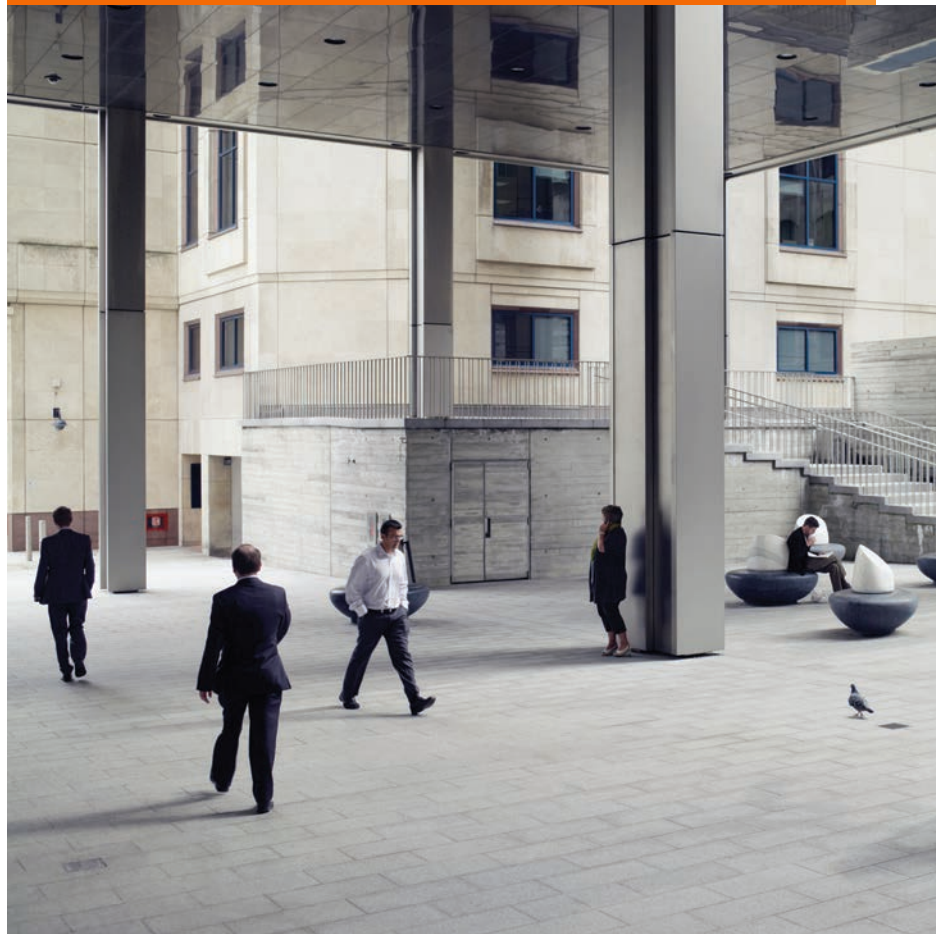


# *Regulatory Briefing:* SRM – What to expect from Banking Union

May 2014



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# Introduction

*On 15 April 2014, all outstanding Banking Union legislation was adopted by the European Parliament including the Bank Recovery and Resolution Directive (BRRD), the Deposit Guarantee Scheme Directive (DGSD) and importantly, the Single Resolution Mechanism (SRM) Regulation. We expect publication in the Official Journal and entry into force of the package in June or July this year.*

Parliamentary passage of this package of rules provides clarity of intent; resolution of banks in Europe should henceforth be based primarily on 'bail-in' of shareholders and creditors rather than 'bailout' by sovereigns. To reinforce this intention, European regulators and resolution authorities can be expected, from 2015, to conduct and use resolvability assessments to press banks for changes: to their structures and funding mechanisms; to the amounts, location and availability of bail-in capital; and to arrangements for ensuring continuity of critical functions during a resolution.

The mobilisation phase as the new institutions of the Eurozone take charge from late 2014 and 2015 is likely to see these new authorities dealing with significant challenges. Chief among them will be managing the outcome of the asset quality reviews (AQRs) being conducted by the European Central Bank (ECB) before it takes on bank supervision and the stress tests to be conducted by the European Banking Authority (EBA). The potential exists for these to lead to requirements for resolutions before or very early in the mandate of the new SRM, essentially before the full range of resolution tools is practically available. How the

AQR results are communicated and addressed will be key to ensuring market confidence in the short term.

