Introduction

Since the beginning of the crisis, a considerable effort in financial regulation has been observed. Nonetheless is it a necessity to complete these measures by a European framework, which would allow EU authorities to orderly resolve banks. Because banks can fail like any other business, public authorities need to be equipped with tools, which enable them to prevent systemic damage that could be created by a disorganized failure, and therefore preserve EU taxpayers.

The actual proposition of the European Commission on “a framework for the recovery and resolution of credit institutions and investment funds” is an important step in this direction. Every Member State would have to be equipped with a resolution authority, which is still not the case today. However, the Member States of the banking union should push forwards, as soon as possible, for a single Resolution Authority for this area.

In addition, Member States should decide as from now on what should come next on the long term and establish a clear road map for an Integrated Deposit Guarantee Scheme, once the convergence of EU economies supported by the much improved EU economic governance, is sufficiently evidenced.

The implementation of financial reforms decided by the G20 has diminished the probability of a banking crisis and limits its consequences

The crisis has brought forward the shortcomings of financial regulation and triggered major improvements at global and EU levels

1. Solvency: Better and more capital requirements. The Basel regulatory frameworks introduced a major overhaul in order to capture all risks of banks in particular in the area of market and counterparty risks. This new prudential regulatory framework enhanced also significantly the quantity and quality of capital for banks. It is estimated these capital requirements have to be multiplied by five since Basel II by 2013 in Europe.

2. Liquidity: Proposed in Basel III as well, new liquidity standard includes a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR is designed to bolster the short term resilience of a bank’s liquidity risk profile by ensuring that it has high quality liquid assets in sufficient quantity to survive a plausible severe stress scenario lasting for 30 calendar days. The NSFR is designed to promote resilience over a longer timeframe by creating additional incentives for banks to use more stable resources of funding on an ongoing basis.

3. Lower interconnectedness and improved market transparency in particular for derivatives transactions: First, the G20 and Europe (EMIR Regulation) in particular have agreed that standardized OTC derivatives need to be traded on an exchange not bilaterally, and cleared through a central counterparty (CCP). This will strengthen the system by making financial institutions less interconnected. Second, OTC derivatives trades will have to be reported to a trade repository, which registers electronically all relevant details of an OTC derivatives transaction over its lifetime. And third, banking and market supervisors are developing rules to make sure that the risks of derivatives that are not centrally cleared are covered by appropriate capital and margining.

4. Holistic view of financial risks: regulation and supervision also encompasses the shadow banking. Another critical element of the reform agenda is to monitor and, where appropriate, to address the risks posed by shadow bank. The FSB brought forward two approaches: a monitoring exercise, by which authorities regularly exchange data and information on shadow banks in their specific jurisdictions; the framing regulatory responses to specific risks already identified in the shadow banking. In that respect work is ongoing in five priority areas, including money market funds, securitization and repo markets, with specific recommendations expected within months. (See Eurofi Executive Paper on Shadow Banking)

5. Macro- and microprudential supervision: “For any global system to be robust and resilient safeguards are needed and a proactive supervision is one of them. Full, consistent, and timely rules are important but not sufficient.” This is why a macro and microprudential supervision in Europe, and in particular in the Euro area, is also vital. (See Eurofi executive summary on a European Banking Union).

The financial crisis has highlighted the need for an EU framework for bank recovery and resolution.

Banks must be allowed to fail, like any other business. Public authorities must be equipped with tools that enable them to prevent the systemic damage caused by disorderly failure of such institutions, without unnecessary exposing taxpayer and causing wider economic damage.

The crisis clearly demonstrated that the absence of arrangements at European level could result in diverging national solutions, which might be less effective in resolving the situation and ultimately prove more costly for the EU taxpayer as a whole. Crisis management and financial sector repair, the rescue and resolution of financial institutions, were left to national authorities, despite large cross border financial players active in the EU. In addition, domestic banks recently illustrated that they may require financial help exceeding the means of their home country. This resulted in the retrenchment of citizens and financial systems within national borders, sowing the seeds for the subsequent adverse feedback loops between sovereign and banks.

