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ROBUSTNESS OF THE BANK RESOLUTION FRAMEWORK IN THE EUROPEAN UNION

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J E L Classification: G21, G01, G33, F36.

Abstract: The purpose of this article is to identify the key elements of resolution framework under the Single Resolution Mechanism (SRM) and to assess the robustness of the bank resolution framework in the European Union (EU). The 2007–2009 global financial crisis exposed number of weaknesses in the banking sector. It also showed the unpreparedness of the European governments in dealing with failing banks and the possible negative consequences it can have on the wider economy. As result, in order to save the economy from even deeper crisis, governments in many European countries had no other choice than to bail-out the "too-big-to-fail" banks using taxpayers' money. Post-crisis, banking regulators recognised the need for a broader reform and creation of a formalized resolution framework which would allow for efficient resolution of troubled banks with no or limited use of public funds. The resolution proceedings are complex procedures, which need to balance the interest of the different bank stakeholders such as: shareholders, debt holders, regulatory and supervisory authorities, governments and many others. In the EU, the SRM was put in place together with Bank Recovery and Resolution Directive (BRRD) to address the issues identified during the crisis. This article is an attempt to demonstrate that the new European resolution framework contains provisions and tools that may limit the use of public funds in resolution of failing banks. The outcome provides a framework for further research focused on better

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understanding of the trade-offs in resolution framework and measuring the efficiency of bank resolution in the EU.

Introduction

The 2007–2009 financial crisis revealed many weaknesses of banking industry which included: low loss absorption capacity of capital instruments, inadequate risk management practices regarding liquidity and funding, the "too-little-to-late" recognition of credit losses, too much complexity. These were only few of the problems related to banks that required post-crisis attention from the regulators. The crisis has also shown how the wider economy was exposed to the banking crisis due to the high interconnectedness of institutions and existence of banks which outgrown the economy of the host country effectively becoming "too big too fail". In the midst of the crisis, the governments of many European countries realised that the failure of the country's banking sector would have catastrophic consequences to their economy and had no other choice than to bail-out these failing banks. Report of World Bank Group (2016) indicates that the European Commission authorized total aid of EUR 3,892.6 billion (29.8% of EU GDP in 2013) for guarantees on liabilities between 2008 and 2014. In addition, EUR 448 billion (3.4 % of EU 2013 GDP) was spent on the public recapitalization of European banks between 2008 and 2013.

At the time of the crisis, there was no bank specific resolution framework in the EU or separate Member States. In 2003 and 2005, EU did introduced two non-binding Memoranda of Understanding (MoU) on cross-border cooperation. These two agreements covered basic principles of cross-border communication, exchange of information and contingency plans. However, these MoUs were inadequate to deal with a complex cross-border banking system of the EU and did not provide a robust enough framework or sufficient tools and powers to deal with the issue of failing banks. The crisis has proven that the actual resolution actions were limited to bail-outs of these banks and providing them with guarantees and loans from governments of the host Member States. These rescue actions were not coordinated and the involvement of EU institutions was very limited. The cooperation between Member States has proven to be a very difficult task in the time of crisis. This was especially visible in the case of banks, which had a pan-European character.

Čihák and Nier (2012) describe such cooperation difficulties related to the case of Fortis Group. Fortis has been active in the Benelux countries and up until the crisis had a complex bi-national holding structure, with ownership resting ultimately with Fortis SA/NV based in Belgium. Despite initial joint measures taken by the governments of Belgium, Netherlands and Luxemburg, markets and depositors continued to withdraw their funds causing further liquidity problems. Following the ruling of Belgian court, which resulted in requirement to submit the sale of the business agreed between the three states for shareholders' approval, the resolution was delayed resulting in failure the burden-sharing agreement reached between the three governments. The Fortis case is a good example of conflict of interests between the governments of different Member States.

Classes, Herring and Schoenmaker (2010) describe resolution conflict of interests as the "Financial Trilemma" where there are three simultaneous policy objectives: maintaining global financial stability, fostering cross-border financial integration and preserving national resolution authority. Achievement of any two of these objectives is feasible, however achieving all three can prove to be difficult. Experience of the last crisis in Europe based on the example of Fortis Bank showed that the national authorities centre their efforts on preserving the national interests, which meant that the resolution of a cross-border bank was not coordinated and could not have been effective. Kudrna (2012) compares this situation as analogous to a "prisoner's dilemma", when multilateral resolution of a banking group as a whole is likely to be the least costly overall, but unilateral resolution may allow some Member States to avoid resolution costs at the expense of others.

