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EU Bank Recovery and Resolution Directive 'Triumph or tragedy?'

Hot Topic: European FS Regulation

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A new era for crisis management

1. Overview

On 11 December 2013, the European Parliament and the Council reached agreement on the Bank Recovery and Resolution Directive (BRRD). This important piece of legislation sets a common framework across all 28 countries of the European Union (EU) on how to deal with troubled banks. The BRRD will be implemented in the Eurozone countries through the Single Resolution Mechanism (SRM). SRM is one of the three important pillars – together with the Single Supervisory Mechanism (SSM) being built by the ECB, and a Single Deposit Guarantee Scheme (DGS) - which the Member States of the Eurozone agreed should be the foundation of their Banking Union.

The BRRD is likely to come into force on 1 January 2015, so banks need to begin analysing the impacts now. This measure will have important implications, even for healthy institutions – changing the nature and availability of equity and debt funding, drawing more supervisory scrutiny of organisational structures and recovery planning, and adding more compliance costs.

2. Why is the BRRD important?

The BRRD sets common rules for when and how authorities will intervene to support troubled banks. It foresees a phased approach to supporting such banks, encompassing precautionary, early intervention and measures designed to prevent bank failures. Where failure is unavoidable, the BRRD aims to ensure orderly resolutions, even for banks operating across national borders.

Along with the revisions to the DGS Directive, this further harmonises the approach to protecting retail depositors in the EU.

It clearly establishes the principle that private investors in banks must pick up the first costs for banks' poor risk management, before EU countries and their taxpayers are called on for financial support. By doing so, it directly addresses the question of moral hazard, through increasing market discipline over banks' activities and limiting the risks they take on.

The BRRD still leaves open the possibility of temporary public intervention to respond to systemic threats to the banking and financial markets more widely, but on a very limited basis. Any such intervention would be subject to the EU's rules governing state aid.

Having agreement on the BRRD sets the stage for the Eurozone countries to agree on how the SRM should work.

3. Critical elements of the BRRD

- Banks will have to prepare and maintain recovery plans, establishing how they would deal with problems – these plans will be subject to ongoing and attentive scrutiny by regulators.
- National resolution authorities will develop resolution plans for individual firms, identifying the most appropriate resolution tools to be used in each case; these exercises are very likely to lead to supervisors reassessing firms' recovery plans, and perhaps also their business models.
- Bailing-in investors and creditors will be the norm – investors and creditors representing 8% of a bank's total balance sheet will have to be bailed-in before resolution authorities can access other forms of stabilisation funding. This requirement will create a different dynamic between the banks and their shareholders, and may impact the way in which banks raise funding.

4. Controversial elements of BRRD?

- It adopts new common EU-wide rules for how costs of bank rescues will be met – banks will have to bail-in bank creditors before public funds can be used for rescuing an institution, from 1 January 2016.
- It establishes a (limited) new source of resolution funds – to be self-funded by the industry over 10 years.
- Depositors with eligible deposits of up to €100k will not be bailed-in and senior debt holders must be bailed-in before any depositors.
- It sets minimum requirements for banks' own funds and eligible liabilities (MREL) based on the bank's size, risk, business model and resolution approach.

5. The main concerns

Banks will have to make significant contributions to the new resolution fund each year, based on the size of covered deposits – this may have a wider impact on costs of funding for the markets and borrowers.

Bank capital instruments not governed under EU law will have to include a legally enforceable clause, indicating the instrument could be used for bail-in purposes … and whether this will need to be applied to existing liabilities, or only new liabilities. If this is applied retroactively, banks and creditors may need to renegotiate instruments, resulting in increased compliance costs and possibly impacting costs of funding.

Deposits' ranking in an insolvency hierarchy may change. Particularly controversial is the definition of natural persons; how this definition will apply to natural persons not in the EU; and how hierarchy may be affected by bilateral bail-in agreements between Member States and non-EU countries. The main concerns are how the rules will be interpreted for implementation, the administrative complexity of achieving compliance and the potential impact on depositors outside the EU.

The European Banking Authority (EBA) is expected to propose technical standards on the last two topics.

6. Our perspective

'Triumph' and 'tragedy' each represent powerful, end-of-a-spectrum extremes. If BRRD is to be a 'triumph', it will be because its explicit bail-in hierarchy succeeds in creating a more certain and orderly legal framework for resolution. The changes are explicitly designed to address the issue of moral hazard in banks: the presumption that taxpayers will ultimately bail-out banks, socialising losses from excessive risk-taking. Under BRRD, any future resolution of a European bank should result in a very different balance of costs borne by shareholders and especially, bank creditors, instead of being largely borne by taxpayers. It remains to be seen how markets will react – ultimately they will price these fundamental changes into the costs of the capital they provide to the banks.