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The new framework should pursue two equally important and interrelated objectives:
1. Reducing the risks of taxpayers by ensuring that banks can be allowed to fail in an orderly way.
2. Breaking the link between banks and sovereigns which has created a vicious circle in some EU Member States.

1. Preparation, Prevention and Early Intervention

An effective crisis management should rely on two pillars: prevention and correction. There is a need for preparatory steps and plans to minimize the risks or potential problems (living wills and intra-group financial support) but also for power to arrest a banks deteriorating situation at an early stage so as to avoid insolvency (early intervention).

1.1 Living wills

Institutions will be required to draw up recovery plans (“living wills”) 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. Banks will be required to develop plans at both group level and for the individual institutions within the group. Supervisors will assess and approve these recovery plans. They will allow an institution to be resolved by minimising taxpayer exposure to loss from solvency support while protecting vital economic functions.

A living will, prepared with the supervisory authorities (the ECB in the Euro area) and later with the resolution authorities (when they will be set up accordingly to the Commission’s proposal for a framework for the recovery and resolution of credit institutions and investment firms), 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. Group resolution plans will include a plan for the group as well as plans for each institution within the group.

Besides, confidentiality and interaction with the Single Supervisor are essential aspects of living wills to ensure their credibility. Member States will have to make sure that each financial institution drafts a recovery plan, respecting of course the principle of proportionality regarding the risk, size and interconnectedness of each institution.

1.2 Intra-group financial support

The proposal of the Commission establishing a framework for the recovery and resolution of credit institutions and investment firms, aims to overcome current legal restrictions to the provision of financial support from one entity within a group to another. 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. Such early financial help can address developing financial problems within individual group members. These case by case agreements validated by the group supervisor, will allow banking groups to define the arrangements that would be in the group interest and identify the companies that should be party to the agreement. As a safeguard, the supervisor of the transferor will have the power to prohibit or restrict financial support pursuant to the agreement when that transfer threatens the liquidity or solvency of the transferor or financial stability.

1.3 An essential role for the EBA

The European Banking Authority (EBA) before all will ensure a uniform construction of the living wills.

In addition to ensure a uniform definition of the conditions to exercise preventive powers, the EBA will have to develop regulatory technical standards defining the necessary criteria, parameters and thresholds to evaluate in particular the likeliness of a failure and its systemic effects. More generally, the binding mediation role of the EBA will be crucial regarding coordination and mediation of different resolution authorities of financial groups and their branches abroad.

1.4 Early intervention

The Single Supervisor of the banking union and the different supervision authorities of non-Euro Members should have the power to intervention in an early and orderly manner by reacting to financial difficulties. This early intervention procedure would start happening as soon as a financial institution does not respect its capital requirements or is on the verge of doing so. It will be important that the trigger is clearly defined, so that intervention is not perceived as arbitrary. The Single Supervisor of the banking union would be endowed with these powers.

The proposal of the Commission (Articles 23-26) expands the powers of supervisors to intervene at an early stage in cases where the financial situation or solvency of an institution is deteriorating. These powers do not derogate any rights or procedural obligations established in accordance with Company Law. Powers of early intervention include the power to request the institution to implement arrangements and measures set out in the recovery plan; draw up an action program and a timetable for its implementation; request the management to convene, or convene directly, a shareholders’ meeting, propose the agenda and the adoption of certain decisions; and request the institution to draw up a plan for restructuring of debt with its creditors. In addition, supervisors 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. However, the proposal to appoint a special manager could lead the market to assume the firm is no longer viable. As such, the use of a special manager seems more appropriate in the context of resolution, when the firm has clearly failed, than early intervention.
Living wills and intra-group financial supports constitute two essential tools in preventing crises, while early intervention gives important powers to the Single Supervisor which would be part of the ECB to be able to intervene before it is too late.

