The Emerging EU Framework for Bank Recovery and Resolution

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Abstract

On the 6th January 2011, the European Commission's DG Internal Market and Services issued an ambitious consultation document, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution* which elaborates further on its bank rescue proposals. This paper critically reviews these proposals. Following the receipt of responses to this consultation, the EU proposes to release draft bank rescue legislation by June 2011. A harmonised European financial institution rescue regime is proposed to build upon national laws and national supervisory bodies. The proposed resolution framework will require adherence to seven key principles, including the reduction of moral hazard and risk reduction. Other principles include an emphasis upon prevention and preparation; providing credible resolution tools, enabling fast and decisive action by authorities and contributing to a smooth resolution of cross border groups. Investment firms that are not currently subject to prudential regulation will not be covered, but there will be new group resolution procedures. Due to the influence of prevailing laissez-faire market ideas, little room seems to exist in these proposals for continued state involvement in the banking sector, even though excessive adherence to these narrowly market-oriented ideas was a cause of the recent global financial crisis; some other parts of the world were able to more effectively weathered the storm of the recent financial crisis with some degree of government involvement in markets.

1. Introduction

The global financial crisis of 2007-09 has shown that there is an urgent need for more broad ranging legal mechanisms for dealing with banks and financial institutions in crisis. The collapse of large financial institutions which operate across national boundaries, such as the collapse of Lehman Brothers, has demonstrated the need for new legal tools to respond to bank crises which may have systemic implications or which may be regarded as being too big to fail. Other high profile bank failures such as those of Fortis, the Anglo Irish Bank and the Icelandic banks have also shown that there are major gaps in the European legislative framework. On 20 October 2009 the EU Commission proposed "An EU framework for Crisis Management in the Financial Sector – Frequently Asked Questions" (Europa, Memo/09/468 and IP/09/1549).

A year later, the Commission issued a paper which was seen as a roadmap for European bank crisis management reform (Europa, Memo/10/506). In announcing these proposals, Michel Barnier, the EU's Internal Market and Services Commissioner, saw these measures as being directed to avoiding a future financial crisis by introducing "a clear framework which ensures authorities throughout Europe are well prepared to deal with banks in difficulty and handle possible bank failures in an orderly manner" (Europa, Press Release, "Commission sets out its plans for a new EU framework for crisis management in the financial sector", IP/10/1353).

Then, on 6 January 2011, the European Commission's DG Internal Market and Services issued an ambitious consultation document, ***Technical Details of a Possible EU Framework for Bank Recovery and Resolution*** (hereinafter referred to as "Technical Details"), which elaborates further on its bank rescue proposals. In an accompanying press release, it was noted that at present "there are very few rules at EU level which determine which actions can and should be taken by authorities when banks fail and, for reasons of financial stability, cannot be wound up under ordinary insolvency rules" (Europa, Press Release, "Commission seeks views on possible EU framework to deal with future bank failures", IP/11/10).

These 2011 reform proposals seek to develop a comprehensive European framework to build upon national special resolution rules, such as the UK Banking Act 2009; it also complements the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act in the USA. In a press release broadly welcoming these EU proposals, the chief executive of the British Bankers' Association noted that the proposed measures "would put in place for the first time mechanisms to address the failure of cross-border institutions…" They would also recognise that no European banking institution is too big to fail. This would be a very significant achievement.

After considering responses to its January 2011 working document, the EU Commission now proposes to have draft legislation based on these proposals by June 2011. Rather than creating a single or over-riding new bank resolution authority, the aim of these latest bank special resolution reforms is to put in place a harmonised regime for the rescue of banks and financial institutions in EU Member States, whilst retaining national laws and national supervisory bodies which operate in a coordinated way in the context of generally agreed principles.

The Commission has also announced that it plans to issue a report by the end of 2012 in which it will examine the need for further harmonisation of bank insolvency regimes in Europe; it also proposes to review the European Banking Authority in 2014 with a view to developing a more integrated framework for the resolution of cross-border groups. The Commission has been troubled by problems of moral hazard and by the fact that state aid by EU Member States has amounted to 13% of GDP, largely because “no alternative to government bail-outs exist”. The proposed reforms seek to draw upon other sources of support for failing EU banks. In some ways, these proposals echo the more robust approach adopted by Scandinavian regulators when dealing with their 1990s banking crisis.

2. Nature of the Commission’s Proposals

The January 2011 Commission resolution proposals are set out in six parts and contain three Annexes. These six Parts cover: (i) Scope and Authorities; (ii) Supervision, Preparation and Prevention; (iii) Early Intervention; (iv) Resolution Tools, Powers and Mechanisms; (v) Group Resolution; and (vi) Financial Arrangements. Annex 3 lists the 150 questions to which responses are sought by early March 2011. Annex 2 points to some necessary changes to the Company Law Directive if these reform proposals were enacted. More controversially, Annex 1 discusses the use of “bail -in” or the use of debt write-down as a resolution tool. This has provoked some criticism from those who suspect that this will have a retrospective effect upon existing bank debt holders.

