

**TASK FORCE**



*Thinking ahead for Europe*

**EUROPEAN BANK RESOLUTION:  
MAKING IT WORK!**

**INTERIM REPORT  
OF THE  
CEPS TASK FORCE  
ON  
IMPLEMENTING FINANCIAL SECTOR RESOLUTION**

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BRUSSELS**

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The Centre for European Policy Studies (CEPS) is an independent think tank based in Brussels. Its mission is to produce sound policy research leading to constructive solutions to the challenges facing Europe today.

This report is based on discussions in the CEPS Task Force on “Implementing Financial Sector Resolution” and was complemented by substantial additional research. The members of the Task Force participated in extensive discussions in the course of several meetings, and submitted comments on earlier drafts of the report. Its contents convey the general tone and direction of the discussions, but its recommendations do not necessarily reflect a common position reached by all members of the Task Force. Nor do they represent the views of the institutions to which the members or Chairman belong. A list of participants and invited guests and speakers appears in Annex 3 at the end of this report. The chair and rapporteur of the Task Force is Thomas F. Huertas, Partner and Chair, EY Global Regulatory Network.

This interim report focuses exclusively banking sector resolution following implementation of the Single Resolution Mechanism in the EU. A final report will be published later this year with additional chapters on non-bank resolution.

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## List of Abbreviations

A-TVP	Agencija za trg vrednostnih papirjev
AT1	Additional tier 1 capital
BB	Bail-in at banks
BP	Bail-in at parent
BRRD	Bank Recovery and Resolution Directive
CCP	Central counterparty
CBRC	China Banking Regulatory Commission
CEPS	Centre for European Policy Studies
CET1	Common equity tier 1
CNVM	Romania National Securities Commission
CMG	(Global) Crisis management group
CoB	Close of business
CRDIV	Capital Requirements Directive IV
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
ECB	European Central Bank
ELA	Emergency liquidity assistance
ESRB	European Systemic Risk Board
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FINMA	Financial Market Supervisory Authority
FMI	Financial market infrastructures
FMSA	Financial Market Stabilisation Agency
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
G-SIBs	Global systemically important banks
G-SIFIs	Global systemically important financial institutions
HANFA	Hrvatska agencija za nadzor financijskih usluga
HKMA	Hong Kong Monetary Authority
IC	Initial condition
KNF	Komisja Nadzoru Finansowego
LB	Loss in bank subsidiary

LGR	Loss given resolution
LT	Long-term
MAS	Monetary Authority of Singapore
MPE	Multiple point of entry
MREL	Minimum requirement for own funds and eligible liabilities
NBR	Banca Națională a României
NCB	National central bank
NCWO	No creditor worse off
NDC	Non-defaulting counterparty
NPR	Notice of proposed rulemaking
NRA	National resolution authority
PBC	People's Bank of China
PONV	Point of non-viability
QFCs	Qualified financial contracts
RTS	Regulatory technical standards
RWA	Risk-weighted assets
SIFI	Systemically important financial institution
SME	Small and medium-sized enterprise
SPE	Single point of entry
SREP	Supervisory review and evaluation process
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSB	Single Supervisory Board
ST	Short-term
T2	Tier 2 (capital)
TA	Temporary administrator
TLAC	Total loss-absorbing capacity
UK	United Kingdom
US	United States

# EUROPEAN BANK RESOLUTION: MAKING IT WORK!

## INTERIM REPORT OF THE CEPS TASK FORCE ON IMPLEMENTING FINANCIAL SECTOR RESOLUTION

### Introduction

Following the financial crisis of 2007-08, global leaders (G20, 2009) launched a sweeping reform of banking regulation and supervision<sup>1</sup> designed to reduce: i) the probability that banks would fail,<sup>2</sup> ii) systemic risk<sup>3</sup> and iii) the impact that the failure of a bank could have on taxpayers, financial markets and the economy at large.

To achieve this third objective, policy-makers embarked on a policy agenda to end “too big to fail” conundrum and improve the ability to resolve global systemically important financial institutions (G-SIFIs). The aim was to create a regime in which financial institutions, especially global systemically important banks (G-SIBs), could ‘fail’ without significant adverse effects on financial markets or the economy at large and without cost to the taxpayer.

Now that this regime is largely in place, attention must turn to implementation. This report outlines, principally with respect to the EU, key steps that authorities, banks and financial market infrastructures (FMIs) should take to make resolution effective. Particular emphasis is placed on how the bail-in tool should be employed, as this tool is most likely to feature prominently in the resolution plans for significant banking institutions in the EU.

### 1. The institutional framework for resolution is largely in place

Over the past five years, the principal jurisdictions (i.e. home authorities for G-SIBs) have established the legislative and institutional framework required for an effective resolution regime. In 2011, the Financial Stability Board (FSB) laid out the “Key Attributes of Effective Resolution Regimes for Financial Institutions (hereafter the “key attributes”) (FSB, 2011).<sup>4</sup> To

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<sup>1</sup> See Lannoo (2015) for a discussion of the post-financial crisis legislative framework.










<sup>2</sup> To reduce the probability that banks would fail, policy-makers increased capital requirements and raised the quality of capital that could be used to meet the more stringent requirement. They also introduced a global liquidity standard for the first time. In addition, they took steps to improve the quality of supervision, both via institutional change (such as the introduction of the Single Supervisory Mechanism, discussed in more detail below) and the introduction of new supervisory tools, such as stress-testing, and the conduct of thematic reviews and recommendations on key topics, such as risk governance and data integrity. Finally, policy-makers required banks to develop recovery plans that outlined how they would deal with extreme stress.

<sup>3</sup> To reduce systemic risk, policy-makers introduced the concept of macro-prudential supervision and established systemic risk boards at the national (e.g. the Financial Stability Oversight Council [FSOC] in the US and the Financial Policy Committee [FPC] in the UK), EU (European Systemic Risk Board [ESRB]) and global (Financial Stability Board [FSB]) levels. In addition, policy-makers took steps to strengthen markets, notably the derivatives market through the introduction of mandatory clearing. However, this concept potentially makes central counterparties (CCPs) a single point of failure, increasing the importance that the CCP itself be resolvable (see chapter 2).

