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Association for Financial Markets in Europe

# Bank Recovery and Resolution Directive

# Deposit Guarantee Schemes Directive

## Level 2 Priority Issues

17 April 2014

The Association for Financial Markets in Europe (AFME) welcomes the agreement of the Bank Recovery and Resolution Directive (BRRD). It represents a crucial step that will address the issue of 'too-big-to-fail' and provide the authorities with the powers to ensure that all banks in Europe can, when required, be resolved in an orderly manner without resorting to taxpayer bail-outs. We also welcome the agreement of the Deposit Guarantee Schemes Directive (DGSD). This should provide greater consistency of deposit insurance throughout the EU and increase depositors' awareness of and confidence in Deposit Guarantee Schemes.

With the finalisation of the BRRD and DGSD texts and the commencement of the Level 2 process, we welcome the opportunity to present our preliminary thinking on a number of important issues which are the subject of level 2 technical standards, guidelines and delegated acts.[1] We will be engaging on these issues in more detail in due course but we set out below some high level messages on the most important level 2 issues. We would of course be very pleased to engage further with you and your colleagues on these topics.

### Minimum Requirement for Eligible Liabilities (MREL)

- **RTS specifying criteria for assessing the quantum of MREL:** Ensuring appropriate criteria for the assessment of MREL is key to developing effective group resolution plans.
- ***Consistency with the global framework:*** It is important to take into account the work that the FSB is currently undertaking in relation to global standards for gone concern loss absorbing capacity and to align MREL with this in order to assist global consistency and aid international cooperation.
- ***Focusing on resolvability and the group resolution plan:*** As recognised in the level 1 text, the focus of the assessment of the amount of MREL that each institution should be required to hold should be on resolvability and supporting the group resolution plan. MREL should accordingly be set as part of the resolution planning process and tailored to the relevant group resolution plan. This is recognised by recent FSB guidance which states that loss absorbing capacity "needs to be available ... at the right location to facilitate a recapitalisation or orderly wind down."[2]
- The assessment criteria should accommodate both single point of entry (SPE) and multiple point of entry (MPE) resolution strategies and emphasize the need to consider whether losses would be imposed on external creditors of the relevant institution under the group resolution plan. For groups with an SPE resolution strategy, the starting point should be that MREL should apply at the holding company, as this is where bail-in would be applied. For groups with an MPE resolution strategy, this implies MREL at the predetermined points of entry since resolution would be conducted at a local level, albeit coordinated by the home resolution authority.

[1] Please note that the references to articles in this note are references to the numbers prior to the renumbering arising out of the jurist linguist process.

[2] See FSB, *Guidance on Developing Effective Resolution Strategies,* 16 July 2013, para. 1.1

- The underlying principle that should be reflected in the assessment criteria is therefore that MREL should be required in the entity or entities which would be "points of entry" where bail-in or another resolution tool would be applied under the group resolution plan. There should be no requirement for significant MREL to be held at entities that are not points of entry provided that the group is resolvable under the group resolution plan. This should be emphasised in the assessment criteria in the RTS pursuant to Article 39.
- ***Taking due account of the impact on firms' operations:*** The assessment criteria should reflect the FSB guidance that authorities should take into account "the potential impact of [loss absorbing capacity] requirements on the firms' financing cost and business operations".[3]

## Valuation

- **RTS specifying valuation methodologies:** Articles 30(7a) and 66(4) of the BRRD give the EBA the power to adopt draft RTS specifying the methodology for carrying out the valuations under these articles. Putting in place a credible valuation methodology under Articles 30 and 66 is essential to provide confidence in the application of the resolution tools and the protection afforded by the NCWOL principle. We therefore believe that the EBA should exercise that power as we see RTS under these articles as necessary. Without confidence that an appropriate valuation will be conducted there is likely to be greater uncertainty in the market and greater scope for challenges to resolution.

## Content of resolution plans

- **RTS specifying the contents of resolution plans:** The content of resolution plans should reflect the FSB's guidance in this area.[4] The RTS should emphasize the need for content to be aligned with and/or part of the global resolution planning process for groups which also operate in third countries. Resolution plans will need to be tailored to the resolution regime in each relevant jurisdiction. The RTS on the information required should be set on the basis of principles and incorporate a principle of proportionality and relevance of the information to the resolution plan.
- **ITS on procedures and templates for information required for resolution planning:** While we acknowledge that resolution plans and the information required to prepare them will need to be tailored to the particular group, consistency in the scope and format of information required to be provided for resolution planning would assist banks in providing the information in a timely and efficient manner.
- We propose that the information required to be provided for resolution planning purposes be assessed in a phased manner. Resolution authorities could require basic information on a firm's financial, legal, operational structures and economic functions etc. as a first step (phase 1) submission to enable determination of the appropriate resolution strategy. Second phase submissions should then cover detailed information requirements needed to support the resolution authorities' preferred resolution strategy and the preparation of the resolution plan. This phased approach should be reflected in the ITS on procedures and templates for the provision of information.

[3] FSB, *Guidance on Developing Effective Resolution Strategies,* 16 July 2013.

