies and critical systems and infrastructures.

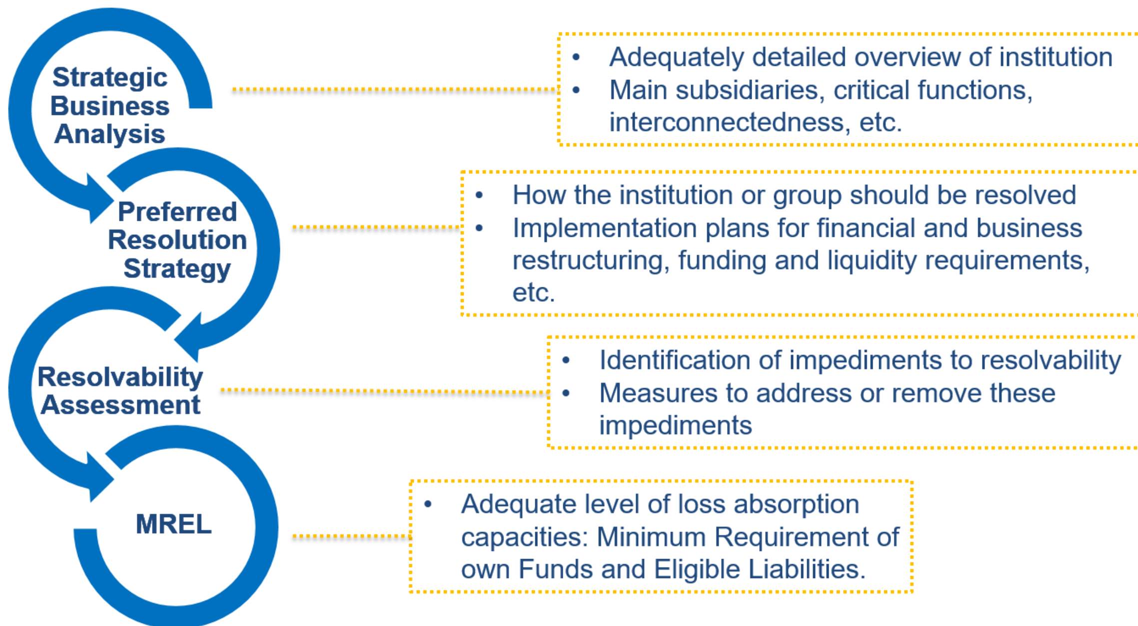
Next, the preferred resolution strategy, that assess whether, in case of a bank's failure, the resolution objectives are best achieved by winding up the bank under normal insolvency proceedings or resolving it. When the resolution strategy has been determined, the financial and operational prerequisites to ensuring continuity in resolution so as to achieve the resolution objectives are assessed.

There is also a chapter of information that contains a communication plan.

And finally, the conclusion of the resolvability assessment, where is assessed whether impediments exist to the winding up under normal insolvency proceedings or the resolution of a bank. Where winding up or resolution is not possible, appropriate measures to address such impediments are identified. The bank is entitled to provide its opinion in relation to the resolution plan. The resolution plan is reviewed and, where necessary, updated at least annually and after any material changes relating to the bank.

In addition, the BRRD itself, transposed in all Member States, requires banks to comply with the 'minimum required eligible liabilities'- MREL- in order to be able to absorb losses and restore capital levels so that the entity can continue to perform its critical economic functions during and after its crisis. The establishment of MREL is thus an integral part of the resolution planning task. MREL is key to achieving the resolvability of entities. Only by establishing correct levels of MREL can we ensure that entities will have sufficient capacity to absorb losses, recapitalize the entity and enable resolution authorities to effectively protect critical economic functions without having to dispose of taxpayer money. MREL will give more flexibility when addressing crisis situations to take appropriate actions before and in resolution.

The SRB is further enhancing its gradual MREL multi-year policy. The MREL policy for 2017 introduces binding targets requirements and starts to address both the quantity and quality of MREL with bank-specific features.



