News Bulletin

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# European Resolution and Recovery Framework for Financial Institutions

On 6 January 2011, the European Commission (the "Commission") published a consultation paper on the technical details of a possible EU framework for bank recovery and resolution (the "Consultation Paper").[1] The paper follows the communication from the Commission dated 20 October 2010 on an EU framework for crisis management in the financial sector (the "Communication").[2]

The need for jurisdictions to ensure they have adequate frameworks to deal with failing institutions at an early stage, in particular to address some of the "moral hazard" issues arising in relation to institutions regarded as "too big to fail," has been a key issue in the international response to the financial crisis. The G-20 leaders' summit in Seoul in November 2010 endorsed the Financial Stability Board's proposals in its report on reducing the moral hazard risk posed by systemically important financial institutions, dated 20 October 2010. The Basel Committee on Banking Supervision ("BCBS") also published a report and recommendations in relation to cross-border resolution issues in March 2010,[3] and its October 2010 report to the G-20 noted it had discussed conducting an evaluation of different legal and policy changes to assist authorities in addressing future needs for crisis management and resolution of financial institutions. The BCBS is continuing a review assessing the systemic importance of financial institutions at global level and a review on going concern loss absorbency that could be provided by financial instruments. Its proposals are likely to be published during 2011 and will inevitably have an impact on the EU Commission's proposals as set out in the Consultation Paper.

Some jurisdictions have already taken steps to introduce recovery and resolution regimes for banks and other financial institutions. In the United Kingdom, the Banking Act 2009 introduced a special resolution regime giving various powers to the UK financial authorities to intervene prior to the insolvency of a failing bank or other deposit taking institution. These included facilitating a private sector rescue of the bank, transferring all or part of the bank's business to a state controlled bridge bank as a temporary measure or bringing the bank into full temporary public ownership. The Financial Services Act 2010 also introduced various measures, including requiring the Financial Services Authority to require certain firms to develop and maintain recovery and resolution plans (or "living wills"). Most recently, the UK has introduced a special administration regime for investment banks, to address a number of issues that arose in connection with the administration of Lehman Brothers International Europe in the UK, in particular aiming to assist in the swift return of client assets and money.

[1] European Commission (DG Internal Market and Services) working document: Technical details of a possible EU framework for bank recovery and resolution (6 January 2011), http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.
[2] European Commission communication: An EU framework for crisis management in the financial sector (20 October 2010), http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf.
[3] Report and Recommendations of the Cross-border Bank Resolution Group (March 2010), http://www.bis.org/publ/bcbs169.pdf.


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The EU Consultation Paper envisages granting supervisory authorities certain emergency powers and tools to intervene at an early stage and to restructure or resolve financial institutions without resorting to the use of taxpayers' funds involved in a public sector bail-out. We summarise below the key proposals under consideration.

## Scope

The Commission proposes that all credit institutions (as defined in Article 4(1) of the Banking Consolidation Directive (2006/48/EC) ("BCD")) should come within the scope of the regime. It also intends that certain investment firms should be subject to the provisions, including those that are part of a banking group or those that execute orders on behalf of clients and meet certain size tests (not yet specified). The Commission is also seeking views as to whether EU holding companies of credit institutions and other financial companies should be included.

## Resolution Authorities

Each member state will be required to identify a "resolution authority" to exercise the resolution powers, which authority should be functionally separated from the supervisors (although it envisages the supervision and regulatory functions could be within the same organisation). It also envisages that the European Banking Authority ("EBA") would be given a significant role in the supervision of the proposed framework and the development and coordination of recovery and resolution plans.

## Supervision, Planning and Prevention

The Commission intends to reinforce the supervisory regime under the Capital Requirements Directive ("CRD"), by providing for enhanced supervision of credit institutions, and requiring recovery and resolution plans as a key component of an effective crisis management regime.

### *Recovery planning*

All credit institutions and investment firms covered by the proposed framework would be required to prepare and maintain, and submit to supervisors for assessment, detailed recovery plans setting out measures they would take in different stress scenarios, assuming no public sector support. In addition, the Commission proposes that EU parent banks or financial holding companies should prepare group recovery plans (including a recovery plan for each constituent entity). These measures are aimed at restoring the long term viability of the entity where it has suffered a material deterioration in its financial situation.

The Commission proposes that the recovery plans should reflect the size of the institution, its funding sources and the availability of any financial support and include, among other things: (i) measures to restore its capital, to ensure adequate access to liquidity and to reduce risk and leverage, (ii) arrangements for the sale of assets or businesses and for intra-group financial support and (iii) other management strategies to restore financial soundness.

### *Intra-group financial support*

The Commission is considering establishing a framework for intra-group liquidity management to facilitate asset transfers within a group where a group entity is experiencing liquidity stress. This would involve supervisors giving prior approval to shareholders' agreements setting out the conditions for asset transfers. It also considers options under which, subject to prior authorisation of the consolidating supervisor, financial support could be provided between group companies where an entity is experiencing financial difficulties.

