

The Banking Recovery and Resolution Directive and the EU's Crisis Management Framework: Principles, Interplay with the Comprehensive Assessment and the Consequences for Recapitalizing Credit Institutions in Crisis Situations

Within the EU, a new framework has been designed to define, when banks are considered no longer viable, how such banks can exit the market without creating widespread financial distress and how a smooth exit or recovery should be financed. It consists of a complex set of rules and international agreements, with responsibility for their implementation assigned to various authorities. This study analyzes the objectives of the new regime and the new powers of the various authorities involved, as well as the main underlying tradeoffs that are defining the policy debate in terms of the allocation of losses to various stakeholders, the associated conditionality and the degree of mutualization of decision-making and financing within the euro area and the EU at large.

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Since the beginning of the financial crisis in 2008, the EU has made substantial progress in drawing conclusions from the lessons learned and in finding an answer to the question as to how to regulate, supervise and govern the financial sector more effectively. With the establishment of the Single Supervisory Mechanism (SSM) and the assumption of supervisory responsibility for banks in the euro area by the European Central Bank (ECB) in November 2014, on the one hand, and the transposition of the Bank Recovery and Resolution Directive² (BRRD) into national law by the beginning of 2015, on the other, two key elements of the

banking union that will add a new dimension to banking supervision in Europe have come into effect only recently.

A lack of adequate tools to deal with unsound credit institutions and to minimize negative repercussions by preserving banks' systemically important functions when insolvency occurs had been observed in many EU Member States. That made it necessary for several governments in the EU to intervene in their financial sectors in order to stabilize banks. More than 100 EU banks, which accounted for around 25% of the banking system's total assets, received state aid, and 22 Member

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² 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.

States provided aid in support of the financial sector.³ Hence, the aim was to break the link between banks and sovereigns, and to put an end to the old paradigm of bank bail-outs.

Beginning in 2008, the European Commission reacted promptly to the crisis and developed a comprehensive framework of rules for crisis-related state aid that defined general conditions under which Member States could support banks. In 2013, the European Commission decided to strengthen these rules with a further Communication⁴ requiring banks to elaborate restructuring plans before recapitalization measures can be authorized and, in the event of capital shortfalls, banks' shareholders and subordinated creditors to assume a first part of the burden before banks can ask for public funding.

Even though the European Commission launched a first consultation on an EU framework for cross-border crisis management in the banking sector at the beginning of 2010, a harmonized regime ensuring that shareholders and creditors bear losses first, and thus minimizing the cost for taxpayers, while preserving financial stability, did not come about, and reaching common

agreement for the BRRD at the European level took almost five years.

That was why many EU Member States decided in the meantime to adopt bank recovery and resolution tools of their own, with the drawback of creating different national regimes to handle crisis situations. However, the BRRD will bring harmonization to this area as of January 1, 2015.

The perceived need for an instrument that allows a direct recapitalization of banks at a supranational level has been a driving force behind the whole move toward a banking union. European leaders considered an EU institutional architecture and regulatory framework comprising, in particular, the SSM,⁵ the BRRD, the Single Resolution Mechanism⁶ (SRM) and amendments to the Deposit Guarantee Schemes Directive⁷ (DGSD), to be a prerequisite for any financial backstop, via the establishment of the European Stability Mechanism (ESM), that might be used if national funding were to prove insufficient for dealing with domestic challenges. Consequently, in June 2014, the EU Member States came to a preliminary agreement on the future ESM direct recapitalization instrument.

³ See Almunia, J. 2014. "Some highlights from EU competition enforcement". Speech presented by the Vice-President of the European Commission responsible for Competition Policy. Florence. September 19. Available at http://europa.eu/rapid/press-release_SPEECH-14-608_en.htm?locale=FR.

⁴ Communication from the Commission on the application, from 1 August 2013, of state aid rules to support measures in favor of banks in the context of the financial crisis (2013 Banking Communication).

⁵ Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. The SSM was established to align supervisory responsibility at the European level and to reflect that EU financial markets are highly integrated and interconnected, with many institutions operating extensively across national borders. The Regulation grants the ECB authority to supervise the banking sector in the euro area and to ensure that a single rulebook for financial services is applied in a coherent and effective manner and that credit institutions are subject to supervision of the highest quality.

⁶ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund.

⁷ Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes to amend Directive 94/19/EC.

The forthcoming establishment of the SRM will further reduce differences between national resolution rules in the euro area and will address the lack of unified decision-making for the resolution of banks. That will mean a break with the past where banks operating across borders were international in life, but national in death.

1 Key Elements of the BRRD

The BRRD comprises three key elements that provide authorities with a set of tools to intervene in an institution in different phases, and sufficiently early and quickly, to ensure the continuity of the institution's critical economic functions. The first element consists of an *improvement of preparatory and preventive measures* to the effect that, on the one hand, institutions are required to draw up recovery plans and outline possible measures they themselves will take to restore their financial position, including support through institutional protection schemes (IPSS)⁸ or measures based on intragroup cross-border support agreements.⁹ On the other hand, newly established resolution authorities will have to prepare for future crisis situations by drafting resolution plans¹⁰ and to ensure, *inter alia*, by setting a minimum requirement of own funds and eligible liabilities (MREL),¹¹ the resolvability of an institution, so that the impact of its failure on the economy and financial system is minimized. Resolution plans

will be drawn up for each institution or group, and will provide a roadmap of actions to be taken when the respective institution fulfils the prerequisites for resolution. Such plans shall be scenario-based and updated at least once a year. If the resolution authority is not convinced that a smooth market exit is possible, it has various powers for removing material impediments, including the right to require the institution to limit exposures, divest assets and restrict business lines, or even to require changes to the institution's legal or operational structure, in order to ensure that critical functions can be carried out separately if necessary. That means that resolution authorities have the power to take intrusive actions that affect the institution as a going concern and should, therefore, cooperate very closely with the competent authorities.