The financial crisis has revealed number of issues related to resolution of financial institutions. In response to the crisis, the two main international bodies promoting global financial stability, the Bank for International Settlements (BIS) and the Financial Stability Board (FSB) developed new regulatory policy proposals for globally active banks. Both BIS (2010) and FSB (2011) published international standards and recommendations, which outlined the changes needed to improve resolution of financial institutions and cross-border cooperation. One of the areas of focus in these proposals is the role of resolution authority in the resolution framework and the powers it requires in order to be able to execute effective resolution. The overarching objectives set for the authority is to preserve stability of financial system, protect insured depositors and avoid unnecessary destruction of value. Cross-border cooperation of authorities on crisis management is fundamental for effective resolution of internationally active banks. The two proposals define in more detail the broad range of resolution tools that should be given to the resolution authority in order to enable execution of the assigned task.

Kudrna (2012) defines three basic components required for effective cross-border bank resolution regime: regulations that reinforce the communication and co-operation between all national resolution authorities involved; governance agreements that enable decision-making and implementation of the selected resolution strategy in all relevant jurisdictions; and financing arrangements including fiscal backing.

The bank resolution is a complex and multi stage process. Dewatripont and Freixas (2011) differentiate three stages where bank resolution requires a policy: stage 1, before the crisis takes place, the design of the regulatory rules related to the resolution regime; stage 2, at the time when bank is in distress but the liquidation can be avoided by means of resolution tools which allow for continuation of key activities and functions of the institution; stage 3, in this stage bankruptcy has become inevitable and the resolution focuses on allocation of losses based on proceeds from assets. Resolution framework, in order to be effective, must correctly address the challenges from design to execution stage.

The research methodology and the course of the research process

The article aims to describe and evaluate the European regulatory response to the issues faced during the 2007–2009 global financial crisis in relation to resolution of failing banks. The article is based on comprehensive analysis of European regulatory framework related to the bank resolution and selected literature covering bank resolution in the EU.

Regulatory response in the EU

Following the financial crisis, EU has changed the way the banks are supervised and resolved in Europe by creation of Banking Union. Banking Union is currently built on two pillars i.e. the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) with the third pillar in form of the European Deposit Insurance Scheme (EDIS) to be implemented. SRM is the response of the EU to the problems with resolution of failing banks experienced during the previous financial crisis. From legal perspective, SRM is based on the Bank Recovery and Resolution Directive (BRRD) and Single Resolution

Mechanism Regulation (SRMR)[1]. BRRD (2014) explains that: "a*n effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers. It should ensure that systemic institutions can be resolved without jeopardising financial stability".* One of the other key objectives of resolution is to ensure continuation of the critical functions of institutions. The critical functions are defined as: "*activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group".*

In order to enable effective resolution, the European Commission needed to develop a comprehensive framework, which combines multiple elements required to address and overcome the issues identified during the crisis. One of the key elements of resolution framework under SRM is the resolution authority which is a public body entrusted with administrative powers to manage resolution activities. The BRRD directive foresees a separate governance body specially focused on resolution as the crisis has proven that the supervisory authority may not be effective for dealing with failing banks. In order to facilitate an effective resolution process, the authority in charge of such process should be assigned with clear responsibilities and powers. In the Banking Union, the role of resolution authority was assigned to the Single Resolution Board (SRB), which was created in 2015 and became operational under SRMR in 2016. SRB is responsible for preparation of resolution plans for euro zone significant and cross-border institutions, which are under supervision of ECB. SRB is also in charge of adoption of resolution schemes, preparation of resolution plans for institutions in scope. Resolution plans are formal documents where resolution strategy, actions and tools are pre-determined for banking union parent or group entities in participating Member States. It is the SRB that is responsible for triggering of resolution plans[2] for a failing bank. In addition, SRB owns and decides on usage of the Single Resolution Fund (SRF), which is financed by the banking industry. The purpose of SRF is not to absorb losses of investors by providing new capital to failing banks but instead to provide short to medium term financial aid in

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[1] BRRD as European directive must be transposed by each Member State into a local law, however SRMR as European Regulation is directly binding in all Member States.