But clear, ongoing communication will also be crucial in the medium term. The effective operation of the SRM depends on the requirements of the BRRD being adopted into national law: for the next 18 months the SRM Board and national resolution authorities may be operating with a significant degree of legal uncertainty. The effective operation of the Single Bank Resolution Fund depends on the ratification of a yet to be elucidated intergovernmental agreement (IGA), hopefully before the end of 2015. Market confidence in the banking union as a whole will depend on progress being made, and well-communicated, throughout this period.

Despite remaining uncertainties, the passage of the Level 1 rules provides a significant degree of clarity on the direction of travel. There may be considerable advantages to firms that self-assess and act early – on a range of resilience and resolution-improvement measures – taking charge and shaping responses that best suit the desired business model, rather than awaiting a regulatory instruction, which is likely to be less optimal.

In this briefing we focus mainly on the SRM, against the backdrop of the BRRD:

- background: key elements
- application of the SRM: who is affected
- backstops
- decision-making on resolutions
- the Fund

offering views on impacts to consider in planning effectively to operate under the new rules.

# Background: key elements of the SRM

*As a key pillar of the Eurozone Banking Union complementing the Single Supervisory Mechanism (SSM), the SRM is the agreement on how the EU-wide BRRD will be implemented in Eurozone countries.*

Its key features are:

- a new resolution authority for the Eurozone, the Single Resolution Mechanism Board (the SRM Board), primarily responsible for implementing recovery and resolution plans, and for resolving banks

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## **The SRM Board**

- The SRM Board will be set up as an EU agency, with a permanent secretariat based in Brussels.
  - Five independent and experienced individuals will be appointed as permanent members of the SRM Board: a chair, and four other permanent members.
  - The SRM Board will generally operate in executive session, comprising its permanent members plus a representative of the relevant national resolution authority(ies) for the bank in question.
  - The ECB and the European Commission will both have permanent observer status.
  - Only when a resolution action necessitates drawing more than €5bn from the Single Resolution Fund (SRF), or when this €5bn threshold is crossed in one year, does the Executive need to obtain approval of resolution schemes from the SRM Board in plenary session, comprising members of the executive session, plus representatives from all SRM national resolution authorities.
  - Although the ECB supervisor is responsible for determining when an institution needs resolution, the SRM is able to take the decision itself if the SSM fails to act.
- a new Single Resolution Fund (SRF), which can be used by the Board to help execute timely bank resolutions. The BRRD requires all EU countries to establish a national resolution fund; under the SRM, Eurozone countries will systematically pool their respective funds, with use of this common Fund managed by the Board.



## ***Our view:***

In addition to appointing the five permanent members of the SRM Board, a sizeable secretariat (some 300–400, perhaps) will need to be set up to support it. There is not a well-established European network of resolution authorities, comparable to the supervisory network, from which the SRM will be able to draw expertise, so we expect that mobilising a full complement for the SRM secretariat may prove challenging.

The SRM Board, however, is mandated to be fully operational from 1 January 2015. The European Commission is tasked with setting it up and, until such time as the SRM Board ‘has the operational capacity to implement its own budget’, the European Commission will appoint an official and the interim chair and provide the necessary staff to run it.

If the Commission assumes this role, there is a potential conflict of interest between the Commission’s different roles, endorsing technical standards (for BRRD) and preparing delegated acts (for both BRRD and SRM) versus running the SRM. There is also an issue of self-review and potentially one of undue influence exerted on the EBA in the preparation of regulatory technical standards. To overcome these risks, the Commission should strive to be as transparent as possible regarding its interaction with the different parties.



## *Application of the SRM – who is affected, and when*

*The SRM applies to all Eurozone headquartered banks including EU subsidiaries of foreign banks. At the outset, it will apply directly to those banks supervised by the SSM and to any cross-border banks not included in this group.*

The SRM Board will define common processes for resolvability assessments and resolution. National resolution authorities will implement these SRM processes in respect of 'domestic' banks in Eurozone countries, but the SRM can assume direct responsibility at any time, or direct/instruct national resolution authorities. If national authorities need to call on the shared resources of the SRF, the SRM Board will need to be involved. All Eurozone banks will contribute to the SRF.