<sup>4</sup>The FSB subsequently revised and updated this framework; see (FSB, 2014).

implement the key attributes the principal jurisdictions enacted appropriate legislation and designated or established resolution authorities. Compliance has been especially high in jurisdictions that are home to the 30 G-SIBs (FSB, 2015b) or host to the principal foreign branches and subsidiaries of such G-SIBs (see Table 1).<sup>5</sup>

Table 1. Principal G-SIB jurisdictions are in compliance with FSB key attributes

Home jurisdiction		Home resolution authority	Compliance with FSB key attributes	G-SIBs (Home)	Important as host
EU	Euro area	SRB/NRAs		8	✓
	UK	Bank of England		4	✓
	Sweden	Riksgälden		1	
Switzerland		FINMA		2	
United States		FDIC		8	✓
Japan		FSA		3	✓
China		PBC / CBRC		4	
Hong Kong SAR		HKMA	 *	0	✓
Singapore		MAS	 *	0	✓
Total				30	

\* Following implementation of planned legislation in 2016.

The EU plays a particularly important role in resolution reform, as it is home to 13 of the 30 G-SIBs and host to practically all the others. In the EU the banking recovery and resolution Directive (BRRD) – supplemented by the EBA’s implementing measures – effectively transposes the FSB key attributes into EU law.<sup>6</sup> The BRRD is applicable to all credit institutions incorporated in a member state of the EU, including EU subsidiaries of third-country banking groups. The deadline for the transposition of the BRRD into national law was set at 31 December 2014. By the end of 2015, however, five member states including the Czech Republic, Luxembourg, Poland, Romania and Sweden, had not yet fully transposed the rules into national laws, and were consequently referred by the European Commission to the Court of Justice (European Commission, 2015).

The BRRD requires each member state to designate or establish a national resolution authority (NRA), and practically all member states had done so as of 30 September 2015 (see Annex 1). Within the eurozone the Single Resolution Mechanism (SRM) ties these NRAs together under the aegis of the Single Resolution Board (SRB).<sup>7</sup> The SRM complements the SSM (Single

<sup>5</sup> Most of the foreign branches and subsidiaries (in terms of asset size) of any G-SIB are located in a jurisdiction that is home for another G-SIB (e.g. the UK is the host jurisdiction for a number of the branches and subsidiaries of G-SIBs headquartered in the United States).

<sup>6</sup> EBA implementing measures include draft Regulatory Technical Standards [RTS], draft Implementing technical Standards, Guidelines and Opinions.

<sup>7</sup> OJ L 225 of 30.7.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN>).



Supervisory Mechanism)<sup>8</sup>: together the SRM and SSM are implementing banking union within the eurozone.

The Directive requires each credit institution to draw up -- and its competent authority to assess -- a recovery plan.<sup>9</sup> This plan will be implemented by the institution itself, on its own initiative, if its financial situation deteriorates. In case this is not sufficient, and certain performance criteria are triggered by the institution,<sup>10</sup> the BRRD also equips the competent authority with “early intervention powers” (sometimes also called “crisis prevention measures”). These entitle the supervisor to order ‘troubled’ institutions<sup>11</sup> to implement measures as set out in the recovery plan or take certain additional steps. Such additional steps may include changes to the bank’s business strategies and/or legal or operational structure that the authorities consider necessary to prevent the bank’s economic condition from deteriorating further. The supervisor may also require “the management body of the institution to draw up a plan for negotiation on restructuring of debt with some or all of its creditors”.<sup>12</sup>

Should the management not succeed in arresting the deterioration in the bank’s condition, the supervisor has the right to remove the management of the institution<sup>13</sup> and appoint a temporary administrator (TA), who would be empowered to conduct the affairs of the institution.<sup>14</sup> The TA would be able to change the institution’s business strategy and the TA would be required – to the extent it is reasonable to do so -- to seek a private-sector solution to

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<sup>8</sup> For Lannoo (2014) for a discussion of the SSM.

<sup>9</sup> Article 5, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>); (EBA, 2013 & 2014b).

<sup>10</sup> Article 27, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>); (EBA, 2015d).

<sup>11</sup> According to the BRRD, authorities can take early intervention measures if “an institution infringes or, due, inter alia, to a rapidly deteriorating financial condition, including deteriorating liquidity situation, increasing level of leverage, non-performing loans or concentration of exposures as assessed on the basis of a set of triggers, which may include the institution’s own funds requirement plus 1.5 percentage points, is likely to infringe the requirements” for continuing authorisation. Article 27, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). The EBA advises authorities to consider the following as triggers for early intervention: 1) an overall SREP (supervisory review and evaluation process) score of 4, or an overall score of 3 with a score of 4 in certain individual items (internal governance and institution-wide controls; business model and strategy; capital adequacy; and liquidity adequacy); 2) material changes in key SREP indicators that could cause a review of the SREP score; and 3) significant events that could cause a review of the SREP score, such as major operational risk events; a deterioration in the amount of eligible liabilities and own funds; signals that asset quality or specific portfolios/assets should be reviewed; significant outflow of funds; unexpected loss, without replacement, of senior management/key staff; significant rating downgrades (EBA 2014d).

<sup>12</sup> Article 27.1(e), OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). Note that the institution should have already outlined the basis for such a renegotiation in its recovery plan.

<sup>13</sup> Article 28, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>)

<sup>14</sup> Article 29, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>)

the recapitalisation of an institution.<sup>15</sup> If such efforts are not successful, the TA may write down equity and write down and/or convert into common equity the bank's additional tier 1 and tier 2 capital.<sup>16</sup> Finally, the TA is also tasked with preparing the institution to enter resolution.<sup>17</sup>

If the bank does enter resolution, then the BRRD provides the resolution authorities with a full array of resolution powers, including the right to bail in (write down and/or convert to equity) certain liabilities of the bank upon the entry of the bank into resolution, subject to the safeguard that no creditor will be made worse off than it would have become, had the bank-in-resolution been liquidated under normal insolvency procedures (see Box 1).

*Box 1. No creditor worse off than in liquidation*

“No creditor worse off than in liquidation” is a safeguard for creditors. Its goal is to ensure that they will get under resolution at least as much as they would have received if the authorities had decided to liquidate the bank rather than apply resolution measures. Any compensation due to creditors shall be payable by the Resolution Fund, based on an independent valuation.<sup>18</sup>

To evaluate whether the “no creditor worse off than in liquidation” principle has been met, an ex-post valuation needs to be carried out by independent valuer as soon as possible after resolution actions have taken effect to determine whether any difference exists between the treatment that shareholder and creditors would have received had the bank entered normal insolvency procedures and the actual treatment they have received through the resolution process.<sup>19</sup>

The Directive effectively creates a hierarchy that dictates the order – subject to certain exceptions and national discretions -- in which liabilities shall be bailed in and losses allocated. Within each (liquidation) class of liabilities, there should be *pari passu* treatment (subject again to the exercise of certain national discretion). Note that the power of the resolution authority to bail in liabilities extends – with some clearly delineated exceptions – all the way up the creditor hierarchy to deposits. Within the deposit tranche, guaranteed deposits have what amounts to a super preference. If bail-in does reach the guaranteed deposit tranche, the deposit guarantee scheme (DGS), not the insured depositor, will be subject to bail-in and bear the loss attributable to insured deposits (up to €100,000 per depositor).<sup>20</sup>

<sup>15</sup> Article 32(1)(b), OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>)

<sup>16</sup> But not other forms of MREL or TLAC, even if in subordinated debt form. These may be bailed in only if the bank enters resolution.