***Resolution plans***

In addition to recovery planning specified above, to deal with the situation where an entity has failed and there is no realistic prospect of recovery, the Commission believes that resolution authorities should, in consultation with supervisors, draw up and maintain both an individual resolution plan for each institution, and a group resolution plan for each banking or financial group, which is under its remit. This will generally be with a view to transferring or winding down the relevant business.

The Commission sets out issues it believes a resolution plan could cover, including the options under different stress scenarios, financing, critical functions and measures to ensure continuity of arrangements and necessary information for resolution authorities to apply the resolution tools and powers. Upon request by the resolution authorities, an institution should provide them with relevant information including its (or group members') legal and operational structures, a list of critical economic functions within the group mapped to business lines and details of intra-group and counterparty exposures.

Group level resolution authorities should be responsible for drawing up and maintaining group resolution plans and cooperating with other relevant resolution authorities. It is proposed such plans should contain various information, including the circumstances in which a group resolution would be appropriate, the extent to which resolution tools and powers could be applied at the group level and how group resolution options would be financed.

## Early Intervention

With the stated aim of seeking to address developing problems at an early stage, the Commission proposes to extend the powers of intervention under Article 136(1) of the CRD so that supervisors may intervene in circumstances of likely breach of the CRD. It also proposes to increase the powers available to regulators, including requiring the institution to take steps to raise additional capital, restricting or limiting its business, imposing additional reporting requirements or requiring it to draw up and implement a specific recovery plan.

The Commission is also considering giving relevant supervisors the power to appoint a special manager for a period of up to one year to replace or assist the management of a failing institution. It proposes that such powers should be exercisable either (i) where the institution fails to provide or implement a specific recovery plan requested by the supervisor or where the supervisor considers that the proposed recovery plan would not lead to a recovery of the relevant entity or (ii) the supervisor believes management is unwilling or unable to take measures required by the supervisor in exercising its powers of intervention under the CRD.

In relation to groups where there is more than one relevant supervisor, the Commission suggests that the consolidating supervisor, in cooperation with other supervisors involved within the relevant supervisory college, should assess whether coordination is desirable on the grounds that it would be more likely to restore the viability of the relevant entities and preserve the financial soundness of the group as a whole (taking into account any likely adverse impact on other entities within the group).

## Resolution Tools and Powers

***Trigger conditions, resolution objectives and general principles***

The Commission believes that resolution authorities should apply the resolution tools and powers when a credit institution is failing or likely to fail and there is no reasonable prospect that it will be able to rectify the situation within a reasonable period. The action should also be justifiable in the public interest.

The Commission is considering three alternative trigger options:

**Option 1 (solvency test):** i) the entity has incurred, or is likely to incur, losses that will deplete equity; (ii) its assets are, or are likely to be, less than its liabilities; or (iii) it is, or is likely to be, unable to pay its debts in the normal course of business.

**Option 2 (regulatory authorisation test):** it no longer fulfils the financial conditions for authorisation (or is likely to fail to do so).

**Option 3 (regulatory capital test):** it no longer possesses, or is likely to cease to possess, sufficient tier 1 instruments to meet the requirements of the CRD.

The Commission believes that in exercising their resolution powers, the relevant authorities should have regard to the following "resolution objectives": (i) ensuring the continuity of essential financial services, (ii) avoiding adverse effects on financial stability, (iii) protecting public funds, and (iv) protecting insured depositors. It also believes the authorities should be guided by certain general principles, including that shareholders should first bear the losses of the institution and unsecured creditors bear the residual losses. Creditors of the same class should be treated in a fair and equitable manner and no creditor should incur greater losses than it would under a liquidation.

***Resolution tools***

The Commission proposes that resolution authorities be given the following resolution tools:

**Sale of business tool**: the sale of the bank or the whole or part of its business on commercial terms without shareholders' consent or other procedural requirements.

**Bridge bank tool:** the transfer of all or part of the bank's business to a "bridge bank," which is wholly owned by a public authority (intended to be a temporary measure pending sale to the private sector).

**Asset separation tool:** the transfer of certain high-risk assets of the bank to an asset management vehicle owned by a public authority. Due to moral hazard concerns, the Commission intends this tool to be used in conjunction with another resolution tool.

**Debt write-down or conversion tool:** the write-down of the claims of unsecured creditors of a failing bank or the conversion of debt claims into equity (but preserving the insolvency ranking of claims and *pari passu* treatment of creditors within the same class).