Other EU Member States not in the Eurozone can opt into the SSM and, in doing so, they automatically opt into the SRM. All SRM members will be able relinquish their resolution responsibility completely to the SRM Board: a potentially attractive option for smaller Member States that would otherwise struggle to maintain expertise or resources necessary to undertake resolution effectively.

Bail-in requirements under BRRD will only apply from 1 January 2016. Both bail-in and resolution functions of the SRM also apply from 1 January 2016. However, all preparatory work including the preparation of resolution plans and resolvability assessments will apply from 1 January 2015.





### ***Our view:***

Although the SSM has not yet explicitly focused on supervision of Eurozone-based subsidiaries of foreign (non-European Economic Area (EEA)) banking groups, we expect that both the SSM and SRM will also assume responsibility for these banks in due course. Large, systemically important subsidiaries can expect to be subject to the resolution planning and resolvability assessment requirements of the SRM sooner rather than later. However, in the interim, these subsidiaries can expect the SRM to impose stringent common standards over the national authorities. And all Eurozone-based subsidiaries will be subject to contributions to the SRF from the outset.

As a regulation, the SRM is automatically binding on Member States. However, BRRD, on which it relies, needs to be transposed into national laws; six months is too short a transposition period for many countries, as experience with CRD IV has demonstrated. Realistically, we are not likely to see the relevant laws in place throughout the EU until mid-2015. The majority of technical standards to be prepared by the EBA for BRRD (15 out of 22) have to be submitted to the European Commission for endorsement within 12 months but, with the additional endorsement and scrutiny periods, they will not become law until well into 2015.

Logically, in the absence of the detailed regime and full resolution powers for national resolution authorities, the authorities, both supervisory and resolution, will focus in the short term on preventive measures: recovery plans for the former, resolvability assessments for the latter. The considerable amount of potential overlap between these two requirements means the authorities will need to work closely together, suggesting enhanced scrutiny on firms' plans and more complex regulatory relationships.

# ***To backstop or not to backstop?*** **...that is the question**

*To be considered a success, this new resolution regime needs to be able to demonstrate that a future banking crisis will be handled quickly, safely and pragmatically. It needs to show that individual or multiple bank failures will no longer push Eurozone sovereigns to the edge. The vote in the European Parliament, following intense negotiations with the Council, demonstrates there is political will to see the ‘Too Big to Fail’ issue addressed in Europe: that failing banks should be wound down or otherwise resolved in an orderly fashion, without resorting to large injections of public funds. But will it work in practice?*

Many have expressed concern that the new SRF, even when it achieves its target level of €55 billion, will be an insufficient backstop if a major financial institution, or several institutions, were to fail. BRRD does foresee the possibility of ‘precautionary and temporary’ recourse to public funds as a last resort in extraordinary situations, but with a view to preventing contagion from a failing institution to otherwise solvent banks, not the recapitalisation of a failing institution itself.

Essentially, the EU recovery and resolution regime has been designed – in combination with increased micro- and macro-prudential capital requirements, more stringent corporate governance rules and strengthened supervision – to remove the need for any public backstop over time.





## Our view:

The SRF is not a backstop or a bailout fund. It is the 'oil' to lubricate the resolution process, facilitating the use of other resolution tools by the SRM. It is a stabilising mechanism to provide sufficient time to ensure that any resolution or crisis is ultimately paid for by those responsible without increasing short-term instability in the system.

The European approach to resolution, via BRRD, will be firmly rooted in a very deep 'bail-in' of shareholders and creditors, before 'bailout' by public treasury. Solutions to a sudden or widespread systemic crisis which hamper bail-in, or at least bail-in anywhere close to the targeted amounts both in the BRRD and in the EU state aid rules, may still require the national governments of the Eurozone to hammer out a political agreement – or alternatively, for the empowerment of the ECB, or the European Stability Mechanism to act as a collective backstop for Eurozone banks. These kinds of further or 'ultimate' backstop arrangements have not been spelled out yet. Negotiations will not take place until the new Commission takes shape – in the autumn of 2014 at the earliest.

There are to be new arrangements for the Fund to borrow against its future resources, in order to 'bulk up' its capacity to provide interim funding. These arrangements will enable the Fund to perform its stabilising mission during the first few years, when the Fund has not yet reached its target level, but this will not be of a scale to be a large backstop, either.

