

Europe's new recovery and resolution regime for credit institutions

Since the onset of the financial crisis back in 2007, governments looking to preserve financial stability have repeatedly been forced to use public funds to bail out credit institutions that had run into difficulties. In an effort to prevent such bail-outs going forward, and also to facilitate the resolution of more complex banks without resorting to tax resources, policymakers joined forces at the global level to define a set of key attributes for resolution regimes. In the European Union (EU), two legislative projects were rolled out to put this initiative into practice – first, the Bank Recovery and Resolution Directive (BRRD), a piece of legislation which applies across the entire Union and harmonises the recovery and resolution toolkit but leaves its use to the national resolution authorities, and second, the Single Resolution Mechanism (SRM). The latter builds on the tools created by the BRRD and augments the establishment of the Single Supervisory Mechanism (SSM) for banks, a process which is already well on the way to completion. Banks in member states participating in the SSM – ie member states which have adopted the euro as their currency as well as any non-euro-area member states that “opt in” to the SSM – are subject to the SRM, an institutional mechanism with a Single Resolution Board (SRB) at the European level as well as a Single Resolution Fund (SRF). Contributions to the SRF raised at the national level will be progressively mutualised over a transitional period of eight years.

The BRRD represents a major step towards restoring the principles of the market economy, which dictate that if a credit institution fails, its shareholders and creditors should be first in line to absorb the attendant risks and losses before a dedicated resolution fund financed by the banking industry steps in. This is an objective which the BRRD chiefly seeks to achieve through the new bail-in tool, though it does allow exceptions to the rule that losses should be absorbed primarily by shareholders and creditors. The SRM forms part of the broader banking union reform project and is a crucial pillar complementing the SSM, which, having already been adopted, is set to take charge of supervising euro-area banks in November 2014. The introduction of the SRM means that liability and control are two sides of the same coin once more. However, the set-up which legislators have now arrived at has a complex set of institutional decision-making mechanisms, and the prevailing primary law framework means that it involves legal risk. The SRM in its current form should therefore merely be a stepping stone towards creating a robust foundation under primary law. It remains a matter for policymakers to do what is necessary to encourage permanently sustainable policymaking going forward. This presupposes that the scope for influencing the quality of bank balance sheets on the one hand and responsibility for the repercussions of bank insolvencies on the other are aligned at the same level – not just for bank failures that lie ahead, but equally so for the legacy assets which already exist in the banking sectors.

Background to the two sets of legislation

Initiating insolvency proceedings over a systemically important bank can endanger financial stability and the real economy, ...

Events since the onset of the financial crisis back in 2007 have vividly demonstrated the importance of setting up a dedicated resolution regime for credit institutions. It became plain during the crisis that initiating insolvency proceedings over an insolvent or over-indebted credit institution can have severe repercussions for the financial system as a whole owing to that bank's interconnectedness with other market players (a concept known as contagion). These contagion effects eroded confidence among banks, and because they also impaired key functions which banks perform for the real economy (accepting deposits, granting credit, processing payments), they spread beyond the financial sector, causing the crisis to spill over into the real economy. This was one of the main reasons why the financial crisis evolved into one of the most severe recessions since the Great Depression of the 1920s and 1930s.

... notably on account of changes in business models, ...

This perilous state of affairs was exacerbated by structural change within the banking sector. Over the past decades, business models in some quarters of the EU banking sector have drifted away from the traditional focus on credit and deposit business and increasingly towards trading/capital market operations. So when the financial crisis erupted in 2007, the EU banking sector was significantly larger, more complex, more interconnected and more integrated across national borders than before. These banks were not just oversized – they were also too interconnected and altogether too important for the economy as a whole for it to appear conceivable that they could go bankrupt without severely impacting on both the financial system and the real economy ("too big to fail").

... leading to repeated bail-outs during the crisis

As the crisis evolved, European governments, in an effort to diminish such inestimable systemic aftershocks, had no option but to roll out bail-out programmes to prop up banks threatened with insolvency. These bail-outs came in differ-

ent shapes and forms. In some cases, ailing institutions conducted capital increases to allow governments to take an equity stake and thereby strengthen their capital base. Elsewhere, governments issued guarantees to back assets or liabilities.

The unprecedented scale of government assistance raised hopes among banks that they would be rescued, providing fertile ground for market distortions and inefficiencies. After all, if investors anticipate that losses will be socialised, that is, taken off their backs, they might be encouraged to engage in riskier behaviour than would be economically efficient (moral hazard). Besides inflicting damage on the overall economy, such behaviour also provokes widespread public and political resistance and undermines the willingness to accept fundamental market economy principles. So it is no surprise that the bail-outs repeatedly came in for sharp public criticism. In view of this response, the overriding objective of the measures taken must be to make banks more crisis-proof and to allow insolvent institutions to be wound up without taxpayer support. That way, risks and opportunities would once again be aligned at the same level, just as the principles of a market economy would have it.

The idea behind the new resolution regime for banks is to overcome the dilemma of deciding between systemically risky insolvency proceedings on the one hand and economically and politically questionable bail-outs on the other. Its aim is to provide a set of resolution tools that facilitate the resolution of banks without resorting to taxpayers' money.

This topic was addressed at the global level after the outbreak of the crisis, most prominently under the auspices of the Financial Stability Board (FSB), a body comprising governments, financial supervisory authorities and central banks from the 24 most important industrial and emerging market economies worldwide. International and supranational institutions including the IMF, the European

Resolution regime: a third option alongside insolvency and bail-out

FSB's Key Attributes

Commission and the European Central Bank (ECB) also participated in deliberations. The G20 tasked the FSB with drawing up an international policy framework for the recovery and resolution of systemically important financial institutions (SIFIs). In October 2011, the FSB presented the Key Attributes of Effective Resolution Regimes for Financial Institutions (KA), which were endorsed by the G20.¹ This document outlines the criteria which the resolution regimes operated by the participating jurisdictions need to satisfy. One notable requirement is that the participating jurisdictions set up resolution authorities and equip them with tools which facilitate the orderly resolution of financial institutions without taxpayer exposure. The KA set out the core elements of the envisaged tools, the principles to be applied, and the cross-border interaction between participating authorities. The FSB's member countries have committed to transpose the KA into national law by 2015, a process that will also see the rules being fleshed out in greater detail. Hence, the KA represent a crucial step towards resolving the global "too big to fail" problem.

The initiative coincided in the EU with the joint statement by the Heads of State or Government in 2012 that they intended to strengthen European Economic and Monetary Union by adding a banking union which would comprise a single banking supervision mechanism, a joint framework for recovering and winding up credit institutions and greater harmonisation of deposit guarantee schemes. Work on the first pillar of this banking union, the Single Supervisory Mechanism, which transfers prudential responsibility to the ECB, is already under way, the associated Regulation having come into effect back in November 2013. The SSM's supervisory activities are scheduled to be fully operational on 4 November 2014.² As regards the third pillar – deposit protection – a compromise has been reached for a Directive that will further harmonise the national deposit guarantee schemes.

Resolution regime at European level: one pillar of overall banking union project

■ Legislative processes

The KA are neither legally binding nor are they directly applicable in the participating jurisdictions. So their practical applicability is conditional on the respective jurisdictions enacting legislation to transpose them into national law. This is a path which the EU, in its capacity as a jurisdiction, also committed to follow, but its undertaking was of a political rather than a legal nature.

KA implemented in EU by way of BRRD and SRM as components of the banking union

Accordingly, on 6 June 2012 the European Commission presented a proposal for a Directive establishing a framework for the recovery and resolution of credit institutions (Bank Recovery and Resolution Directive, or BRRD)³ and on 10 July 2013 presented a proposal for a Regulation establishing a uniform regime for resolving banks (Single Resolution Mechanism Regulation).⁴

The two documents represent distinct pieces of legislation, legally speaking, but the SRM Regulation builds on the provisions of the BRRD. The BRRD applies across all 28 member states of the EU and harmonises substantive resolution law – that is to say, it provides a set of resolution tools and contains related legal provisions governing matters such as recovery and resolution planning and early intervention. But it leaves responsibility for applying these

How the two pieces of legislation complement each other

¹ Available online at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

² See Deutsche Bundesbank, European Single Supervisory Mechanism for banks – a first step on the road to a banking union, Monthly Report, July 2013, pp 13-31.

³ 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. Commission document No COM/2012/0280 final.

⁴ Proposal for a Regulation of the European Parliament and of the Council 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 Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council. Commission document No COM (2013) 520 final.

powers at the national level and, accordingly, provides for the establishment of national resolution authorities and resolution financing arrangements by those member states that have not already done so. From the perspective of European law, the BRRD is a directive that needs to be transposed into national law by way of national legislation in order to be applied.

The SRM Regulation, by contrast, additionally transfers the decision-making process to the European level. It establishes a European resolution board with powers that can be exercised by national resolution authorities under the BRRD framework. In keeping with this objective, the SRM will be established as a directly effective EU Regulation. Where the BRRD confers options and discretion on member states, such options and discretion shall be exercised by the SRM Regulation in a certain manner. Even though the SRM Regulation is applicable across all 28 member states, the SRM does not, to all intents and purposes, cover all of them, only those also participating in the SSM. So strictly speaking, only the SRM, and not the BRRD, is part of the banking union project, an initiative which only covers euro-area member states and countries which choose (“opt in”) to cooperate closely with the ECB in banking supervisory matters. Nonetheless, it only makes sense to view the two sets of legislation in conjunction with one another because, in terms of substantive law, they largely cover the same ground.

Both pieces of legislation are to be enacted on the basis of Article 114 TFEU (approximation of laws in the internal market) and therefore require Council and Parliament approval in accordance with the ordinary legislative procedure. Trilogue negotiations among the EU’s legislative bodies were successfully concluded at the end of March 2014, this political agreement forming the basis for the plenary of the European Parliament to approve both sets of legislation on 15 April. The BRRD was published in the Official Journal of the EU on 12 June

2014.⁵ Should any of the small print of the SRM Regulation need to be changed, the necessary corrigendum can be approved by the inaugural plenary session of the newly elected Parliament (following the European elections) before the Council submits its formal vote. This means that the SRM Regulation can also be published in the Official Journal before the end of this summer.