<sup>17</sup> These are tasks that the supervisor is empowered under Article 27 to direct the institution to undertake. Article 27, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>18</sup> Article 101, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>)

<sup>19</sup> Article 74, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>)

<sup>20</sup> Article 50, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). To reinforce the point on the creditor hierarchy, the BRRD mandates that a distinction be made between senior and subordinated debt when converting such debts into equity, so that each euro of senior debt is converted into a higher number of common equity shares.

The BRRD also requires resolution authorities to conduct resolvability assessments, draw up resolution plans and set an institution-specific requirement for the bank's minimum requirement for own funds and eligible liabilities (MREL) – the amount of long-term (remaining maturity greater than one year) liabilities with high loss absorbing capacity or for which bail-in is especially feasible and credible.

Although the BRRD mandates that member states set up a resolution fund,<sup>21</sup> recourse to that fund may occur only after 8% of the bank's liabilities have been bailed in. And, any such recourse is limited to 5% of the bank's liabilities as well as subject to state aid rules.<sup>22</sup> Furthermore, the BRRD and SRM Regulation constrain the ability of member states to bail out their banks. Although member states are allowed to extend "extraordinary public financial support" as a preventive measure to recapitalise banks that are in need of new capital but unable to raise it privately in the market, either as response to stress-test results or in the context of a systemic crisis, any such assistance is subject to EU state aid rules and to prior approval by the European Commission, and after other resolution tools have been exhausted.<sup>23</sup>

Finally, the Directive and the SRM Regulation create the basis for international cooperation within the SRM, within the EU and with the authorities in third countries. This is especially important, as the EU's principal banks all operate across national borders via branches and/or subsidiaries.

Within the SRM the SRB becomes in effect both the home and the host resolution authority. The SRB has the responsibility for all banks supervised directly by the ECB and all cross-border banks to assess their resolvability and develop their resolution plans as well as establish each bank's level of MREL. The SRB will replace the national resolution authorities in in crisis management groups (resolution colleges). The SRB will act as the home resolution authority for banks and banking groups headquartered in a eurozone member state, and it will act as host resolution authority with respect to branches and subsidiaries in the eurozone of banks and banking groups headquartered outside the eurozone. In such global groups, the SRB will determine, along with resolution authorities from other jurisdictions, the approach that will be taken to resolving the banks, should this become necessary. However, national resolution authorities remain responsible for implementing the SRB's decisions.

*Authorities should use crisis management groups to establish a preferred path.* Authorities have also established, in line with FSB guidance, a global crisis management group (CMG) for each G-

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<sup>21</sup> Article 100, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). Similar to national funds mandated by the BRRD, the SRM regulation establishes the Single Resolution Fund (SRF), which is owned and administered by the SRB. The SRF is funded by regular ex-ante and extraordinary ex-post contributions from all institutions to which the Regulation applies, and is to reach, by 2024, 1% of the amount of covered deposits of all these institutions. Contributions are raised annually by member states and transferred under the Intergovernmental Agreement on the Single Resolution Fund to the SRF. The SRF is owned and administered by the SRB. For an estimation of the funds required by the SRF, see De Groen and Gros (2015).

<sup>22</sup> Article 44(5)(a), OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). See also Article 37(10)(a). The a priori valuation of Article 36 should be used to measure the quantum of liabilities including own funds when calculating the percentage. For institutions with less than € 900 billion of assets, the threshold may be 20% of risk-weighted assets.

<sup>23</sup> Articles 56 to 58, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

SIB. The CMG should include supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for deposit guarantee schemes in both home and host jurisdictions for entities material to the group.<sup>24</sup>

The principal task of the CMGs is to establish an institution-specific resolution plan that can guide the actions of the authorities in home and host jurisdictions, if all or part of the banking group were to require resolution. Such plans must work both at the level of each individual credit institution within the group as well as at the level of the group as a whole.

As a practical matter, resolution plans are more likely to succeed, if home and host authorities plan together on how they would coordinate their activities with respect to the banking group, if resolution were to be required. In other words, resolution is more likely to be feasible, if home and host authorities have developed in advance a ‘preferred path’ that outlines how they would approach the resolution of the banking group in question. Indeed, without such a preferred path, it is difficult to see how authorities can reasonably conduct the resolvability assessment that they are required to perform. And, there is much to be said for communicating that preferred path not only to the banking group concerned but to markets more generally. That will serve to put investors on notice that they will in fact be bailed in and are therefore at risk, if the bank does enter resolution. Publication of the key features of the preferred path may also increase the likelihood that the authorities will in fact act in the manner outlined by the preferred path. That in turn may increase the willingness of investors to create a private-sector solution (if the entry into resolution is certain to result in bail-in, rather than lead to bail-out, the creditors exposed to bail-in should be more inclined to take the opportunity to negotiate a restructuring).

Even the simplest of corporate structures may require international coordination and cooperation. Take a bank headquartered in jurisdiction A with a branch in jurisdiction B. If host jurisdiction B takes a territorial approach to resolution, the authorities in jurisdiction B may be required, or have the option, to resolve the bank’s branch in jurisdiction B separately from the parent bank. If the host country exercises that option (i.e. insists on what might be called “my point of entry”), this may dictate the course that the home authority will have to take with respect to the parent bank. If the host elects to liquidate the branch, the home may not be able to avoid liquidating the parent bank as well. Home authorities therefore need to gain some assurance from host authorities that the latter will not exercise what amounts to a nuclear option. This will be particularly important for EU banks that have branches in the United States, as such branches are often material to the EU bank and the US has under its laws the option to follow the territorial approach to resolution (Lee, 2014).<sup>25</sup>

International cooperation is also important for banking groups organised with a parent in one jurisdiction and one or more subsidiaries in other jurisdiction(s). There are two principal approaches to resolution of such groups: multiple point of entry (MPE) and single point of entry (SPE). Under the MPE approach, resolution powers are applied at the operating subsidiary level and can involve two or more resolution authorities. Under the SPE approach the home jurisdiction resolution authority applies resolution powers at the top-level parent or holding company level and directs the resolution of the group as a whole.