We are entering a period of transition. Future calls on public resources will be much less likely, although certainly possible in a systemic crisis. For example:

- Before the 2008 crisis, a large bank with €1 trillion assets, €400bn in risk-weighted assets (RWA) and a loan book of, say, €600bn would have been required to hold perhaps €24bn in Core Tier 1 equity capital. A crisis resulting in loan losses equivalent to just 4% of the loan book would have been sufficient to wipe out the most liquid Core Tier 1 equity capital of the business. A severe crisis, like that of 2008 with large, generalised losses to some loan books, meant that governments trying to save their national banks were required to put sums significantly greater than €55bn into several European banks.
- With BRRD and Basel III implemented in Europe via the Capital Requirements Directive (CRD), a bank of the same size, RWA profile and loan book as in the 2008 example, above, would from 2016 need to hold minimum loss-absorbing capital of over €70bn (of which some £45bn would need to be Core Tier 1 capital, plus additional convertible debt). The BRRD requires the hierarchical bail-in of shareholders, then creditors. In a resolution, the bail-in of shareholders and creditors of up to 8% of total liabilities including own funds is mandated before recourse to resolution funds. Loan losses would have to be almost three times greater than in 2008 to exceed the new bail-in capital resources.

Regulators will expect banks, when developing resolution plans, to lay the groundwork for bail-in by establishing contingent capital and convertible debt arrangements to facilitate the process.

Banking Union in the Eurozone is ultimately built on trust. The agreement on SRM demonstrates that the European Union has learnt some important lessons from the financial crisis. It has taken steps that were inconceivable five years ago. Trust between Member States was seriously diminished by the financial crisis of 2008 and the subsequent European sovereign crises. The challenges of negotiating BRRD and SRM have exposed the wariness that still exists, but also suggested that EU institutions, including the ECB, truly are prepared to make new commitments to collective action when it is necessary to protect the euro.

# Decision-making on resolutions/managing the resolution process

*The construction of the SRM has had to rely on existing European Treaty provisions in terms of institutional structures and competences. As a result, the decision-making mechanisms are somewhat cumbersome, but nonetheless the processes are designed to enable banks to be resolved ‘over a weekend’ if necessary. While there remains a risk of ‘too many cooks’ or of political influence, deadlines have been set so that key decisions can be taken within 32 hours.*

The SRM will work closely with the SSM. The SSM is to be the primary actor for triggering a resolution; however, the SRM has been given authority to step in to force a resolution should the SSM fail to act. These powers mean that the SRM is likely to be closely involved with any bank as soon as any significant issues with recovery plans are identified. In practice, the SRM will need to be involved early in the process of determining whether resolution is needed for a troubled bank, and definitely involved in any situation where early intervention measures are launched by the SSM.

It will need to work closely with the national resolution authorities in developing and executing resolution plans, too. National resolution authorities will be responsible for developing resolution plans for all banks not supervised directly by the SSM, but which may ultimately need to call in the skills of the SRM, or the resources of the SRF. More importantly, the SRM will need to rely on the national resolution authorities to put into effect resolution schemes, as these will still need to be executed within the context of national insolvency law.

Given that use of the SRF is to be minimised, the SRM can be expected to focus early on preparations and readiness for resolutions: early intervention measures including reorganisations and ringfencing of banking activities; location and triggers for contingent bail-in capital; availability of additional liquidity facilities; valuation of assets; readiness of data that would be needed for resolution. The EBA is expected to outline in its technical standards, triggers and thresholds for determining when and how a bank should be moved to a resolution scenario.

In its role as the resolution authority for the Eurozone, the SRM Board will also chair and participate in cross-border crisis management groups for its largest banks. With currently seven global systemically important banks (G-SIBs) headquartered in the Eurozone, the SRM Board will quickly become a key player in the development of global frameworks for resolution of international banks – not only as the lead, home resolution authority, but also joining as a key influencer on the crisis management groups for a number of other global banking groups.



## Our view:

Until now, resolution was the exclusive remit of national resolution authorities (governments). The SRM Board has been given real powers, resources and a degree of autonomy to prove it is capable of doing resolutions with much lower levels of national bias. Especially initially, this is likely to prove politically challenging, but also necessary if the Eurozone is credibly to build the next phase of its Banking Union.

The first resolutions undertaken by the SRM can expect great scrutiny as a demonstration of whether the politics of mutualisation or national interest will hold sway in the Eurozone.

