

LEGAL DEVELOPMENT

Enhancing European Bank Resolution and Recovery

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§1. INTRODUCTION

During the financial crisis of 2007–09, most EU states did not have effective bank resolution and recovery regimes to ensure an orderly restructuring or winding-up of a failing bank or financial institution. When a number of major European banks began to fail in 2008, including Fortis, Dexia and the Royal Bank of Scotland, the absence of an effective resolution and recovery framework led EU Member State authorities to engage in a chaotic scramble to freeze and seize assets located in their jurisdictions in order to pay creditors and depositors of distressed financial institutions in their countries. Moreover, national authorities resorted to ad hoc measures to provide state guarantees and inject capital into failing financial institutions.¹ The crisis demonstrated the EU's lack of a clear and predictable legal framework to govern how a distressed financial institution would be reorganized or liquidated in an orderly manner without undermining financial stability.

To address this, the European Commission published a Communication in 2009 on an 'EU Framework for Cross-Border Crisis Management in the Banking Sector', which analysed gaps and weaknesses in the EU legal framework governing bank resolution.² In December 2010, the Council of Ministers (ECOFIN) adopted conclusions calling for a more comprehensive Union framework to regulate financial markets, including crisis prevention, management and resolution. After further consultation, on 6 June 2012 the European Commission proposed a Directive on a Framework for Bank Recovery and

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¹ According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 were close to € 1 trillion or 8% of the EU GDP. In addition, between October 2008 and October 2011, the Commission approved € 4.5 trillion (equivalent to 37% of EU GDP) of state aid measures to financial institutions. See www.g20.org/images/stories/docs/eng/washington.pdf (last visited 9 August 2012).

² Commission Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector, COM(2009) 561 final.

Resolution (BRRF).³ The BRRF provides new resolution tools and powers for Member State supervisory authorities to ensure that uninterrupted access to deposits and payment transactions is maintained during periods of market stress or when an individual bank or banking group becomes insolvent.⁴ Member State authorities would be empowered to sell viable assets of the bank and to apportion losses in an equitable and organized manner by requiring, for example, that certain creditors incur losses on their claims against the distressed financial firm. The BRRF is not intended to replace Member State bank insolvency laws and regulations, but rather to enhance and provide minimum powers across the EU for Member State authorities to require banks and financial groups to recapitalize or restructure creditor claims during periods of market stress in order to reduce the likelihood of a bank becoming insolvent and to mitigate the impact of a bank resolution or insolvency on the financial system.⁵

§2. BRRF'S LEGAL FRAMEWORK AND REGULATORY OBJECTIVES

The legal basis for BRRF is Article 114 of the Lisbon Treaty (TFEU) which provides for the establishment of EU bodies and institutions that are vested with responsibilities for contributing to the harmonization of laws and facilitating their uniform implementation by Member States.⁶ The BRRF attempts to improve the conditions for the establishment and functioning of the internal market by proposing minimum harmonizing legislation that delegates authority to the European Banking Authority (EBA) to draft and propose technical implementing standards for Member States to adopt for their resolution regimes. These tasks conferred on the EBA are closely linked to the subject matter of the BRRF, which is to promote more harmonized Member State resolution practices that will reduce barriers to the internal market.

The BRRF's scope of application extends widely to include all credit institutions, investment firms subject to capital requirements of at least € 730,000, any financial institution engaged in a wide range of financial services which is a subsidiary of a credit institution and which is subject to consolidated supervision at the level of the parent

³ Commission 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, COM(2012) 280/3.

⁴ The European Commission proposal has incorporated some of the international standards on bank resolution adopted by the Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', (July 2011) (BIS: Basel). See www.financialstabilityboard.org/publications/r_111104cc.pdf (last visited 8 August 2012).

⁵ See BRRF, Recital 1 provides 'adequate tools to prevent the insolvency of credit institutions or, when insolvency occurs, to minimise negative repercussions by preserving systemically important functions of the failing institution'.

⁶ See Case C-66/04 *United Kingdom v. European Parliament (Smoke Flavours)* [2005] ECR I-10553, Case C-217/04 *United Kingdom v. European Parliament (ENISA)* [2006] ECR I-3771.

company.⁷ Through the entity subject to resolution, the institution or its assets are liquidated in parallel with the normal liquidation and governance of the institution. It is a maximum of 10% of the total assets that may not depart from the institution. The harmonization of laws will be required to be adopted into their national law, whilst the Directive will be implemented by the Member States.

Each Member State will be required to implement the BRRF under the BRRF. The BRRF will be a separate act from the bank regulation within the same legal framework between the authority and the conflicts of interest.

Each financial institution will be required to have a consolidated supervision authorization.¹⁰ The BRRF will be implemented through their recovery plan. The Directive will be implemented through their recovery plan for approval to the resolution authority and financial services. The impact on the financial business strategy and management. The authority will be required to implement the BRRF.