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<sup>24</sup> Within the EU, the BRRD calls for the creation of a resolution group for each significant bank.

<sup>25</sup> Also note that home countries may also give host countries such an option, if they do not elect to require parent banks to deduct their investment in their subsidiary according to Article 49 (2) , OJ L 176 of 27.6.2013 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN>).

Both approaches presume a certain degree of cooperation among home and host authorities.<sup>26</sup> However, as a practical matter, each resolution authority will give primary consideration to its own jurisdiction (indeed, they may be required by law to do so).<sup>27</sup> To facilitate home and host cooperation, the FSB's standard on total loss-absorbing capacity (TLAC) includes a framework for internal TLAC, whereby the loss-absorbing capacity held at the level of a G-SIB's resolution entity in the home jurisdiction is committed to the G-SIB's material subsidiaries in host jurisdictions. This 'internal TLAC' is intended to provide confidence to host authorities that loss-absorbing capacity will be made available to subsidiaries in their jurisdiction.

Internal TLAC therefore assures host authorities that they can recapitalise the operating subsidiary within their jurisdiction without having to rely on the parent to infuse new capital at the point at which the subsidiary reaches non-viability. This is conducive to the subsidiary's continuing to perform critical economic functions and may enable the subsidiary to continue as a going concern without entering resolution at all.

Internal TLAC also provides the host subsidiary with the wherewithal to resist the contagion that might arise, if the subsidiary's parent and/or one or more of the subsidiary's sister affiliates were to enter resolution. To ensure that the capital of the subsidiary (should it remain healthy) cannot be drained to support affiliates and/or the parent, were the affiliate(s) and/or the parent to enter resolution, host jurisdictions may supplement internal TLAC requirements by imposing restrictions on inter-affiliate transactions<sup>28</sup> and on the ability of the subsidiary to pay dividends or make distributions.<sup>29</sup>

In effect, the requirement that each material entity has its own TLAC amounts to a requirement that parents provide strength to their subsidiaries up front. This gives rise to four further issues:

1. To what extent does the subsidiary's strength (TLAC) have to come from the parent alone, or can the subsidiary also issue TLAC instruments to third-party (external to the group) investors. Both the Federal Reserve (2015) and the Bank of England (2015) have expressed a strong preference for the former. Such a stance certainly simplifies resolution: bail-in simply changes the form in which the parent holds its investment in the subsidiary (e.g. from T2 capital to common equity). That avoids the need to consider a change in control and greatly diminishes the significance of the actual terms on which the TLAC instrument is written down and/or converted to common equity. However, such a solution is not open to groups where an operating bank is the top-level parent company. For these entities the resolution plan must accommodate the possibility that the bail-in will result in a change in control to third-party external investors (see below). As such plans are developed, it would seem sensible to allow groups to apply such plans to their subsidiaries, particularly where the group does not currently hold 100% of the subsidiary's common equity. This would be much more consistent with an overall MPE approach to resolution and would allow additional flexibility with respect to an SPE approach.

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<sup>26</sup> For a discussion of MPE and SPE approaches see (Huertas, 2015).

<sup>27</sup> For a discussion of the issues facing a host country supervisor see (Tarullo, 2012 and 2015).

<sup>28</sup> For example, such restrictions apply to the bank subsidiaries of the intermediate holding company that large foreign banking organisations are required to form in the United States.

<sup>29</sup> This will be the case for IHCs owned by FBOs in the United States. See Tarullo (2015).

2. To what extent can the group effectively limit its liability for the entity entering resolution to the amount of its investment in the entity? If losses at the entity entering resolution exceed the amount of MREL issued to the parent holding company, is the entity entering resolution effectively severed from the rest of the group, as the doctrine of limited liability would imply?<sup>30</sup> Note that the BRRD allows group financial support, but does not make it mandatory.<sup>31</sup>
3. What triggers resolution at the parent holding company – the entry of a subsidiary into resolution, or the failure of the parent holding company to meet minimum consolidated capital requirements? It is possible that the parent holding company would still be in compliance with minimum capital requirements even if losses at the wholesale bank led to the loss of the holding company’s entire MREL investment. This is particularly likely to be the case, if the holding company’s liability is limited to the amount of its investment in the bank subsidiary, so that the write-off of its investment in the failed subsidiary results in the deconsolidation of that subsidiary from the group. In such a case, what is the rationale for putting the holding company into resolution? Does the answer differ depending on which subsidiary has entered resolution?
4. If a holding company does enter resolution, what is the resolution process? Specifically, what do investors receive and what rights do they have? As the parent holding company is an ordinary business corporation, to what extent can the resolution process be modelled on ordinary bankruptcy or insolvency proceedings?<sup>32</sup> Note that the closer the resolution process for the parent holding company comes to ordinary insolvency proceedings, the greater will be the certainty on the part of investors as to what recoveries they might make, if the holding company were to enter resolution. This will in turn facilitate the ability of banking groups to place instruments qualifying for treatment as MREL with investors.

## 2. The focus should now be on planning for resolution

In drawing up resolution plans, authorities and banks need to think through what needs to be accomplished – without recourse to the taxpayer – during and after a ‘resolution weekend’ in order to assure continuity in the provision of critical economic functions as well as avoid significant adverse effects on financial markets and the economy at large. This process will

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<sup>30</sup> If so, bail-in at the subsidiary that has entered resolution must move up the creditor hierarchy and begin to apportion losses at the bank level to the bank’s third-party creditors. This may in turn adversely affect financial markets, making it all the more important that the authorities avoid forbearance.