In 2016, the SRB made significant progress not only on enhancing resolvability identifying barriers to resolution and by providing and starting implementing guidance on ways to remove them, but also in developing resolution plans, building up the Single Resolution Fund (SRF), and together with National Resolution Authorities (NRAs) strengthening cooperation within the Banking Union and beyond. The SRB focused on the following main operational areas: ensuring resolution readiness; setting up and managing the SRF; fostering and broadening cooperation; and consolidating its capacity building. For further information, please see: 2016 Annual Report.

Additional information may be found in the Resolution Planning Manual.

Resolution of an entity and resolution objectives

What does the resolution of an entity involve? A resolution aims to restructure the entity through resolution tools in order to safeguard the public interest, including the continuity of critical functions, financial stability and minimizing the costs to the taxpayers.
What is ultimately sought are the objectives of the resolution, which both the Directive itself and the Regulation detail:

a) Ensure continuity of critical functions;
b) Avoid any adverse effects on the stability of the financial system, in particular preventing contagion, including market infrastructures and maintaining market discipline;
c) Protect public funds by minimizing reliance on extraordinary public financial support;
d) Protect depositors covered by the Deposit Guarantee Fund and investors covered by the Investment Guarantee Fund;
e) Protect funds and assets of customers.

Likewise, when the objectives of the resolution are pursued, both the SRB and the National Resolution Authorities will try to minimize the cost of the resolution and avoid the destruction of value unless it is necessary in order to achieve the objectives of the resolution.

Conditions to put an entity into resolution

The resolution of a bank occurs when authorities determine that:

i) The entity is Failing or Likely to Fail (to be determined by the Supervisor – in standard case);
(ii) There is no supervisory or private sector measure that can restore the viability of the entity in a short period of time and;
iii) That the resolution is necessary in the public interest; i.e. the resolution objectives would not be met to the same extent if the entity were liquidated by normal insolvency proceedings.

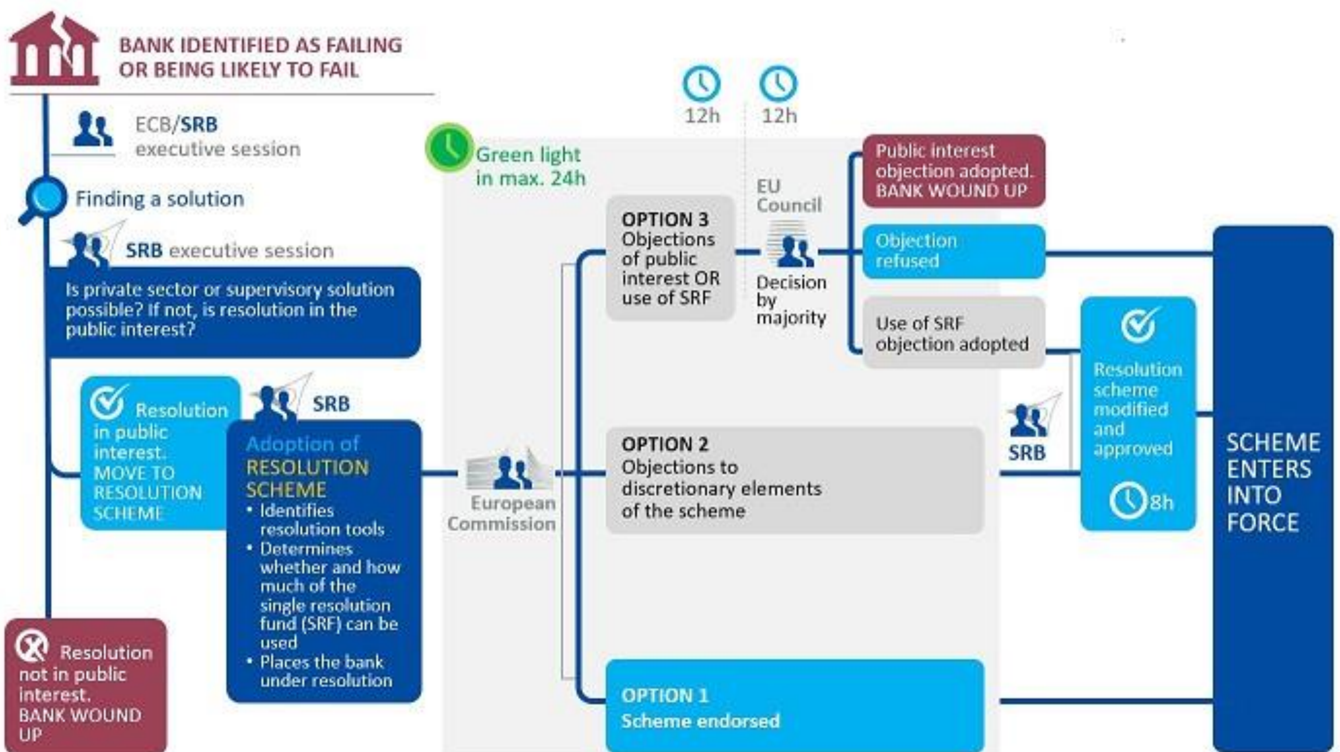
As these conditions clearly show, there is not entitlement to resolution; the normal consequence of failure is insolvency; resolution is for the few not the many.