[4] See FSB, Guidance on Developing Effective Resolution Strategies, 16 July 2013 and FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

## Resolvability assessments

- The criteria for conducting resolvability assessments and the application of measures to address impediments to resolvability are key elements of the resolution regime. While resolvability will necessarily be required to be assessed on the basis of each particular bank, a consistent approach and interpretation of resolvability would be supported by consistent criteria and guidance on how resolvability assessments will be conducted.
- The criteria for assessing resolvability are addressed by Annex II of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. The criteria set out in the RTS under Article 13(3) of the BRRD should be consistent with this.
- The EBA guidelines under Article 14(8) of the BRRD specifying the measures to address impediments to resolvability and the circumstances in which they may be applied should give due recognition to the need to address only *substantive* impediments, for the measures to be proportionate and to take account of the effect of the measures on the business of the institution.

## Risk adjustment of contributions to resolution funds[5]

- The risk adjustment of contributions to resolution funds should be focused upon ensuring that an institution's contributions reflect the risk of loss that it poses to the fund. This approach would maximise incentives for firms to reduce the risk that they pose to the fund and minimise moral hazard. Contributions based on any other principles are likely to create perverse incentives. For example, absent an appropriate adjustment, raising additional loss absorbing debt which does not class as own funds would increase contributions despite reducing the risk to the fund.
- In order to assess the risk of loss to the fund, we propose that this should be calculated based upon an assessment of the following components:

    a) the probability that the institution fails and enters resolution; and
    b) the risk of loss to the fund in such event.

- The probability of failure of an institution should be based upon a supervisory assessment of a range of indicators including its capital adequacy (including leverage), asset quality and liquidity profile because it cannot be determined solely by reference to any particular ratio. This assessment should utilise existing indicators and supervisory processes rather than creating a new risk assessment process and be based upon consistent factors across the EU. The assessment should also take account of actions that could be taken by the group to avoid failure under the institution's recovery plan.
- The probability of entering resolution should reflect whether the particular institution would be placed into resolution under the relevant group resolution plan. It should also take account of the likely systemic (whether global or domestic) impact of the failure of the firm and whether it falls within the scope of the waivers or simplified obligations in Article 4 of the BRRD. However such assessment should not be limited to the impact of the failure of the institution alone, but should also recognise that the fund could be used for any bank and that the failure of a number of institutions which on their own might have a small impact on the financial system could together have a systemic impact and therefore require resolution.
- The risk of loss to a resolution fund in the event of resolution should reflect the likelihood that a resolution of the institution would require the use of the resolution fund. It should therefore take account of the recovery capability and resolution strategy of the institution and whether, in the event that the institution was placed into resolution, it is likely that the resolution fund would be used.

[5] See our separate paper on this issue at: http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10547.

- It should also reflect the resolvability of the institution and its loss absorbing capacity. The best way of assessing this would be based upon the level of liabilities that are not excluded from bail-in relative to the size of the balance sheet and potential losses. This would reflect the fact that the greater the level of "bail-in-able" liabilities, the greater the loss absorbency available and therefore the lower the likelihood that a resolution fund would be used for loss absorption.
- It is also necessary to ensure that the assessment of contributions based upon the liabilities of each institution in a group does not result in double-counting of intra-group liabilities. We suggest that this is addressed by deducting intra-group liabilities from the assessment base of total liabilities less own funds and covered deposits.

## Risk adjustment of contributions to Deposit Guarantee Schemes[6]

- We also support a consistent approach to the risk adjustment of contributions to Deposit Guarantee Schemes (DGS) under the DGSD and the EBA should ensure this through its guidelines under Article 11. Again the key principle should be focused upon ensuring that an institution's contributions reflect the risk of loss that it poses to the fund. This is necessary to minimise moral hazard and provide appropriate incentives. In respect of DGS contributions, the risk of loss to the DGS should be based upon an assessment of the following components:

    a) the probability that the institution fails and the DGS is triggered; and
    b) the risk of loss to the fund in such event.

- The probability that the DGS is triggered should be based upon the probability that deposits become unavailable, which is the trigger for payout by the DGS. This should be based on the probability of failure of the institution, assessed in the same manner as considered above in respect of resolution funds, i.e. based on a supervisory assessment of the institution's capital adequacy (including leverage), asset quality and liquidity profile and adjusted to take account of actions that could be taken by the group to avoid failure under its recovery plan.
- The risk of loss to the DGS should be based upon the proportion of liabilities that are subordinated to covered deposits, reflecting the seniority provided to covered deposits under the BRRD and that the DGS would not suffer any losses unless the institution incurred losses in excess of all such subordinate liabilities.
- The risk assessment should also reflect the fact that covered deposits are highly unlikely to become unavailable if the institution is placed into resolution, as a key objective of resolution is to maintain access to covered deposits. In this case, if the institution does not have a significant amount of liabilities subordinated to covered deposits, the DGS may be required to make a contribution under Article 99 of the BRRD based on the losses that covered depositors would have suffered. The value of the contribution is likely to be lower than the losses that the DGS would suffer in a liquidation of the institution and therefore if an institution is likely to be placed into resolution in the event of its failure, the risk of loss to the DGS should be lower.
- Accordingly, the probability of entering resolution in the event of failure should also be reflected in the risk assessment of DGS contributions such that the greater the likelihood of being placed into resolution in the event of failure, the lower the risk of loss to the DGS. The probability of entering resolution in the event of failure should be assessed in the same manner as discussed above in respect of contributions to resolution funds.