<sup>31</sup> Article 19, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

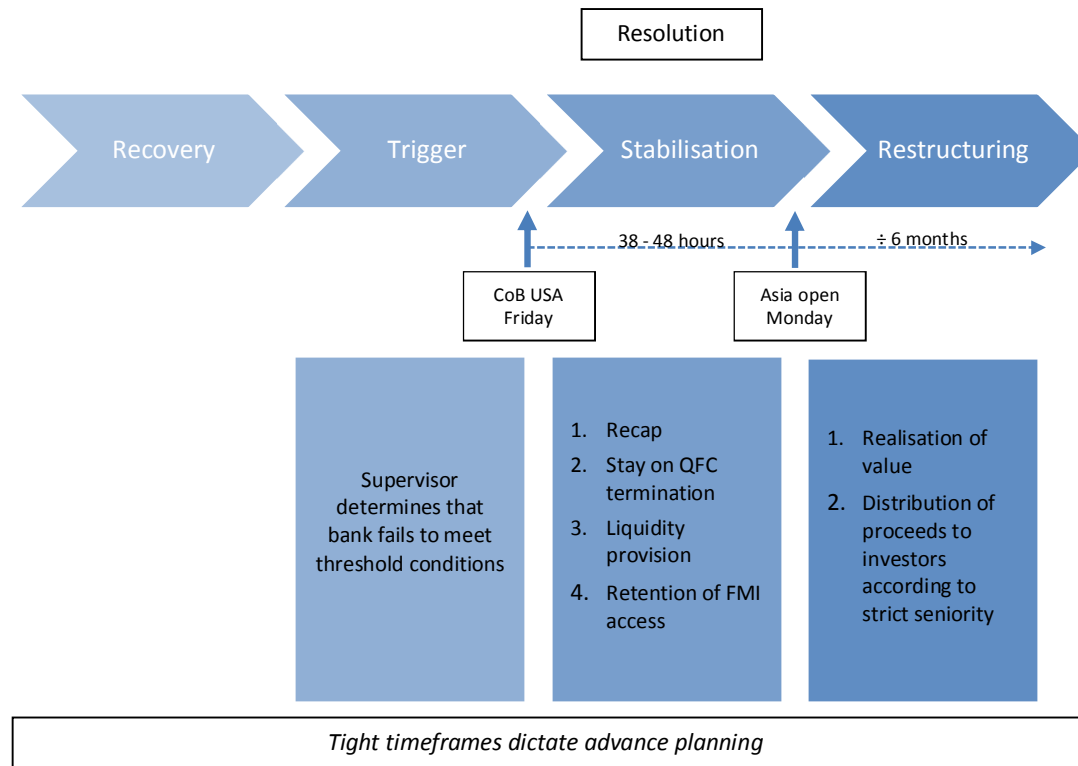
<sup>32</sup> In such processes:

- A receiver or administrator is appointed to run the business in the interest of the creditors.
- A stay is placed on payments and distributions to shareholders and creditors.
- Creditors are given receivership certificates entitling them (in strict order of seniority) to any proceeds realised by the administrator from running the business.
- Losses are apportioned in reverse order of seniority, starting with equity, then proceeding upward through the creditor hierarchy to preferred stock (additional tier 1 capital), subordinated debt (Tier 2 capital) and senior debt.
- Creditors have various rights, including the right to propose a reorganisation plan.

identify obstacles to resolution and develop recommendations on how to remove such obstacles.

The authorities must plan for all three stages of resolution: pulling the trigger (the entry into resolution), stabilising the bank and restructuring the bank (see Figure 1).

Figure 1. Resolution has three stages



Source: Author.

Authorities should prepare themselves to pull the trigger promptly at the point of non-viability. The first stage of the resolution process is the decision to pull the trigger. The decision to pull the trigger has two aspects: a determination that the bank meets the criteria for entering resolution and the selection of the resolution strategy and tools to be employed. These two decisions have to be taken together. It makes no sense to make a determination that a significant bank should enter resolution unless the authorities have a resolution plan in mind and are ready to execute it.

Five questions stand out in connection with pulling the trigger: i) What criteria should be used? ii) What resolution tools, if any, should the resolution authority employ? iii) Who should make the decision? iv) When should the decision be implemented? v) What should be communicated to the market at the time the decision is made?

*What criteria should be used?* The BRRD states that resolution action shall be taken on conditions that the institution is “failing or is likely to fail”, that there is no reasonable alternative private-sector measure or supervisory action (e.g. write down or conversion of capital instruments) that would prevent the failure within a reasonable timeframe, and that resolution is necessary

in the public interest (e.g. to prevent adverse effects on the financial system).<sup>33</sup> These conditions are determined sequentially, with the competent authority (in the case of the SSM, the ECB) determining that the institution is “failing or likely to fail” and the resolution authority (in the case of the SRM, the SRB) determining the subsequent two conditions that there are no alternate private solutions and that a resolution action is necessary in the public interest.

There is general agreement that a bank should indeed be put into resolution when it reaches the point of non-viability (PONV), i.e. the point at which it is decided that the institution would “cease to be viable” if eligible capital instruments were not written down or converted.<sup>34</sup> There are several points to note about this definition:

1. The decision must be based on an *a priori* valuation of the bank’s assets and liabilities.<sup>35</sup> The BRRD requires that a “fair, prudent and realistic” valuation of the institution’s assets and liabilities be conducted by an independent valuer<sup>36</sup> not affiliated with public entities including the resolution authority, in order to determine whether conditions for resolution are met and if so, what resolution tools and to what extent they should be applied. Valuation shall also ensure that any losses on the assets are fully recognised at resolution.

This represents a considerable challenge, given the short time frame and given the scope and scale of a bank’s operations (especially for G-SIBs with substantial cross-border operations). A regulatory-adjusted accounting valuation requires the valuer to apply assumptions and judgements that might deviate from the management’s opinions, while the existing valuation system and processes of the bank also need to be adapted in order to facilitate the resolution evaluation.

As a practical matter, the authorities may well need to have recourse to their ability to make in circumstances of urgency a provisional valuation. This can also serve the basis for choosing resolution actions (see below), provided that a buffer is included for additional losses.

2. The bank may have positive net worth at the PONV (as determined by the *a priori* valuation). This is especially likely to be the case for banks that rely on short-term funding from wholesale sources, for such investors may be more likely to run on a bank that they consider weak. In such a case, the bank is more likely to run out of liquidity before its capital is run down. Note that this has implications for the bail-in of MREL/TLAC instruments such as T2 capital (see below).
3. Access to emergency liquidity assistance (ELA) may obscure the PONV and lead to forbearance. By refinancing itself at the central bank, the distressed bank not only maintains its liquidity, but also benefits from the viability test that the central bank conducts prior to granting ELA. This makes it difficult for the supervisor to argue that

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<sup>33</sup> Article 32, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>34</sup> Recital 81, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>35</sup> Article 36, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>36</sup> The EBA (2015c) has published the final draft RTS on the general criteria for the legal compliance of independence of valuers.



the bank has reached the PONV, especially if the supervisor is part of the central bank. That in turn increases the likelihood of forbearance.

