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## Bank Recovery and Resolution Directive

3 December 2013

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### Introduction

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

This note addresses matters arising in the Bank Recovery and Resolution Directive (BRRD) trilogues and emphasises some key issues. Please refer to our position paper<sup>1</sup> for our fuller position on the BRRD.

### Government stabilisation tools

We support the provision of public funding to provide temporary liquidity to banks in resolution where this is unavailable from private sources. However, a distinction must be made between temporary liquidity support and solvency support and we remain concerned by the message conveyed by incorporating taxpayer bailout powers in the BRRD.

As required by the FSB Key Attributes, effective resolution regimes should “not rely on public solvency support and not create an expectation that such support will be available”. Including the government stabilisation tools would risk undermining the key objectives of ensuring that failing banks are resolved with shareholders and creditors bearing losses rather than taxpayers and efforts to remove the sovereign-bank link.

If however legislators do decide to include public support powers in the BRRD to permit public solvency support, strong and clear constraints and safeguards are crucial. They must be accompanied by clear communication of the conditions under which this could take place to ensure that the tool is temporary, limited to extraordinary circumstances where systemic stability is genuinely at risk and as a last resort tool. This framework must ensure that the preferred strategy remains that failing banks are resolved with shareholders and creditors bearing losses rather than taxpayers.

### Bail-in and financing

We remain very concerned about the use of resolution funds to absorb losses, which creates moral hazard and undermines the key objectives of shareholders and creditors bearing losses and instilling market discipline. Any resolution funds should only be used for liquidity purposes and should not be available for loss absorption or recapitalisation.

Comments on Commission bail-in analysis: We were very interested to see the Commission’s analysis of the different approaches to bail-in and the use of resolution funds and public stabilisation tools. This analysis shows that under the Council approach, big banks have bail-in-able liabilities of 53% of their total liabilities on average. Under the Parliament approach without access to the DGS, this figure is still 34%. A very significant level of loss absorbing capacity is therefore already available and should be utilised before resolution funds are used. As the Commission notes in the paper, “most banks today appear to have enough capital and bail-in-able liabilities to withstand losses in non-extreme cases without resorting to resolution funds or state support.”

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<sup>1</sup> Available here: <http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=9726>.

We regard the Commission's assumption of losses of 25% of total assets as an extreme scenario. According to the analysis, this equates to a loss of €245 billion for the average big bank. However, the analysis of the Commission's approach (with or without depositor preference) shows that even this very high level of losses can be absorbed without recourse to resolution funds or taxpayer support.

The Commission's 10% of total assets loss scenario represents a less extreme, but still very high level of losses (an average of €98 billion for a big bank) which is significantly higher than most of the losses suffered in the recent crisis. The analysis from this scenario demonstrates that **under the Commission (with depositor preference), Council or Parliament approaches to excluded liabilities, this level of losses could be absorbed without imposing any losses on preferred depositors and without any intervention from a resolution fund, DGS or public funds.**

The ability for shareholders and creditors to absorb very large losses and contribute to recapitalisation is therefore present. This should be utilised fully, subject to the protection of the NCWOL principle, before any use of resolution funds or public support. Otherwise the potential use of resolution funds or taxpayer support will create moral hazard and undermine market discipline: two of the biggest issues that the BRRD is supposed to address.

The Commission's analysis also demonstrates that a large ex-ante fund is unnecessary and as the Commission notes it is important to avoid "spurring moral hazard by creating an excessively large resolution fund".

*Proposed additional principle:* We propose that an additional principle should be added to ensure that before the resolution fund could be used to absorb losses (in addition to the minimum level of loss contribution set out in the General Approach), shareholders and creditors have borne losses to the fullest extent possible, in accordance with the creditor hierarchy and subject to the NCWOL safeguard.

*Amendments arising from SRM negotiations:* We are pleased to see that Olle Schmidt MEP proposed a similar principle in relation to the Single Resolution Fund.<sup>2</sup> This should also be applied to the BRRD resolution funds to ensure a level playing field throughout the EU.

Our proposal is also reflected in the following additional principle proposed by the Council in its second compromise on the SRM, which should also be included in the BRRD:

"when exercising the resolution powers, it should be ensured that shareholders and creditors bear the cost of loss absorption and recapitalisation to the fullest extent possible. When deciding on the framework of the resolution tools as well as the resolution scheme ... the Commission and the Board shall respectively opt for the framework and scheme that is most effective at meeting the [resolution objectives]. Where the Commission and the Board consider that certain frameworks and schemes are equally effective at meeting the resolution objectives, they shall opt for the least costly option for the Fund."

