THE NEW EUROPEAN RECOVERY AND RESOLUTION FRAMEWORK

Ionuț Mircea Ph. D Student
Romanian Academy
National Institute for Economic Research "Costin C. **Kiriţescu"**
Bucharest, Romania

Abstract: The Bank Recovery and Resolution Directive define a common set of rules to establish when and how the authorities should intervene to stabilize troubled banks. It establishes the principle that shareholders and creditors are the first to bear the losses of a failing bank, before authorities and taxpayers. This addresses the moral hazard, increasing the market discipline of banks and limiting the risks they are taking. The Directive introduces also the concept *no creditor worse off* to protect the shareholders and creditors. It is also provided a framework for orderly resolution, even for banks operating across borders. The gradual mutualisation of the resolution scheme requires political compromises that have not been achieved yet and there cannot be a banking union without a mutualisation.

JEL classification: E 58, E 59, E 60

Key words: banking system, risks, depositors, financial crisis, resolution and recovery

1. OVERVIEW

The document *Towards a banking union,* proposed by the Commission in September 2012, mentioned that in June 2012 EU leaders agreed to *deepen economic and monetary union as one of the remedies of the current crisis*. At that meeting, the leaders discussed the report entitled *Towards a Genuine Economic and Monetary Union* in which were set out the main building blocks towards deeper economic and monetary integration, including banking union. In the memo it is also mentioned that regulations reforms will not be sufficient to ensure financial stability, more steps being needed to respond to the financial sector crisis and its contagion to sovereigns.

Therefore, a banking union was seen as the key to support economic and monetary integration.

The Commission made a proposal to design a banking union, to give solid grounds to the banking system and to restore the confidence in the euro area.

The banking union was supposed to be based on four pillars:

i) single rulebook;

ii) single supervisory mechanism;

iii) single deposit guarantee scheme

and,

iv) single bank resolution mechanism.

The measures were seen as being a part of a long-term vision for economic and fiscal integration.

According to the press release on september 12, 2012 on proposing new supervision powers to the ECB, the banking union is crucial, all of the four pillars being vital.

We are now at a point where all of the four pillars were defined. The single rule book was isssued and it consists of a directive and a regulation, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV) and Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR). The first one has directly application at national level, while the second must be transposed into the national legislation.

Single supervisory mechanism (SSM) is already functional, although it is still in the process of refining its procedures and oversight processes but that can only lead to an improvement in the future activity.

The rules for deposit guarantee scheme were also defined in 2014, by issuing the Directive 2014/49/EU on deposit guarantee schemes (DGS).

The last step, namely issuing a common regulatory framework on recovery and resolution across the 28 EU countries and establishing a single recovery and resolution authority was conducted by adopting Bank Recovery and Resolution Directive (BRRD).

BRRD implementation, in the Eurozone, will be through a ***Single Resolution Mechanism*** (SRM), which is one of the main pillars that will underpin the banking union, in addition to the Single Supervisory Mechanism (SSM) and Single Deposit Guarantee Scheme (DGS).

Whilst the CRD seeks to reduce the probability of financial institutions to face financial distress, by strengthening their balance sheets, the BRRD seeks to ensure that financial institutions will be restructured without the taxpayer contribution or causing systemic disruption in the banking system.

The main objective of introducing BRRD is regaining confidence. The banking crisis in Europe has had dramatic implications on public finances and has significantly decreased the confidence in the banking sector. According to the IMF, losses caused by the financial crisis, recorded between 2007 - 2010, reached €1 trillion, representing 8% of the European Union GDP. Additionally, according to the Commission, the measures adopted between October 2008 and December 2012 to recapitalize banks and the asset purchases have cost member states €591.9 billion, representing 4.6% of the 2012 EU GDP. If the state guarantees given during this period are added, the final impact is €1.6 trillion.

This impact was taken into account when it was established a regulatory framework, which is based on principles of taking the first losses by shareholders and creditors and only after by taxpayers, if needed.