2. EU Resolution Framework

Following preventive measures, recovery and resolution tools are essential in order to stabilize the financial system through an organized crisis management framework at EU level. A Single Resolution Authority for the banking union area and the EU Single Rulebook for bail-in instruments are feasible and necessary measures Member States should implement on the short-term.

2.1 A Single Resolution Authority for the Banking Union

Eurofi proposes a Single Resolution Authority for the banking union to be created next year. *(see Eurofi Banking Union paper)*

Indeed, since the agreement reached during the last Council on June 29th 2012, it has been decided that the ESM will be able to recapitalize directly banks and to buy the bonds on the secondary market of Member States facing difficulties, provided that they meet their commitments on budgetary and current account imbalances. A clear European Resolution Authority able of taking care of banks facing difficulties is hence an absolute necessity and should not be delayed.

A Single Resolution Authority would have the advantage of simplifying procedures with clear and unequivocal criteria in case a bank needs to be resolved. Moreover, this European Authority would be able to act much faster than different smaller national resolution authorities but also it would be able to bring forward the general interest of the Euro area Member States.

The crisis has strengthened the case for action at EU level, since it clearly demonstrated that the absence of arrangements at this level could result in diverging national centric solutions, which might be less effective in resolving the situation and ultimately prove more costly for Euro area taxpayers as a whole. A Banking Union Resolution Authority should be put in place at the same time as a Single Supervisor.

A Banking Union Resolution Authority would be able to deal with big transnational groups in an orderly. For example, “the resolution case of Fortis in 2008, a Belgian/Dutch financial conglomerate with substantial subsidiaries in Belgium, the Netherlands and Luxembourg, illustrates the possible tension between the cross-border nature of a group and the domestic focus of national legal frameworks and responsibilities for crisis management” as Mr. Constâncio explains. Moreover, the tendency of national governors to protect “their” banks have caused negative externalities and a fragmentation on financial markets along national borders. *(see Eurofi Banking Union paper)*.

Achieving a Single Rulebook for bankruptcy e.g. harmonizing

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1 Victor Constâncio, « Towards a European Banking Union », September 7th 2012
different bankruptcy laws would ease resolution of failing banks. However, the prospect of doing this in the near future seems unrealistic due to the burden it represents. In this context, as far as the banking union is concerned, a Single Resolution Authority seems to be more realistic option on the short term. Indeed, it would be simpler to have one authority with 17 different law systems, than 17 authorities with 17 law systems. Moreover, a crisis handled by a Single Resolution Authority would be less costly and faster because this authority would prevent conflicts between national resolution authorities in the case of the resolution of a cross-border group.

For these reasons, the constitution of a Resolution Fund in the Euro area is not a necessary element of the implementation a Resolution Authority. Firstly, it could be backed by the ESM for bank resolution. The harmonization of deposit guarantee systems as well is no prerequisite either for a Resolution Authority since it is completely independent form. Indeed, in the framework resolution, the authority is no more (not less either) than an organization in charge of the legal and operational management of bank resolution. In many European countries, these authorities still do not exist.

In addition, we foresee unnecessary concerning downsides negative message to the markets on the political will to foster the political integration, unnecessary risk and fragility within the banking union, etc. - if we were to wait building up a EU consensus on both deposit guarantee schemes and resolution funds before setting up the single resolution authority.

Indeed, defining the size and the arrangements of those financial tools proves complex. For instance the experience of the FDIC in the US shows that the amount of public money, which may be temporarly necessary, is not necessarily significant. One could add that at the moment we are trying to improve the protection of depositors and taxpayers we should be careful not to reduce the positive incentives to reduce risk appetite, which are currently provided by certain local arrangements. For example, in some countries, deposit industry led guarantee schemes encompass demanding peer reviews, which are empowered to impose strategic changes to adventurous banks. This explains why the creation of a single Banking Resolution Authority should be an independent legislative priority.

a. Why the Proposition of the Commission is a step forward yet not fast enough?