During negotiations on the SRM Regulation, it also came to light that key questions surrounding the mutualisation of resolution financing cannot be addressed by way of an EU Regulation but necessitate a separate intergovernmental agreement (IGA), a matter which is discussed later in this article. That is why an IGA was hammered out alongside the SRM Regulation and signed by all the member states, with the exception of the UK and Sweden, on 21 May 2014. The next step is a ratification procedure in accordance with the national constitutional requirements.

Bank Recovery and Resolution Directive (BRRD)

General information

The BRRD is applicable to institutions that are established in the EU, that is, credit institutions and investment firms (Article 1 (1) letter a, Article 2 (23) BRRD). For the purposes of the BRRD, the term “credit institution” refers to deposit-taking and the granting of credit as defined in European law – that is to say that not all enterprises that satisfy the broader definition set forth under German law (section 1 (1) of the German Banking Act (*Kreditwesengesetz*)) are covered by the BRRD. Other entities covered by the BRRD include EU-based branches of institutions that are established outside the European Union as well as certain financial holding companies, mixed financial holding companies, mixed holding companies and parent financial

Scope

Trilogue negotiations concluded

⁵ OJ EU No L 173/190, 12 June 2014.

holding companies and financial institutions (details can be found in Article 1 (1) letters b to e BRRD).

BRRD governs both recovery and resolution proceedings

Much like the existing national legal frameworks – such as Germany’s Credit Institution Reorganisation Act⁶ – the BRRD likewise makes a fundamental distinction between two different sets of proceedings which can be initiated if an institution experiences financial difficulties and which are already reflected in the Directive’s name: recovery, and resolution in the narrower sense of the term.

Recovery proceedings

Recovery proceedings conducted by the institution itself

Recovery proceedings are characterised by the fact that they are conducted independently by the institution itself. To this end, the institution can avail itself of a non-exhaustive range of options set forth by the BRRD. For instance, certain of the institution’s assets or lines of business can be sold to different entities, or certain activities can be discontinued, reorganised or downsized. Common to all recovery measures is that they are solely private-law arrangements that do not involve any sovereign or official powers. Hence, they do not permit any interventions in the rights of investors (shareholders or creditors) against their will. As part of their early intervention powers, supervisory authorities can require an institution to take recovery action.

Obligation to draw up a recovery plan

If an institution runs into difficulties, valuable time can be lost if senior management only then begins to map out its road to recovery. That is why Article 5 BRRD requires institutions to draw up and maintain recovery plans. The measures to be taken as part of the recovery process need to be developed and prepared in these recovery plans upfront – ie before a recovery event occurs – so that the institution can draw on a previously prepared action plan, if need be. Unlike under current German law, which only requires institutions that potentially pose a systemic risk to prepare a recovery plan,

the BRRD essentially asks all institutions to do so; however, banks which are members of a group that is supervised by a consolidating supervisor do not need to prepare individual plans because they are instead included in a group recovery plan (Article 7 BRRD). Small institutions – notably those which, like the German savings banks and credit cooperatives, are members of an institutional protection scheme or which, if wound up, would be unlikely to adversely impact on financial stability – are governed by a simplified set of recovery planning obligations (Article 4 BRRD). Recovery plans must be updated at least annually or in the event of significant changes and must be submitted to the competent authority for review. Where the competent authority assesses that there are deficiencies in the recovery plan, the authority can ask the institution to remedy these shortcomings and also direct the institution to take measures such as changes to its governance structure or risk profile.

Groups looking to ready themselves for financial difficulties that might materialise at some point in the future also have the option of drawing up agreements governing the granting of financial support among group entities, although such arrangements are subject to supervisory review.

Intra-group financial support

Early intervention

Addressing financial difficulties before they pose a significant threat is one of the main objectives of the BRRD, which is why the section of the BRRD entitled “Early intervention” (Articles 27 to 30) gives the competent authorities a broad range of additional powers to intervene in institutions. Authorities can notably ask an institution to change its business strategy, appoint a temporary administrator or demand

Supervisory authorities have additional powers to intervene

⁶ Enacted as Article 1 of the German Restructuring Act (*Restrukturierungsgesetz*) of 9 December 2010 (Federal Law Gazette I, p 1900).

that measures set out in the recovery plan be implemented.

Resolution

Resolution proceedings allow interventions in creditor rights

Ideally, banking supervisors, by intervening early on, will be able to ensure that an institution has sufficient internal capital adequacy or the bank, by following the prudential recommendations, will succeed in regaining its resilience through recovery proceedings. However, extreme cases – circumstances in which the above-mentioned courses of action do not suffice or any attempt at recovery is destined to fail – cannot be ruled out, meaning that measures extending as far as allowing interventions in shareholder and creditor rights against their will might be needed. Such interventions are of a sovereign nature, hence the need for an authority to be involved which has statutory powers, ie ones that override contractual arrangements. Resolution proceedings and the resolution authority serve this purpose. When applying resolution tools and exercising resolution powers, resolution authorities shall have regard to the resolution objectives set forth in Article 31 BRRD. These objectives comprise ensuring the continuity of critical functions; avoiding significant adverse effects on financial stability, in particular by preventing contagion; protecting public funds by minimising reliance on extraordinary public financial support; protecting depositors with deposits covered by deposit guarantees; and protecting client funds and client assets.

Resolution planning by resolution authorities

Resolution is another area in which planning takes place upfront as this simplifies the task of selecting the most appropriate course of action in an emergency. Crucially, unlike recovery planning, the resolution authority must draw up the resolution plan rather than the institution (Article 10 BRRD), with Article 11 BRRD requiring institutions to cooperate with resolution authorities and provide them with all the requisite information. Again, there are simplified obligations for smaller institutions and the

option of treating group institutions as part of a group resolution plan.

The process leading up to the preparation of the resolution plan might bring to light impediments that could hamper orderly resolution proceedings. For instance, it is conceivable that an institution might have different lines of business which are interconnected to such an extent that it would be virtually impossible to gauge the systemic repercussions of resolution proceedings. That is why the BRRD instructs resolution authorities to assess institutions' resolvability; should there be any shortcomings in an institution's resolvability, resolution authorities have the power to require that institution to address or remove any such impediments (Article 17 BRRD). The resolvability assessment is combined with recovery and resolution planning as part of an iterative process. This process necessitates close cooperation between supervisory and resolution authorities. For instance, if the supervisory authority has any doubts over the feasibility of a recovery plan presented to it, it must encourage changes to be made which impact positively on both resolvability and resolution planning. By the same token, insights which the resolution authority gains from its resolvability assessment might be a catalyst for changes in recovery and resolution plans.

Upfront assessment of resolvability and how it relates to recovery and resolution planning

Resolution proceedings can only be initiated if all three of the conditions (or triggers) set forth in Article 32 (1) BRRD are met.

Resolution proceedings: three conditions must be met

- The institution is failing or is likely to fail. This criterion, which is fleshed out in greater detail in Article 32 (4) BRRD, looks beyond the institution's over-indebtedness and solvency to also consider infringements of requirements for continuing authorisation, such as a loss which depletes all or a significant amount of its own funds. Additionally, the criterion "failing" or "likely to fail" is deemed to have been satisfied if an institution receives extraordinary public financial support, except where certain exceptions apply. This

provision is designed to deter early bail-outs.⁷

- There is no reasonable prospect that any alternative private sector measures or supervisory action (such as early intervention measures) would prevent the failure of the institution within a reasonable timeframe. This arrangement is particularly important from a German perspective because institution-based protection schemes, which are found predominantly in Germany’s credit cooperative and savings bank sectors, are explicitly mentioned as alternative measures. This is a sensible approach because experience has shown that failures of member institutions of such networks can be prevented efficiently and often less expensively by the respective institutional protection schemes. This arrangement underscores the nature of the resolution regime as a last resort.
- Resolution is necessary in the public interest. This criterion draws a comparison with normal insolvency proceedings. Resolution proceedings are in the public interest only if they are necessary to achieve and are proportionate to one or more of the resolution objectives, and winding up the institution under insolvency proceedings would not meet those resolution objectives to the same extent. The criterion shows that the existing insolvency legislation is not crowded out by the new resolution regime but that an additional option has been created – in the event of a concrete bank failure, a case-by-case assessment should be carried out to determine whether insolvency or resolution proceedings are to be initiated. The “no creditor worse off than under normal insolvency proceedings” principle shall be respected.

ives. These tools are listed in Article 37 (3) BRRD. Specifically, they are as follows.

- Sale of business tool
- Bridge institution tool
- Asset separation tool
- Bail-in tool

The tools can be used individually or in any combination, the only exception being the asset separation tool, which may only be used together with another resolution tool.

Articles 56 *et seq* BRRD state that government financial stabilisation tools may also be used, albeit as a last resort. Effectively, these tools are government bail-outs sanctioned by the BRRD. Given that this runs counter to the objectives of the BRRD, such government financial stabilisation tools may only be deployed after the other resolution tools have been assessed and exploited to the maximum extent practicable.

Government financial stabilisation tools as a last resort

The sale of business tool is the mechanism used for effecting a transfer of some or all of the shares issued by an institution under resolution, or some or all of its assets, rights or liabilities, to a recipient. In effect, this tool constitutes the sale of business activities to another institution in return for a consideration determined by way of a prior valuation. This facilitates the continuation of critical functions by a different institution. There is no need to obtain the consent of the institution under resolution

Sale of business tool

⁷ Here, the BRRD provides a key transitional arrangement on the path towards the launch of the banking union. Under certain circumstances, extraordinary public financial support does not trigger a resolution event if it is of a precautionary and temporary nature and it is proportionate to remedy the consequences of serious disturbances. This provision primarily addresses the stress tests conducted by the European Banking Authority and the asset quality review which is currently taking place under the auspices of the ECB at those banks which are scheduled to be subject to direct ECB supervision as of November 2014 (see also the wording of Article 32 (4) letter d BRRD). This arrangement allows capital shortfalls which come to light under these proceedings to be addressed through injections of public funds, if necessary, thereby allowing the banking union to be launched free of legacy risks. The details of the precise conditions in which such recapitalisations can be made without triggering a resolution event are still a subject of debate.