The European Commission has calculated that increasing the costs of financial institutions may have a negative impact on GDP, but the improved financial stability of the sector and the reduced probability for taxpayers' money to recapitalize failing banks would have a much larger positive impact on GDP. The European Commission calculated, as it is specified in the table 1 bellow, the accumulative benefit of the BRRD, the new capital requirements under Basel III and the positive net benefits of the funding of the deposit guarantee scheme.

Table.1

Cumulative impact of Basel III, RF/DGS and Debt Write Down tool (bail-in) (costs and benefits as % of annual GDP.)

	Basel III	DGS/RF	Bail-in	Sum
Cost (% of EU GDP annually)	0.16	0.04	0.14 – 0.42	0.34 – 0.62
Benefits (% of EU GDP annually)	0.30	0.32	0.76	1.38
Net Benefits (% of EU GDP annually)	0.14	0.28	0.34 – 0.62	0.76 – 1.04

Source: European Commission Memo 15 April 2014, EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions

The BRRD is very important because it defines a common set of rules to establish when and how the authorities must intervene to stabilize troubled banks.

Also, it establishes the principle that shareholders and creditors must retain the first costs for banks' poor risk management, before authorities and taxpayers are called on for financial support. This addresses the moral hazard, increasing the market discipline of banks and limiting the risks they are taking.

In the same time it was defined another principle, that *no creditor should be worse off* as a result of a resolution than it would have been had under applicable insolvency law. That was based on the industry pressure and is appropriate, because many measures taken in the last years proved that the shareholders would have been better off in an insolvency process and they considered to be expropriated, the new bank resulting from the failing one being sold for profit.

Measures that can be taken are precautionary type, early intervention and measures designed to prevent bank failures.

When bankruptcy is inevitable, the BRRD provides a framework for orderly resolution, even for banks operating across borders. Together with DGS Directive, the Directive completes the protection of retail depositors in the European Union.

The public intervention is still possible, but only temporary and when systemic risks are likely to occur. Anyway, these will be governed by the state aid rules established at the EU level.

The BRRD states that measures that can be taken must protect the continuity of critical functions of banks, must lead to the avoidance of significant adverse effect on the financial system, must prevent contagion and maintain the market discipline. The final objective is protecting the public funds, the depositors and the bank's client funds and assets.

2. Critical Elements

Banks must prepare and regularly update recovery and resolution plans, in which will have to state how they intend to act in a crisis situation and what measures are fit to be applied in order to maintain the critical functions, according to their organizational structure, their business model, the interconnectivity with the banking system as a whole and group structures.

Those plans will be under the regularly supervision of the national/EU recovery and resolution authorities.

On the other side, the national/EU recovery and resolution authorities must prepare plans for each credit institution in order to identify the appropriate resolution tools which are suitable to be applied, depending on the business model and organizational structures involved.

The bail-in investors are regular shareholders and creditors, who must cover in the bail-in procedure 8% of the total assets of the bank, before any use of the resolution authority to access other stabilisation funds. This requirement will modify the way in which banks raise funding and the relation between banks and their shareholders.

The entry into force of the BRRD will affect all credit institutions, changing the equity and the funding structure, the organisational charts. In the same time, the process will lead to an increase of the funding costs for banks and for borrowers.

The headlines of the BRRD are as fallows:

i) the bail-in procedure which will be applied starting with January 1, 2016 by writing down liabilities towards some creditors, before any public stabilisation funds to be used to rescue a bank;

ii) it establishes a new source of funding for the banking resolution. Banks have to made significant contributions, over a period of 8 years, to the recovery and resolution fund, based on the size of the insured deposits;

iii) depositors with eligible deposits under €100k will not be bailed-in and senior debt holders must be bailed-in before any depositors;

iv) minimum requirements are set for banks' own funds and eligible liabilities (minimum requirements for own funds and eligible liabilities - MREL) depending on the bank's size, risk profile, business model and resolution approach.