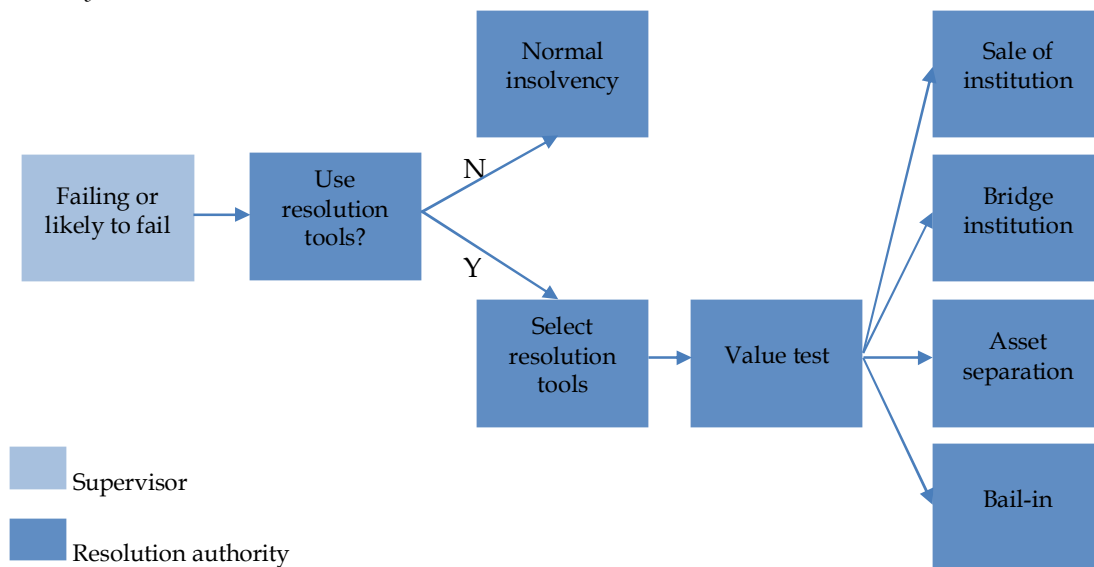
This ‘stay of execution’ allows, indeed may even accelerate, the run on the distressed bank. That in turn would potentially increase losses to holders of ‘reserve capital’, such as subordinated debt (Tier 2 capital).

Banking union may be particularly prone to this risk, for ELA remains the responsibility of national central banks (NCBs), subject to an appropriate member state guarantee of the institution’s obligations and no objection from the ECB on monetary policy grounds only. This means that any costs of, and risks arising from, the provision of ELA are incurred by the relevant NCB (and its member state). Although the SSM confirms to the NCB and the ECB that the bank meets minimum capital requirements, it is the NCB that makes the viability assessment in connection with granting ELA, not the ECB.<sup>37</sup> This increases the likelihood of forbearance.

Authorities should therefore consider transferring responsibility for ELA within the eurozone to the ECB. As an input to such a decision, the Single Supervisory Board (SSB) should provide an opinion to the Governing Council of the ECB regarding the distressed bank’s viability.<sup>38</sup>

*What resolution tools, if any, should the resolution authorities employ? As outlined above, the determination that a bank is failing or likely to fail, is only part one of “pulling the trigger”. Just as important are the resolution plan and the resolution tools. That is reflected in the BRRD – the decision to pull the trigger is taken with the knowledge of the resolution plan and resolution tools that the resolution authority intends to employ.*

Figure 2. The process of “pulling the trigger” involves both the supervisor and the resolution authority



Source: Author.

<sup>37</sup> However, the ECB may limit the total amount of ELA available, especially in systemic situations. For a full statement of ELA procedures see (ECB, 2014).

<sup>38</sup> Similar proposals are made in Gortsos (2015), Lastra (2015) and Huertas (2014a).

Logically, the resolution authority needs first to determine whether it is the public interest to follow normal bankruptcy or insolvency procedures or to employ resolution tools (see Figure 2). The smaller and simpler the failing institution, the less likely it is that the bank is performing functions critical to the economy and the more likely it is that the resolution authority will opt for normal insolvency procedures, particularly if the deposit guarantee scheme is able to quickly pay out insured depositors.

In contrast, if the failing bank is performing functions critical to the economy, the more likely it is that the resolution authority will find it in the public interest to employ resolution tools, either singly or in combination, in executing the resolution plan. The resolution tool kit includes:

- *Sale of the institution.* The resolution authority may sell the failing institution as a whole to a third party without the consent of shareholders. Such a sale may take the form of a sale of shares (with the proceeds going to the shareholders) or the sale of substantially all of the failing institution's assets and liabilities (with the proceeds going to the institution).<sup>39</sup>
- *Transfer assets to bridge institution.* The resolution authority may transfer the shares of the failing institution or some portion of its assets (together with an amount of liabilities less than or equal in value to the amount of assets transferred) to a special purpose, limited-life bridge institution owned by the authorities. Such a bridge institution would be authorised to conduct banking activities, pending its sale to a third party or until such time as it wound down its operations.<sup>40</sup>
- *Asset separation.* The resolution authority may transfer assets, rights and liabilities from the failing bank to a separate asset-management vehicle under the ownership and direction of the authorities. Such a separation may help the authorities realise greater value from the assets, and such asset-management vehicles have proven particularly effective in cases where they have received transfers of assets from two or more banks.
- *Bail-in.* As outlined above, the BRRD empowers the resolution authority to write down and/or convert into equity the liabilities of the bank. As noted above, this tool is most likely to be relevant to the resolution of significant banks and the focus of this chapter is to assess how this tool can be used to facilitate resolution of such banks.

Note that prior to implementing any of these tools, the resolution authority will have had to commission and complete an independent *a priori* valuation of the bank's assets to determine the amount of additional losses that should be recognised and (in the case of the bail-in tool) the amount of CET1 capital that must be created (via write-down or conversion) to restore CET1 capital to a level that will enable the stabilised bank to gain the confidence of the market.<sup>41</sup>

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<sup>39</sup> The asset-sale route is particularly suited to situations where the failing institution may be subject to contingent liabilities such as legal claims.

<sup>40</sup> Note that the bridge institution tool may be used to transfer insured deposits or deposits generally to a third party. As deposits have preference under the BRRD, it is possible for the resolution authority to cherry-pick the best of the failing bank's unencumbered assets and then match them against the deposit liabilities to be transferred to the bridge institution. This potentially permits depositors to have continued access to their accounts, particularly if the bridge institution is immediately sold to a third party.