*Treatment of derivatives:* We remain very concerned by the Parliament's proposal for prioritising derivatives that are centrally cleared and those exempted from the CVA charge over those that are not, for the following reasons:

- It would be a material departure from the creditor hierarchy and give rise to claims for breach of the NCWOL principle;
- It is likely to encourage the premature close-out of non-cleared derivatives, exacerbating liquidity issues and precipitating the entry into resolution and impacting upon financial stability;
- Counterparties cannot necessarily choose whether a derivative is cleared or not as CCPs do not offer clearing for all derivatives. In particular, SMEs would be penalised as they might not have access to central clearing systems due to the costs and collateralisation requirements involved;
- It is unclear how the subordination of non-cleared derivatives would work in practice. For example, netting agreements may operate across both cleared and non-cleared derivatives and it is unclear how the net liability following such netting would be treated.

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<sup>2</sup> See Parliament amendments 671 and 675 to the Single Resolution Mechanism. Several other MEPs also proposed amendments confirming that the Single Resolution Fund should not be used for loss absorption or recapitalisation. Again these amendments should be reflected in the BRRD principles and apply to the EU as a whole.

## MREL

*Consolidated/individual requirement:* As set out in our previous paper, the proposals currently under discussion will have significant adverse effects on banks operating in Europe. The important issue of the need for MREL to take account of the group resolution strategy has not received sufficient consideration.

The objective behind MREL is to ensure that there is an appropriate level of loss absorbing capacity for the relevant group to be resolvable. **This requires that the application of MREL within a group reflects the group resolution plan.** Accordingly MREL should be set as part of the group resolution planning process, with the application of MREL tailored to the group resolution plan.

Different requirements will be appropriate for different group resolution strategies, as required by recent FSB guidance:

- For groups with a multiple point of entry (MPE) resolution strategy, this implies access to sufficient loss absorbing capacity at each point of entry since resolution would be conducted at a local level, albeit coordinated by the home resolution authority. However, requiring such groups to comply with a consolidated MREL would not be appropriate.
- For groups with a single point of entry (SPE) strategy, different considerations are relevant such as ensuring sufficient MREL can be accessed via the holding company and that there is a mechanism for recapitalising subsidiaries. A consolidated MREL requirement is likely to be appropriate for such groups, but an individual requirement could be very damaging. Ring-fencing additional loss absorbing capacity at each subsidiary will constrain the group's ability to recover during periods of stress by deploying its resources to where they are most needed, making the group less resilient.
- **Therefore the current proposals which require all groups to have MREL applied at a consolidated and an individual level are potentially very damaging and additional flexibility is required.** The requirement for every group to comply with MREL set at a consolidated and an individual level should accordingly be removed.
- Any home/host concerns can be addressed through the group resolution planning process and ensuring that an appropriate group resolution plan is put in place, supported by MREL in the correct location(s) required for the plan to be capable of implementation. This would be further strengthened by the introduction of presumptive paths.

*Denominator:* To accurately reflect the true exposure of the firm, if MREL is to be set on the basis of total liabilities, liabilities arising from derivatives and securities financing transactions should be included on a **net** basis, taking into account the value of collateral to reflect the true exposure of the institution. We also welcome the recognition in Article 39(3)(c) that MREL should be set on the basis of the risk profile of the institution.

## Presumptive paths

We welcome the Parliament's proposed inclusion of "presumptive paths" in the BRRD. Presumptive paths should provide the authorities with greater clarity and predictability of the approach that would be likely to be taken to resolution, while accepting that flexibility needs to be retained to accommodate specific circumstances. Importantly presumptive paths should provide the authorities with greater confidence in group resolution plans and therefore aid cross-border cooperation and the speed of decision-making.

## Use of Deposit Guarantee Schemes (DGS) in resolution

Prioritising insured depositors in the creditor hierarchy will greatly reduce the risk of the DGS having to contribute in resolution or a winding up and should result in much lower funding requirements for DGSs. However, in the unlikely event that losses are so great that insured depositors would (but for the DGS) suffer losses, the DGS should contribute in their place.

Resolution should result in lower costs to the DGS than the alternative of a winding-up by protecting insured depositors. The DGS therefore benefits and should contribute under Article 99(1). We therefore support the Council position providing that the DGS should contribute the amount of losses that insured depositors would have suffered in the resolution, subject to the no creditor worse off than liquidation principle and oppose the Parliament's removal of this.