Banks must contribute to build the resolution fund on a horizon of 8 years, which will affect the funding costs.

Having in view the bail-in procedure, the capital instrument governed under other rules than the EU must be harmonized in such a way to allow the use of those instruments in bail-in. If the new rule applies to the existing debts, banks must renegotiate the terms of these instruments, also at higher costs.

Deposit hierarchy may be changed in insolvency procedures and can be influenced by the bilateral bail-in agreements between member states and non-EU states. Also there are questions about the BRRD implementation, taking into consideration its complexity. All EU banks must prepare recovery and resolution plans. New rules will end in changing the operational and organizational structures. Also, the funding structure will be affected and the relations with shareholders.

It must be clarity in what concerns the minimum own funds and eligible liabilities (MREL), in what shape exists, under what contractual terms regarding the deployment and clear mechanism for intra-group relations. Banks contributions to the newly established fund will also raise the cost of funding.

3. Single Resolution Mechanism (SRM) for the Eurozone (and for other joining member states)

Mario Draghi, President of the ECB, has suggested that the SRM should have three core elements: *"a single system, a single authority, and a single fund"*.

The system will be run by a new Single Resolution Board (the 'Board'), which will be *the authority*. There will be also defined the roles for the Commission, the Council, the ECB and the national resolution authorities.

The system for resolutions proposed by the Commission:

i) the Resolution Board prepares resolution plans for all banks directly supervised by the ECB, while national authorities remain responsible for the plans for all other Eurozone banks;

ii) the ECB is responsible for notifying the Resolution Board, the Commission and the relevant national resolution authorities that a bank should be resolved;

iii) the Resolution Board assesses whether there is a systemic threat and adopts a resolution scheme, the relevant resolution tools and use of the Fund;

iv) The Resolution Board Executive will have limited powers to use the Fund, up to a threshold.

The Resolution Board cannot require a member state to use its national budget to provide public support to any entity under resolution.

In what concerns the *Resolution Fund*, this must be build up through ex-ante contributions at national level. The national funds will have to reach in a 8 year period, 1% of the covered deposits. The Single Resolution Fund (SRF) will be created by pooling the national funds. The Fund will also be gradually mutualised over the 8-year transition period (initially 10), moving in to be a single, fully mutual SRF at the end of 8 years.

According to the Commission, resolution funds can also be used to compensate shareholders or creditors if and to the extent that their losses under bail-in exceed the losses they would have undergone under normal insolvency proceedings, in line with a "no creditor worse off" principle. Also, national resolution authorities will be able in special cases to exclude some liabilities and to use the resolution fund to absorb losses or recapitalize a bank. The Commission states that this can happen only after a minimum level of losses equal to 8% of total liabilities including own funds has been imposed on an institution's shareholders and creditors, or under special circumstances - 20% of an institution's risk-weighted assets where the resolution financing arrangement has at its disposal ex-ante contributions that amount to at least 3% of covered deposits.

The contribution of the resolution fund is capped at 5% of a bank's total liabilities.

According to BRRD, financial public support can be made in case of a significant disturbance of a member state economy for maintaining financial stability, without adopting resolution measures, and can be in the form of a:

i) state guarantee for the liquidity facilities provided by central banks;

ii) state guarantee of newly issued liabilities; or

iii) injections of own funds or purchase of capital instruments of an institution where, it has no and is not objectively determined to have infringed its continued authorization, its assets are greater than its liabilities, it is able to pay its debts as they fall due and the requirement to write down capital instruments has not been triggered under the terms of the BRRD.

4. Range of instruments at each stage: preparatory and preventative, early intervention and resolution

4.1 Preparation and Prevention

On the prevention side, the BRRD includes rules for recovery and resolution planning, as well as for intragroup financial support. The global recession was exacerbated by limited preparation with respect to how individual institutions would be restructured if needed. This led to bail-out the *too big to fail* institutions which provided critical banking functions.