The January 2011 proposed bank recovery and resolution framework is to be based on seven principles which were first set out in October 2010. Under these principles, it is stressed that bank failure must be “a credible option, not only a theoretical possibility” (Technical Details p.8) These seven principles have a strong economic dimension; they are as follows:

• **Putting prevention and preparation first** to reduce the risk in the financial system;

• **Providing credible resolution tools** which minimize the risk of contagion and ensure continuity;

• **Enabling fast and decisive action** by providing well defined powers and processes for authorities;

•**Reducing moral hazard** by allocating losses to shareholders and creditors and protecting taxpayers;

• **Contributing to a smooth resolution of cross-border groups,** minimizing market disruption and fairly sharing costs and preserving essential banking services;

• **Ensuring legal certainty**, safeguarding third parties, restricting unjustified interference in property rights and ensuring that creditors are treated as they would be in a winding up;

• **Limiting distortions in competition** that arise from interventions that arise from State aid that is inconsistent with the requirements of EU Treaty rules and the rules of the internal market.

Some of these principles echo provisions found in the UK Banking Act 2009. But, they probably go further due to the more complex policy framework in which the EU Commission finds itself. The Commission summarises these principles by noting that:

> "…the general rule should be that failing credit institutions should be liquidated under ordinary insolvency proceedings. However, this will not always be feasible, and in some cases an orderly winding down through resolutions will be necessary for reasons of financial stability: that is to minimize contagion, ensure continuity of vital economic functions, maximise the value of remaining assets and facilitate their return to productive use in the private sector" (pp. 8-9).

Due to the influence of prevailing laissez-faire market ideas, little room seems to exist for continued state involvement in the banking sector, even though excessive adherence to these ideas was a cause of the crisis; interestingly, other parts of the world were able to more effectively weather the storm of the recent financial crisis with some degree of government involvement in markets. In particular, the departure from anti-State Aid rules seems difficult to avoid, as we saw during the height of the recent crisis.

A threshold question raised in the 2011 Commission paper is the need to determine the ambit of the EU resolution regime that is being proposed. Whilst there is an argument for applying the resolution scheme to all credit institutions because of the systemic risk that banks may pose, the reality is that a very broad range of investment firms is currently regulated under the EU's 2004 Markets in Financial Institutions Directive. The Commission acknowledges that most of these "are unlikely to be systematically important" and that it "would be disproportionate" to bring all of them all within the scope of the resolution regime (pp. 11-12).

It is therefore proposed to exclude investment firms that are not currently the subject of prudential regulation; a complicating issue concerns investment firms that are part of banking groups. Another problem is the degree to which the actions of one firm have an impact on financial stability in another Member State; in such situations, the question arises as to whether each Member State should retain a discretion as to whether the firm should be subject to the exercise of resolution powers. At the very least, some degree of co-ordination is required in such cases. The European Banking Authority could have a significant role in developing and coordinating recovery and investment plans. Where there is disagreement between resolution authorities in different Member States, the Commission considers that mediation can be used to resolve such disputes.

In 2010 the Commission concluded that a contributing cause of the recent financial crisis was a failure of effective supervision of financial institutions; it is proposed to deal with this problem by ensuring that prevention and preparation are given first priority by supervisors. This involves the adoption of an annual examination program for credit institutions, the use of stress testing and "enhanced supervision" of those institutions that are shown to pose significant systemic risks to the market. Credit institutions and investment firms covered by the regime would be required to prepare firm specific and group "recovery plans" that were based on realistic assumptions, and these firms should not assume that public financial support will be available to them. These plans should be assessed by firm supervisors to determine if they are "credible, realistic and sufficient" (p 20). Group recovery plans should be concerned with restoring the group's viability. In dealing with disagreements regarding the viability of these plans, mediation is once again seen as an appropriate mechanism for doing this.

3. Dealing with Corporate Groups, etc

A major strand of the 2011 "Technical Details" paper concerns group issues affecting firms, such as the transfer of assets within a group where liquidity stress is being experienced by an entity within the group. Part 5 is specifically concerned with group resolution issues. The circumstances under which such intra-group transfers are made are a matter of concern and a question is raised whether the supervisor of the transferring entity should have the power to prohibit such transfers. A group financial support agreement between the parent financial holding company and its subsidiaries is one way of controlling this situation by specifying the amounts that would be payable and the principles to be applied. It is suggested that such agreements would require prior authorisation (by both the firm's supervisor and its shareholders) in view of the potential disagreements that might arise in this area. National insolvency regimes may also need to be amended to protect claims of the group providing financial support and of its creditors, as otherwise, claw back claims against the entity receiving support might be made in the event of the provider of support being declared insolvent.

