Institutions

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The institutional framework for banking resolution in Europe

The institutional framework in Europe is based on the Single Rulebook which removes any national biases – harmonization – or supervisory forbearance. The new regulation introduces the 'bail-in' principle which puts some resolution costs on creditors of the stressed bank. Consequently, 'bail-out' is replaced as resolution mechanism.

The Directive 2014/59/EU - Banking Recovery and Resolution Directive (BRRD) - transposes the Financial Stability Board (FSB) Key Attributes into EU law (FSB, 2014). The BRRD entered into force on the 1st January 2016[5] and put in place a set of common tools and powers to the national regulators which would enable them to avert the failure of a bank and, if necessary, resolve branches of banks based in other countries and circumstances. (FSB, 2016a).[6] The package of measures is aimed at reducing the probability the G-SIIs may fail. The FSB indeed proposed a new international standard for resolution regimes to address possible differences amongst jurisdiction and allow them to promptly intervene without disrupting in the overall financial system.

The European resolution framework is advancing to implement a bank-specific requirement for own funds and eligible liabilities (MREL) that will be

5. The deadline for the transposition of the BRRD into national law was set at 31 December 2014. By the end of 2015 the Czech Republic, Luxembourg, Poland, and Sweden had not fully transposed the rules into national law. Consequently, the case was referred by the European Commission to the Court of Justice.

6. The BRRD requires each member state to designate a national resolution authority, and practically the whole member states had done so as of 30 September 2015.

applicable to all banks. The European Union is working to transpose the FRB's total loss-absorbing capacity (TLAC) standards into EU directives in manner consistent with MREL, which shares the same regulatory features with TLAC (FSB, 2016a). The proposal of the Commission of 23 November 2016 implements the TLAC standards issued by FSB in November 2015 (after the approval of BRRD) and integrates the TLAC requirement with the MREL rules avoiding redundancy. Among other novelties, the proposal contemplates harmonization of MREL across countries, as it is the case for TLAC, but only for G-SIIs as it was expected. The proposal also harmonizes creditors' hierarchy keeping the existing class of senior debt and reacting a new asset class of non-preferred senior debt bailnable after other capital instruments, but before other senior liabilities. Institutions remain free to issue debt in both classes while only the non-preferred senior class will be eligible for the minimum TLAC requirement.

The BRRD also requires each bank to draw up a **resolution plan**, or Living Wills, along with supervisory authorities, with the purpose of using it in the event of bank's failure. The resolution plan shall include, where applicable, an analysis on how and when the bank may apply for central banks facilities and identify those assets which would be expected to be used as collateral (Avgouleas et al., 2013). Furthermore, institutions should put in place **recovery plans** for critical resources to enable them to return to ordinary business procedures in a reasonable timeframe (EBA, 2016).

The **Single Resolution Mechanism** (SRM) was established by the Regulation (EU) 806/2014. The SRM envisages the centralized European-decision making and financing mechanism for resolution. The **Single Resolution Board** (SRB) is its executive board. The SRM is a coordinated system in which the SRB and the European Central Bank (ECB) work as the single resolution authority. The resolution process is organized as follows. Firstly, the European Central Bank (ECB) determines whether the bank is "failing or likely to fail" (EBA, 2015). Then, the SRB determines the resolution scheme, i.e. resolution tool the bank should be liquidated or resolved in combination with national resolution authorities and the Living Wills (Huertas, 2016)[7], which may be validated by the ECB in the following 24 hours.

7. Article 32 of BRRD.

Finally, the resolution scheme enters into force if no objection has been expressed by the Council or the European Commission (FSB, 2016b).

The **Single Resolution Fund** (SRF) is an essential part of the SRM which harmonizes resolution of the European financial institutions within its 19 Member States. The SRF will be built between 2016 and 2023 and shall reach the 1% of covered deposits, estimated at roughly 55 billion euros. To estimate *ex-ante* contributions of the banks to the Fund, the SRB applies the methodology set out in the Commission Delegated Regulation (EU) 2015/63 and the Council Implementing Regulation (EU) 2015/81. Accordingly, the SRB takes into consideration the size and the risk of each financial institution to estimate its 'risk factor adjustment'; otherwise, a lump-sum treatment is applied to small or low-risk banks (SRB, 2016). Table 1 displays the annual contributions of banks computed based on Euro area level estimations (SRM level) and national level (BRRD level) estimations (Hadjiemmanuil, 2015).

