

# Credit institutions and investment firms: framework for recovery and resolution

2012/0150(COD) - 06/06/2012 - Legislative proposal

**PURPOSE:** to establish a framework for the recovery and resolution of credit institutions and investment firms.

**PROPOSED ACT:** Directive of the European Parliament and the Council.

**CONTEXT:** the financial crisis severely tested the ability of national and Union-level authorities to manage problems in banking institutions.

The absence of effective tools to manage institutions in crisis has too often required the use of public funds to restore trust in even relatively small institutions so as to prevent a domino effect of failing institutions from seriously damaging the real economy. Accordingly, **an effective policy framework is needed to manage bank failures in an orderly way and to avoid contagion to other institutions.**

The Commission published a [communication](#) in October 2010 setting out plans for a Union framework for crisis management in the financial sector. The framework would equip authorities with common and effective tools and powers to tackle bank crises pre-emptively, safeguarding financial stability and minimising taxpayer exposure to losses in insolvency.

In June 2010, the European Parliament adopted an [own-initiative report](#) on recommendations on cross-border crisis management in the banking sector. It stressed the need for a Union-wide framework to manage banks in financial distress.

**At the international level**, G20-Leaders have called for a review of resolution regimes and bankruptcy laws in the light of recent experience. In November 2011 in Cannes, they endorsed the core elements that the Financial Stability Board (FSB) considers to be necessary for an effective resolution regime (Key Attributes of Effective Resolution Regimes for Financial Institutions).

Finally, in December 2010, **the Council (ECOFIN)** adopted conclusions calling for a Union framework for crisis prevention, management and resolution. The conclusions stress that the framework should apply in relation to banks of all sizes, improve cross-border cooperation and consist of three pillars (preparatory and preventative measures, early intervention, and resolution tools and powers).

**IMPACT ASSESSMENT:** The impact assessment came to the following conclusions:

- The proposed Union bank resolution framework will achieve the objectives of **enhancing financial stability**, reducing moral hazard, protecting depositors and critical banking services, saving public money and protecting the internal market for financial institutions;
- **The social impact is expected to be positive:** i) reducing the probability of a systemic banking crisis and avoiding losses in economic welfare that follow a banking crisis; and ii) minimising taxpayer exposure to losses from insolvency support to institutions.
- **The costs** of the framework derive from a possible increase in funding costs for institutions due to the removal of the implicit certainty of state support, and from the costs related to resolution funds. Institutions might transmit those increased cost to customers or shareholders by pushing rates on

deposits lower, increasing lending rates and banking fees or reducing returns on equity. However, competition might reduce ability of institutions to pass on the costs in full.

The Commission takes the view that the potential benefits of the framework in terms of economic welfare over the long term in terms of a reduced likelihood of a systemic crisis are substantially higher than the potential cost.

**LEGAL BASIS:** Article 114 of the Treaty on the Functioning of the European Union (TFEU).

**CONTENT:** the proposal harmonises national laws on recovery and resolution of credit institutions and investment firms to the extent necessary to ensure that Member States have the same tools and procedures to address systemic failures. The aim of the proposed framework is to **equip authorities with common and effective tools and powers** to tackle bank crises pre-emptively, safeguarding financial stability and minimising taxpayer exposure to losses in insolvency.

Since the risk posed by any individual bank to financial stability cannot be fully ascertained in advance, **these powers should be available to the relevant authorities in relation to any bank**, regardless of its size or the scope of its activities.

To this end, the range of powers available to the relevant authorities should consist of **three elements**:

**1) PREPARATION AND PREVENTION:** Preparatory steps and plans are required to minimise the risks of potential problems:

**Recovery and resolution plans:** Institutions will be required to draw up recovery plans setting out arrangements and measures to enable it to take early action to restore its long term viability in the event of a material deterioration of its financial situation. Groups will be required to develop plans at both group level and for the individual institutions within the group. Supervisors will assess and approve recovery plans.

Furthermore, a resolution plan, prepared by the resolution authorities in cooperation with supervisors in normal times, will set out options for resolving the institution in a range of scenarios, including systemic crisis. Such plans should include details on the application of resolution tools and ways to ensure the continuity of critical functions.

**Powers to address or remove impediments to resolvability:** Based on the resolution plan, the resolution authorities shall assess whether an institution or group is resolvable. If resolution authorities identify significant impediments to the resolvability of an institution or group, they may require the institution or groups to take measures in order to facilitate its resolvability.

Such measures might include: i) reducing complexity through changes to legal or operational structures in order to ensure that critical functions can be legally and economically separated from other functions; ii) drawing up service agreements to cover the provision of critical functions; iii) limiting maximum individual and aggregate exposures; iv) restricting or preventing the development of new business lines or products.

**Intra-group financial support:** Institutions that operate in a group structure will be able to enter into agreements to provide financial support (in the form of a loan, the provision of guarantees, or the provision of assets for use as collateral in transaction) to other entities within the group that experience financial difficulties. The agreement may be submitted for approval in advance by the shareholders' meetings of all participating entities in accordance with national law. It will authorise the management bodies to provide financial support if needed within the terms of the agreement.