Resolution tools

Once the resolution conditions have been met and resolution proceedings have been initiated, the resolution authority can deploy a host of resolution tools to achieve the stated object-

nor that of its shareholders, creditors or debtors whose claims and liabilities are transferred because the resolution authority effects the sale of business in a sovereign capacity; the consent of the recipient is required, however.

Bridge institution tool

As an alternative to seeking a recipient in the market that is willing to acquire such business or in the absence of such a recipient, the resolution authority also has the option of establishing a bridge institution with a view to maintaining critical functions. Some or all of the shares issued by the institution under resolution, or some or all of its assets, rights or liabilities, can be transferred to a bridge institution but the total value of liabilities transferred to the bridge institution may not exceed the total value of the rights and assets. Here too, an appropriate purchase price informed by prior valuation shall be paid. The main difference between this tool and the sale of business tool is that the resolution authority establishes and operates the bridge institution specifically for this purpose (Article 41, Article 40 (2) BRRD); however, there is also the option of establishing a bridge institution without a specific need as a “shelf corporation” in order to respond more quickly to a critical situation – Germany’s Restructuring Fund Act already allows the Financial Market Stabilisation Agency, or FMSA, to do so. The bridge institution or its assets, rights or liabilities should be sold as soon as possible (normally within two years), although Article 41 (5) and (6) BRRD allows the holding period to be extended.

Asset separation tool

Certain similarities exist between the asset separation tool and the bridge institution tool inasmuch as assets, rights or liabilities of an institution under resolution are transferred to a recipient controlled by the resolution authority. Unlike the case of the bridge institution, the purpose of this recipient, designed as an “asset management vehicle”, is not to maintain critical functions but, on the contrary, to eventually sell assets or wind them down in an orderly fashion (Article 42 (3) BRRD). Activities deemed not worthy of being maintained can therefore

be transferred to this asset management vehicle (also known as a “bad bank”). These assets, too, shall be sold for an equitable price.

The possibility of writing down or converting capital instruments (Article 60 BRRD) is not a resolution tool in the narrow sense but is a further option available to the resolution authorities under the BRRD and precedes a bail-in. The first step is to write down common equity tier 1 (CET 1) capital in proportion to the losses, ie to reduce its principal amount. If this is not enough to achieve the resolution objectives, the next step is then to write down additional tier 1 (AT 1) capital instruments or to convert these to CET 1 capital. A further possible stage would be to convert tier 2 (T 2) capital into CET 1 capital or to write it down.⁸ Despite having structural similarities to the bail-in instrument, which will be discussed below, these options are not resolution tools in the strict sense of the term since the liabilities concerned were issued as subordinate, loss-absorbing instruments from the outset.

The above-mentioned tools were all used in similar forms during the crisis; they therefore have their functional equivalents in, for instance, current German law (sections 48a *et seq* of the German Banking Act for the transfer order, section 5 of the Restructuring Fund Act (*Restrukturierungsfondsgesetz*) for setting up bridge institutions, section 8a of the Financial Market Stabilisation Fund Act (*Finanzmarktstabilisierungsfondsgesetz*) for the establishment of resolution agencies for risk exposures acquired before 30 September 2012). By contrast, the bail-in, which is supposed to allow investors to be made to bear losses directly and is thus at the centre of the BRRD’s objective of presenting an alternative to the current bail-out

Write-down or conversion of capital instruments

Bail-in as the centrepiece of the system of resolution tools

⁸ CET 1, AT 1 and T 2 denote different classes of capital instruments, distinguishable in terms of quality and, following from that, their treatment by supervisors. Shares issued by a public limited company are an example of CET 1 instruments. AT 1 instruments include indefinite debt securities with no fixed payment or redemption incentives, whereas subordinate loans with an original maturity of at least five years count as T 2 instruments.

regime, is a completely new concept from a legal standpoint and is thus the resolution tool being debated most heatedly by policymakers. It is similar to the write-down or conversion of capital instruments already introduced earlier, with one exception: in principle, it encompasses all of an institution's liabilities and not just instruments subject to an explicit subordination agreement.

Calculating the aggregate amount to be raised through bail-in

The first step when applying the bail-in tool is to assess the total amount of funds necessary to absorb the cumulated losses and thus return the net asset value of the institution under resolution to zero. The established aggregate amount can also be higher in order to restore a CET 1 ratio greater than zero within the meaning of the CRR as well as to absorb cumulated losses (Article 46 BRRD).

BRRD envisages hierarchy of shareholders and creditors

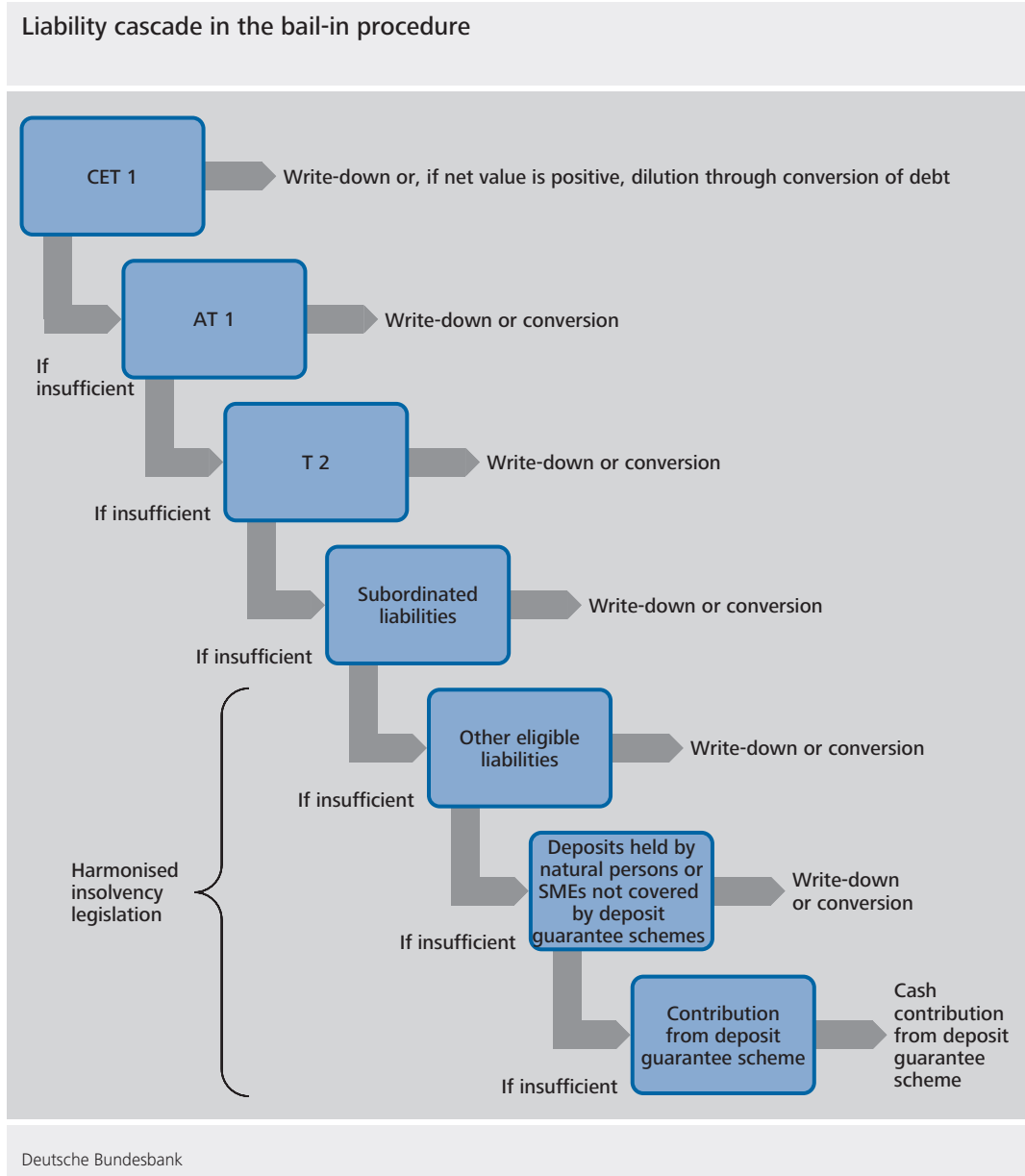
After the assessment, the aggregate amount to be raised, including the amount to be raised by writing down or converting capital instruments pursuant to Articles 59 and 60 BRRD, will be allocated to shareholders and creditors in accordance with a sequence, or liability cascade (Article 48 BRRD; see chart on page 40). The first instruments to be written down will be CET 1 instruments, in accordance with Article 60 (1) letter a BRRD. Should this not suffice to raise the target amount, AT 1 instruments will then be written down, followed by T 2 instruments. Unlike under Article 60 BRRD, however, the hierarchy does not end once regulatory capital instruments have been exhausted. Instead, in a further stage, other subordinated liabilities can be written down as appropriate in a manner which respects the statutory ranking of claims under normal insolvency proceedings. Last but not least, all other creditors can be called to task, including preferred creditors, though the ranking of claims set forth in Article 108 BRRD must be complied with, as would be the case under normal insolvency proceedings: deposits held by natural persons or by micro, small and medium-sized enterprises (SMEs) – also known as “eligible deposits” – that would normally benefit from deposit protection but are in

excess of the deposit guarantee threshold of €100,000 per institution and depositor outrank the claims of other creditors. Covered deposits and deposit guarantee schemes subrogating to the rights and obligations of covered depositors have the highest ranking. Even in a bail-in scenario, creditors can be involved both by writing down capital instruments, ie reducing their principal, or by converting capital instruments into CET 1 instruments. Shares in CET 1 instruments can be written down or diluted in order to involve their investors in losses; this dilution comes about through the conversion of other instruments into CET 1, thereby reducing the original investors' percentage share in the institution. The condition for this approach, which forgoes the write-down of CET 1 instruments, is, however, that the institution still has a positive net value⁹ despite the cumulated losses (Article 47 (1) BRRD). This provision is motivated by the idea that the institution's remaining positive value belongs to existing shareholders and that writing down the shares would therefore be inappropriate.