⁷ BRRF, Article 1.
⁸ Capital Adequacy Directive 2006/43/EC [2010] OJ C 29.
⁹ institutions, [2010] OJ C 29.
¹⁰ Article 3 BRRF.
¹¹ Article 5 BRRF.
 European Banking Authority (EBA/DP/2012).

company.⁷ Throughout the Directive, the term ‘institution’ is used generally to signify an entity subject to the BRRF requirements. The Directive defines ‘institution’ to be a credit institution or investment firm defined as a € 730,000 firm. The BRRF’s coverage runs parallel with the Capital Requirements Directive,⁸ which harmonizes capital, liquidity, and governance arrangements for financial institutions and banking groups. The CRD is a maximum harmonization directive, the requirements of which Member States may not depart from except in specified circumstances, whereas the BRRF is a minimum harmonization directive based mainly on general principles and recommendations to adopt into their domestic legal frameworks if they so choose. Member State authorities will be required to implement most requirements of the BRRF by 1 January 2015, whilst the Directive’s more controversial bail-in requirements discussed below must be implemented by 1 January 2018.

Each Member State is required to designate a resolution authority to exercise powers under the BRRF.⁹ States are free to decide whether or not the resolution authority will be a separate authority or combined with some other institutional authority, such as the bank regulator. However, where supervisory and resolution authorities are located within the same institutional structure, functional separation and independence between the authorities must be demonstrated and there must be safeguards against conflicts of interests.

Each financial institution, covered investment firm and parent entity subject to consolidated supervision will be required to prepare a recovery plan as a condition for authorization.¹⁰ Article 4 prescribes certain information to be provided in the recovery plan. The Directive also requires that the EBA and Commission adopt technical implementation standards on the minimum content to be provided by institutions in their recovery plans.¹¹ Article 5 requires institutions to submit their recovery plans for approval to the resolution authority. In reviewing the proposed recovery plan, the resolution authority must consider whether the plan can restore the firm’s viability and financial soundness in difficult market circumstances without having adverse impact on the financial system. Recovery plans will contain information addressing business strategy, organization structure of the firm, expected funding sources, and risk management. Authorities have the power to require firms to adopt any measure which the authority believes is necessary to overcome potential impediments or deficiencies in the implementation of the firm’s plan.

⁷ BRRF, Article 1. A € 730k firm is defined as such under Article 9 of Directive 2006/49/EC (the Recast Capital Adequacy Directive).

⁸ Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, [2010] OJ C 293/1; and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, [2009] OJ L 94/97.

⁹ Article 3 BRRF.

¹⁰ Article 5 BRRF.

¹¹ European Banking Authority, *EBA Discussion Paper on a template for recovery plans*, 15 May 2012 (EBA/DP/2012/2) (containing draft template with information to be provided in recovery plan).

The requirement to prepare and maintain a recovery plan also applies to parent companies and subsidiaries subject to consolidated supervision. This means each institution within or which is part of the financial group is required to prepare a recovery plan consisting of the elements and arrangements set forth in Article 5. These plans must also provide the details of any arrangements for intra-group financial support for entities within the group that are experiencing financial difficulties.¹² The group recovery plan must be submitted for review by the lead supervisor of the consolidated group and by any competent authorities where the group has significant operations. The recovery plan must be approved and endorsed by the board of directors of the institution (or equivalent managerial body).¹³ In the case of a financial group, the board of the parent company or group subject to consolidated supervision, and the board of each institution within the group, must approve the group recovery plan before it is approved by the resolution authority.

The resolution authority will be required to develop resolution plans for each financial institution that is not part of a group and for each group subject to consolidated supervision.¹⁴ Unlike the recovery plans which are prepared by the regulated entity or group, the resolution plans are prepared by the resolution authority in consultation with the regulated entity or group. Resolution plans are required to show how crucial payment functions and business lines can be separated economically and legally so as to ensure continuity of the bank's services to depositors and other customers. The plan must also provide an assessment of the institution's resolvability and a list of measures to address or remove impediments to resolvability. A feasibility assessment of alternative resolution strategies and how they could be financed without the assumption of extraordinary public support must be included, along with an analysis of the impact of the plan on other institutions within the group.¹⁵

The resolution plan of the financial group shall consist of resolution plans for the parent company or institution subject to consolidated supervision and for each institution or firm within the group.¹⁶ The resolution authority responsible for consolidated supervision of the group is responsible for preparing the resolution plan jointly with the resolution authorities of the subsidiaries in resolution colleges. The financial institutions will be required to provide the authorities with the information necessary to write the resolution plan. The authorities will be required to update the resolution plan annually or after any event which could have a material effect on the plan. The EBA will propose guidelines and technical standards seeking to promote supervisory convergence in the development of resolution plans and in proposing scenarios to be used for testing the robustness of resolution plans. The BRRF envisages that the resolution plans should be

¹² Article 16 BRRF.

¹³ See Annex XI to Draft Directive for the content requirements of a recovery plan.

¹⁴ Articles 9–12 BRRF.

¹⁵ Article 10 BRRF.

¹⁶ Article 9 BRRF.