- Will the SSM, or the SRM Board, be decisive in tipping banks into resolution?
- Will it have the resources (e.g. people and funding) to execute resolutions quickly and effectively?
- Will Eurozone nations attempt to change or block SRM Board actions?

Banks should expect the SRM Board to communicate its priorities for resolution planning – timing, data requirements – from early in 2015. These are likely to change and develop over time, as they have in other major banking markets. Ultimately, the EBA's binding technical standards for implementing the BRRD will form the basis of SRM interactions with banks, as they will for resolution planning in other parts of the EU.





# The Fund and other costs to be borne by banks

*The target level of the Fund, estimated at €55bn, is to be built up progressively over eight years. Mutualisation will be front-loaded: almost 70% of national funds will be mutualised within three years.*

The IGA among the Eurozone countries, separate from the SRM itself, will govern the arrangements for building and ‘mutualising’ the SRF. Eurozone states have committed to ratifying the IGA before 1 January 2016. The IGA will cover key areas:

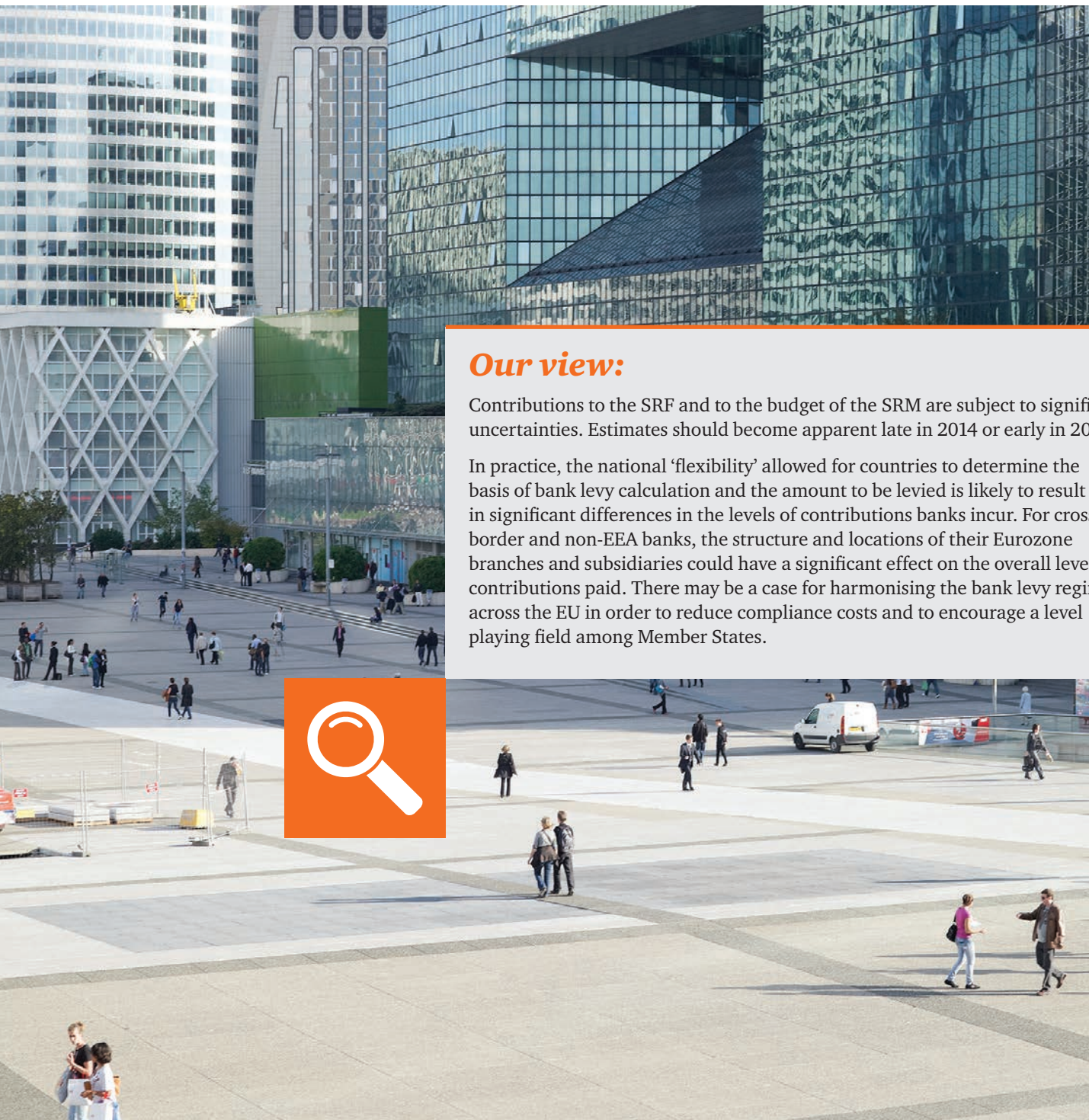
- How the contributions raised by national resolution authorities will be transferred to the national compartments of the SRF, and how the funds within the national compartments will subsequently be mutualised.
- How compartments will be replenished.
- The order in which financial resources will be mobilised to cover resolution costs.
- Provisions for the temporary lending among national compartments.
- Bail-in conditionality.
- How to treat non-Eurozone countries that opt into the SRM (including contributions to SRF) and compensation benefits for those that do not participate in the SRM.