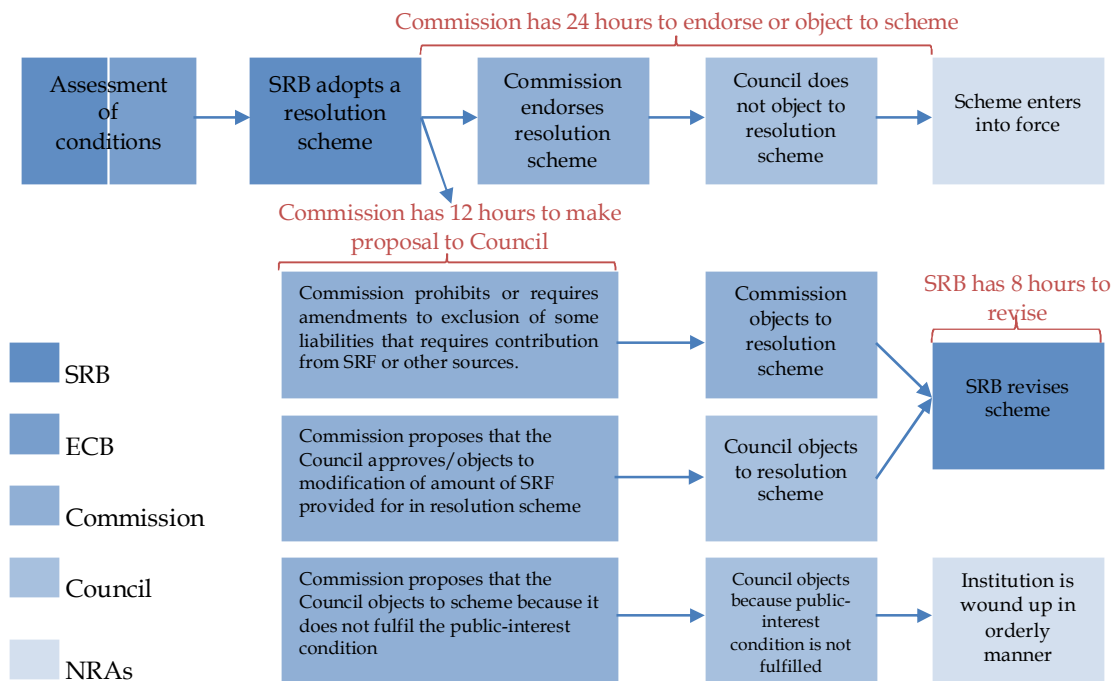
<sup>41</sup> Article 46, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>); in practice, the competent authority will

## 2.1 Who should make the decision to pull the trigger?

As a practical matter, however, pulling the trigger will require a high degree of coordination between the supervisor (who generally has primary responsibility to determine whether the bank is failing or likely to fail)<sup>42</sup> and the resolution authority (which generally has the responsibility to decide whether the bank should be liquidated or resolved under a plan employing one or more of the BRRD’s resolution tools).

Note that additional parties must be involved in the trigger decision, if the resolution authority wishes to employ certain tools, particularly those involving the use of public resources.<sup>43</sup> Given the limited amount of time available to stabilise a bank once the trigger has been pulled, it is essential that the resolution authority has in place all the necessary approvals prior to the trigger being pulled. Note that these approvals should include not only those necessary in the bank’s home jurisdiction, but also those required in the principal foreign jurisdictions in which the bank has branches and/or subsidiaries.

Figure 3. Adopting the actual resolution scheme is a complex process



Source: Author.

determine the capital requirement, since ultimately it is responsible for granting the institution a banking licence.

<sup>42</sup> Article 32, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>). Note, however, that the resolution authority may also make this determination (Article. 32.2).

<sup>43</sup> In the United States, for example, the decision to employ the Orderly Liquidation Authority under Title II of the Dodd-Frank Act requires the prior approval of the FDIC itself (two-thirds of its board of directors), the Board of Governors of the Federal Reserve System (two-thirds majority) and then the decision by the Secretary of the Treasury “in consultation with the President” as to whether to appoint the FDIC as receiver for the financial company in danger of default. In the EU, the Directorate General for Competition in the European Commission must similarly approve any state aid and it has a stated policy that in such circumstances it will require “burden sharing” by the holders of capital securities.

This is especially important in the eurozone. Under banking union there is an extremely complex procedure for approving the resolution scheme that the SRB proposes (see Figure 3).

This procedure can potentially take up to 32 hours – leaving only six to twelve hours for the NRAs to actually implement the plan. That is unlikely to be enough time, especially if the distressed bank has significant operations outside the eurozone. Indeed, if the eurozone authorities were to take all the time allowed under the SRM Regulation to approve the resolution plan, this would raise the risk that one or more of the authorities outside the SRM would initiate action to ring-fence and/or resolve branches and/or subsidiaries of the failing eurozone bank prior to the SRM’s reaching a final decision. If one or more non-SRM authorities were to “jump the gun”, this could make it difficult, if not impossible, for the SRM to implement its preferred resolution strategy. In addition, the cooperation between the SSM, part of an independent central bank, and the SRM, an agency reporting to the European Commission, will need to work. This is particularly important in determining the quantity of fresh capital required, on a timely basis. Ideally, therefore, the decision to place the bank into resolution will be one well prepared in advance. As outlined above, cross-border coordination among home and host authorities in jointly developing a preferred path is the key to being able to implement resolution successfully. Any necessary approvals (or statements of no objection) should be obtained prior to putting the bank into resolution, so that the authorities can move immediately to implement resolution along the preferred path. This should also help prevent fragmented resolution actions in non-SRM jurisdictions.

*When should the decision be implemented?* The exact time at which the bank enters resolution matters greatly. Entering at the end of the business day after payment systems and other financial market infrastructures have completed settlement greatly simplifies resolution. In contrast, entering resolution in the midst of the business day creates significant settlement (Herstatt) risk<sup>44</sup> and reduces the likelihood that stabilisation will be successful.

For internationally active banks the “end of the business day” is likely to mean the end of the business day in the United States and the completion of the settlement cycle on US financial market infrastructures. This raises the practical problem of how to offset the liquidity outflows that are likely to occur during the final hours before the distressed bank officially reaches the PONV and enters resolution. The problem is likely to be especially acute for non-US banks with branches and/or subsidiaries in the United States.

The introduction of intra-day liquidity reporting is a first step toward solving this problem, for it allows supervisors and central banks to determine the scope and locus of the liquidity shortfall (BCBS, 2013). But solving the problem will require further steps, either to:

- Define a universal “end of the business day” standard for internationally active banks and agree procedures necessary to make sure that the group gets to that point as a going concern. This is likely to be especially important for SPE resolution strategies.
- Work out how part(s) or all of an internationally active banking group could fail during the business day. This is likely to be especially important for MPE resolution strategies.