Therefore, each institution (also at group level) shall prepare and maintain a recovery plan according to which the management shall apply measures for the restoration of the financial position in the event of significant deterioration. They must provide in measures for maintaining the critical functions of banks.

Through the resolution plans the resolution authorities lay down the actions to be taken when the institution meets the conditions for resolution and also, they serve as a basis for the assessment as to whether the institution is resolvable or not.

4.2 Early Intervention

In case an institution either breaches or is likely to breach the regulatory requirements, resolution authorities may require:

i) implementation by the management of one or more measures layed down in the recovery plan;

ii) the management of the institution to examine the situation and draw up an action programme to solve the problems within a certain period of time;

iii) that one or more board members or board of directors be removed and replaced;

iv) a plan on debt restructuring or contact potential buyers in case the institution is to be resolved.

These measures allow the resolution authorities to intervene at an early stage.

Another important tool is the appointment of a special manager, who will take over the management of the bank. Although it will run the bank, for some operations it will need the resolution authority approval.

4.3 Resolution Measures

The resolution measures defined by BRRD are not particularly new, as certain European jurisdictions have already adopted it (including Romania) and have already used some.

The newly introduced is the principle that banks will have to bail-in creditors before public funds can be used for rescuing an institution.

In the situation that an institution cannot be rescued, the BRRD provides various tools which can be used to preserve critical functions of the institution, such as:

i) the sale of (part of a) business, without the consent of the shareholders;

ii) the creation of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity);

iii) the asset separation (the transfer of impaired assets to an asset management vehicle, good bank and bad bank);

iv) bail-in measures (imposing the losses, taking into consideration the seniority, on shareholders and unsecured creditors).

In addition to the tools defined by the BRRD, other tools could be adopted by member states under the condition that they are consistent with the principles and objectives of the BRRD.

4.3.1. Sale of Business

When applying the sale of business tool, the resolution authorities must seek to obtain a market value for the sale. The marketing must be transparent, free of any conflict of interest, taking account of the necessity for a rapid action, aiming at maximizing the sale price and shall not discriminate between potential purchasers.

4.3.2. Bridge Bank

When using this tool, the resolution authority has the right to transfer all or part of the assets, rights and liabilities of the institution to a temporary special entity - the bridge bank. The bridge bank can transfer the instruments back to the institution under resolution if certain conditions are met or to third parties. When transferring the instruments to the bridge institution, the total value of liabilities must not exceed the amount of assets and rights, so as not to create a bridge institution with unsustainable liabilities.

4.3.3. Asset Separation

The purpose of this measure is to separate the distressed assets of the institution from the others, so as to maximize their value. The measure can be applied only in conjunction with another tool.

4.3.4. Bail-in Measures

Bail-in provisions will enable resolution authorities to write down or convert into equity the claims of the shareholders and creditors of banks that are failing or

likely to fail. Also, the measure can lead to recapitalization of a failing institution in order to continue on solid ground its activity, by reducing the liabilities. The measure can be applied only if there is estimation that long-term viability and financial stability of the institution will be achieved.

4.3.4.1. Liabilities eligible for the bail-in tool

According to BRRD, certain types of liabilities will be permanently excluded from bail-in. The minimum level of losses that will have to be imposed on shareholders and banks creditors, before any use of the resolution fund, must equal to 8% of total liabilities, including own funds. Eligible deposits from individuals and small and medium sized enterprises will have a higher rank than the claims of ordinary unsecured, non-preferred creditors and depositors from large corporations. The deposit guarantee scheme, which will always step in for covered deposits (i.e. deposits below €100k), will have a higher ranking than eligible deposits.

Types of liabilities that will be permanently excluded from bail-in:

i) insured deposits (i.e. deposits below €100k); secured liabilities, including covered bonds;

ii) liabilities to employees of failing institutions, like regular salaries and pension benefits;

iii) commercial claims relating to goods and services critical for the daily functioning of the institution;

iv) liabilities arising from a participation in payment systems that have a residual maturity of less than seven days;

v) inter-bank liabilities with an original maturity of less than seven days.