[2] ECB acting as supervisor within Banking Union decides whether particular bank is considered Failing or Likely to Fail (FOLTF) and has a non-voting representation in SRB Board.

form of loans or guarantees. Such a financial assistance will preserve the value and allow to maintain the critical functions of banks undergoing the resolution process. SRF became operational at the beginning of 2016 and will be gradually built up based on contributions from banks via national compartments until 2024. SRB is also responsible for other tasks such as for example setting the minimum requirement for own funds and eligible liabilities (MREL) which aims to increase bail-inability of liabilities and therefore increase loss absorption by investors and therefore limit the need for bail-outs funded by taxpayers.

Next to creation of one central resolution authority for Banking Union (i.e. SRB), BRRD requires each Member State to designate the national resolution authorities indicating that such a role can be assigned to *national central banks, competent ministries or other public administrative authorities or authorities entrusted with public administrative powers.* In some countries, such as in the Netherlands, the role of resolution authority was assigned by exception to the authorities responsible for banking supervision that is to De Nederlandsche Bank[3]. However, in such cases, the directive requires special arrangements to ensure independence and to avoid possible conflict of interests between these two functions i.e. supervision and resolution.

Another issue identified during the crisis was the weakness or even complete lack of the cross-border cooperation of authorities involved in the resolution process. SRB is the central resolution authority in the Banking Union, however all Member States, whether participating or non-participating in the Banking Union, must have their own resolution authority. Under BRRD, the co-operation of these different resolution authorities in preparation and execution of resolution plans and strategies for cross-border banks is organised in form of resolution colleges. SRM not only enhances the co-operation between Member States but also contains provisions, which ensure a level playing field and prevent discrimination on grounds of nationality or place of business.

Resolution tools in the EU

Creating a structured and cooperative resolution authorities is only one of the elements needed to build an effective and comprehensive framework for bank

[3] Article 3(3) of BRRD states that Member States may exceptionally provide for the resolution authority to be the competent authorities for supervision for the purposes of Regulation (EU) No 575/2013 and Directive 2013/36/EU.

resolution in the EU. The next element needed is a set of resolution tools and powers, which will provide the resolution authorities with essential instruments to resolve the troubled banks. These tools should enable resolution authorities not only to react in timely manner but also achieve other objectives of resolution framework such as efficiency, ensuring continuation of critical functions, protection of depositors, no creditor worse-off, minimise disruption to financial system, cost optimisation and foremost limitation of public support in form of bank bail-out. The main tools available to resolution authorities under BRRD include: Sale of business tool, Bridge institution tool, Asset separation tool and Bail-in tool.

Sale of business tool gives resolution authorities the power to sell the bank, or part of the bank, to a buyer or group of buyers in a relatively swift process. This tool is put in place to enable resolution authority to take timely action in order to protect the value and therefore minimalize the losses. There are number of requirements that must be met by the resolution authority when using this tool. For example, the price for the business sold must be fair and should reflect valuation of assets and liabilities. The sale process should be open, transparent and non-discriminatory.

Bridge institution tool aims at creating a temporary structure where the key and critical functions of the failing bank are transferred in order preserve this part of the business until a structural solution is found. The bridge bank is wholly or partially owned by one or more public authorities, which may include the resolution authority and can be in place for a maximal period of two years.

Asset separation tool aims to separate problem assets from the bank in order to preserve the remaining healthier part of the balance sheet and allow maintenance of the key functions. The problem assets, when transferred into a separate vehicle can be wind-down with objective of maximisation of recovery value. The asset separation tool is therefore only a first step in resolution proceedings, as subsequently the sale of the business tool could be used.

Bail-in tool underlines one of the key principles and reasons for the resolution framework i.e. the use of public funds should be limited to minimum. During the crisis banks were bailout by the governments, which means that the taxpayers money was used to safe banks from bankruptcy therefore absorbing bank losses. Bail-in tool aims at loss absorption by the bank investors and creditors instead of the taxpayers. This tool allows the resolution authorities to convert banks liabilities into loss absorbing common equity instruments or even completely write-off such eligible liabilities. Bail-in can be explained as the statutory imposition of losses on bank's liabilities even if in the legal terms of these liabilities there are no provisions allowing for absorption of such losses outside of an insolvency procedure. BRRD explains that the bail-in tool achieves objective of effective resolution *by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution.*