Even for entities that might go through normal insolvency procedures in case of failure, a reasoned analysis will have been done beforehand, during resolution planning, the so called Simplified Obligation Plans. And in any case: good planning will ease the analysis at the point of Failing or Likely to Fail even help finding private solutions instead of resolution or insolvency.

Taking resolution decisions

The process of analyzing compliance with the conditions to determine whether or not an entity is brought to resolution involves a series of steps. The European Central Bank (ECB), after consultation with the SRB, determines whether the entity is Failing or Likely to Fail. The SRB may also make such an assessment after informing the ECB of its intention and only if the ECB has not made such an assessment within 3 days of receiving such notification. The ECB will provide information to the SRB to help inform the process. The SRB will be responsible to determine if there is no alternative to the resolution and whether the resolution action is necessary in the public interest.

If the conditions are met, the SRB will bring the entity to resolution. Therefore, a resolution scheme should be adopted to determine which appropriate and necessary resolution tools will be applied to the entity and, if necessary and the conditions are met, the Single Resolution Fund will be used. Before bringing the entity to a resolution, the resolution scheme is sent to the European Commission (EC) and it will only come into force if there is no objection from the EC or the Council within 24 hours of its receipt.



The powers of the Single Resolution Board

In order to be able to carry out the resolution, since January 2016, the SRB is fully operational and has a set of resolving powers. The Regulation contains a wide range of powers throughout its articles, among which are:

(i) Access to information for the preparation of resolution actions;
(ii) The appointment of a special administrator, which entails the taking of control of an entity in resolution including the powers to replace the management team. If the resolution authority decides to resolve the entity, it will be crucial to have control of the entity in order to effectively implement the resolution measures. This point will be especially important if there are suspicions of fraudulent behavior that could have

caused the entity's non-viability;
(iii) The exercise of the rights and powers over the shareholders and the management team. In order to achieve the goal of taking control, the resolution authority has the power to replace the management team and the directors;
(iv) To be able to transfer shares, rights, assets and obligations;
(v) To modify the maturity of the obligations eligible to be used for bail-in, converting them into shares or reducing their principal;
(vi) Cancel or reduce the shareholders' equity without their consent. In order to overcome the obstacles related to the shareholder structure, one of the main powers is the possibility of exercising all rights and powers over shareholders without their consent. This means, among other things, that the Resolution Authority can quickly replace legally required votes or implement corporate measures to create the new entity structure.