The special provisions for treating deposits perpetuate the guiding principle of depositor protection, elevated to one of multiple resolution objectives in Article 31 (2) BRRD. To this end, deposits protected under statutory deposit guarantee schemes (which have been harmonised throughout Europe) are exempted from the bail-in tool up to a statutory limit of currently €100,000 per institution and depositor; the deposit is neither reduced nor converted and remains as a claim of the depositor on the institution (or a bridge institution). However, the deposit guarantee schemes responsible for the covered depositors are required to make a cash contribution in the amount by which covered deposits would have been written down had they not been exempted from the bail-in (Article 109 BRRD); this is an indirect method of bearing the costs. The rationale for this provision is that it allows deposit guarantee

Exemption from bail-in provides depositor protection, yet deposit guarantee schemes contribute to costs

⁹ In this sense, “positive net value” ultimately means that the institution's assets exceed its liabilities.



schemes to be made to bear the same percentage of the costs of resolution that they would have had to bear had depositors been compensated following insolvency proceedings in place of resolution. In order to calculate the deposit guarantee scheme's contribution to the costs, the scheme is located at the end of the "liability cascade", ie given the most preferential status.

maturity of less than seven days. The apparent rationale behind this arrangement is to be easy on the interbank money market, which is important for the monetary policy transmission process; however, it sets incentives towards short-term, and thus less stable, bank funding and should therefore not be accepted entirely uncritically.

Statutory and discretionary exemptions from the bail-in mechanism

The wording of the directive sets forth additional exemptions from the principle that all liabilities should be covered by the write down and conversion powers and the bail-in; the most prominent provision is the exception given to interbank liabilities with an original

Alongside these legal exclusions, the resolution authority is also empowered, at its discretion and within the scope provided by Article 44 (3) BRRD, to exclude certain liabilities in whole or in part from bail-in, thus modifying the hierarchy of liability outlined above. This gap, ie the

share of the burden accruing to the exempted creditors, can either be distributed across other creditors, whose burden increases accordingly (Article 44 (3) BRRD, at the end) or covered by the resolution financing arrangement (Article 44 (4) BRRD). However, the precondition for the latter option, which is tantamount to offsetting losses within the banking sector, is that costs amounting to at least 8% of total liabilities have been covered by shareholders and, as appropriate, creditors. In addition, the contribution of the resolution financing arrangement is capped at 5% of total liabilities. In exceptional cases, Article 44 (8) BRRD allows exemptions from these limits under certain conditions.

Minimum requirements for own funds and eligible liabilities and international minimum requirements for gone-concern loss-absorbing capacity

In order to assure sufficient funding for a bail-in procedure, Article 45 BRRD sets out a minimum requirement for own funds and eligible liabilities (MREL). European legislators have therefore put into practice a scheme being promoted globally with maximum priority by the FSB – in keeping with a mandate by the St. Petersburg G20 summit to develop a proposal for “gone-concern loss-absorbing capacity” (GLAC). The European and global approaches share the idea that the ability to put the previously agreed resolution plan into operation, and thus give credibility to the entire resolution process, is predicated on ensuring adequate loss-absorbing capacity at the time of resolution. Whereas the European MREL regime applies to all institutions covered by the BRRD and gives the supervisory authorities discretionary scope, the global GLAC requirement is to apply only to global systemically important banks (G-SIBs) and is to be defined as an internationally binding minimum standard.

The MREL is the quotient of own funds and eligible liabilities divided by the institution’s total liabilities and own funds, with derivative liabilities included in the denominator on a net basis. The minimum requirement (in per cent) is set individually for each institution by the resolution authority; the liability must have a residual maturity of at least one year to count

towards meeting the requirement. The calculation of the MREL is based on the institution’s total liabilities since a majority of EU member states did not think that basing it on risk-weighted assets (RWA) was useful as they potentially lack meaningfulness in crisis situations. Although calculating the ratio on the basis of unweighted balance sheet values in a non-risk-adjusted manner involves the danger that high-risk and thus high-margin, small-volume business activity will be preferred over low-risk, low-margin and thus high-volume transactions, it avoids the drawbacks that emerged in the past when the calculations were based on risk-weighted ratios caused by inadequate risk weighting (resulting, for instance, from using internal models or zero-weighting certain assets such as government bonds). The GLAC requirements for G-SIBs, which are being debated globally, could, however, lead to changes in the calculation basis, at least for European G-SIBs, as the global calculation basis is still being negotiated.

The MREL ratio is competing, in a sense, with the CRR own funds ratios since, to a bank, both are binding ratios which have to be complied with at all times; on balance, it is the stricter regime, in each individual case, which informs the bank’s business practices.

Resolution financing

The starting point for the BRRD is the aforementioned guiding principle that the shareholders and creditors of the institution – in that order – should be the parties to bear the losses. However, it cannot be ruled out that, in individual cases, external sources of funding might need to be tapped in a resolution event. In order not to make taxpayers as a whole liable for the resulting costs, the BRRD requires member states to establish resolution financing arrangements, generally in the form of a resolution fund.

Hierarchy of liability pursuant to the BRRD: shareholders/creditors – resolution fund – fiscal backstop

Ex ante contributions the rule in resolution financing

These funds are generally financed through *ex ante* contributions. Pursuant to Article 103 BRRD, all institutions authorised in the territory of the EU member states are required to make contributions, as are branches of third-country institutions located in the EU (Article 2 (89) BRRD). The contributions are calculated based on the amount of liabilities (excluding own funds) of the contributing party less covered deposits, as contributions to the deposit guarantee schemes have already been made for these liabilities. This calculation base is then divided by the aggregate of all contributing parties in the respective member state and adjusted for the institution's risk profile. The actual contribution amount is to be calculated such that each member state reaches the target level¹⁰ of 1% of covered deposits in its territory by the end of 2024 (Article 102 BRRD). The Commission will be empowered to enact a delegated legal act fleshing out the details of these BRRD provisions.

According to current estimates, for Germany this would result in a total of currently around €2 trillion in covered deposits and thus require annual contributions of around €2 billion over a ten-year period. This represents a distinct increase over the current national bank levy, which raised a total of around €520 million in 2013.¹¹ Since the SRM Regulation shortens the period for building up the envisaged fund from ten to eight years (for more see page 50), the annual burden could be even higher.

Ex post contributions if resolution fund is insufficiently funded

If the amount raised through *ex ante* contributions is not sufficient to cover the fund's expenditure, *ex post* contributions can be raised. Their size is capped at three regular *ex ante* annual contributions. In those cases where the requirement to pay *ex post* contributions could endanger the solvency or liquidity of a contribution-paying institution, the BRRD permits an institution to defer its payments.

Article 105 BRRD permits, as a last resort, the use of alternative funding means in the form of borrowings or other forms of support. Institu-

tions and financial institutions are named as examples of contractual parties for providing such support, but the BRRD explicitly also mentions the option of "other third parties". Loans taken out on this basis are to be repaid from future contributions to the fund. At all events, central banks are out of the question as third-party lenders, since resolution is a public task and lending to a resolution fund by a central bank would ultimately violate the ban on monetary financing of governments (Article 123 TFEU).

Article 101 BRRD lists the purposes for which the resolution financing arrangements may be used; these include guaranteeing or purchasing the assets or the liabilities of the institution, a bridge institution or an asset management vehicle, and making contributions to a bridge institution or an asset management vehicle. Moreover, in cases where certain creditor classes are excluded from bail-in, the resolution financing arrangements may be used where private investors have already contributed an amount equivalent to at least 8% of total liabilities. Moreover, the resolution fund may also be used to pay compensation to a shareholder or creditor in a resolution procedure if the losses incurred are greater than would have been incurred in hypothetical insolvency proceedings.

Article 100 (2) BRRD allows member states to use the same administrative structure for the resolution financing arrangement as for the deposit guarantee scheme. The financial means raised through these two structures have to be administered separately, however, and may only be used for the respective purposes.

Article 100 (6) BRRD, by contrast, gives cause for concern. It gives member states the option of not establishing the resolution financing

Possible uses for resolution fund financing arrangements

Possibility of combining resolution financing arrangement with deposit guarantee

¹⁰ Whereas covered deposits thus form the basis for calculating the resolution fund's target level, they are explicitly omitted from the calculation of the individual institution's contribution requirement.

¹¹ FMSA press release of 22 November 2013.

“Fiscal solution” envisaged as an option for member states but questionable

arrangement as a dedicated fund. Instead, institutions’ contributions would flow directly into the central government budget; if necessary the member state is then required to make available immediately to its resolution authority, upon the latter’s request, an amount equal to these contributions (a “fiscal solution”).

The apparent purpose of this provision is to save member states already operating such a scheme the need to change their procedure. However, this type of resolution financing arrangement is not without its risks to the aims pursued by the BRRD. There is reason to fear that political pressures could lead to the financial means from banks’ contributions, once they are available to central government budgets, being appropriated for non-resolution purposes instead of being set aside for later use in resolution. However, it is precisely in times of crisis, which require the use of resolution tools, that the distressed member state might not be able to issue bonds in the markets at acceptable terms and conditions. The result would be to counteract one of the basic tenets of the resolution regime: to loosen the “doom loop” between government finances and banks’ balance sheets.