By setting out common rules, the EU is also aiming to facilitate cross-border resolutions in Europe. In a system with separate national legal frameworks, supervisors and bankruptcy procedures, this common framework is a necessary step. Whether it results in a safer banking system will ultimately depend on the way the precautionary measures and early intervention powers are exercised, and how well interactions between national and regional supervisors and resolution authorities across the EU work.

Despite progress on BRRD, the potential for 'tragedy' remains, particularly in the short term, because the BRRD's bail-in provisions will not be mandatory until 1 January 2016. The resolution funds are designed to be built up over a 10-year transition period, so initially only limited funding will be available. Even at the end of 10 years, such a fund is unlikely to be able to handle large or multiple bank failures without further backstop.

7. Impact for banks

Banks can expect these changes to:

- require all banks in the EU to prepare recovery and resolution plans – details will be forthcoming from the EBA, and from national/regional competent authorities;
- drive a wider focus on resolvability – requiring banks to change their structures, operations and financing, under pressure from supervisors;
- require greater clarity about where bail-in capital is held and in what forms – about the contractual terms governing conversion/deployment, and the precise mechanisms for transmission around a group. Because bail-in must occur before public funds can be tapped, this clarity will be particularly important; and
- require new contributions to build an industry resolution fund – the balance-sheet impacts of these contributions will need to be assessed.

Single Resolution Mechanism (SRM) for the Eurozone

On 19 December 2013, the European Council agreed a 'general approach' for the SRM. This is an important step for EU legislation; trilogue negotiations with the Commission and Parliament will now take place, based on the Council text; the general approach may be tweaked, but final deals are typically based around these concepts. The Banking Union seeks to 'break the linkages' – the negative feedback loop between bank debt and sovereign debt, which has perpetuated European financial crises. Mutualisation of liabilities would make this possible, demonstrating that resources from across the whole Eurozone could be marshalled to stabilise banks in any part of it. Fundamentally, banks that will be supervised at European level cannot then be expected to be resolved at national level.

So the SRM is important as a signal of the commitment of Eurozone countries to stabilising banks in future – avoiding the interference of national interests in a resolution. Achieving a deal has been challenging; strong political forces and interests exist at national levels, which mitigate against mutualisation.

Key elements of the SRM

Mario Draghi, President of the ECB, has suggested that the SRM should have three core elements: **"a single system, a single authority, and a single fund"**. In effect, the SRM must be capable of acting quickly and decisively to address bank crises, and it must have access to funds to do so.

The Council's general approach consists of:

An authority: The system will be run by a new Single Resolution Board (the 'Board'). There will be defined roles for the Commission, the Council, the ECB and the national resolution authorities. The Board will be made up of an Executive Director and four other permanent members.

A system for resolutions:

- The Resolution Board prepares resolution plans for all banks directly supervised by the ECB; national authorities remain responsible for the plans for all other Eurozone banks.
- The ECB (SSM) is responsible for notifying the Resolution Board, the Commission, and the relevant national resolution authorities and ministries that a bank should be resolved.
- The Resolution Board assesses whether there is a systemic threat and any private sector solution. If not, it adopts a resolution scheme including the relevant resolution tools and use of the Fund
- The Resolution Board Executive will have limited powers to deploy the Fund, up to a threshold. Use of the Fund above the threshold would require a plenary vote.

- The Resolution Board cannot require a Member State to use its national budget to provide public support to any entity under resolution.
- In line with the prescription of the Bank Recovery and Resolution Directive (BRRD), bank shareholders and creditors would have to be bailed-in before any public funds or the Single Resolution Fund could be used deployed.

A fund: A Single Resolution Fund (SRF) will be created by pooling contributions from all the banks in the participating Member States. It will be "owned and administrated" by the Board: the Board will recommend any use of the SRF. The SRF would be designed to reach a target level of 1% of covered deposits over a 10-year period. The Fund will also be gradually mutualised over the 10-year transition period, moving in increments to be a single, fully mutual SRF at the end of 10 years.

Our perspective

From a standing start, Europe has moved quickly from agreeing the initial concept for the Banking Union in 2012, to an SSM that is being implemented, and agreement on an approach for an SRM.

But without mutualisation, there is effectively no Banking Union. The SRM calls for mutualisation to be achieved gradually, which reflects the political compromise required for agreement. However, important questions remain:

- The size of the SRF – is it likely to be big enough? A fund of €50bn by year 10 does not seem large, but it is designed to be used only after bail-in of creditors and shareholders.
- What backstop, beyond the SRF, ultimately exists to confront wider systemic crises? For example, under what circumstances could a bank resolution call directly on the wider resources of the European Stability Mechanism (a pot of €500bn designed primarily to support sovereigns), or the European Central Bank?
- How will the proposed resolution Board take shape? What will be the base for its permanent secretariat? How will Members be selected?

The Council also agreed that use of the resolution Fund will be the subject of a further intergovernmental agreement.

It's clear that much more negotiation lies ahead before the Eurozone's resolution approach is complete.

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