The second element is that the *early intervention powers* of competent authorities will be strengthened. They will be entitled to intervene earlier and more effectively by requiring an institution to implement measures set out in the recovery plan or by appointing a special manager for a limited period to restore the institution's financial viability when its solvency is deemed to be at risk.

Finally, the BRRD introduces a *resolution regime* and requires resolution authorities to take action on the basis of a *determination* that an institution is

⁸ According to Article 113(7) of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (known as the Capital Requirements Regulation – CRR), an IPS is a “contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary”.

⁹ See Articles 19 to 26 of the BRRD.

¹⁰ See Articles 10 to 14 of the BRRD.

¹¹ See Article 45 of the BRRD.

failing or likely to fail,¹² and that there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe.

Therefore, the provision of extraordinary public financial support¹³ usually triggers resolution. However, this is not the case when, for economic and financial stability reasons,¹⁴ it takes the form of a state guarantee for specific liabilities¹⁵ or if the support is granted by way of an injection of own funds or a purchase of capital instruments at prices, and on terms, that do not confer an advantage upon the institution (*precautionary public recapitalization*).¹⁶ In any event, such public support measures must be confined to solvent institutions, be proportionate, be precautionary and temporary in nature and may not be used to offset losses that the institution has incurred or is likely to incur in the near future. Furthermore, they are conditional on final approval under the EU's state aid framework.

In addition, the use of precautionary public recapitalizations in the form of capital injections is limited to addressing a capital shortfall that has been

established in national, EU- or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, the European Banking Authority (EBA) or national authorities. Under such circumstances, public capital injections would not trigger the mandatory write-down or conversion of capital instruments that would generally be required if the support takes the form of a state guarantee.¹⁷ Against the backdrop of the aforementioned requirements, it would appear that there is only a very narrow scope of application for precautionary public recapitalization in the form of capital injections without triggering resolution.

The broad range of *new powers* resolution authorities have been provided with include taking control of an institution under resolution and exercising all the rights and powers conferred upon shareholders, transferring assets or liabilities out of a failing institution to another entity, reducing the principal amount of the outstanding liabilities of an institution under resolution or converting them into ordinary shares, and removing or replacing the management body of a failing bank.

¹² *The determination is primarily the responsibility of the competent authority. However, Member States may also entrust resolution authorities with this task, whenever they have the necessary tools at their disposal. According to Article 32(4) of the BRRD, an institution is deemed to be failing or likely to fail if (1) it infringes or will, in the near future, infringe the requirements for continuing authorization in a way that would justify the withdrawal of the authorization, (2) its assets are or will, in the near future, be less than its liabilities, (3) it is or will, in the near future, be unable to pay its debts or other liabilities as they fall due, and/or (4) extraordinary public financial support is required.*

¹³ *According to Article 1(28) of the BRRD, extraordinary public financial support is state aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), or any other public financial support at supra-national level, which would, if provided for at national level, constitute state aid that is provided in order to preserve or restore the viability, liquidity or solvency of a bank.*

¹⁴ *In order to remedy a serious disturbance in the economy of a Member State and preserve financial stability.*

¹⁵ *To either back liquidity facilities provided by central banks according to the central banks' conditions or newly issued liabilities.*

¹⁶ *The institution must not be likely to fail for any other reason at the time the public support is granted. Also, none of the circumstances cited in Article 59(3) of the BRRD may be given, especially not that of the bank no longer being viable unless relevant capital instruments were written down.*

¹⁷ *Article 59(3)(e) of the BRRD stipulates that any support in the form of a state guarantee requires an assessment of whether or not a write-down or conversion of capital instruments is necessary. Depending on whether the underlying liquidity shortfall also involves a need for recapitalization, the amount of a write-down and the conversion rate are to be determined on the basis of an independent valuation.*

These powers are intended to enable authorities to uphold uninterrupted access to critical functions, in particular deposits and payment transactions, avoiding a destruction of values. When applying resolution tools, authorities should take into account and follow the measures provided for in the resolution plan unless circumstances specific to the case warrant a different course of action.

The BRRD does *not preclude* an institution from being declared to be *insolvent*, nor the winding-up of nonsystemic parts. If it is deemed to be in the public interest¹⁸ to do so, however, an institution must be resolved, in particular in order to ensure the continuity of critical functions, to protect depositors, to avoid significant adverse effects on the financial system and to protect public funds.

2 Rules for the New Loss-Absorption Sequence and Resolution Financing under the BRRD against the Backdrop of the Rules on State Aid

Shareholders and creditors will become the primary source of financing for restoration or resolution and will have to bear losses, provided that no creditor incurs losses greater than those incurred if the institution were wound up under normal insolvency proceedings (principle of “no creditor worse off”). Contributions from holders of

capital instruments in the form of a write-down or conversion of relevant capital instruments are required prior to resolution if the authority responsible¹⁹ determines that the institution will be no longer viable unless that is done. As shown in chart 1 below, the BRRD has established a clear hierarchical order for the writing-down of liabilities that observes the priority of claims under normal insolvency proceedings and stipulates that higher-ranking liabilities are touched only if lower-ranking liabilities do not suffice to achieve the required capital effect. Common equity tier I (CET1) capital items are the first to be permanently reduced, followed by additional tier 1 capital and then tier 2 capital instruments.²⁰ Only thereafter will remaining eligible liabilities be written down or converted in line with the hierarchy of claims in normal insolvency proceedings.