Since September 12th 2012, the Commission communicated on its intention to create a “single resolution mechanism” and on the importance of establishing a clear roadmap towards a banking union to better manage crises at the EU level. It urges the Council and the Parliament to consider these issues by the end of 2012, once the two propositions on a resolution framework and a DGS are adopted.

Indeed, since the beginning of the crisis, the Commission has brought forwards several proposals. In the Commission’s proposal for a Directive for Bank Resolution and Recovery, this framework would coordinate national resolution authorities and establish mechanisms for cooperation for cross-border groups in order to protect financial stability and achieve the most effective outcome for the institution. Every Member State would have to have a resolution authority. They would be able to choose between creating a new authority as such and transferring this mission to its central bank, supervision authority, its deposit guarantee fund or to its finance minister. However, in order to prevent any conflicts of interests, they would have to separate the resolution activities from the other activities these institutions bear. The resolution activity will have to be independent.

However the intrinsic difficulty to coordinate national resolution authorities (as it is the case in the Commission’s proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms until now) relies in the fact that they support their own national interests and not Europe’s general interest. The European optimum is never the sum of the optima of its Member States.

Even for local banks, it is better to have a centralized Resolution Authority because even local banks can bear systemic risk putting at stake the stability of other Member States, or engage their public funds. For D-SIFIs, National authorities are intrinsically not able to defend the European interest above their own national ones.

The absence of such organized schemes have created severe discrepancies on markets during the crisis, be it because of lack of early intervention, the absence of information sharing, financing problems or no cooperation between authorities, especially for cross-border groups.

The Commission has recognized in its communication “A roadmap towards a Banking Union” (September 12th, 2012) the limits of a mere cooperation between Member States regarding the recovery and resolution of credit institutions. It wishes that its proposal for a framework on recovery and resolution be adopted by the Parliament and Council by the end of 2012, in order to start harmonizing legislations and procedures to protect the Single Market. Moreover, the Commission would like to start writing a proposal for a “single resolution mechanism” as soon as possible.

We believe that work on a proposition for this “single resolution mechanism” should be immediately launched, in order for it to be backed by the ESM when it is instituted. Indeed, if the adoption of the two proposals for a resolution framework and a DGS are essential in order to preserve the Single Market at the EU level, we do not believe we should wait for their legislative adoption to start preparing the “single resolution mechanism” for the Euro area. (as explained above)
b. Which tools and powers should a European Resolution Authority have?

The proposition of the Commission regarding the mandate, powers and tools seems convincing (see articles 25, 28, 31, 56 of this draft regulation). It should be adequate also for a single Banking Resolution Authority, which should be created at the banking union level.

In case of an intense stress, resolution powers and tools must be activated. The proposition of the Commission defines early the launching conditions of a resolution procedure (Articles 27 and 28). The proposal establishes common parameter for triggering the application of resolution tools. The four resolution tools are the following (article 31): the sale of business, the creation of a bridge institution, the separation of certain assets (good bank/bad bank) and the bail-in tool (see below), which makes it necessary to have a unified framework for bail-in instruments.

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. At the same time, it is necessary to ensure that intrusive measures are triggered only when interference with the rights of stakeholders is justified. Therefore, resolution measures should be implemented only if the institution is failing or likely to fail, and no other solution would restore the institution within an appropriate timeframe. In addition, the intervention by means of resolution measures must be justified by reasons of public interest as defined under Article 28.