Under BRRD, the target level is set as at least 1% of covered deposits. This is a minimum: EU states can require higher levels, or determine a different base for the calculation as long as this minimum is reached. Similarly, although the calculation for contributions to the SRF is prescribed, again the 1% of covered deposits is seen as a minimum.

The overall contribution to the SRF is to be split between a pro rata based contribution based on each institution’s liabilities excluding own funds and covered deposits, and a risk-adjusted contribution. The calculation of the latter will be determined by a further delegated act. Under BRRD, contributions to national resolution funds should be made in 2015, but these will not be moved to the SRF until 2016 (after the IGA has been ratified by all participating countries).

In addition to contributions to the SRF, Eurozone banks will also be required to contribute to the budget of the SRM Board and secretariat. Some correlation between each institution’s level of contribution to the operations of the Board and its contributions to the SRF may be anticipated, but the overall budget for the SRM and the basis for contributions is not clear at this stage. While an annual budgetary process is foreseen in the SRM, it does not stipulate how the first year of operation will be funded.





### ***Our view:***

Contributions to the SRF and to the budget of the SRM are subject to significant uncertainties. Estimates should become apparent late in 2014 or early in 2015.

In practice, the national 'flexibility' allowed for countries to determine the basis of bank levy calculation and the amount to be levied is likely to result in significant differences in the levels of contributions banks incur. For cross-border and non-EEA banks, the structure and locations of their Eurozone branches and subsidiaries could have a significant effect on the overall level of contributions paid. There may be a case for harmonising the bank levy regimes across the EU in order to reduce compliance costs and to encourage a level playing field among Member States.

## The future/summary

*The SRM is an important milestone – a key step in delivering a true banking union for the Eurozone.*

Important details are still unknown: the binding Level 2 technical standards for resolution to come from the EBA; the costs and budget of the SRM; the charging mechanisms for the SRM budget and the SRF, which will need to be paid by the industry. And there will be many pragmatic challenges to be overcome during the transition period leading to full operational mobilisation: from preparation of delegated acts in a shortened timeframe; to recruitment and selection of executive Board members; to effective mobilisation of an all-new secretariat organisation during 2015.

The asset quality review exercise underway to prepare for the Single Supervisor could, in particular, also result in significant immediate resolution challenges for the SRM, before it is fully resourced or its SRF fully funded.

Even though details remain to be resolved, it is clear that the SRM will need to drive a programme of resolution planning and resolvability assessments for banks. Banks should consider acting early to assess their options for improving resolvability, if they wish to take control and optimise outcomes that will fit best with their business models.

A successful SRM can be a key mechanism for building confidence in the euro, in the banks of the Eurozone, and therefore as a support tool underpinning growth in Eurozone economies. And if its near-term challenges are seen to be satisfactorily met, the SRM could also prove an important mechanism for attracting additional EU nations to opt into the SSM/SRM before they join the euro – having a competent authority and a shared Fund for resolving banks could prove quite attractive to a number of European countries.

In short, the SRM is vitally important for the banking union 'project'. The resolutions it conducts will be important to the process of building trust and belief in shared approaches between the Eurozone nations. And in turn, this trust is the only commodity that can serve as a foundation for proceeding with a deeper banking union.

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