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The BRRF contains a number of other important provisions that will be briefly mentioned. Articles 31–64 authorize Member State authorities to apply resolution tools against financial institutions and groups when they do not satisfy prudential standards, or when certain early intervention trigger points are reached. For example, the authority can compel the institution to sell a business, or an institution can have all or part of its assets transferred to a ‘bridge institution’, usually state-owned. The authority can also engage in asset separation by transferring viable assets to third party purchasers, thus allowing non-viable assets to be wound down in the rump institution or in a bridge bank. Authorities will also be encouraged to use bail-in measures that allow institutions to recapitalize themselves whilst in distress by imposing losses on priority creditors and other unsecured creditors according to their ranking only after shareholders’ interests have been extinguished. Depositor claims will be treated *pari passu* along with priority unsecured creditors.¹⁷ Articles 16–19 create the legal concept of ‘group interest’, that each member of the corporate group has an indirect interest in the prosperity of the rest of the group, and that intra-group financial support from one subsidiary to another would be permitted and not a breach of national law restrictions on intra-group support. The BRRF requires Member States to allow groups to enter into agreements for intra-group financial assistance in the form of loans, guarantees, and collateral provision to support third party transactions so long as certain conditions are met, including, *inter alia*, that the financial support has the objective of preserving or restoring the financial stability of the group as a whole. The resolution authority must approve such agreements and determine that they will not result in the parties breaching their capital and liquidity requirements or becoming insolvent.

Although the BRRF’s detailed requirements for recovery and resolution plans are important steps for improving Member State resolution regimes, these measures are incremental at best and do not go far enough in providing the clear legal authority for Member States to exercise the necessary intervention tools to require bank management to undertake certain actions, such as recapitalizing the bank or restricting dividends, when it is in breach of prudential standards or when it poses a risk to financial stability. The BRRF proposes harmonized principles and enumerates a set of resolution tools that encourage Member State authorities to intervene in the institution’s risk management and strategy, but Member States are free to adopt divergent approaches in deciding both whether and when to use these tools. Although the EBA will publish guidelines on how and when Member State authorities should use resolution tools, Member States will have ultimate discretion to decide whether or not to adopt these tools in their legal and regulatory frameworks. This may create incentives for states to adopt light touch

¹⁷ This conflicts with the UK Independent Commission on Banking (Vickers’ Commission) proposals which would give retail deposit creditors a priority over the banks priority unsecured bondholders.

approaches to resolution practice and potentially lead to regulatory arbitrage within the Union. The Commission recognizes this by stating expressly that the draft Directive provides a minimum harmonization framework that is meant to allow Member States to experiment with different resolution approaches and to use their discretion in the exercise of resolution powers. Nevertheless, more legal certainty should be provided that establishes clearly that the resolution tools supersede existing domestic law and related EU law. It is not enough to provide a harmonized set of principles and a proposed resolution framework to be applied in a discretionary manner by Member States. An effective EU resolution regime must consist of precise legal powers for Member State authorities to impose specific corrective measures on weak and failing financial institutions and groups at the early intervention stage before insolvency.

Finally, any consideration of the BRRF should be undertaken within the broader context of the ongoing and intensifying eurozone sovereign debt and banking crisis and the decision by EU Heads of State on 28 June 2012 to establish a European Banking Union.¹⁸ The Heads of State decision supporting the creation of a European Banking Union is intended to strengthen EU economic and financial governance by providing the ECB supervisory powers over certain cross-border banks based in the Euro Area. The Commission is expected to propose legislation in autumn 2012 establishing a Banking Union and possibly to provide the ECB with some role in the resolution and recovery of cross-border banking institutions. Indeed, it is envisaged that the ECB could be involved in providing liquidity support to banks and financial groups subject to a resolution procedure and in administering a Euro Area resolution fund. It is clear therefore that the proposed BRRF Directive will be part of a broader policy and legislative package that will undoubtedly include major changes to EU banking regulation, supervision and resolution. This will probably result in substantial revisions to the BRRF.

§3. CONCLUSION

The European Commission's proposed Directive on a Bank Recovery and Resolution Framework is an important step toward building a more effective cross-border EU regulatory regime. It contains important principles that provide the basis to build a stronger EU resolution regime. However, clearer and more specific powers are needed for national resolution authorities to intervene in the operations of financial institutions so that they do not pose a serious risk to taxpayer funds. Effective prudential regulation and supervision requires a seamless process between the use of crisis prevention measures and crisis management powers, including recovery and resolution measures, for financial institutions in distress. The BRRF proposal recognizes the important link between crisis prevention and crisis management and therefore supports other important regulatory

¹⁸ Council, Conclusions, 29 June 2012, EUCO 76/12, p. 3.

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reforms designed to stabilize the European financial system. Nevertheless, this article suggests that although the BRRF represents an important step in reforming the EU bank resolution regime, Member State supervisors should be given stronger powers to impose prompt corrective measures on failing banks and financial groups. Also, the need for burden-sharing amongst countries affected by possible fiscal costs of recapitalization must also be considered, as well as the imperative to minimize bailout costs for taxpayers. These outstanding issues suggest that continued work on a EU bank resolution regime is urgently needed and should be addressed within the context of the expected proposals for a European Banking Union.

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