The resolution tools

The BRRD, the SRMR and EBA's guidelines collect and detail the tools available to the Resolution Authority in order to carry out the resolution:

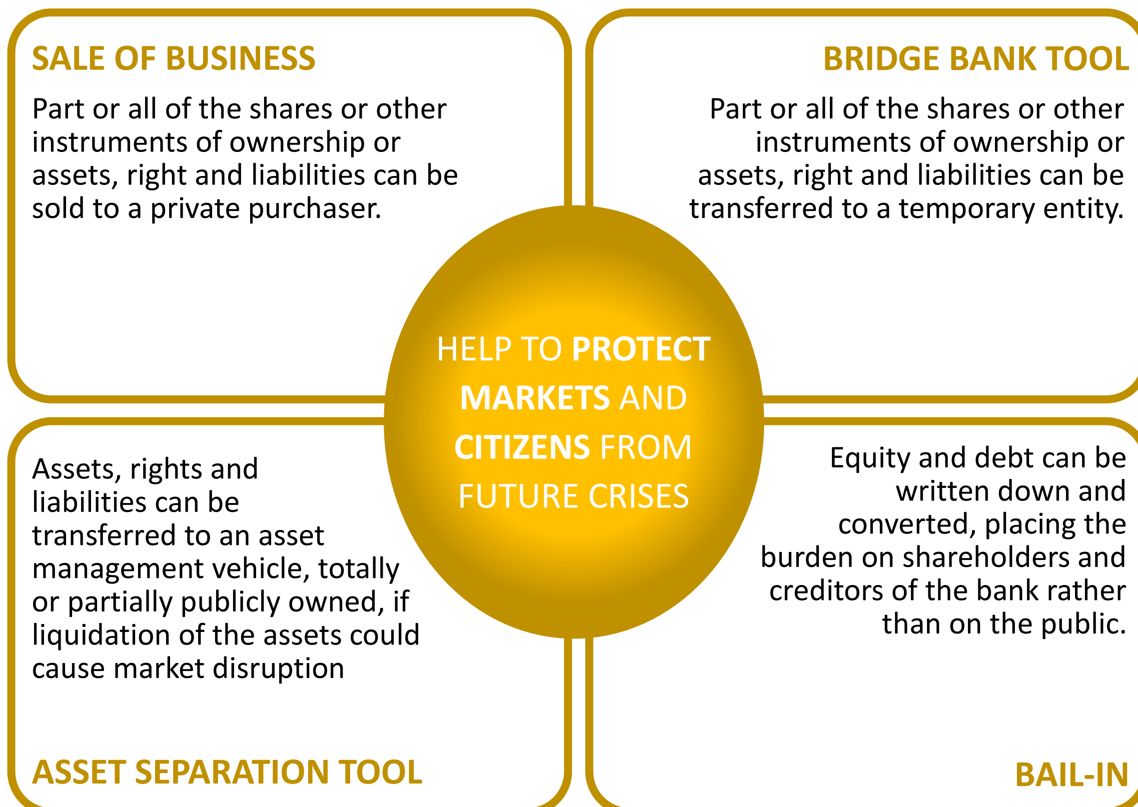
(i) The sale of business, which allows the total or partial sale of the entity's business,
(ii) The bridge bank, created with a temporary life, to which part or all of the entity is transferred and may be publicly controlled in whole or in part
(iii) The asset separation tool, through which assets, rights and obligations may be transferred to a vehicle wholly or partially owned by one or more public authorities and controlled by the Resolution Authority,
(iv) And finally, the bail-in tool, as an effective resolution tool to minimize the possibility that the costs of solving an unviable entity are assumed by the taxpayers. It must also ensure that entities with a systemic scope are subject to resolution without endangering financial stability. It pursues this objective by ensuring that the shareholders and creditors of the unenforceable entity suffer the relevant losses and assume the corresponding part of the costs arising from the unfeasibility of the entity. It will therefore imply an important incentive for shareholders and creditors of entities to control the health of an entity under normal circumstances.