Another preparatory measure is the development of resolution plans by individual and group credit institutions and investment firms. A key issue here is the width of this requirement; should it only apply to systemically important firms or to all credit institutions. Such resolution plans for individual firms would set out such things as options for the application of resolution tools, identifying critical functions and preparatory measures and identifying how the resolution would be financed. These plans would need to be reviewed to determine whether there are significant obstacles to the application of resolution tools or to the exercise of resolution powers (p. 34). It is suggested that "any measures proposed to address or remove impediments should be proportionate to the systemic importance of the credit institution and the likely impact of its failure on financial stability."

In addition, such measures should not affect the exercise of the "right of establishment" under the EU Treaty (p. 35). In regard to the exercise of preparatory and preventative measures, it is proposed that a number of general principles should apply, in particular, non-discrimination, necessity and proportionality and that institutions should have a right of appeal to a court where any requirement is imposed by a resolution authority (p. 37). As in any corporate rescue situation, it is recognised that early intervention is essential, both at the individual firm and group level. The appointment of one or more special managers is suggested, with a view to restoring the financial situation of the firm by implementing a recovery plan.

4. Resolution Tools and Powers

The largest section of the Commission's 2011 "Technical Details" paper is concerned with resolution tools and powers of supervisory authorities; this is discussed in Part 4. This parallels tools that are to be found in the UK Banking Act 2009. The Commission emphasised that:

> "…the overriding goal of an EU resolution framework is to ensure that authorities have at their disposal credible resolution tools, allowing them to resolve failing institutions in a way that minimises risks of contagion and ensures continuity of essential financial services, including continuous access to deposits for insured depositors. The availability of such tools is also intended to minimise moral hazard" (p. 48).

Three possible triggers for the use of resolution tools are considered in situations where the credit institution is failing or is likely to fail; the first of these is broadly one of insolvency; the second arises where the firm is unable to fulfil its authorisation conditions and the third trigger arises where the firm fails to possess sufficient Tier 1 instruments as required under legislative requirements.

Five general principles are suggested as applying to the use of resolution tools: (i) shareholders must first bear the losses of credit institutions; (ii) unsecured creditors must bear residual losses; (iii) senior management of the credit institution should be replaced and bear losses having regard to their responsibility; (iv) creditors of the same class should be treated in a fair and equitable way and creditors should not incur losses that would be any greater than under a liquidation; and (v) any interference with property rights should not contravene legal guarantees, such as those contained in the European Convention on Human Rights. In addition, resolution authorities are urged to seek to minimise the overall resolution costs (pp. 49-50). The Technical Details document also seeks to propose national financing arrangements (Part 6) to defray the cost of resolution and effective cross-border cooperation.

Four principal resolution tools are to be available in bank resolution cases; these are:

(i) the sale of the business;
(ii) the use of a bridge bank;
(iii) the separation of assets; and
(iv) debt write down or conversion.

Annex A provides a more detailed discussion of debt write down procedures. Resolution authorities are to be required to comply with their procedural obligations, such as to ensure that affected parties are adequately informed about resolution actions. The payment of compensation to stakeholders who have been adversely affected is also provided for (p. 63). Other safeguards are also provided for (p. 69ff). Consideration is also given to allowing affected persons to challenge resolutions.

In regard to group resolutions, the Commission proposes coordinated action by regulators in Member States "..to promote cooperation and prevent fragmented responses" (p. 75). It is proposed to establish cross-border resolution colleges which would provide a forum for exchanges of information and coordinated resolution measures. National resolution measures may be curtailed so as not to "prejudice the effectiveness of the group resolution scheme" (p.75). However, responsibility for the resolution of individual entities in a group would remain national and group resolution plans would not be binding on national supervisors. Group resolution is defined as:

> "…in any relevant case (a) the application of resolution powers and resolution tools at the level of the parent entity with a view to resolving two or more credit institutions of the group that meet the conditions for resolution and stabilizing the group as a whole; and (b) the coordination of the application of resolution tools and the exercise of resolution powers by resolution authorities in relation to the legal entities of the group that meet the conditions for resolution" (p. 79).

A group level resolution authority would be designated for every EU consolidated cross-border group; this should be the resolution authority of the Member State where the supervisor of the group is located (p. 78). A group level resolution authority would have a wide range of powers, such as the power to sell fully-owned assets of the EU parent credit institutions and its fully-owned subsidiaries; it would also have the power to apply the bridge bank tool at group level to stabilise the group. The group level resolution authority would also have power to apply a debt conversion at parent company level.

5. In Conclusion

It is not possible in this short overview to provide detailed consideration of the rich variety of policy options that are present in this most recent EU Commission document, let alone to answer the long list of questions that are raised by the Commission. This will require industry and government responses. The key issue will be to ensure that the new resolution regime has realistic boundaries and that it does not go beyond what is necessary to avoid contagion in financial markets.

The proposed regime should also not be over-burdened by too many conflicting policy objectives. This will be essential in view of the effort that is being made to harmonise Member State bank resolution tools and principles, as well as to deal more efficiently with cross-border group resolutions. EU legislative drafters acting upon these important proposals will need to carefully balance these competing considerations and it is more than likely that adjustments will need to be made to any regime in the light of further experience.