The BRRD provides for covered deposits and deposit guarantee schemes subrogated to the rights and obligations of covered depositors to have the highest ranking in the hierarchical order of creditors,²¹ followed by the proportion of eligible deposits of natural persons and small and medium-sized enterprises that would have been deemed to be covered deposits if they had not exceeded the coverage level.²² Covered deposits up to a coverage level of EUR 100,000 are excluded from any bail-in.

¹⁸ In this context, resolution is in the public interest if it is necessary and proportionate to achieve a resolution objective and if that objective cannot be attained to the same extent by winding up the institution under normal insolvency proceedings. The protection of depositors is one of the objectives of any resolution.

¹⁹ According to Article 61 of the BRRD, each Member State is required to designate either the competent authority or the resolution authority as that which is to be responsible for making this determination.

²⁰ An alternative provided for under certain circumstances is the possibility of converting the latter into CET1 capital instruments.

²¹ Hence, deposit guarantee schemes profit from that high ranking, which typically significantly reduces the contribution of the respective deposit guarantee scheme during resolution. This treatment is aimed at safeguarding the funds of deposit guarantee schemes for fulfilment of their primary pay-out function when deposits are unavailable.

²² See Article 48(1)(e) of the BRRD, in connection with Article 108 thereof.

However, as the losses of an institution under resolution have to be distributed in accordance with the aforementioned principles, other eligible liabilities have to suffer relatively higher haircuts – similar to what occurs in the theory of communicating vessels.

This hierarchical order is applicable both under the BRRD and under the state aid regime. In principle, state aid rules require burden-sharing up to the level of subordinated debt prior to any public intervention in cases of precautionary recapitalization as well as during resolution, unless that would endanger financial stability or lead to disproportionate results.²³ The Commission decides on whether or not to grant an exemption on a case-by-case basis. The Commission finding that the requirements for granting an exemption are not met could lead to a divergence of state aid rules from the BRRD provisions, in particular when the competent authorities or the resolution authorities assess the situation differently and do not require shareholders and creditors to contribute, or at least not on the same scale. While the divergence in resolution cases would probably be limited to a possible involvement of subordinated debt,²⁴ capital instruments could also be an issue in cases of precautionary public recapitalization.

According to the BRRD, the bail-in tool covering creditors with claims ranging from subordinated debt to preferred liabilities needs to be transposed into national law by January 1, 2016. However, several Member States have

decided to implement the bail-in tool together with the transposition of remaining BRRD provisions, thus applying it as from January 1, 2015, in order to strengthen internal loss-absorption capacity. One of these countries is Austria, according to the draft implementing act²⁵ that is scheduled for adoption by parliament in December 2014. That may affect the ratings of Austrian banks as a consequence both of the shifting of the burden of bearing losses from the taxpayer to the shareholders and creditors of failing banks and of a changed perception of implicit government support.

In any event, the burden-sharing approach will be supported by funds established under *resolution financing mechanisms* and the *deposit guarantee scheme* (DGS). The latter will finance resolution up to certain limits. Both these funds will be built up through annual contributions of banking institutions and will provide for ex ante backstops to ensure that the financial sector bears the costs of future crises, thereby avoiding any injection of capital by the public sector or any other equivalent public financial support. This notwithstanding, the use of resolution financing mechanisms or DGS funds to assist in the resolution of failing institutions must always comply with the relevant state aid provisions.

In exceptional circumstances,²⁶ however, the *support of public resources* may be necessary, and the BRRD explicitly provides Member States with the possibility to put in place govern-

²³ This could hold true of cases where the amount of state aid that could be granted is small in comparison with a bank's risk-weighted assets and where the original capital shortfall has been reduced significantly through capital-raising measures.

²⁴ Resolution authorities may – under certain circumstances – exclude subordinated debt instruments from bail-in while the European Commission could have a diverging view.

²⁵ This act will replace the already applicable national implementation act (*Banking Intervention and Restructuring Act – BIRG*) that had anticipated certain elements of the BRRD.

²⁶ For details, see Section 2 above.

Loss Absorbency Regimes

Commission communication State aid rules

Burden sharing except when it would endanger financial stability or lead to disproportionate results



BRRD precautionary public recapitalization¹

No burden sharing required when support takes the form of a capital injection; burden sharing including capital instruments when a state guarantee is granted



BRRD resolution

Burden sharing: (i) no exception for capital instruments (ii) for subordinated debt, other and preferred liabilities it is at the discretion of resolution authorities²



Possible gaps between state aid and BRRD

Liabilities eligible for bail-in

Capital instruments eligible for write-down/ conversion



Applicable only in systemic crisis + EC state aid approval required

Source: Authors' illustration.

¹ Required for economic and financial stability reasons to remedy a serious disturbance in the economy of a Member State and preserve financial stability.

² In exceptional circumstances if not possible within reasonable time, would cause destruction in value, necessary for continuity of critical functions or to avoid widespread contagion.

³ Incl. use of other national compartments of the SRF.

ment financial stabilization facilities for use, as a last resort, to finance the resolution of an institution. The effects of any use of such government stabilization facilities should be fiscally neutral over the medium term. If such resources prove insufficient, the ESM can, under specific circumstances, provide a supranational backstop.²⁷ According to the BRRD, contributions from preferred liabilities and from eligible deposit holdings above the ceiling

of EUR 100,000 are not required prior to recapitalization through the ESM (as highlighted with a red box in chart 1).

2.1 Independent Valuation the Basis for Write-Downs, Conversion-of-Capital Instruments and Bail-Ins

Before writing down or converting relevant capital instruments and before designing the actual resolution, including the application of the bail-in tool, resolution authorities must ensure that a fair, pru-

²⁷ For details, see section 2.2 below.

dent and realistic *valuation*²⁸ is carried out by an independent body. Since such valuations tend to be highly complex and time-consuming, the required information should be collected as early as possible.