**2) EARLY INTERVENTION:** The proposal expands the powers of supervisors to intervene at an early stage in cases where the financial situation or solvency of an institution is deteriorating. Powers of early intervention include: i) the power to request the institution to implement arrangements and measures set out in the recovery plan; ii) drawing up **an action program and a timetable** for its implementation or requesting the management to convene, or convening directly, **a shareholders' meeting**, propose the agenda and the adoption of certain decisions; and iii) requesting the institution to draw up a **plan for restructuring of debt with its creditors**.

In addition, the supervisor would have the power to appoint a special manager for a limited period, when the solvency of an institution is deemed to be sufficiently at risk. The primary duty of a special manager is to restore the financial situation of the institution and the sound and prudent management of its business.

**3) RESOLUTION:** If insolvency of an institution presents a concern as regards the general public interest, a clear means is required to **reorganise or wind down the bank in an orderly fashion while preserving its critical functions** and limiting to the maximum extent any exposure of taxpayers to losses in insolvency (resolution).

**Resolution conditions:** The proposal establishes **common parameters** for triggering the application of resolution tools. The authorities shall be able to take an action when an institution is insolvent or very close to insolvency to the extent that if no action is taken the institution will be insolvent in the near future.

**Instruments and powers of resolution:** The framework sets up a number of **general principles** that will have to be respected by the resolution authorities. These principles refer, inter alia, to the allocation of losses and the treatment of shareholders and creditors and to the consequences that the use of the tools could have on the management of the institution.

The implementation of the resolution tools and powers is based on an assessment of the real value of the assets and liabilities of the institution that is about to fail. To this end, the framework incorporates a **valuation** based on the principle of 'market value'. This will ensure that the losses are recognised at the moment when the institution enters into resolution.

When the trigger conditions for resolution are satisfied, resolution authorities will have the power to apply the following resolution tools:

- **sale of business**, enabling resolution authorities to effect a sale of the institution or the whole or part of its business on commercial terms, without requiring the consent of the shareholders or complying with procedural requirements that would otherwise apply.
- **bridge institution**, enabling resolution authorities to transfer all or part of the business of an institution to a publicly controlled entity. The bridge institution must be licensed in accordance with the Capital Requirements Directive and will be operated as a commercial concern within any limits prescribed by the State aids framework.
- **asset separation**, enabling resolution authorities to transfer impaired or problem assets to an asset management vehicle to allow them to be managed and worked out over time.
- **bail-in**, giving resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity. The tool can be used to recapitalise an institution that is failing or about to fail.

**Cross border resolution:** This will be done through measures that will require enhanced cooperation between national authorities and creation of incentives for applying a group approach in all phases of preparation, recovery and resolution.

**Resolution colleges** will be established with clearly designated leadership and with the participation of the European Banking Authority (EBA). The EBA will facilitate cooperation of authorities and mediate if necessary.

**Relations with third countries:** Because many Union institutions and banking groups are active in third countries, an effective framework for resolution needs to provide for **cooperation with third country authorities**.

The proposal provides Union authorities with the necessary powers to **support foreign resolution actions of a failed foreign bank** by giving effect to transfers of its assets and liabilities that are located in or governed by the law of their jurisdiction. However, such support would only be provided if the foreign action ensured fair and equal treatment for local depositors and creditors and did not jeopardise financial stability in the Member State.

**Resolution funding:** the proposal establishes **funding arrangements financed by institutions themselves** in order to minimize taxpayer's exposure to losses from solvency support. It provides for the setting up of financing arrangements in each Member State.

The proposal lays down the rules on the contributions to the financing arrangements, and involves **a mix of ex ante contributions**, supplemented by ex post contributions and, where indispensable, borrowing facilities from financial institutions or the central bank. In order to ensure that some funds are available at all times, and given the pro-cyclicality associated with ex post funding, a minimum target fund level is set, to be reached through ex ante contributions in a time span of 10 years. Based on model-calculation, an optimal minimum target fund level is set at 1% of covered deposits.

The proposal also deals with the role of Deposit Guarantee Schemes (DGS) in the resolution framework. DGS may be called upon to contribute to resolution.

**BUDGETARY IMPLICATION: EUR 2,080 millions payment to cover the operational commitment for the period 2013-2015.**

The present proposal would require EBA to (i) develop around 23 technical standards and 5 guidelines (ii) take part in resolution colleges, make decisions in case of disagreement and exercise binding mediation and (iii) provide for recognition of third country resolution proceedings according to Article 85 and conclude non-binding framework cooperation arrangements with third countries according to Article 88. The delivery of technical standards is due 12 months after the entry into force of the Directive which is estimated to be between June and December 2013. The proposal of the Commission includes long-term tasks for EBA that will require the establishment of 5 additional posts (temporary agents) as from 2014. In addition, 11 seconded national experts "SNE" are foreseen to carry out temporary tasks limited to 2014 and 2015 years.

**DELEGATED ACTS:** the proposal contains provisions empowering the Commission to adopt delegated acts in accordance with Article 290 of the Treaty on the Functioning of the European Union.