### General Powers (art.56), Proposition of the Commission on Bank Resolution and Recovery

| (a) | to require any person to provide any information necessary for the resolution authority to decide upon and prepare a resolution action; |
| (b) | to take control of an institution under resolution; |
| (c) | to transfer shares and other instruments of ownership issued by an institution under resolution; |
| (d) | to transfer debt instruments issued by an institution under resolution; |
| (e) | to transfer to another person specified rights, assets or liabilities of an institution under resolution; |
| (f) | to write down or convert the instruments of ownership of the institution under resolution; |
| (g) | to reduce the principal amount of or outstanding amount due, of an institution under resolution; |
| (h) | to convert eligible liabilities of an institution under resolution into ordinary shares or other instruments of ownership; |
| (i) | to cancel debt or shares instruments issued by an institution under resolution; |
| (j) | to require an institution under resolution to issue new shares; |
| (k) | to require the conversion of debt instruments which contain a contractual term for conversion; |
| (l) | to amend or alter the maturity of debt instruments issued by an institution under resolution or amend their amount of interest payable; |
| (m) | to remove or replace the senior management of an institution under resolution. |

### 2.2 A Single Rulebook for Bail-in Instruments

Improving bank resolution also requires a single definition of bail-in instruments and process.

Bail-in instruments within a resolution framework generally refers to a regulatory tool to make banks ready to absorb losses during a crisis. Technically, it refers to the process by which some classes of creditor’s claims are converted into equity. The underlying reason for this is to call upon creditors for extra capital rather than on taxpayers, as was the case during the last financial crisis. Bail-in instruments should be considered only to reduce the recourse to taxpayers, and be used mainly when an institution must be run off or to facilitate an appropriate liquidation in particular to enable the continuity of systemic functions. Bail-in is a resolution tool, not a recovery tool. They should not be used before the Point of Non-Viability (PONV) has been reached.

The PONV/resolution trigger should be the same for all resolution tools. There should be robust safeguards that ensure due process and avoid acceleration of the trigger.

### The Bail-in tools as in the proposition adopted by the Commission on a Directive for Banking Resolution and Recovery

It will have two purposes (art.37):

1. To recapitalize an institution that meets the conditions for resolution and can carry on the activities (only if there is a realistic prospect for a sound and long-term return to activity) or
2. To convert to equity or reduce the principal amount of claims or debt instruments that are transferred to a bridge institution.

The bail-in tool may be applied to all liabilities of the institution under resolution except from deposit guaranteed by the DGS, secured liabilities, liability arising from holdings of client assets, liabilities from original maturity of less than one month or liabilities related to employee salaries, pensions or other fixed remuneration. (Art. 38)
NB: According to the Commission, the crisis has shown that a level of loss-absorbing capacity (own funds, sub-ordinated debt and senior liabilities) at 10% of total liabilities (exclusive of regulatory capital) could broadly represent a threshold at which most recent bank failures could have been resolved with bail-in, and one which is largely consistent with the composition of banks’ liabilities today.

This is the only tool for which a delay of implementation is allowed is 2018 instead of 2015 to ensure that institutions would not be prevented from issuing new shares or instruments of ownership.

It is thus extremely important to differentiate bail-in instruments from contingent capital. While bail-in instruments can be triggered by regulators, contingent capital is a contractually agreed private sector trigger that generally kicks in at an earlier point than bail-in instruments. They function in a similar way to bail-in instruments: automatically convert to common equity upon the occurrence of a predefined event, such as the breaching of a predetermined capital ratio. Because they become equity at the point when they are most needed, they are inherently counter-cyclical.

Bail-in instruments should be used in a smart and proportionate way. Banks are facing ever-increasing regulatory capital requirements in order to increase their stability. This positive development should not prevent them from working appropriately and not being able to finance the economy.

According to many industry players:

- The senior debt write down tool should be a last resort measure to be used it should be considered only to reduce the recourse to taxpayers, and be used when an institution must be run off or to facilitate an appropriate liquidation in particular to enable the continuity of systemic functions.
- The trigger for senior debt bail-in should be at the point of non viability.
- The senior debt write-down tool should not be used before all equity and sub debt have already been depleted/written down.
- The ranking of senior debt should be respected; it should not be applied to any creditor a treatment “worse than in a liquidation scenario”. The mechanism should avoid creating new rankings among creditors that would normally rank pari passu. Therefore, the scope should be as wide as possible for senior unsecured debt (even for short term debt).
- “Grandfathering” should be avoided, as it would create different ranks for senior creditors. The implementation should be delayed by a few years, until the financial markets have stabilized. This should help to minimize disruption regarding bank funding.