Such an *ex ante resolution valuation* has different dimensions and purposes. It forms the basis for a number of decisions that have to be taken by the resolution authority during the resolution process and has to be distinguished from the *ex post insolvency valuation* of differences in treatment in comparison with treatment under normal insolvency proceedings.

First, it provides an *assessment of the assets and liabilities* of the struggling institution to determine whether the prerequisites for resolution or a write-down and conversion of capital are given and to ascertain the appropriate amounts of capital instruments and, where necessary, eligible liabilities that need to be written down or converted to restore compliance with regulatory requirements and market expectations.

Furthermore, the *ex ante resolution valuation* should entail a breakdown of creditors into classes based on the priority of consideration under applicable insolvency law and an *estimation of the treatment* that each class of *shareholder/creditor* would enjoy if the institution were wound up under normal insolvency proceedings (a fictitious

insolvency valuation). That estimation is needed to allow resolution authorities to take the principle of “no creditor worse off” into account.

Depending on the financial situation of the institution under resolution, the resolution authority has to decide which action is appropriate, i.e. whether existing shares or other instruments of ownership should be canceled or transferred to bailed-in creditors, and/or whether they should be diluted as a result of the conversion of relevant capital instruments or eligible liabilities to equity.²⁹

A *full cancelation* or *full transfer* of shares or other instruments of ownership is necessary if the *going-concern value* determined in the *ex ante resolution valuation* is zero or negative. That would necessitate writing down liabilities according to the hierarchical order of creditors. A write-down of liabilities would not be appropriate as long as shareholders retain some value. If the institution has a *positive net asset value* both on the basis of the assessment of its assets and liabilities and according to the fictitious insolvency valuation, a *dilution* of existing shareholdings would suffice, making it appropriate to give holders of equity a share in the upside potential.³⁰ In cases where the asset value is zero only according to the fictitious insolvency valuation, authorities may choose from the whole set of

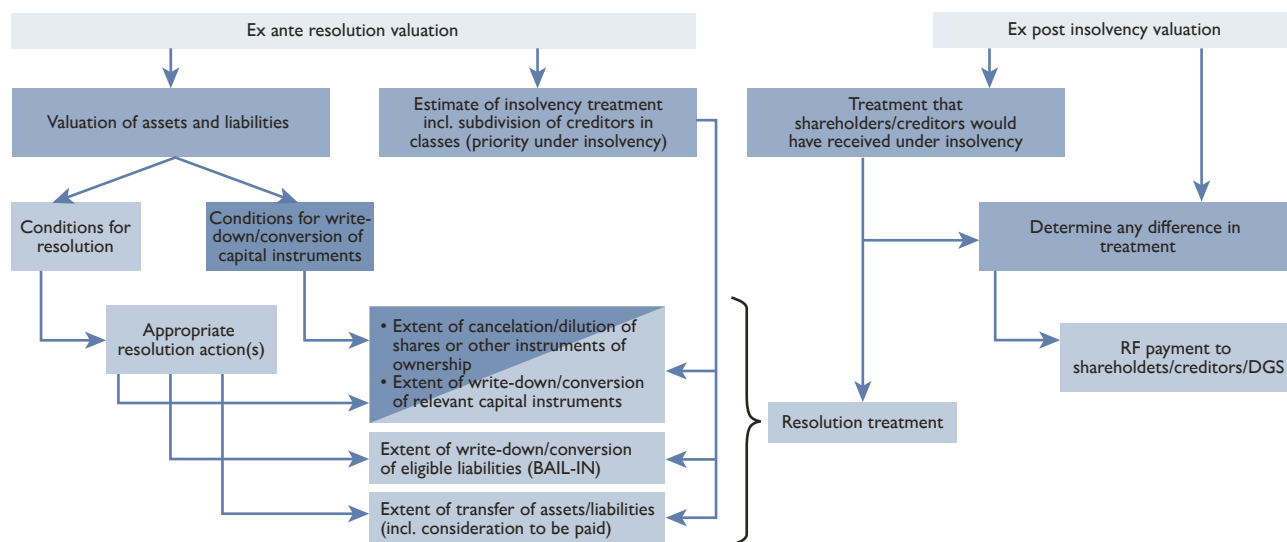
²⁸ The methodology for assessing the value of the assets and liabilities, and for calculating a buffer for additional losses in the provisional valuation, will be specified in further detail by the EBA, in accordance with Article 36(15) of the BRRD. See EBA. Draft regulatory technical standard on valuation. Consultation paper. November 7, 2014.

²⁹ See EBA. Draft Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments. Consultation Paper. November 11, 2014.

³⁰ Depending on the situation, a dilution may be combined with a partial cancelation or transfer of shares. Where certain shares entail special voting rights, authorities may consider it to be more appropriate, in order to simplify the structure of the reorganized institution, to cancel those shares than to transfer them. Where shares of a public limited company are listed on an official stock exchange, transferring shares, rather than canceling them, may help avoid an interruption of listing and any discontinuity in the valuation of the shares. Although the resolution authority has the power to have new shares or other instruments of ownership listed or admitted to trading, its doing so may be operationally burdensome and cause unnecessary delays.

Chart 2

Valuation Types and Purposes



Source: Authors' illustration.

options and decide which serves best operationally to take the BRRD principles into account.³¹

The valuation also serves other purposes, including, when the bail-in tool is applied, that of informing the decision on the extent of the write-down or conversion of eligible liabilities³² and the eventual contribution of a deposit guarantee scheme.³³

On a slightly different note, in the context of the ESM direct bank recapitalization instrument,³⁴ a valuation of the bank's assets conducted under the guidance of the ESM, in liaison with the ECB and European Commission, is used to determine the contributions of the requesting ESM Member and the ESM under a burden-sharing scheme.