Cross-border procedures

Establishment of resolution colleges modelled on approach used by supervisors

Pursuant to the BRRD, national resolution authorities are basically responsible for the application of the envisaged tools. Dealing with banking groups which operate across national borders puts this approach, which is focused on individual member states, to the test. To solve the problem, the BRRD requires extensive cooperation and coordination between national resolution authorities. To this end, resolution colleges will be established (Articles 88 and 89 BRRD). This will be the framework for taking joint decisions on a group resolution plan, for instance. If no consensus on a joint decision can be reached, the group-level resolution authority, which usually means the resolution authority in the parent company’s home

country, decides on the group resolution plan (Article 13 (5) BRRD). Similar provisions apply to the assessment of the group recovery plan by the responsible national supervisory authority.

If, indeed, a cross-border group is to be resolved, the BRRD calls on the national resolution authorities involved to reach a joint decision on the group resolution scheme in which the resolution actions to be taken for the individual group members are laid out and the costs are allocated to the national resolution funds involved. If no consensus can be reached, each national authority may take independent resolution actions or measures for the group members domiciled in its jurisdiction (Article 92 (4) BRRD). In such a case, a “multiple-point-of-entry” approach will ultimately be chosen: resolution measures will be imposed separately on each legally independent entity, as opposed to the approach of applying instruments only at the level of the parent entity for the entire group (“single-point-of-entry” approach).

Ideal case: joint decision on resolution scheme for entire group; however, national authorities have option of disagreeing

National implementation in Germany

As an EU directive, the BRRD needs to be implemented by means of a national implementing act. The German Federal Ministries of Finance and Justice are therefore developing draft legislation to implement the BRRD.

Work on BRRD Implementation Act in progress

This implementation act is being drafted as an omnibus act. An Act on the Recovery and Resolution of Institutions and Financial Groups (*Gesetz zur Sanierung und Abwicklung von Institutionen und Finanzgruppen*, Recovery and Resolution Act) is being introduced; at the same time, the legislation will make the necessary amendments to existing acts, such as the German Banking Act (*Kreditwesengesetz*) and the Credit Institution Reorganisation Act (*Gesetz zur Reorganisation von Kreditinstituten*), introduced by the Restructuring Act (*Restrukturierungsgesetz*). The new statute is designed to

Recovery and Resolution Act as omnibus act with material provisions and amendments to other acts

cover measures to prepare and conduct recovery and resolution actions, which is why the existing recovery and resolution provisions of the Banking Act will be rescinded. With respect to the new act's general scope of application, it currently looks as though it will be synchronised with the BRRD's provisions: this means that the scope will be narrower than that of the Banking Act.

Recovery plan currently only for institutions that potentially pose a systemic risk, but in future for all institutions

The provisions of the new regime will, in future, apply not just to those institutions regarded as potentially posing a systemic risk; instead, once the national implementation act has entered into force, all institutions covered by the Recovery and Resolution Act will have to create recovery plans. In individual cases, however, institutions will be able to apply for exemptions, or simplified requirements for creating recovery plans may be applicable.

Issue of competent resolution authority not yet clarified

The implementation of the BRRD will require the creation of a national resolution authority. In order to avoid potential conflicts of interest, it needs to be separate from entities responsible for banking supervision. No decision on the specific allocation of responsibilities has been taken yet. By contrast, it is the task of off-site supervisors to review the recovery plans which means that – in line with general principles (see section 7 of the Banking Act and the Prudential Supervisory Guideline (*Aufsichtsrichtlinie*)) – involving the Bundesbank would be appropriate.

Bail-in to be introduced in Germany in 2015, ahead of schedule

Under the BRRD, the national implementing statute is to become law by 1 January 2015 at the latest. The deadline for implementing the bail-in tool is 1 January 2016 according to the BRRD. Germany is seeking to introduce the bail-in tool ahead of schedule, at the same time as the other instruments, with effect from 1 January 2015.¹²

Overall assessment of the BRRD

The underlying aim of the BRRD, to avoid socialising the risks of banking business and the attendant losses when they materialise, merits support; it allows a restoration of the market economy principle that investors themselves should bear responsibility for the risks arising from their investment decisions, and thereby reduces moral hazard.

BRRD helps to reduce moral hazard and restore a distribution of risks in line with market economy principles ...

However, this fundamental approach is riddled with statutory or discretionary exceptions. Chief among these is the discretion to exclude certain creditors from bail-in. The option of using the resolution fund for indirect loss absorption or the possibility of using, in exceptional cases, public funds as part of government stabilisation mechanisms to bail institutions out also further constrain creditor liability. However, socialising losses within the banking industry through the resolution fund is still preferable to fiscal bail-outs, the bill for which would be footed by taxpayers at large.

... but provides for numerous exceptions which should not be expanded unduly

To be sure, a certain degree of flexibility is necessary to make the resolution regime tractable in practice; in the absence of any options for exceptions, the complexity and interconnectiveness of individual instruments might make the application of the regime dangerous in terms of financial stability, which could render a resolution procedure unviable as a third option alongside insolvency or bail-out. However, it must be assured that the application of such exclusions is in fact limited to extreme exceptional cases and does not *de facto* become the rule.

¹² In order to provide added incentive for member states to implement the provisions in the BRRD governing the bail-in of creditors at an early stage, a broad majority of Eurogroup finance ministers agreed that the ESM should provide direct recapitalisation to banks only if indirect recapitalisation through the home country is not possible and shareholders and creditors have been bailed in to the tune of at least 8% of the bank's total liabilities. See remarks by Jeroen Dijsselbloem at the press conference following the Eurogroup meeting of 5 May 2014.

Financial market stabilisation justification for applying BRRD also to small institutions

Extending the scope of the BRRD to cover small institutions will be problematic. It initially does not seem appropriate to include such banks in the BRRD's scope of application and to make them contribute to the funding of a system from which they themselves will most likely not benefit since their current size means that they do not pose a danger to financial stability. However, small institutions, too, benefit from the overall financial market stabilisation afforded by the existence of an effective resolution regime. Specific experience of the financial crisis abroad has also shown that numerous small interconnected institutions ("too many to fail") can, through forced mergers, become a systemically important institution. Against this background, fund contributions, particularly those which are fraught with controversy, should not be seen in economic terms as a sort of insurance premium to cover the potential default of the contribution-paying institution but more as a type of financial stability levy.

Increased funding costs not per se an argument against the resolution regime but an expression of a reduction in implicit government guarantee

A criticism occasionally levelled at the new resolution regime, yet without any traction, is that it will cause credit institutions' funding costs to rise, therefore leading ultimately either to a deterioration of profitability or higher lending rates, which would weigh on the real economy. There are various indications¹³ that especially institutions regarded as being too big to fail still enjoy an implicit government guarantee under the current regime: investors anticipate that a distressed institution will be rescued with public funds and therefore offer the institution funding at more favourable rates than if the risks were completely internalised. An increase in banks' funding costs owing to the existence of a credible resolution regime is, in such cases, not an adverse side-effect but quite the opposite: a sign that the actual risks have been priced properly, and thus an effective instrument to reduce moral hazard.

Single Resolution Mechanism – SRM

General principles

Although the BRRD harmonises substantive resolution law and related regulations, such as those on restructuring and resolution planning, it leaves institutional responsibility at the national level. In terms of subject matter, the scope of the SRM Regulation extends further than that of the BRRD: it creates a uniform institutional framework for decision-making on how to apply the tools harmonised under the BRRD. However, the SRM Regulation has a narrower geographical scope than the BRRD, as it applies solely to banks that are subject to the SSM Regulation and thus, *de facto*, only to the EU countries participating in the SSM,¹⁴ ie the euro-area countries and any non-euro-area EU countries which have opted into the SSM by entering into close cooperation with the ECB.

BRRD harmonises tools, SRM establishes uniform rules for their application

The SSM and SRM are both key building blocks in the overall banking union project; monetary union will now be followed by the introduction of European-level responsibility for related areas such as banking supervision and bank resolution. In addition, the supervisory and resolution regimes will complement one another. Much like private investors, regulatory bodies should be bound by the principle that the level responsible for ensuring that bank balance sheets are sound should also bear the consequences of any harm caused if they are not; otherwise, there is little incentive for sustainable behaviour. Consequently, the SSM project to raise banking supervision to the European level, which is already under way, now needs to be followed by a European resolution

SRM as a building block in the banking union

¹³ For an estimate of the value of implicit government guarantees see eg S Schich, M Bijlsma and R Mocking, *Financial Market Trends*, OECD Journal, March 2014, preliminary version downloadable at http://www.oecd.org/finance/financial-markets/Improving_monitoring_guarantees_bank_debt.pdf. See also Chapter 3 of the IMF *Global Financial Stability Report* of April 2014, pp 101-132.
¹⁴ For detailed information on the SSM, see Deutsche Bundesbank, *European Single Supervisory Mechanism for banks – a first step on the road to a banking union*, op cit.

Lack of legal foundations for European resolution authority

mechanism; responsibility for these two key building blocks in the banking union must not remain at two different levels in the long run. This principle is described as “aligning liability and control”.

The SRM project faces two difficulties, however. From a legal point of view, the fact that the existing EU treaties were not drawn up with a banking union in mind is problematic. As a result, the treaties do not provide the necessary legal foundations for creating an independent European resolution authority with extensive decision-making powers. The current approach to the SRM project is adapted to the constraints of existing primary EU law, and should therefore be viewed in this light (see box on pages 48 to 49). The fact remains, however, that a European resolution authority can only be given limited decision-making powers.

Gradual rather than immediate mutualisation of liability

In addition, there is a potential economic obstacle to immediate and full mutualisation of bank resolution. For the euro-area countries at least, the SSM will largely raise banking supervision to the European level. Yet other areas such as fiscal, economic or taxation policy will remain under national responsibility, and these can also have substantial and lasting effects, at least indirectly, on the stability of the banking sector.¹⁵ A gradual mutualisation of liability is therefore in line with the responsibility of member states for past imbalances.

