EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing
"Crisis Management"

Introduction

Establishing an effective framework for the recovery and resolution of financial institutions which enables all banks to be resolved effectively with losses being primarily borne by shareholders and investors instead of taxpayers is crucial for well-functioning financial markets that appropriately price risk and eliminate moral hazard. It is also required to support lending, stability and growth.

Substantial progress has been made towards this goal. In Europe, in addition to strengthened prudential requirements, the key legislation includes the Bank Recovery and Resolution Directive (BRRD), the Deposit Guarantee Schemes Directive (DGSD), the proposed regulation to establish a Single Resolution Mechanism (SRM) and the establishment of a Single Supervisory Mechanism (SSM). At the time of writing, trilogue negotiations are in progress on the BRRD and DGSD and the Council and Parliament are considering the Commission's proposal for the SRM. These initiatives together provide a big step in the right direction to provide a framework in which all banks will be better capitalised, better supervised and better able to recover from stressed situations; authorities can take preventative action at an earlier stage and where necessary have the tools to conduct a resolution where losses are imposed on shareholders and creditors with no or very limited recourse to taxpayers. They also make substantial progress towards implementation of the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions in Europe.

However, important challenges and areas of uncertainty remain such as the use of resolution funds, the application of minimum requirements for loss absorbing debt and ensuring effective cross-border cooperation. The design of the SRM is also the subject of considerable political debate. It is of great importance to everyone that policymakers continue to make swift progress in addressing these issues to "finish the job".

Bank Recovery and Resolution Directive

The Parliament and the Council each agreed their position on the BRRD before the summer and trilogue negotiations have now commenced. Key areas of negotiation in trilogues include the degree of flexibility in the application of the bail-in tool, resolution financing, the scope of depositor preference and home/host issues.

Concerns have been raised[1] that discretion to exclude liabilities from bail-in creates uncertainty, unpredictability and the potential for divergent approaches; others argue that flexibility is required to ensure that the bail-in tool is operational. The focus is likely to be on the degree of discretion and the constraints that can be put on this to minimise these issues.

The role of resolution financing is another area of focus. The Council's general approach permits the use of resolution funds rather than imposing losses on creditors once 8% of total liabilities have been written down. The Parliament does not provide for such use, although this should be clarified in the text. The industry has opposed the use of resolution funds for loss absorption because this creates moral hazard and weakens market discipline in the same way as an implicit state guarantee. However, it appears that some Member States believe that such use is desirable and are not ready to ensure that banks can be resolved through bailing in shareholders and creditors fully, subject to the protection of the principle that no creditor shall be worse off than in liquidation.

[1] For example see Yves Merch, 26 September 2013: http://www.ecb.europa.eu/press/key/date/2013/html/sp130926.en.html

Following the crisis in Cyprus, increased focus has been placed on the protection of depositors. This led both the Parliament and the Council to introduce amendments to provide depositors with priority in the creditor hierarchy, ensuring that senior debt would be bailed in before preferred deposits would suffer any losses.

Home-host issues are a further key area of negotiations. Cross-border cooperation and a coordinated approach to resolution is crucial for the orderly resolution of international banking groups. It is essential to support the implementation of group resolution plans which respect the structure of banking groups, to minimise instability and support a least cost approach to resolution. However, given the political pressures involved, Member States are reluctant to rely on cross-border cooperation, which leads to demands for additional requirements for individual entities, such as individual recovery and resolution plans and local loss-absorbing capacity. Binding EBA mediation can play a crucial role in order to facilitate joint decisions between home and host authorities.

Ring-fencing loss-absorbing capacity, for example through requirements for every entity in a group to hold a minimum amount of eligible liabilities, will constrain the ability of a centrally funded group to recover from stressed situations and make the group less resilient. Higher local capital requirements will reduce the flexibility of centrally funded banks to manage capital and transfer it to where it is most needed. Individual requirements will therefore make such banks more brittle and balkanised. However, for decentralised banking groups consisting of stand-alone subsidiaries, and therefore compliant with sufficient local loss absorbing capacity, a consolidated minimum requirement would impose an additional unnecessary constraint for the effective and credible implementation of their resolution strategy. Flexible and efficient use of capital supports cross-border lending and growth in the real economy. As Andrea Enria, chair of the EBA, has stated, "*it is our duty in the EU and at the global level, to strive to find institutional solutions, cooperation arrangements and practical mechanisms which provide sufficient reassurance to home and host authorities that cross-border groups could be smoothly resolved, without imposing organisational structures that unduly constrain the most efficient use of capital and liquidity*".[2] This is one of the greatest challenges remaining, but its importance cannot be overstated.

Deposit Guarantee Schemes Directive

Alongside the BRRD, trilogues are recommencing in relation to the recast DGSD. Deposit insurance is vital to increase confidence amongst depositors and avoid bank runs. It can also assist with the resolution of deposit-funded banks. In order for deposit guarantee schemes (DGS) to be effective, depositors must have confidence in them.[3] DGSs must therefore be credible, reliable and understood. The proposed DGSD seeks to do the following:

- harmonise eligibility for deposit insurance;
- shorten the timeframe for payouts by DGSs;
- harmonise the funding of DGSs;
- provide for borrowing between DGSs; and
- enhance access to information from banks and requiring stress tests for DGSs.