Finally, the *ex post insolvency valuation* of differences in treatment in comparison with treatment under normal insolvency proceedings is an element foreseen – in addition to, and separate from, the *ex ante resolution valuation* – as a tool to safeguard shareholders and creditors against any possible misalignments. It serves to determine whether the treatment of shareholders and creditors in the context of the resolution was worse than that they would have enjoyed in the event of normal insolvency proceedings. If a difference in treatment is ascertained, they will be compensated by the resolution financing mechanism.

³¹ Where more than one option is appropriate, the contractual terms of instruments of ownership or provisions of national company law may affect the choice between dilution solely through the issuance of new shares, dilution through a combination of canceling shares and issuance of new shares, or dilution through the transfer of some shares, possibly in combination with new issuance.

³² See EBA. *Draft Guidelines on the rate of conversion of debt to equity in bail-in or the write-down and conversion of capital instruments. Consultation Paper. November 11, 2014.*

³³ In accordance with Article 109(1) of the BRRD, and with the safeguards provided for in Article 75 there.

³⁴ For details on the ESM direct recapitalization instrument, see Section 2.2 below.

Absorbing losses by means of the bail-in tool

In addition to the sale-of-business, bridge-institution and asset-separation tools at the disposal of the resolution authority, bail-in is a further tool that the resolution authority may apply.³⁵ The purposes of the bail-in tool are two-fold: first, the recapitalization of an institution under resolution so as to restore its ability to comply with the conditions of authorization and to continue to conduct banking activities. This also includes recapitalization to the extent necessary to sustain market confidence in the institution concerned.

Second, the bail-in tool may also be applied to reduce principal amounts of debt instruments or to convert them into equity, if such instruments are transferred to a bridge institution or disposed of by way of the sale-of-business or asset-separation tools. The haircut on debt instruments in this context, or their conversion into equity instruments, also provides capital for the absorption of losses.³⁶ The tool must be deployed in accordance with the resolution principles,³⁷ and must meet the resolution objectives.

The bail-in tool is not applicable to covered deposits, client money and fiduciary liabilities, as well as short-dated liabilities to certain infrastructures and institutions.³⁸ Moreover, secured liabilities, including covered bonds, are ex-

cluded from any bail-in to the extent covered by collateral.

Exclusion of eligible debt from bail-in

In exceptional circumstances, resolution authorities may exclude liabilities from coverage of the bail-in tool on an ad-hoc basis, thus potentially altering the waterfall of liabilities' loss absorberency. This may have repercussions on the pricing of the instruments concerned.

Specifically, eligible liabilities may be excluded if it is impossible to bail them in within reasonable time, or for financial stability purposes to avoid contagion if the exclusion is necessary and proportionate, or to avoid a destruction of value.³⁹ In such cases, the losses would have to be borne by other creditors to the extent the principle of "no creditor worse off", i.e. the insolvency counterfactual, allows this.⁴⁰ Before using its discretionary powers to exclude an eligible liability from bail-in, the resolution authority must notify the European Commission. Where contributions of the resolution financing arrangements or an alternative source of financing⁴¹ is required, the Commission may prohibit, or require amendments to, the proposed exclusion in order to protect the integrity of the internal market. This is without prejudice to the application by the Commission of the EU's state aid framework.⁴²

³⁵ The resolution tools are listed in Article 37(2) of the BRRD.

³⁶ See Article 43 of the BRRD for both purposes.

³⁷ As specified in Article 34 of the BRRD.

³⁸ See Article 44(2) of the BRRD for the full list of liabilities excluded from bail-in.

³⁹ This is the case if the losses of other creditors would be even higher as a result of the application of the bail-in tool.

⁴⁰ At the same time, however, two further principles must be upheld, namely the principle that losses must be borne by shareholders and creditors and the principle that adequate resources for resolution financing must be maintained.

⁴¹ See section 2.2 below for details on alternative sources of financing.

⁴² Article 44(12) of the BRRD.

Resolution financing arrangements, deposit guarantee scheme funds and alternative sources of financing to fill the gap caused by bail-in exclusions

If losses cannot be passed on to other creditors to any sufficient extent, the required contributions⁴³ may be made by *resolution financing arrangements* only if (1) prior contributions to loss absorbance by other holders of equity and debt amount to at least 8% of the total liabilities, including own funds, of the institution under resolution and (2) the contribution of the resolution financing arrangement does not exceed 5% of said total liabilities, including own funds.⁴⁴ Only in exceptional circumstances and only if all unsecured, non-preferred *liabilities other than eligible deposits* have been written down or converted in full and the resolution fund has been used to contribute to bail-in in lieu of those liabilities to the limits permissible (i.e. 5%), may the resolution authority seek *further funding* from *alternative sources of financing*.⁴⁵ By way of an alternative, or as an additional measure, recourse may be taken to available resources from ex ante contributions to the resolution financing arrangements that have not yet been used.

It is this possible source of financing (other banking industry contributions to resolution financing arrangements and funding of public sources, including direct or indirect funds from other

Member States)⁴⁶ that makes the discretionary power to exclude liabilities from bail-in a highly sensitive issue. Interesting in this respect is also the fact that *not all eligible liabilities have to be written down before such sources can be drawn upon*, within the scope defined by the BRRD, *because write-downs of eligible deposits are not deemed to be a prerequisite*.