Decision-making processes

Creation of the SRB

The Single Resolution Board (SRB), which is to be established as an EU agency with legal personality, will be at the heart of the SRM’s institutional framework. The SRB will take decisions regarding the resolution of all banks subject to direct ECB supervision and regarding other banks with subsidiaries in other participating member states, as well as in cases where member states have transferred responsibility to the European level. In the above instances, the SRB

will adopt a resolution scheme which stipulates the measures to be taken and must be implemented by the national resolution authorities (Article 16 (5) SRM Regulation). In all other cases, responsibility for resolution will remain with the national resolution authorities. However, the national resolution authorities will only be able to adopt measures which do not require any use of the Single Resolution Fund (SRF), as recourse to SRF resources will also only be permitted on the basis of an SRB resolution scheme (Article 6a (3) SRM Regulation).

SRB meetings can be convened in either the executive or the plenary session. In its executive session, the SRB will be composed of a chair¹⁶ and four other full-time members. The SRB’s plenary session will additionally include representatives of the national resolution authorities. This will enable the SRB to draw on national expertise to complement the European perspective. In both sessions, the European Commission and the ECB will merely participate as observers, not members. This is to avoid possible conflicts of interest with other tasks in their respective roles as the EU’s competition watchdog and the European banking supervisory authority. The “European” members of the SRB, ie its chair, vice-chair and the four other full-time members, are to be chosen on the basis of an open selection procedure. They will be appointed for a five-year term of office by the Council of the European Union (the Council), based on a proposal submitted by the European Commission and approved by the European Parliament (Article 52 SRM Regulation). The national resolution authorities will appoint their own representatives.

Members of SRB in its executive and plenary sessions

¹⁵ One example would be regulations on the tax deductibility of interest on building loans, which can encourage the formation of property bubbles.

¹⁶ In addition, the draft SRM Regulation makes reference to a vice-chair on several occasions. According to Article 52, the vice-chair will also be appointed at the European level. However, the office of vice-chair is not mentioned in the articles governing the SRB’s composition, which implies that, unless the chair is absent, the vice-chair will not have his or her own position with voting rights on the SRB. The recitals do not provide absolute clarity on this matter either.

Decisions on bank resolutions taken in executive session

The SRB's executive session, which will be geared towards practical needs, will be the key forum for addressing specific resolution cases. Alongside the chair and the full-time members of the SRB, only the member states in which the institution operates will participate; additional observers may be invited on an *ad hoc* basis. The composition of the executive session is thus geared towards practical needs and primarily involves only those member states which are directly affected.

SRB's tasks

The SRB's tasks will include drawing up resolution plans, assessing the resolvability of specific banks and preparing concrete resolution decisions. To enable the SRB to carry out its tasks, it will be given far-reaching investigatory powers. For instance, it will not only be allowed to access all information available to the ECB or to the national supervisory authorities, it will also be entitled to conduct all necessary investigations and on-site inspections either directly or through the national authorities. In addition, the SRB will have far-reaching powers to remove impediments to an institution's resolvability. For example, it will be entitled to require the entity to divest specific assets or change its legal or operational structures, or those of any group entity under its control, so as to reduce complexity and ensure that critical functions may be separated from other functions through the application of the resolution tools.

Resolution trigger: responsibilities divided between SRB and ECB

Ahead of a bank resolution, it is envisaged that the initial assessment of whether the institution can be deemed failing or likely to fail will generally come from the ECB. To avoid supervisory failures and omissions, however, the executive session of the SRB will also be entitled to determine that an entity is failing or likely to fail if the ECB does not take a decision within three days of the SRB informing the ECB of its intention to reach this assessment. By contrast, the SRB itself must always judge whether the other criteria for a resolution are met (resolution is in the public interest, no alternative private sector measures would prevent the entity's failure).

If the decision is taken to resolve an entity, the SRB will develop a resolution scheme. However, the Meroni doctrine (see box on pages 48 to 49) dictates that only EU institutions enshrined in primary EU law have the power to take decisions implying a wide margin of discretion. The strategy set out in the SRM Regulation (Article 16 (6)) for involving the Commission and the Council – as institutions enshrined in primary EU law – therefore envisages that the resolution scheme will only enter into force if neither of these institutions has raised any objections to it within 24 hours. Should either institution raise an objection, the SRB will be obliged to modify the resolution scheme within eight hours.

The Commission will be entitled to base its objections on discretionary aspects of the resolution scheme put forward by the SRB. By contrast, the Council will only be permitted to act on a proposal from the Commission and not on its own initiative. The Council will be able to object to an SRB decision if it does not fulfil the public interest criterion, and it will be entitled to approve or object to the Commission's modification proposal when there is a material modification (of 5% or more) to the amount of the Fund to be used compared with the SRB's original proposal. In both cases, the Council will act by simple majority.

The Commission's approval will also be required in cases where resolution action would involve state aid within the meaning of EU law (Article 107 of the TFEU) or SRF aid. As there is a danger of competition being distorted in such situations, the Commission, in its role as competition watchdog, must approve the use of funds in these instances (Article 16a SRM Regulation).

The SRB's plenary session will be responsible for general policy issues (eg annual work programme, budget, investment decisions). In addition, the plenary session will take decisions on individual resolutions in cases where use of the SRF reaches the €5 billion threshold or

Complex institutional interplay between SRB, Commission and Council due to Meroni doctrine

Internal decision-making processes within the SRB

Limitations on the functioning of the Single Resolution Board (SRB) imposed by primary law

In the run-up to the creation of the Single Resolution Board (SRB), it is even more questionable now than when the European supervisory authorities (on which less extensive decision-making powers have been conferred) were established whether the envisaged sweeping transfer of powers to this body is legal under the chosen legal basis. Essentially at issue is the scope for discretion that can be given to EU bodies and agencies, which – like the SRB – are not provided for by the European treaties if sovereign decision-making powers are conferred on the basis of Article 114 TFEU. According to a 1958 ruling by the Court of Justice of the European Union (CJEU), an EU institution may only establish an EU agency and may only delegate decision-making powers within that agency's mandate if the scope of the agency's powers is clearly defined, limiting the institution's margin for discretion from the start. The purpose of this is to prevent the agency from overstepping its mandate while ensuring oversight by the delegating body and the amenability of the agency's decisions to judicial review (the "Meroni judgement").¹

Just recently, the CJEU issued a detailed judgement on the delegation of powers to EU agencies in a case involving the European Securities and Markets Authority (ESMA).² With regard to the limitations on the decision-making powers to be conferred on the EU agency, the CJEU expressly referred to, in particular, the scope for discretion laid down by the EU legislature regarding the harmonisation measures pursuant to Article 114 TFEU. The CJEU held that the Union's legislature is authorised to establish EU agencies if the legislature deems the establishment of such an agency necessary for objective reasons. In particular, this is

likely to be the case if the measures to be taken require special professional and technical expertise and a corresponding ability to respond swiftly and appropriately. However, due to the aforementioned reasons, the CJEU also required that the conferred powers be subject to specific criteria and limitations. Overall, the CJEU clearly specified this requirement in its decision on the ESMA by ruling that the tightness of the limits in each case also reflect the objectives established for that particular EU agency.

In an opinion published in October 2013, the Council's Legal Service was critical of an earlier draft of the SRM Regulation for, in some cases, providing the SRB with excessive discretionary powers (eg regarding the creation of a resolution plan or the use of resolution funds) which were no longer consistent with the Meroni doctrine. It held that either the criticised powers had to be so clearly defined that the SRB would not be able to exercise wide discretion, or the powers affected would be taken on by EU institutions (already provided for in the treaties of the European Union) with executive authority.

The current version of the draft regulation still envisages discretionary decision-making powers for the SRB, which merit criticism in the light of the Meroni doctrine. Despite a number of amendments made during the legislative process, the SRB's competencies remain broad. Against the backdrop of the CJEU's ruling on ESMA powers, one could therefore critically examine whether the CJEU's findings have been sufficiently reflected. Although the Commission and the

¹ CJEU, judgement of 13 June 1958-9/56.

² CJEU, judgement of 22 January 2014 – C270/12.

Council are involved in the decision-making process, the ability of such involvement to constrain the SRB's scope in line with the Meroni doctrine is doubtful, for two reasons. First, both bodies have only limited powers to influence the SRB's resolution decisions since both their veto and amending powers are limited to certain aspects (in the case of the Commission, these are discretionary aspects of the resolution programme; the Council, in turn, acts on a proposal from the Commission if there is a lack of public interest or if considerable changes have been made to the use of fund resources). Second, doubts arise about whether the understandably tight deadline of a maximum of 24 hours to ensure the ability to act is sufficient for the Council and the Commission to adequately assess the aspects under their control. Ultimately, these Council and Commission control mechanisms can do little to limit the

decision-making scope granted to the SRB. Owing to the severity of impact the resolution measures will have, a judicial review of the legality of conferring decision-making powers on the SRB cannot be ruled out. With regard to legal certainty, it would therefore be desirable for the SRB and its powers to be anchored in the treaties of the European Union.