Financing of resolution is an integral part of resolution planning. The key principle of BRRD is to limit the use of taxpayer's funds in bail-outs of failing institutions. Based on this perspective, the first source of funds used is resolution of banks should be the shareholders and creditors of the bank. Even though the bail-out of failing banks was widely criticised during the last crisis, the new resolution framework does not prohibit public support. The use of public funds is possible, but in contrary to the last financial crisis, it should only be a last resort and not first choice. There are number of conditions that must be met before resolution authority in cooperation with a Member State can use government financial stabilisation tool to help the failing bank. The tool can only be used in case of a systemic crisis and when the other resolution tools were already used to the maximum possible extent. This means that at least 8% bail-in of total liabilities including equity must take place prior to employment of public support, ensuring the minimum private loss absorption. The hierarchy of loss bearing should start with the shareholders, incurring the losses first as in normal insolvency proceedings. The next group, which should suffer losses, are creditors based on their claim class and taking into account the overarching principle 'no creditor worse off than under normal insolvency proceedings'. In addition, BRRD confirms that the insured deposits are outside of bail-in scope.

Remaining challenges

The interconnectedness of European institutions and cross-border nature of banking in the EU are sources of challenges for the resolution process. These difficulties were experienced during the last crisis when governments were unable to follow one coherent strategy to resolve the failing banks. One of the objectives of SRM was to address the issues of cross-border resolution amongst others thru establishment of the SRB and resolution colleges. The objective of SRB and resolution colleges is to enable resolution authorities to create a coherent and coordinated resolution strategy for cross-border institutions. Without doubt SRM increased coordination and cooperation and should contribute to an improvement in resolution of cross-border banks. However, number of challenges still remains, starting with the choice of resolution strategy. There are two possible resolution strategies that can be used in case of cross-border banking groups in the EU: single point of entry (SPOE) or multiple point of entry (MPOE). The advantage of SPOE strategy is the focus on a holding company allowing for more efficient resolution of the entire group. Gordon and Ringe (2015) indicate that SPOE is more transparent and credible because the bail-inable debt is positioned at the holding company level, which makes it easily available for regulatory actions. In addition, SPOE is more efficient for cross-border institutions putting one resolution authority in charge of the resolution and creating one centre of control. Because SPOE is executed at the holding level, it allows for less disruption and destruction at the level of operating subsidiaries limiting the risk of damaging runs that can result in fire sale liquidations and other knock-on consequences. However, SPOE strategy may not be preferred by the host authorities of material subsidiaries of EU parent due to the fear of lost control and conflict of interest from local and group perspective. This means that reaching an agreement by resolution colleges regarding the appropriate strategy may prove difficult in practice. In addition, in order to be able to employ SPOE strategy, many European banks need to change their legal structure towards a holding company structure where bail-inable Total Loss Absorption Capital (TLAC) and MREL instruments can be issued.

An ongoing challenge during resolution process relates to the trade-off that must be made by the resolution authority. Dewatripont et al. (2011) view resolution regime as the result of a constrained cost–benefit optimization. The resolution related decisions must balance not only different policy objectives but also interests of various stakeholders.

Conclusions

The 2007–2009 financial crisis has revealed number of issues related to failing banks such as absence of resolution strategies and plans, lack of designated authorities capable of dealing with failing banks, absence of cross-border coordination. In recent years, in response to the identified problems and following recommendations from global regulatory bodies, the EU has undertaken number of initiatives aimed at creation of a comprehensive resolution framework which would limit the use of public funds in saving failing banks. The new laws under SRM provide the EU and Member States with a strong foundation which is designed to achieve an effective resolution. The framework is built on designated resolution authorities that received the mandate and tools to create and execute resolution strategy and plans. In addition, a number of provisions on cross-border cooperation mechanisms and resolution colleges were put in place. This should enable a coordinated and efficient resolution of cross-border institutions in the EU. Resolution tools and powers given to the resolution authorities allow for proper funding of resolution and should in theory result in no or minimum use of taxpayers funds. All these elements were designed to create a comprehensive and robust resolution framework which should address the issues faced by EU authorities during the recent financial crisis. A number of challenges remain, as Member States are busy implementing the new resolution framework. The provisions on cross border cooperation are in place, however the agreements on resolution strategies and plans need still to be reached and implemented by different authorities. In order to achieve an effective outcome, the resolution authorities will have to act in efficient, decisive and timely manner. There were not many cases of failing banks after BRRD was implementation in Europe, therefore it is challenging to analyse the efficiency of the EU resolution framework but it offers an interesting research opportunity.

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