National resolution authorities will also have the power to exclude/partially exclude liabilities on a discretionary basis if they are not fit to ensure continuity of critical functions, which means cannot be bailed-in within a reasonable time in order to avoid contagion or to avoid value destruction that would affect the creditors.

4.3.4.2. Hierarchy of Claims

The recovery and resolution authority must assess the aggregate amount by which the liabilities must be reduced or converted into capital. If the purpose is recapitalization of the bank, it must be take into consideration the amount necessary for complying with the capital requirements and increasing the market confidence.

According to BRRD, the own capital instruments shall be written down first and cancelled in proportion to the losses and up to their capacity and after subordinated debt instruments. When the subordinated debt or other eligible liabilities must be reduced, the losses will be allocated proportionally within the liabilities of the same rank.

5. CONCLUSIONS

It has been created a clear standard regarding the use of public funds, as an ultimately solution leading to solving the problem of moral hazard. The costs will be

supported differently for each resolution schemes, initially by shareholders and afterwards by creditors. The latters will increase the funding costs for banks.

The set of common rules will facilitate the transnational resolution, in a system where there were specific national rules concerning supervision and bankruptcy.

If this will have an effect in creating a safer banking system, it depends on how early intervention and preventive measures will be taken and on the cooperation between supervisors and resolution authorities set at national and European level.

The main downside is that it will be needed a 8 years period for the fund accumulation. Also, on long-term it is unlikely that the fund can support the resolution of several banks or big banks, without the existence of other support mechanisms.

The gradual mutualisation of the resolution scheme requires political compromises that have not been achieved yet and there cannot be a banking union without a mutualisation.

Another question that arises is whether there are other mechanisms to absorb losses that may result from systemic crisis, beyond single resolution fund.

Questions are also raised with respect to the selection and the appointment of Board Resolution members.

Although, one of the goals is to support and stabilize banks in the future without the interference of national interests to appear in the resolution, there are still political forces and national interests against mutualisation.

It was also agreed that the use of amounts from the single resolution fund should be subject to intergovernmental agreements. Thus, there will be probably several stages of negotiations before the single resolution to be completed.

Acknowledgements

This paper is supported by the Sectorial Operational Programme Human Resources Development (SOP HRD), financed from the European Social Fund and by the Romanian Government under the contract number SOP HRD/1599/1.5/S/136077.

REFERENCES

1. BOGNÁR, B. K. Overview of the New System for Bank Recovery and Resolution in the EU, 2013
2. Orrick THE LEGACY OF LEHMAN SERIES: ARTICLE 1 The EU Bank Recovery and Resolution Directive – Bringing Stability Back to the European Banking Sector, 2014
3. *** Communication from the Commission to the European Parliament and the Council - A Roadmap towards a Banking Union' (European Commission), 2012
4. *** Explanatory Memorandum to the Proposal 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 and amending Council Directives 77/91/EEC and 82/891/EC,

Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010' (European Commission, COM(2012) 280 final), 2012

5. *** *EU Bank Recovery and Resolution Directive 'Triumph or tragedy?' Hot Topic: European FS Regulation, January 2014,* www.pwc.com/financialregulation, 2014

6. *** European Economic and Social Committee, 'Opinion of the European Economic and Social Committee on the Proposal 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 and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 COM(2012) 280 final - 2012/0150 (COD)' (European Economic and Social Committee, 2012), 2012

7. *** DIRECTIVE 2014/49/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on deposit guarantee schemes, 2014

8. *** DIRECTIVE 2014/59/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014

9. *** Memo 15 April 2014, European Commission, EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, 2014

10. *** Memo 15 April 2014, European Commission, Banking union: restoring financial stability in the Eurozone

11. *** Proposal 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 and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010' (European Commission, COM(2012) 280 final), 2012