The Commission notes that the write-down proposal gives rise to legal and practical challenges and relates to other work in the international community, including the ongoing work by BCBS on loss absorbency of capital instruments at the point of non-viability. It therefore provides only a general overview of how such provisions might operate in practice and the relevant issues. It sets out two potential models. The first is to give authorities the power to write down or convert into equity, all senior debt (or, at their discretion, certain classes of senior debt) issued after the proposals come into effect (subject to certain exemptions, including swap and repo transactions, short-term debt, deposits and secured debt). The second option is to require banks to issue a fixed volume of "bail-in" debt, which could be written down or converted into equity upon a statutory trigger. Such instruments must specify that the relevant resolution authority may exercise a statutory power to write down the debt if the trigger conditions apply. The amount of the write-down or the conversion rate may either be specified in the bail-in instrument or left to the discretion of the resolution authorities.

The suggestion that authorities could be given the power to write down any senior debt of financial institutions has given rise to particular concern amongst market participants and would be likely to have a significant impact on the pricing and liquidity of senior bank debt in the future. Providing authorities with such powers would

appear to go far beyond the recommendations to date of the BCBS which has been focused on ensuring that capital instruments issued by banks that qualify as tier 1 or tier 2 capital have the ability to absorb losses at the point of non-viability of the entity.

***Resolution powers***

The Commission proposes that resolution authorities should have various powers to enable them to apply the resolution tools effectively, including the power to take control of the relevant entity, to remove or replace its senior management and transfer its shares and debt instruments (or issue new shares). The authorities should also have the power to reduce or write off the claims of unsecured creditors.

***Procedural obligations and protection of stakeholders***

The Consultation Paper sets out proposals to ensure that resolution measures are properly notified and made public. It also states that the resolution framework should provide for safeguards and compensation for interference with the property rights of shareholders, creditors and other third parties, to ensure that they suffer no greater loss than they would in an insolvency.

## Partial Property Transfers

The Commission proposes to include safeguards for the rights of counterparties where a resolution authority uses its powers to effect a partial property transfer of the assets of the affected credit institution or to modify the terms of a contract to which it is a party. It believes the safeguards should apply irrespective of how these arrangements, have been created (e.g., contract, trust or operation of law). It believes safeguards are needed in respect of (i) security arrangements (whether by fixed or floating charge), (ii) title transfer financial collateral arrangements, (iii) set off arrangements, and (iv) netting arrangements.

In relation to financial collateral, set-off and netting arrangements, the Commission believes that, subject to certain limited exceptions, there should not be a transfer of some but not all of the rights and liabilities protected by such an arrangement, nor a modification or termination of such rights and liabilities. Where liabilities are secured under a security arrangement, the protections should ensure that any secured liability is transferred with the benefit of the security (and vice versa) and there should be no transfer of assets against which the liability is secured unless the liability and benefit of the security are also transferred.

The Commission proposes equivalent safeguards to prevent a partial transfer, termination or modification of the property, rights and liabilities forming part of a structured finance arrangement, including securitisations and covered bonds.

## Other Matters

In relation to cross-border financial groups, in the absence of a harmonised insolvency regime and a single EU supervisory authority for those groups, the Commission proposes a coordination framework based on common resolution tools and an obligation for authorities to consult and cooperate when resolving cross-border groups. This will include the establishment of resolution colleges of supervisors for crisis planning, developing common approaches to the application of resolution tools and coordinating resolution measures and actions by resolution authorities.

The Commission also proposes that member states be required to establish a bank resolution fund to cover the costs incurred in using the resolution tools. Such fund will have a target size, defined as a percentage of the aggregate eligible liabilities of all contributing institutions. It is envisaged that every credit institution and investment firm authorised in a member state should contribute pro rata to the resolution fund.

## Next Steps

The deadline for responding to the consultation is 3 March 2011. The Commission stated that it intends to adopt a legislative proposal in June 2011 based on the consultation responses and an impact assessment.

Although the proposal for a resolution and recovery framework for banks in the EU is not surprising and is consistent with the objectives of the G-20, some of the proposals are controversial, in particular the suggestion that regulators be given the power to effect a mandatory write-down of all senior bank debt issued after the proposals come into effect (with certain exceptions). It is also interesting to note that the EU proposals do not contain specific proposals aimed at the speedy recovery of client assets in the event of an insolvency of an investment bank, as the new UK special administration regime for investment banks does.

As mentioned above, the BCBS is conducting ongoing work in relation to systemic issues relevant to global financial institutions including how they can absorb losses on a going concern basis. It is to be expected that the outcome of this work will impact the EU Commission proposals as set out in the Consultation Paper. Certain aspects of the Consultation Paper including some of the possible approaches for requiring write-downs of debt and equity go further than existing BCBS recommendations and are likely to be the subject of considerable debate during the consultation process.

The Commission also plans to examine the need for further harmonisation of bank insolvency regimes and will publish a report (and possibly a legislative proposal) by the end of 2012. It is considering the creation of an integrated resolution regime by 2014.

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