Greater harmonisation and confidence in DGSs is to be welcomed, although in the wake of the decision of the EFTA court in the Icesave case[4], it remains ambiguous as to whether national DGSs are backed by their respective sovereign. Icesave and Cyprus demonstrated that DGSs risk being not credible in the absence of a sovereign guarantee particularly where the amount of insured deposits is very high relative to state resources. The mutualisation of Eurozone deposit insurance is not on the table notwithstanding common deposit insurance being one of the initial three pillars of Banking Union.

The main areas of debate in trilogues are in relation to the period in which depositors must be paid following insolvency and the level of funding of DGSs.

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[2] Enria, "Progress in banking sector and institutional repair in the European Union", 21 April 2013

[3] As emphasised by Paul Tucker, The role of deposit insurance in building a safer financial system, 25 October 2012: http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech614.pdf

[4] http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf

Single Resolution Mechanism

The SRM proposed by the Commission[5] would cover all banks within participating Member States. The SRM is designed to complement the SSM as part of Banking Union. This recognises that centralised resolution decision-making is necessary to support centralised supervision. Rather than national resolution authorities taking decisions in relation to resolution of such banks, decisions would be prepared by a Single Resolution Board (the "Board") and taken by the Commission. National resolution authorities would then implement the decisions made. The regulation is proposed to come into effect on 1 January 2015, concurrently with the RRD. The SRM, together with the BRRD, seeks to break the link between banks and sovereigns and harmonise the approach taken to resolution throughout the Banking Union.

The SRM should provide a more efficient and effective resolution regime, with more certainty regarding cross-border decision making and greater predictability on the approach to early intervention and resolution. Together with the SSM, it is essential to reverse recent trends towards single market fragmentation, ring-fencing and the potential for inefficient capital or loss absorbing capacity requirements in different jurisdictions due to a lack of trust amongst home and host authorities.

Importantly, the SRM should also increase the consistency and coordination of resolution for cross-border groups within participating Member States, as well as assist cross-border cooperation with resolution authorities outside of the Banking Union. This should reduce costs of funding, improve capital efficiency and ensure a level playing field within the Banking Union and, indeed, the wider single market, thus supporting economic recovery.

The SRM would be based upon the framework of powers and tools set out in the BRRD, with the SRM effectively acting in place of the national resolution authorities for participating Member States. In outline, the decision-making process to place a bank into resolution under the SRM would involve the following steps:

a) the ECB, as bank supervisor, notifies that a bank is failing to the Commission, to the Board and to the relevant national authorities and ministries;

b) the Board assesses whether there is a systemic threat and no private sector solution;

c) if so, the Board recommends to the Commission to initiate resolution;

d) the Commission decides to initiate resolution and sets the framework for applying the resolution tools and for using the Single Resolution Fund to support the resolution action; and

e) the national resolution authorities execute the resolution measures decided by the Board according to national law. If the national resolution authorities do not comply with the decisions of the Board, the Board has the power to supersede the national resolution authorities and address certain decisions for the implementation of the resolution measures directly to the banks.

The Board is proposed to be a new EU agency composed of an Executive Director, a Deputy Executive Director, representatives of the Commission and the ECB and members representatives of the national resolution authorities. The Board would meet in two forms: an executive session and a plenary session.

Decisions relating to specific entities or groups will be made in executive session, which is made up of the Executive Director, Deputy Executive Director and representatives of the Commission and ECB. In addition, national resolution authorities of participating Member States where entities in the relevant group are established will join.

[5] This briefing paper outlines the Commission's proposal. Many of these issues are under debate and likely to be the subject of amendments in the Parliament and the Council.

Voting in the executive session would be by simple majority with each of the Executive Director, Deputy Executive Director, representatives of the Commission and the ECB and the home resolution authority (if within a participating Member State) having a single vote. Host resolution authorities within the SRM would together share a single vote. Decisions of a "general nature" would be made in plenary session.
The Board would be accountable to the Parliament and the Council, with a requirement to submit an annual report, respond to questions raised and attend hearings. It would also be obliged to respond to any observations or questions addressed to it by national parliaments.

The proposed regulation also establishes a Single Bank Resolution Fund funded ex-ante by banks in the SRM to 1% of covered deposits, estimated to be €55 billion and built up over a 10-year period. This would replace national resolution funds established under the BRRD for members of the SRM. Much debate remains regarding the use of the fund (see above) and whether a mutualised "backstop" or credit line is required from a public source such as the European Stability Mechanism.

The key areas of debate in relation to the SRM proposal include the legal basis, the scope of the SRM, the decision-making and voting process and accountability. A further area of debate is how the SRM will apply to international banks with operations in participating Member States, non-participating Member States and third countries.

Conclusion

There has been significant progress towards establishing a credible crisis management framework in Europe. The BRRD will ensure that every Member State has a resolution authority with the powers to assess resolvability, prepare resolution plans, take early intervention action and resolve banks. It should change the focus from taxpayer bail-outs and "backstops" to ensuring that banks are resolvable, imposing losses on investors and addressing "too-big-to-fail". The DGSD should support this by enhancing the harmonisation and credibility of deposit insurance. Further, the SRM should, if designed correctly, bring significant benefits from centralised resolution decision-making. However, significant challenges remain and it is necessary to ensure that agreement is reached speedily whilst ensuring that political compromise does not undermine these objectives.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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