However, we are concerned with proposed wording in the Deposit Guarantee Schemes Directive proposing the use of DGS prior to resolution. The uses of the DGS must be consistent with the BRRD framework, avoid creating moral hazard and focus on the objectives of maintaining access to deposits and minimising losses to the DGS. This is particularly crucial in the context of the SRM, where national DGS will have to coexist with centralised decision-making and the Single Resolution Fund. Use of the DGS should therefore be restricted to the resolution phase: assisting with the transfer of insured deposits to a purchaser or bridge institution where this is the least costly option for the DGS and contributing under Article 99 of the BRRD; and paying out on insolvency.

## Important technical issues

Understandably the focus has been on the main political issues. However, a number of more technical issues are of considerable importance to create an effective recovery and resolution regime. These include:

- Article 63(1b) of the General Approach excludes cleared derivatives from the stay power, limiting the ability of the authorities to avoid the potentially very significant costs of an unnecessary unwind of cleared derivatives which could threaten an orderly resolution. The stay power should also apply to central counterparties provided that the substantive obligations under the contract, including payment and delivery obligations and provision of collateral, continue to be performed.
- The Council's proposed approach to depositor preference introduces national depositor preference by using the definitions of "eligible" and "covered" deposits, discriminating against depositors in branches outside the EEA. We have suggested amendments to address this issue.<sup>3</sup>
- Article 31(5) requires a residual institution to be wound up under normal insolvency proceedings when part of its assets, rights or liabilities are transferred through the use of the sale of business tool, the bridge institution tool or the asset separation tool. To avoid the possible unintended consequence of the bail-in process resulting in a viable residual institution being wound up and to increase the flexibility of resolution authorities, this article should be amended so that the entity is only required to be wound up where the residual institution is non-viable.
- Article 85 currently only applies to "third country institutions", which are defined as institutions with their head office established in a third country. This is too limited and should apply to all banks and investment firms, and their holding companies, established in third countries. Otherwise the cross-border recognition powers could not be applied in relation to, for example, a US bank with a branch in the EU.
- Greater clarity is required as to how requirements such as recovery and resolution planning, EBA mediation, resolvability assessments and MREL fit within the global regulatory regime, especially for global institutions (both those headquartered in the EU and in Third Countries).
- The proposed requirement for institutions to include contractual bail-in provisions in any eligible liability governed by third country law will be very difficult to implement in practice, especially for existing liabilities. The amendments required cannot generally be made unilaterally and might also be opposed by third country authorities. The concern around enforcement of bail-in of liabilities governed by third country law is adequately addressed by the proposed Article 39(2a) under the Council General Approach and the power to remove impediments to resolvability. Article 50 should therefore be deleted.

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<sup>3</sup> See our paper and proposed amendments on this issue, available here: <http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=9800>

- The Council's proposed Article 51(1)(1d) which limits the amount of write-down or conversion of capital instruments of a subsidiary to that equivalent to the write down or conversion of liabilities of its parent should be removed. This provision would constrain the ability of resolution authorities to take action in relation to a subsidiary without putting the parent into resolution, potentially preventing the implementation of resolution plans.
- We are concerned by the potential consequences of the proposed exclusion of all intra-group short term debt from the general bail-in exemption for short term debt, in particular as it will incentivise group entities to place short term cash outside their own group in order to benefit from the short term exemption. It can also have the effect of distributing losses to all parts of a group rather than concentrating them in the failing company or the holding company, where they can be best absorbed via bail-in or other resolution tools. For this reason we believe that short term cash/deposits placed with an intra-group banking entity should benefit from the general exemption for short term debt, whilst recognising that it may not be appropriate to exempt other types of intra-group liabilities.
- Greater clarity is required as to the interaction between Crisis Management Groups (CMGs) and European resolution colleges. For large cross-border groups which are head-quartered/operate in third countries, it is important that decisions and responsibilities under the BRRD are made/exercised through the CMG by introducing the Parliament's proposed addition to Article 80(8) confirming that no European resolution college is required where a CMG is established. This principle should also be reflected in Article 81.
- The Council text clarifies the ranking of insured and certain uninsured (eg SME) depositors, leaving other (typically large corporate) depositors to be dealt with under national insolvency hierarchies. This leaves open whether such large corporate deposits will rank pari passu with other unsecured creditors or senior to them. This position should be clarified and a harmonised approach taken to depositor preference throughout the EU.



We hope that you find this analysis helpful and we would be very pleased to provide you and your staff with any additional information you might require. Please do not hesitate to contact any of us via the details listed below.

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