Table 1: Available funds for initial steps in bank resolution (in percentage)

	2016	2017	2018	2019	2020	2021	2022	2023
SRM	40	60	67	73	80	87	93	100
BRRD	60	40	33	23	20	13	7	

Source: SRB (2016).

The Five Presidents' Report (EC, 2015a) indicated as a priority to set up a credible common backstop to the SRF during the transition period. The SRM will serve as a transitional backstop until the fund has reached its full target size. However, the current version of the SRF is allowed to borrow from external markets, but not to have the backing from the Member States. This limitation has been criticized for lack of credibility of enough financial backstop. The combination of a well-endowed resolution fund and ECB liquidity may fulfil the credibility for resolution mechanism, shielding the ECB for potential losses. Finally, under the current ESM Treaty, the SRF is unable to provide funds to non-Eurozone countries which opted to join the Banking Union (Gordon and Ringe, 2015).

The current **Deposit Guarantee Scheme** (DGS) is regulated by the Directive (EU) 2014/49/EU. The Directive allows for coverage of deposits up

to EUR 100,000. However, this feature allows compensations in excess of this amount in case of qualifying deposits.[8] Importantly, the SRB and the European Commission are involved in designing the European Deposit Insurance Scheme (EDIS) to complete the Banking Union. The political discussion on the EDIS is conditional on bank risk reduction measures prior to achieving the full mutualisation of deposit insurance. Preconditioning EDIS on them would result in a delay for the third pillar. However, if the Council decides granting a veto power to individual member States, i.e. via Intergovernmental Agreements, the EDIS might be further delayed.[9] The scheme should include a series of strong safeguards against 'moral hazard' and inappropriate use, in order to give incentives to national schemes to manage their potential risks in a prudent way. In particular, a national scheme should only be able to access EDIS if it fully complies with relevant Union law (Gross and Schenmaker, 2014). As for EDIS funding, the initial target level of the Fund will be progressively reached until 20% of four ninth of the minimum target levels of the DGS of the whole Member states. Banks' ex-ante contributions to EDIS would be calculated based on covered deposits, adjusted to take into account the risk attributes of each bank, to meet a target level of 0.8% of covered deposits of all banks in the SSM by 2024. Table 2 displays the funding path of EDIS and participating national DGS (EC, 2015b).

Table 2: Funding path of EDIS (in percentage)

	2017	2018	2019	2020	2021	2022	2023	2024
EDIS	20	20	20	36	52	68	84	100
DGS (% of covered deposits)	0.14	0.21	0.28	0.28	0.26	0.20	0.11	0

Source: EC (2015b).

8. Deposits resulting from real estate transactions relating to private residential properties; deposits that serves social purposes, and deposits that serve purposes laid down in national law (compensation for criminal injuries or wrongful conviction.)

9. The Intergovernmental Agreement was signed by representatives of all Member States, except Sweden and the United Kingdom.

Challenges for bank resolution in the United States

Title II of the Dodd-Frank Act introduces the Orderly Liquidation Authority (OLA) as a new resolution mechanism for G-SIIs. The central challenge posted by the Title II is to adapt the Federal Deposit Insurance Company (FDIC) receivership to carry out the liquidation and wind-up from small and medium sized banks to G-SIIs. A central element of quickly FDIC resolution is the Purchase and Assumption (P&A), by which a healthy bank purchases assets and assumes liabilities of the troubled bank. Then, the Resolution Trust Company - a special and temporary government entity - proposes the branch breakup to improve upon P&A transactions. (Capponi et al., 2016).

The US legislation is still uncertain as to whether a G-SII will be resolved under OLA or Chapter 11 bankruptcy procedure (11US Code), potentially increased by banks' resolution plans. In fact, the US legislation takes on three challenges for the near future. Firstly, OLA is seen by US regulators as a backstop which would be activated if the organizational complexity of G-SIIs makes difficult to invoke Chapter 11. Secondly, the exemption of qualified financial contracts (QFC) from the automatic stay under Chapter 11 - but under OLA the resolution authority may impose a stay - introduces uncertainty when the derivative and repo counterparties are free to cancel their contracts with the bank. Finally, a carefully designed liquidity provision facility that can be tapped during resolution is another key issue in case TLAC at the holding level could not be ensured. Under OLA, such liquidity may be provided through the orderly liquidation fund.

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