The use of deposit guarantee scheme funds in the context of resolution requires that depositors *continue to have access to their deposits* and that the usual case of a pay-out has been avoided through the application of resolution tools. In all cases, the *liability* of a deposit guarantee scheme in resolution may *not exceed the net losses* the scheme would have incurred in the event of a winding-up *under normal insolvency proceedings* and the overall amount thereof may *not be greater than 0.4% of the covered deposits*, i.e. the equivalent of 50% of the *overall target level* for the financial resources that have to be available to deposit guarantee schemes at the end of the setting-up phase.⁴⁷

When the *bail-in tool* is applied, the deposit guarantee scheme is liable for payment of the amount by which covered deposits would have been written down to absorb losses if they had been included within the amount of eligible liabilities to ensure that the net asset value of the institution under resolution is equal to zero and had been written

⁴³ Article 44(4) and (5) of the BRRD.

⁴⁴ Instead of the limit of 8% of the total liabilities, including own funds, of the institution under resolution, a limit of 20% of the risk-weighted assets of the institution concerned may be referred to.

⁴⁵ According to Article 105 of the BRRD, Member States must ensure that financing arrangements under their jurisdiction are enabled to contract borrowings or other forms of support from institutions or other third parties in the event that the ex ante contributions are not sufficient to cover losses, and that the extraordinary ex post contributions provided for in Article 104 are not immediately accessible or sufficient. Also, according to Article 37(10) of the BRRD, in the very exceptional situation of a systemic crisis, the resolution authority may seek funding from alternative sources of financing through the use of government stabilization tools provided for in Articles 56 to 58 of the BRRD.

⁴⁶ Subject to the financial stability reasons as indicated in the BRRD.

⁴⁷ Unless a Member State decides to set a higher limit (Article 109 of the BRRD).

down to the same extent as the liabilities of creditors with the same level of priority under national insolvency proceedings. Not involving the deposit guarantee scheme would constitute an unfair advantage over the rest of creditors subject to resolution powers.

When *one or more resolution tools other than the bail-in* tool are applied, the deposit guarantee scheme is liable for payment of the amount of losses covered depositors would have suffered, according to the BRRD waterfall of liabilities' loss-absorbency, under national insolvency proceedings.

The financial resources of the *deposit guarantee scheme* do not compete with the *resolution financing mechanism*, nor can they be used instead of the latter. They are *independent from each other*. The decision of a resolution authority, in exceptional circumstances, to exclude or partially exclude certain eligible liabilities from bail-in under the conditions laid down in the BRRD and a potential use of the resolution financing mechanism to cover the losses that have not been absorbed does not have any impact on the liability of the deposit guarantee scheme. In such cases, the financial resources of a deposit guarantee scheme may be used in addition to those

of a resolution mechanism. The latter may be needed to capitalize, or grant loans to, a bridge bank or an asset management vehicle, irrespective of the contribution of a deposit guarantee scheme.

2.2 Public Resources, the European Stability Mechanism and the Single Resolution Fund to Support Resolution

ESM direct bank recapitalization the last line of defense (really?), but depositors not in the line of fire

In June 2014, the euro area Member States reached a preliminary agreement on the *future ESM direct recapitalization instrument*.⁴⁸ Together with the forthcoming *Single Resolution Fund* (SRF), it is a manifestation of the *transnational pooling of resources* within the euro area to backstop bank recapitalization, and thus accommodate possible financial stability concerns associated with resolution cases.

The ESM direct recapitalization instrument may only be used if a set of strict conditions is met, e.g. that the requesting ESM Member is unable to provide financial assistance to the beneficiary bank⁴⁹ without very serious effects on its own fiscal sustainability.⁵⁰ Furthermore, to minimize conflicts of

⁴⁸ On December 8, 2014, the ESM Board of Governors adopted the ESM direct recapitalization instrument for euro area financial institutions. Until then, the ESM can only recapitalize banks indirectly through loans to the Member States where the troubled bank is located. As regards the statistical treatment of ESM operations and their impact on Maastricht debt, it is important to note that the ESM has the status of an international organization (see Decision of Eurostat on deficit and debt and the Statistical classification of the European Stability Mechanism of 31 January 2013). Operations undertaken by the ESM, such as borrowing on financial markets and granting loans to beneficiaries, will not be rerouted to the euro area Member States. Also, payment of the paid-in capital is considered as an increase in equity for the participating Member States, with no impact on government deficit. Only in the case when the ESM would have to record a loss in a support operation and would compensate this loss by a call in capital, it will be treated as a capital transfer and, thus, an expenditure of government.

⁴⁹ Including any indirect recapitalization by the ESM through the routing of funds to the respective Member State.

⁵⁰ The decision to provide stability support through the ESM, the choice of instruments and the financial terms and conditions are taken by the ESM Board of Governors by mutual agreement (Article 5(6)(f) of the ESM Treaty). However, an emergency voting procedure can be used in cases where the economic and financial sustainability of the euro area is threatened. In that case, a qualified majority of 85% of the votes cast is required (Article 4(4) of the ESM Treaty).

interest, the requesting ESM Member would need to contribute financially to the recapitalization, and a Memorandum of Understanding detailing policy conditions for that Member State's financial sector would be concluded. The request addressed to the ESM by the ESM Member will include, inter alia, the amount of capital needed, an opinion of the ECB⁵¹ on the bank's financial situation and the result of the most recent stress test. The design of the mandatory private sector contribution as a prerequisite for the use of the ESM direct recapitalization instrument will require a staggered introduction over the period from 2015 and 2016 since the bail-in instrument may not be available in all Member States until January 2016.

The ESM may contribute to the resolution of an institution by way of acquiring shares or other capital instruments including hybrid instruments or contingent capital in the beneficiary institution, subject to the ESM Board of Governors authorization. The participation is intended to be temporary and a limit on the total amount of ESM resources available for the ESM direct recapitalization instrument is intended to be set at EUR 60 billion. The ESM direct recapitalization instrument is not

intended to be used as a precautionary instrument as defined in the BRRD.