[6] See our separate paper on this issue at: http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10547.

## Contractual recognition of bail-in[7]

- The requirements for contracts governed by the law of third countries to contain contractual provisions for the recognition of bail-in under Article 50[8] give rise to a number of practical and legal difficulties. A balance needs to be struck between the objective of ensuring that bail-in will be effective in respect of all liabilities governed by third country law and the difficulties with achieving this objective.

- It should also be kept in mind that the exclusion of liabilities from the requirements of Article 50 does not mean that bail-in will necessarily be ineffective in respect of those liabilities. Recognition of bail-in can also be achieved through mutual recognition procedures as required by the FSB Key Attributes.[9] This could involve the statutory or common law recognition of the EU resolution and/or the use of equivalent local resolution powers to support the resolution and achieve the same effect.

- There is some uncertainty in the scope of the requirements, for example which contracts fall within the exclusions in Article 50(1)(a), such as the exemption under Article 38(2)(f)(ii) for the provision of goods or services that are critical to the daily functioning of operations. Additionally there are a number of obstacles to including contractual provisions in contracts, such as contracts for membership of payment and settlement systems in third countries and contracts on standard terms where it might be impossible for the bank to negotiate.

- Absent appropriate exclusions, the ability of European banks to conduct business and compete in third countries could be adversely affected. It should be recognized that Europe is more advanced than some other countries in the implementation of its resolution regime. The markets in some third countries are also less developed in their understanding of bail-in and contractual provisions may take time to be accepted in these markets.
- We suggest that the scope of the exclusions should address the difficulties outlined above and that this could be done through a combination of the following in the RTS:

    a) clarifying, to the extent possible, the scope of the exclusions under Article 50(1)(a);
    b) clarifying how the limitation to "new" liabilities should be applied;
    c) excluding contracts with public authorities;
    d) excluding contracts on standard terms which are not set by the bank, or at least qualifying the obligation on the bank to include such terms. For example the bank could be required to use its reasonable endeavours to include the contractual provision in such contracts;
    e) introducing a materiality threshold or at least a *de minimus* value on the liability so that the requirement would only apply to substantial liabilities eg those in excess of €5,000;
    f) clarifying that non-contractual liabilities are excluded from the scope of Article 50; and
    g) phasing in the requirements to start with broader exclusions and narrowing the exclusions over time.

## Functioning of resolution colleges

- The RTS on the operational functioning of resolution colleges should clarify the interrelationship between resolution colleges and Crisis Management Groups for G-SIFIs. The standards should also encourage

[7] See our more detailed paper on this issue, availble here: www.afme.eu/resolution
[8] Article 55 of the renumbered text post the jurist linguist process.
[9] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, Key Attribute 7.5.

cooperation and information-sharing within the colleges. Some guidance could also be helpfully adapted from the FSB's work on information sharing for resolution purposes.[10]

## Exclusion of liabilities from bail-in

- The RTS under Article 50 should also be used to clarify the precise scope of the liabilities excluded from bail-in under Article 38(2) (and which are therefore also excluded under Article 50), for example what goods or services are regarded as critical to the daily functioning of operations for the purpose of Article 38(2)(f)(ii).
- The circumstances when the exclusion of liabilities from bail-in is necessary to achieve the objectives specified in Article 38(3c) could be clarified to ensure consistency in the application of the bail-in tool and provide greater certainty and predictability.

## Additional technical issues

- We also regard a number of more technical issues as important priorities including:
    - the trigger for early intervention (guidelines and RTS under Article 23 BRRD);
    - the conditions for resolution (guidelines under Article 27(4) BRRD);
    - the treatment of shareholders in bail-in (guidelines under Article 42(4b) BRRD);
    - rates of conversion of debt to equity (guidelines under Article 45(4) BRRD);
    - the methodology for valuing derivative liabilities in bail-in (RTS under Article 44(4) BRRD)
    - the sequence of write-down and conversion of liabilities (guidelines under Article 43(4b) BRRD);
    - the information required to be held on financial contracts (RTS under Article 63(7) BRRD);
    - the criteria for assessing "critical functions" and "core business lines" (Commission Delegated Acts under Article 2 BRRD);
    - the scope of the partial transfers safeguard (Commission Delegated Acts under Article 68(4) BRRD); and
    - the requirements for payment commitments for DGS contributions (guidelines under Article 9(2) DGSD).

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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[10] FSB Consultative Document, Information Sharing for Resolution Purposes, 12 August 2013. See also GFMA response, available here: http://www.financialstabilityboard.org/publications/c_131024be.pdf