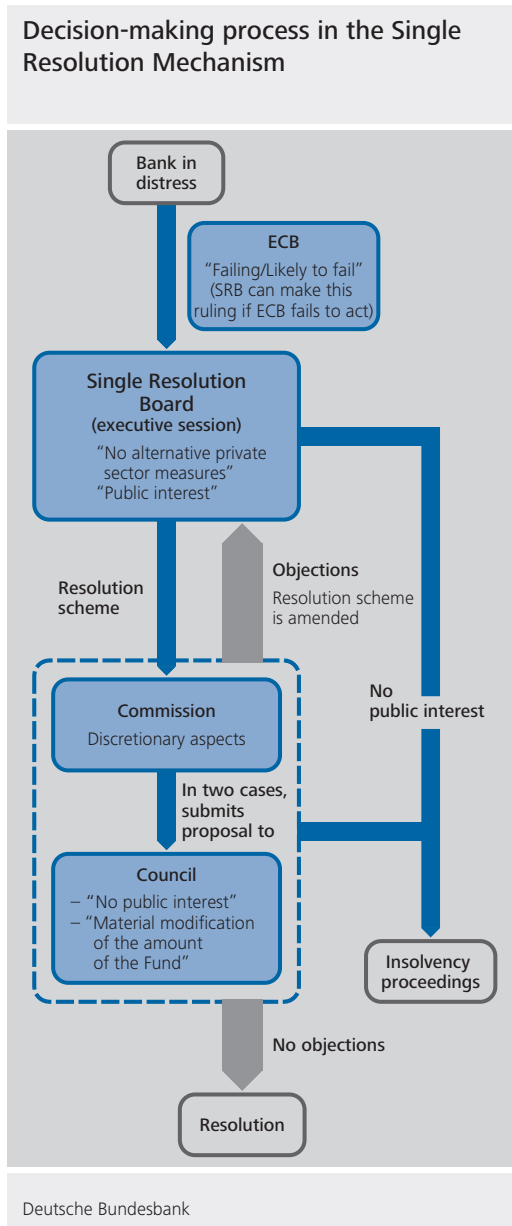
where at least €10 billion in liquidity support would be granted. The executive session will take decisions regarding cases below these thresholds. The plenary session will take its decisions by a simple majority of its members; each member will have one vote. In the event of a tie, the chair will have the casting vote. The SRB will take decisions regarding SRF resources and their mutualisation by a simple majority of its members. Should external funding be needed in addition to the financial means available in the SRF, a majority of two-thirds of the board members, representing at least 30% of contributions (in the first eight years: at least 50%) will be required.

The executive session will take decisions regarding the resolution of a bank by consensus. If the members of the executive session are unable to reach a consensus within a set deadline, the chair and the four full-time members will take a decision by a simple majority. This will substantially reduce the influence of na-

tional representatives on the resolution schemes. A resolution scheme passed by the executive session which requires the approval of the plenary session will be deemed to be adopted unless, within three hours of the draft being submitted, at least one member of the plenary session has requested a meeting of the plenary session. The plenary session will then take a decision on the resolution scheme.

While these multi-layered procedures (see chart on page 50) are intended to address the legal concerns (with regard to primary EU law) outlined above, they also make the decision-making process more complex and therefore affect its effectiveness and credibility. They are a compromise between the national governments' desire to be involved through the Council and the wish expressed in some quarters of the European Parliament to incorporate the European Commission, as the EU's executive body. Although these decision-making processes are much simpler than in earlier versions

Given complexity of decision-making processes, change to primary law needed in medium to long term



of the draft SRM Regulation, the question remains as to how well these complex systems will work in practice. The structures set out in the regulation remain cumbersome and have certain drawbacks in terms of efficiency. The continuing aim should therefore be a change to primary law which creates the legal grounding for a genuine European resolution authority with efficient autonomous decision-making powers. The objective should be to ensure that a bank can be resolved over the course of a weekend (ie between when the markets close in the United States on Friday evening and when they open in Asia on Monday morning).

It remains to be seen whether this is feasible under the conditions outlined above.

Resolution financing

Besides the SRB and the associated decision-making processes, the second key element introduced by the SRM Regulation is a Single Bank Resolution Fund, or SRF. The SRF will be administered by the SRB and will replace national resolution financing arrangements within the meaning of the BRRD (Article 85 SRM Regulation) for the SRM member countries. As in the BRRD, the target funding level for the SRF is 1% of the amount of covered deposits of all credit institutions authorised in the participating member states (currently around €55 billion), which is to be built up within eight years. All institutions established in the SRM countries will be obliged to pay contributions irrespective of whether they are under the direct supervision of the ECB or of a national authority within the SSM.

European fund will replace national resolution financing arrangements

Some member states have already passed autonomous legislation, ie national legislation not based on European provisions, to create mechanisms with a similar function and structure to the resolution funding arrangements established in the BRRD and the SRM Regulation. Germany is one of these countries, having launched its Restructuring Fund – which is financed via a bank levy – on 1 January 2011. The Restructuring Fund can be used to set up bridge entities, acquire business units in the absorbing legal entities, issue guarantees, carry out recapitalisations or fulfil claims arising in connection with such a measure.¹⁷ Its resources totalled around €1.8 billion at the end of 2013.

The launch of the SRM will render such national funds obsolete, as the SRF will then be considered the resolution financing arrange-

¹⁷ Section 3 of the Restructuring Fund Act, which was enacted as Article 3 of the German Restructuring Act of 9 December 2010 (Federal Law Gazette I, p 1900).

ment of the participating member states within the meaning of the BRRD (Article 85 SRM Regulation). The legality of using these financial resources for a different purpose to that for which they were collected would be questionable. Moreover, simply transferring these funds to the SRF without due consideration would be inappropriate, as this would effectively put the banking sectors of the member states which have already introduced this kind of system at the national level at a disadvantage to the banking industries of the other participating countries. It is essential to avoid imposing double payments on institutions which have already paid into national funds and would now also have to contribute to the SRF. Article 66 (2b) of the SRM Regulation therefore permits the national resolution financing arrangements to use their available financial means to compensate institutions for the new contributions that they may be required to pay into the SRF. The existing national resources will thus be depleted gradually until they have, in effect, been transferred to the SRF without imposing double payments on contribution payers.

European level. Yet this is only a rudimentary means of aligning liability and control. During an eight-year transitional period, the SRF will be divided into national compartments, which will receive the contributions paid by banks in their respective countries. The details of this mutualisation are not governed by the SRM Regulation itself, as the legality of entrusting the EU with such far-reaching powers to administer national funds via legislation passed under Article 114 of the TFEU is questionable. Instead, the participating member states (all the EU member states apart from the United Kingdom and Sweden) have signed an inter-governmental agreement (IGA) alongside the SRM Regulation. Once ratified, this IGA will provide the legal foundations, in line with national constitutional provisions, for mutualising SRF funds.

This gradual mutualisation will be implemented through a process of cost distribution between the national compartments, which will go through several stages. The starting point is the provision that, in cases where SRF funds are used, recourse should first be made to the compartments of the member states in which the bank or banking group under resolution is established or authorised. The costs are to be distributed between these compartments in proportion to the past contributions paid by the group to the respective compartments. However, this recourse to the home member states' compartments must remain below certain thresholds. Recourse to 100% of the financial means in these compartments will be permitted during the first year of the transitional period, with the threshold falling to 60% in the second year and 40% in the third, followed by a linear decline during the subsequent years. Once the applicable threshold has been reached, recourse to the compartments of all other participating member states – including those in which the group is neither established nor authorised – will also be permitted in a second stage; this recourse must likewise remain below a certain threshold. The threshold for recourse to these compartments will

Process of cost distribution between the various compartments of the SRF during the first eight years

National resolution funds to remain in place for small investment firms

Certain differences between the BRRD and the SRM Regulation mean that national funds will remain in place for one segment, which is unlikely to account for a very large volume: the SRM will only apply to investment firms if their parent undertakings are subject to consolidated supervision carried out by the ECB within the meaning of the SSM Regulation. Consequently, small investment firms which do not belong to a significant group will remain outside the scope of the SRM and the SRF. In accordance with Article 2 (23) of the BRRD, however, they are also covered by the member states' obligation to set up a resolution financing arrangement.

Gradual mutualisation of liability through system of national SRF compartments

In effect, the SRF will lead to a mutualisation of liability for bank failures. To broadly synchronise the progression to shared European liability with the move to shared European control, the approach set out in the legislation envisages a gradual transition to resolution financing at the

rise gradually. At the end of this process, after the eight-year transitional phase has elapsed, all the national compartments will cease to exist and liability will be fully mutualised at the European level. The various compartments will thus be merged into a single fund.

Mutualisation in SRM Regulation and IGA faster than threshold percentages might suggest at first sight

Several factors need to be considered when judging the speed of this mutualisation. First, the eight-year process of transferring liability from the national to the European level is not linear; a significant reduction in national liability and a corresponding increase in European liability is already envisaged from the second year onwards. Second, the specified percentages do not relate to resolution costs but to the size of the respective national compartments; the potential costs to the compartments of large member states are thus greater than the percentages might suggest, as the overall volume from which the threshold is calculated is larger. Third, the IGA provides for the possibility of temporary transfers between the SRF's national compartments during the transitional period, which could bring forward mutualisation. The SRB will take decisions on such temporary transfers by a simple majority of its plenary session. The member state from whose compartment the transfer is to be made will only be able to veto such decisions under certain circumstances. Although the IGA stipulates that the transfers must be refunded with interest before the transitional period elapses, a higher level of mutualisation will be in place by then; the SRF's division into compartments will be less relevant because of the increased liability at the European level. In effect, such transfers would make the mutualisation of the compartments faster than specified in the IGA.

Further stages in liability distribution under IGA

If the costs facing the SRF are not fully covered by the measures envisaged in the two initial stages outlined above, a third stage entailing unlimited recourse to the compartments of the home member states will be initiated. A fourth stage will allow extraordinary *ex post* contributions to be levied in line with the principles described above, while a fifth stage will enable

the SRB to borrow funds externally on the SRF's behalf or to mandate the above-mentioned temporary transfers between national compartments. The reference to contracting funds via "public financial arrangements" in Article 69a of the SRM Regulation suggests that these provisions were written with national budget funds or the tax-funded European Stability Mechanism (ESM) in mind (see box on pages 53 to 54). This is unproblematic as long as the SRM Regulation is not used to exert legal or practical coercion on the ESM to loan funds; lending decisions must be taken by the ESM's decision-making bodies in line with the applicable procedures.