The interplay between the BRRD – specifically the discretion to exclude liabilities from bail-in – and the requirements for the ESM direct recapitalization instrument will be a sensitive issue as under the BRRD⁵² eligible deposits need not be written down as a prerequisite for (directly or indirectly through the SRF, once available) seeking funds from alternative funding sources.

The SRM, the SRF and the Intergovernmental Agreement

In July 2014, an EU regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms within the framework of a Single Resolution Mechanism was published.⁵³ While the substantive provisions generally correspond to those of the BRRD, the regulation is aimed mainly at tackling the lack of a unified decision-making process for resolution.⁵⁴ What is important is that, as from January 1, 2016, the SRF will be considered to be the resolution financing arrangement of the participating Member States.⁵⁵

In this context, the representatives of all EU Member States except the

⁵¹ In cases where the institution is already directly supervised by the ECB. Otherwise, the national competent authority will provide such an opinion, and the ECB would be requested to take over direct supervision.

⁵² Subject to other conditions set out in the BRRD, including financial stability aspects.

⁵³ Regulation (EU) No 806/2014 of the European Parliament and the European Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

⁵⁴ For Member States participating in the Single Supervisory Mechanism (SSM), centralized powers of resolution have been established and entrusted to the Single Resolution Board (SRB) that will cooperate with national resolution authorities. The SRM is a further element in the process of harmonization regarding prudential supervision, brought about by the establishment of the EBA, the single rulebook on prudential supervision and the establishment of the SSM, which is responsible for the application of the EU's prudential supervision rules. The SRB will become operational on January 1, 2015.

⁵⁵ Article 96 of the SRM Regulation. However, the implementation may be postponed if the conditions for the transfer of contributions to the SRF have not been met.

United Kingdom and Sweden have signed an intergovernmental agreement on the transfer and progressive mutualization of contributions to the SRF (the "IGA").⁵⁶ Under the terms of the IGA, contributions by banks that are levied at the national level⁵⁷ will be transferred to the SRF, which will initially consist of "compartments", i.e. segments comprising the contributions from each individual Member State.⁵⁸ These segments will be gradually merged over a transitional period of eight years. The signatories to the IGA have agreed that, if the resources available in the SRF are not sufficient for a particular case of resolution and if the ex post contributions that are then to be collected from the banks in order to cover the additional amounts required are not immediately accessible, the Member States involved in that particular act of resolution should provide bridge financing from national sources, or from the ESM, in line with agreed procedures. Furthermore, a common backstop to facilitate borrowings by the SRF will be developed.

In any event, systematic recourse to the bail-in of shareholders and creditors, as provided for in both the BRRD and the SRM Regulation, will also be a prerequisite for access to the resources of the SRF. Against the backdrop of the progressive mutualization of contributions to the SRF, the discretionary power to exclude liabilities from a bail-in becomes a particularly delicate issue.

3 Follow-Up to the ECB's Comprehensive Assessment – A Test Case for the Application of BRRD Principles, also with a View to Future Stress Tests

The BRRD, together with the EU's state aid regime and the supervisory rules set out in the CRR/CRD IV,⁵⁹ is the key legal framework for the follow-up to the ECB's comprehensive assessment exercise and the EU-wide stress tests. Against the backdrop of this new framework, several scenarios are conceivable with respect to how banks, supervisors and resolution authorities might deal with capital

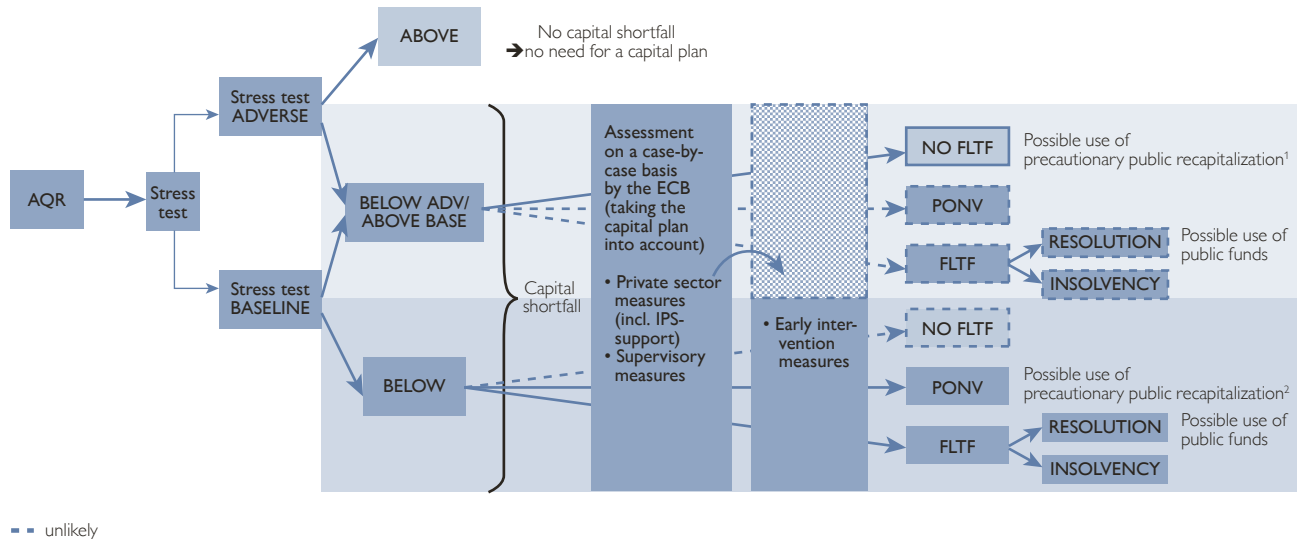
⁵⁶ Council of the European Union. Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund. 8457/14. May 14, 2014. This intergovernmental agreement was deemed necessary because the participating Member States that collect the contributions from institutions located in their respective territories according to the BRRD and the SRM Regulation, remain responsible for transferring those contributions to the SRF. The signatories to the agreement adopted a declaration signaling that they will strive to complete the ratification process in time to permit the SRM to become fully operational by January 1, 2016. It is in this context that the Council's implementing act to specify the methodology for the calculation of contributions of banks to the SRF has been debated so intensively.