3. Resolution Funds and Deposit Guarantee Schemes

3.1 Financial and Economic Prerequisites

A European Deposit Guarantee Scheme will be contingent on fiscal and economic convergence. They will take time to reach agreement because economic and financial prerequisites will have to be fulfilled before.

The financial solidarity that a Integrated Deposit Guarantee Scheme implies, requires, that all European Member States hold their commitments to fiscal discipline and economic governance (Six Pact, Two Pact, TSGC more known as the Fiscal Compact).

A stringent fiscal union is fundamentally necessary to ensure that the Economic and Monetary Union has strong and enduring foundations. As time goes on, this union also has to be lived as a stability union. Before arriving at the goal, however, two obstacles, to which I alluded earlier, have to be overcome.

The second obstacle, which is linked to the first one, is the far-reaching amendment of the European treaties and national constitutions. This is necessary because fiscal union is not envisaged or is expressly forbidden in the existing legal framework. The aim of the amendments is to create a reliable and stable structure that cannot simply be changed yet again in the short term. An established and respected legal framework is a key precondition for the stronger integration of very different nations. This process requires a certain amount of time, but is indispensable. This is because a fiscal union which lacks transparency, which is introduced by circumventing existing regulations and standards, or which is left to the whims of everyday politics would be built on sand and not be a sustainable basis for a stability union.

Democratic legitimacy based on broad public support and amendments to the legal framework are closely linked. While joint liability, for example, is irreversible, changes to the EU fiscal rules might be put up for negotiation at any time. Examples of this are the experiences in dealing with the rules of the Stability and Growth Pact as well as the concrete design of the fiscal compact, which has fallen short of the goals that were originally set.

3.2 Resolution Fund and an integrated Deposit Guarantee Scheme

a. Towards a Resolution Fund

Financing domestic funds: according to the legislative proposal of the Commission, the constitution of national Resolution Funds will have to rely on private contribution and on the financing measures established by articles 93 and 94 from the proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investments firms.

the EU Parliament and the Council, is a step to address the fragilities the current regime as evidenced by the crisis. The crisis has demonstrated that the current organisation of Deposit Guarantee Schemes (DGSs) in Europe are inadequately funded. According to the IMF, “several national Deposit Guarantee Schemes (DGs) in Europe are inadequately funded”. In this respect, preference should be given to schemes which are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty.

Those DGs typically also lack regulatory obligations regarding the availability of information of insured depositors, operational manuals, contractual frameworks and due-diligence tools to prepare and perform the necessary transfers within a rapid timeframe.

In addition, one should be careful to define financial protection schemes which also provide and preserve the appropriate incentives for the banks to reduce their risk appetite. The approach consisting of organizing the EU Deposit Guarantee Scheme on the basis of a network of local schemes should preserve efficient existing ones.

Lastly, the financing of ex ante deposit guarantee schemes, which is expected to cover 1% of the total deposits in one member state, is an issue. Such an amount does not seem fitting for global and systemic risks. In this respect, preference should be given to schemes where they are already in difficulty.

In conclusion, had a properly designed crisis management framework existed three years ago, the financial crisis would have been easier to handle. Some ailing banks would have been rapidly rescued. The contagion through the banking system would have been less pronounced and the fragmentation of the banking system would have been avoided. Above all, the commitment towards the single market would have appeared stronger.

\[^{4}\text{Jens Weidmann : Everything flows ? The future role of monetary policy. Speech at the 2012 ZEW Economic Forum,. June 12th 2012}\]