Overall assessment

The creation of the SRM, as the second pillar of the banking union, through the SRM Regulation and the IGA is essentially a welcome step: in the interests of aligning liability and control, the institutional progression to European banking supervision through the SSM project makes it necessary to transfer institutional responsibility for bank resolution to the European level too, rather than merely harmonising substantive resolution law as is envisaged in the BRRD. Even so, the decision-making processes set out in the SRM Regulation are complex and cumbersome, which ultimately undermines the credibility of the mechanism. Consequently, the member states should not take the forthcoming completion of the SRM legislative project as an excuse to reduce the pace of the necessary institutional reforms. Instead, they should swiftly tackle the requisite treaty changes in order to lay the legal foundations for a more efficient SRM; the current solution can only be temporary given the shortcomings caused by the aforementioned constraints of primary EU law. When devising these treaty changes, thought should also be given to how to resolve any remaining tensions between the full mutualisation of resolution financing which will then be in place and the impact of national policy spheres on the stability of banks. One option

SRM Regulation essentially a welcome step, but politicians still need to lay permanent legal foundations

The envisaged role of public funds in European bank resolution

One aim of the new bank resolution regime is to ensure wherever possible that public coffers, and thus ultimately the taxpayer, will not have to foot the bill for bank bail-outs again. However, it is not realistic to rule out all possibility of public sector support, especially in the event of a severe systemic crisis.¹ The Single Resolution Mechanism (SRM) thus envisages that, after all components in the liability cascade (which is described on pages 39 to 41 and pages 50 to 52) have been exhausted and alongside the possibility of granting temporary loans between the national compartments of the Single Resolution Fund (SRF), the SRF will be able to borrow funds from other sources, including the public sector. According to the Eurogroup's statement of 18 December 2013, during the transitional period these loans will initially be available from national sources and, if necessary, from the European Stability Mechanism (ESM). A common backstop will be developed during the transitional period which will also allow the SRF recourse to public funds.

Irrespective of the concrete form that such a backstop takes, it is a welcome development that the Bank Recovery and Resolution Directive (BRRD) and the SRM envisage that bank resolutions should only involve the use of a fiscal backstop as a last resort, thus protecting the taxpayer. Before the fiscal backstop is used, providers of equity and debt capital are to bear as much of the costs as possible – for instance by means of a bail-in – and, if necessary, the banking sector is to shoulder some of the burden via the SRF. However, exceptions to this rule could mean that, in practice, tax funds are used to support banks at an earlier juncture. For instance, certain creditors may be exempted from a bail-in under specific conditions (see pages 39 to 40). In addition, precautionary recapitalisation using public funds could also breach the no bail-out principle. The BRRD provides scope for precautionary recapitalisation by enabling solvent institutions to receive state aid under certain conditions without this auto-

matically triggering a resolution procedure, meaning that providers of equity and debt capital might shoulder little or none of the burden.²

The introduction of the SRM as a second building block in the banking union alongside the Single Supervisory Mechanism (SSM) is a logical step, as it will ensure that liability and control are adequately aligned with one another within the sphere of banking supervision. However, a common backstop within the banking union could create undesirable incentives which discourage sound public finances and a sustainable economic policy. Joint liability among banks or governments for bank resolution costs could tempt national governments into pursuing a more risky economic and fiscal policy if the benefits are reaped, above all, at national level and the potential costs are shared, in part, at European level. The joint liability established via the SRF, which is set to increase over the transitional period, will already create such undesirable incentives and a common fiscal backstop would only amplify them further.

Problems of this nature will arise above all if national policies can cause national banks to fail. The additional undesirable incentives created by joint liability will be smaller if institutions avoid national risks by diversifying their investments or structures at an international level. The incentive problems for national economic and fiscal policy will also be mitigated by bailing in providers of

¹ A statement issued by the Eurogroup envisages the possibility of involving public budgets, although any such arrangement that is put in place is to be fiscally neutral over the medium term. See Statement of Eurogroup and ECOFIN Ministers on the SRM backstop, 18 December 2013.

² In the event of a precautionary recapitalisation, EU legislation on state aid also applies. Pursuant to the Banking Communication published by the European Commission in July 2013, before state aid is approved, equity holders, hybrid capital holders and subordinated debt holders are to be involved in adequate burden-sharing (the exact details of which are not specified in the communication) as long as this does not endanger financial stability.

equity and debt capital at an earlier stage as the threat of liability in the event of a resolution will give investors an incentive to ensure that banks do not take on excessive risk. However, the effectiveness of this corrective influence will hinge crucially on the perceived *ex ante* credibility of the bail-in and on how strictly it is applied.

Furthermore, European economic and budgetary surveillance procedures as well as macroprudential supervision may also mitigate undesirable incentives through prompt and resolute action to rectify any national economic and fiscal policies that may endanger stability. However, it is uncertain whether the tools envisaged in these procedures will always successfully identify and correct the build-up of excessive risks in the banking sector in good time.

Depending on the perceived severity of these incentive problems and the perceived effectiveness of the aforementioned corrective influences, some degree of national loss retention could be introduced in the liability cascade, either prior, in parallel or subsequent to the resolution fund. The first two cases would constitute a break with the principle of ensuring that the banking sector is generally liable before the taxpayer, as national taxpayers would become liable in the amount of the national loss retention at the same time as or before the banking sector. In order not to free providers of equity and debt capital from their liability, this national loss retention would only come into effect after these parties had been bailed in as fully as possible.

While the precise details of the common fiscal backstop are still outstanding, the Eurogroup has recently reached a political understanding on a new instrument enabling the ESM to recapitalise banks directly.³ The general intention of enabling direct recapitalisation by the ESM was announced at a political level back in June 2012. This instrument is due to come into force when the SSM is launched in November 2014. In contrast to the existing ESM instrument of indirect recapitalisation through lending to governments, ESM funds for supporting

banks are to be provided without their home country becoming liable to the ESM. The SRF would thus be able to approach the ESM for funds and – as bank resolution costs are to be shared at the European level – this would then constitute a common fiscal backstop.

Some of the key aspects of this new instrument have been outlined already. Up to the end of 2015, the ESM will be able to recapitalise a bank directly only after a bail-in of 8% of the respective bank's total liabilities and after recourse has been made to the ESM member's national resolution fund. These prerequisites for direct bank recapitalisation are in line with the minimum level of bail-in stipulated in the BRRD before use can be made of the national resolution fund.⁴ As of 2016, the use of the bail-in regulations as defined in the BRRD will be a precondition for direct recapitalisation. This will ensure that the ESM direct recapitalisation instrument cannot be used to sidestep these bail-in regulations. Furthermore, the existing ESM indirect recapitalisation instrument is to be applied first.⁵ The more narrowly the prerequisites for using the direct recapitalisation instrument are defined, the more likely it is that – after making full use of the support funds available in the SRF – the member states in question will continue to fund backstops themselves during the transitional period. The advantage of providing ESM funds for direct recapitalisation in the form of a loan rather than a guarantee is that it will make the extent of the risks more transparent to the taxpayer and the limit of €60 billion on direct recapitalisation harder to circumvent.

³ See Remarks by Jeroen Dijsselbloem at the press conference following the Eurogroup meeting of 5 May 2014 and the Statement by the President of the Eurogroup on the ESM direct recapitalisation instrument of 10 June 2014.

⁴ However, the BRRD bail-in instrument first has to be transposed into national law by 1 January 2016.

⁵ Should the ESM indirect recapitalisation instrument be used before the BRRD comes into force on 1 January 2015, only EU state aid rules would have to be observed.

would be to transfer additional economic, fiscal and taxation responsibilities to the European level; the alternative would be to modify the procedure for resolution financing, and thus ultimately the degree of mutualisation, while leaving the member states largely autonomous in their economic and fiscal policy (see "Resolution financing", pages 50 to 52).

Will the SRM cause risk-seeking institutions to be bailed out at the expense of more conservative entities?

Particularly in the member states with more stable banking sectors, the indirect mutualisation of liability among banks via the SRF is likely to be met with criticism. The idea that SRF contributions will cause more robust institutions to pay indirectly for risks which were taken in the past by other, less conservative institutions in foreign countries – and which have since materialised – is not unfounded. However, a counterargument would be that, at least following the SSM's launch in November 2014, supervisory control will be harmonised at the European level and that the SRM is aimed at precisely such a mutualisation of liability in order to promote market integration. Yet continuing to differentiate, for resolution purposes, between institutions according to their home country in the long term would perpetuate the fragmentation of the European banking sector in a manner which is incompatible with the principles of the single market. In addition, it is important to bear in mind that the sole alternative to transferring liability for banking sectors to the European level is ultimately a fiscal backstop at the national level, which would force the taxpayer to bear any losses. This would run counter to the objectives of the resolution regime. The current compromise can therefore be regarded as the outcome of weighing up different priorities: faced with the principle of dual subsidiarity (the private sector should be liable before the public sector and, at least during the transitional period, the individual member states should be liable before the European level), the first dimension has been prioritised over the second. All things considered, this decision is justifiable.

However, it would not be appropriate to mutualise liability for existing capital gaps on bank balance sheets (known as legacy assets). These gaps arose on the watch of national supervisors and must therefore be closed at the national level before liability is transferred to the European level. Only then can the banking union, which will entail European liability for any failures or omissions arising under European responsibility, be launched. The comprehensive assessment of the SSM banks, which is now being performed (until summer 2014) under the ECB's leadership, is therefore crucially important. It will identify legacy assets, which will then have to be eliminated under national responsibility. The SRM Regulation allows the member states sufficient time to do this; although the SRB will be given preliminary powers with effect from 1 January 2015, it will not have full resolution powers until 1 January 2016 (Article 88 SRM Regulation). The member states should use this additional time to thoroughly address the legacy asset problem – while ensuring that recourse to public funds is only possible once private investors have shouldered an adequate share of the costs, as is required by EU law on state aid.¹⁸

Problem of legacy assets must be addressed before SRM's launch

Consequently, neither the banking union in general nor the SRM in particular should be viewed as a quick fix to patch up existing problems. Indeed, the SRM is intended to reduce the likelihood of future financial crises and to alleviate their impact should they still arise. Nonetheless, a more comprehensive approach will be needed to overcome the current financial crisis, which stems from the failings of the past.

Banking union is not a quick fix to patch up existing problems in the current crisis

¹⁸ See the communication from the European Commission on the application of state aid rules to bank support measures ("Banking Communication" (OJ EU No C 216/1), 30 July 2013).