⁵⁷ The methodology used for the calculation of the risk-based contributions under the BRRD will be the same as that used for the SRM. However, the shift from a national to a single funding target (SRM level) will cause the individual and aggregate contributions of banks established in each Member State to change.

⁵⁸ The obligation to transfer the contributions levied at the national level to the SRF is not derived from EU law. Said obligation is established by the IGA, which lays down the conditions under which the contracting parties agree, in accordance with their respective constitutional requirements, to transfer the contributions they levy at the national level to the SRF. Channeling financial resources to the SRF is intended to enable it to function properly.

⁵⁹ CRR/CRD IV is used to refer to the combined package of legal provisions set out in the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

ECB Comprehensive Assessment: Possible Scenarios



■ unlikely

Source: Authors' illustration.

¹ For solvent banks without burden-sharing, if needed to preserve financial stability.

² For solvent banks after burden-sharing up to junior debt, if needed to preserve financial stability.

Note: PONV=point of nonviability; FLTF=failing or likely to fail

shortfalls.⁶⁰ The assessment would be undertaken on a case-by-case basis and the process will be iterative. The status of a bank and relating supervisory and possible resolution actions may evolve over time.

If the bank meets requirements under the baseline scenario of the stress test, but a capital shortfall is detected under the adverse scenario, it is unlikely that the point of nonviability or resolution will have been reached. The bank will generally be viable and will endeavor to make the shortfall in capital up through private sector measures (internal resources,

followed by drawing on the market to raise capital). If these attempts are unsuccessful, the ECB will decide on possible supervisory measures.⁶¹ A Member State may provide extraordinary public financial support so as to preserve financial stability, subject to EU state aid rules and the BRRD.⁶² This would not trigger the resolution of the bank if it were considered to be solvent and if that did not infringe upon the requirements for continuing authorization in the near future.

In practice, the issue as to whether the requirements for precautionary

⁶⁰ Supervisory or resolution action may also be necessitated by other circumstances, e.g. liquidity constraints. This study limits itself, by way of example, to describing the case of a capital shortfall.

⁶¹ According to Article 16 of the SSM Regulation.

⁶² See also "precautionary public recapitalization" above and Article 32(3)(d)(iii) of the BRRD for detailed requirements. According to Article 107(1) of the Treaty on the Functioning of the European Union, state aid is generally forbidden, but certain derogations, limited to the minimum necessary, apply. The European Commission has a margin of discretion when assessing the legality of aid measures. In any event, they must not offset losses that the institution is likely to incur and are conditional on final approval under the EU's state aid framework.

public recapitalization are given is not decided by a single body on its own responsibility,⁶³ so that there is scope for a *possible conflict* with respect to the interpretation of burden-sharing requirements under the BRRD and that under state aid rules.

A capital shortfall under the baseline scenario indicates a higher probability that a capital shortfall will materialize, so that there would be less room for any “precautionary public recapitalization.”⁶⁴ From the perspective of competition law, a bank that does not meet minimum regulatory capital requirements can generally receive state aid only after holders of equity and hybrid capital, as well as subordinate creditors, have contributed adequately to offset losses. That aside, an assessment of the viability of the respective bank would have to be carried out from a BRRD perspective.

4 Summary

A new framework has been built to define when banks are considered not to be viable any longer, how such banks can exit the market without creating widespread financial distress and how a smooth exit or repositioning should be financed. It comprises a complex set of rules and international agreements, with various authorities in charge.

The key to understanding them is an acknowledgement of the embedded

tradeoffs between coordinative arrangements to ensure financial stability and market-based policies. The interests of the owners and creditors of banks, of the banking industry that contributes to resolution funds and of the general public need to be brought into balance. The waterfall of liabilities' loss absorbency is characterized by a policy preference for protecting depositors, which in turn leads to a higher share in recapitalization contributions that must be made by subordinated and senior unsecured creditors and, in exceptional circumstances, by resolution funds that are potentially underpinned by euro area-wide support mechanisms.

Cross-border aspects play a prominent role in terms of the distribution of resolution costs and decision-making powers. The shared responsibility for banking supervision at the euro area level will lead to a gradual sharing of resolution costs within the Single Resolution Mechanism. The terms of the Single Resolution Fund, and the potential role of the ESM as provider of a backstop for this fund, and a prospective direct recapitalization instrument for banks all bear the hallmarks of the aforementioned tradeoffs in terms of the allocation of losses to various stakeholders, associated conditionalities and the degree of mutualization within the euro area.

⁶³ According to Article 32(1)(a) of the BRRD, it is the responsibility of the competent authority (for significant institutions, the ECB), after consulting the resolution authority, or, if a Member State avails itself of this option, that of the resolution authority, after consulting the competent authority, to make this determination. However, the European Commission is responsible for assessing the compatibility of aid measures with the internal market.

⁶⁴ As it could be argued that the public measure would offset losses that the bank is likely to incur, such a measure would probably not qualify as “precautionary” within the meaning of Article 32(4)(d) of the BRRD.