The BRRD provides that the bail-in tool can be applied to all liabilities that are not expressly excluded from bail-in. The following liabilities are briefly mentioned, although they are expressly excluded: covered deposits; customer liabilities that are protected in accordance with applicable insolvency law; liabilities arising from a fiduciary relationship provided that the client is protected in accordance with applicable insolvency law; the liabilities of entities, other than companies in the same group, whose initial maturity is less than seven days, liabilities with a remaining maturity of less than seven days, liabilities incurred with employees in relation to wages, pensions or other fixed income remuneration, commercial creditors, tax or social security administrations and deposit guarantee schemes.

In addition, the BRRD provides that, in exceptional circumstances, the Resolution Authority may exclude all or part of certain liabilities from bail-in:

(i) If it is not possible to implement bail-in in a reasonable time or,
(ii) Exclusion is necessary and proportional to achieve the continuity of critical functions and essential business lines or,
(iii) Exclusion is necessary and proportional in order to avoid the contagion effect that could lead to a disruption in the functioning of financial markets, in particular in relation to deposits of natural persons and micro and small and medium-sized enterprises or,
(iv) If bail-in on said liability could cause greater losses to other creditors than if bail-in is not applied.

The bail-in tool always leads the entity to carry out a plan to reorganize its activities. A plan to be drafted by the management team of the entity that has been recapitalized or by the person who has been appointed by the Resolution Authority. It should be designed within a month of the implementation of bail-in. During the following month, both the Resolution Authority and the Supervisory Authority must evaluate and approve the plan that serves to restore the viability of the entity.



Additional financing of the resolution and using the Single Resolution Fund in resolution

One thing we must not forget is that, in order for the Single Resolution Mechanism to be credible, once shareholders and creditors have taken on the first losses, some form of additional financing of the resolution must be available. For this reason, the Single Resolution Fund was created.

The SRF is composed of national compartments for a transitional period of 8 years, before being completely mutualized, at the end of 2023. The funds are being contributed by the sector through the contributions that are determined by the SRB and collected by the National Resolution Authorities.

Funded thus by contributions from credit institutions and investment services companies which are subject to supervision by the European Central Bank, the fund already has a budget of 17 billion (by July 2017) and should reach at least 1% of total deposits covered in the euro area by December 2023.

Within the resolution scheme, the SRF may be used only to the extent necessary to ensure the effective application of the resolution tools, as last resort, in particular to guarantee the assets or the liabilities of the institution under resolution; to make loans to or to purchase assets of the institution under resolution; to make contributions to a bridge institution and an asset management vehicle; to make a contribution to the institution under resolution in lieu of the write-down or conversion of liabilities of certain creditors under specific conditions; and to pay compensation to shareholders or creditors who incurred greater losses than under normal insolvency proceedings.

The SRF shall not be used to absorb the losses of an institution or to recapitalise an institution. But, in exceptional circumstances, where an eligible liability or class of liabilities is excluded or partially excluded from the write-down or conversion powers, a contribution from the SRF may be made to the institution under resolution under two key conditions, namely: (i) losses totalling not less than 8% of the total liabilities including own funds of the institution under resolution have already been absorbed by shareholders after counting for incurred losses, the holders of relevant capital instruments and other eligible liabilities through write-down, conversion or otherwise and (ii) the SRF contribution does not exceed 5% of the total liabilities including own funds of the institution under resolution.

Conclusion

All these measures described serve the ultimate goal of ensuring orderly resolution of non-viable entities with minimal impact on the real economy and public finances under the umbrella of the Single Resolution Mechanism, the Single Resolution Board (SRB), together with the National Resolution Authorities.

In short, the new European resolution framework confers greater solidity to the financial system. It eliminates the implicit subsidy that guarantees the sector, obliges to reduce the structural complexities of the banks and ensures that financial stability is not resentful against possible crises.

The SRB's focus will remain on making banks resolvable through resolution planning, including setting an adequate level of MREL. This will enhance the chances for private solutions, in case of failure, minimizing taxpayers' exposure. By avoiding bail-outs and worst-case scenarios, the SRB will put the banking sector on a sounder footing, only then can we achieve economic growth and financial stability.