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<sup>44</sup> The Herstatt risk, also known as cross-currency settlement risk or foreign-exchange risk is the risk that a party to a trade fails to make payment even though it has been paid by its counterparty. It is named after the German bank Herstatt whose license was withdrawn by German regulators on 26 June 1974, due to its inability to cover its liabilities. This forced the bank into liquidation and it ceased operating. However, because of the time-zone differences, Herstatt was unable to pay some New York banks for the foreign exchange it had received, and hence caused them substantial losses.

*What should be communicated at the time of the decision?* Obviously, resolution authorities need to communicate to the market that they have put the bank into resolution. But the communication need not, indeed must not, stop there. It is vitally important that the communication also includes the following elements:

- overall resolution strategy that the resolution authorities will implement,
- specification of which entities and functions will continue in operation and
- assessment of how resolution will impact the principal liabilities of the bank.<sup>45</sup>

The actual resolution plan should conform as closely to the previously agreed preferred path as possible, given the changing circumstances of the resolution event (e.g. market conditions). That will confirm investors' expectations, enhance market discipline and promote financial stability. When it comes to implementing resolution, certainty is constructive. Ambiguity should be reserved (and observed) for ELA.

Table 2. *Constructive ambiguity and constructive certainty: Is current policy the wrong way round?*

ELA	Resolution	Comment
Certainty	Ambiguity	Certainty to grant ELA creates forbearance, increases loss given resolution (LGR). Ambiguity with respect to resolution plan increases variance of loss given resolution (LGR) and raises risk level
Ambiguity	Certainty	Ambiguity regarding ELA limits forbearance, reduces LGR. Certainty with respect to resolution (announcing and sticking to a 'preferred path') increases the certainty that investors will suffer loss and may reduce variance in LGR.

## 2.2 Resolution plans should create a 'pre-pack' that can stabilise the bank-in-resolution

To stabilise the bank in resolution the resolution authority must be able to i) recapitalise the failed bank and ii) provide assurances that the recapitalised bank-in-resolution can reopen for business. This will enable the bank-in-resolution to continue to perform its critical economic functions.

*Recapitalising the bank-in-resolution.* Effective resolution regimes envisage that investors, and not taxpayers, will recapitalise the bank-in-resolution. To ensure this will be the case, there must be:

- a means by which the resolution authority can force investors to do so, immediately and unequivocally, upon the entry of the bank into resolution. Under the BRRD the bail-in tool provides the means to achieve this.
- a sufficient amount of investor obligations upon which the resolution authority can immediately and unequivocally exercise the above means whilst limiting adverse effects. Under the BRRD, the MREL requirement assures this (if properly implemented, with changes to insolvency law as necessary): it effectively subdivides

<sup>45</sup> This statement should cover (at a minimum) the treatment of common equity, additional tier 1 capital, tier 2 capital, other subordinated debt, senior debt, derivatives and deposits (both insured and uninsured as well as retail, SME and large corporate deposits). This communication should cover the bank's holding company (if any) as well as the group's principal bank and non-bank subsidiaries.

the creditor hierarchy subject to bail-in into two classes: an investor class (MREL) subject to immediate bail-in,<sup>46</sup> and all other liabilities subject to bail-in (this includes customer or operating liabilities such as deposits). In concept, MREL is similar to TLAC (total loss-absorbing capacity) developed by the FSB (FSB, 2015a; Fortésa, Molinari, & Venus, 2015), and the EBA has indicated an intention to standardise the two definitions, at least as far as G-SIBs are concerned (EBA, 2015b).

**Bail-in.** Under bail-in the resolution authority is empowered to write down and/or convert into common equity certain liabilities of the bank upon the entry of the bank into resolution. For this tool to be employed effectively, both the resolution authority and funds providers to the bank should know in advance: i) which liabilities are eligible and ineligible for bail-in, ii) the order in which the resolution authority will bail-in eligible liabilities, iii) the terms on which the bail-in will occur and iv) whether the bail-in can be exercised for all eligible instruments issued by the bank, including those issued in foreign jurisdictions and/or under foreign law.

The BRRD clearly distinguishes between liabilities eligible for bail-in and those exempt from bail-in. The Directive also establishes the order in which the resolution authority should bail-in the eligible liabilities (see Table 3). Bail-in will first be applied to capital instruments, starting with writing down the existing equity, then writing down and/or converting Additional Tier 1 instruments such as preferred stock, and then proceeding to Tier 2 capital instruments such as qualifying subordinated debt.<sup>47</sup> Under CRD IV (and Basel III), such instruments have to be subject to write-down or conversion at the PONV, if they are to continue to count towards capital requirements.

So far, so simple. Capital instruments are plainly investor obligations, and they are clearly subordinated to operational liabilities such as deposits. At the opposite end of the bail-in ladder, things are simple as well. Secured obligations are exempt from bail-in.

It is in the middle of the bail-in ladder that complications arise. These concern the position of the instrument in the creditor hierarchy as well as partial exemptions from bail-in for certain maturities and/or holders of the instrument. In “exceptional circumstances”, the resolution authority has the discretion to exclude some or all of an instrument from bail-in, either generally in advance or on a case-by-case basis during the resolution process itself. In the absence of an EU standard defining what qualifies as “exceptional”, the door may be open for different jurisdictions to make different choices with respect to these options. This creates the prospect that bail-in will proceed differently in each member state – a fact that is likely to confuse investors and raise the cost of funding.

Take the case of senior debt. This is plainly an investor obligation and is subject to bail-in under the BRRD. Senior debt will generally rank *pari passu* with other senior unsecured obligations, such as derivatives. If so, such debt will not qualify for TLAC in most circumstances and may face limits with respect to its use in meeting the MREL requirement. Hence, banks in such situations would need to rely more heavily on AT1 and T2 capital to meet TLAC and possibly MREL requirements. If such debt is subordinated to operating liabilities such as derivatives and deposits, it will count towards TLAC as well as MREL. Such subordination can be achieved statutorily, contractually or structurally (i.e. issued by a non-operating holding company).

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<sup>46</sup> Note that uncovered deposits with more than 1-year residual maturity may also qualify as MREL.

<sup>47</sup> Strictly speaking, common equity is not subject to bail-in as it already bears first loss and is the instrument into which bail-in may convert other liabilities.

Table 3. BRRD creates priorities under bail-in and MREL assures adequate investor capital to support recap

Order of bail-in	Obligation	Eligible		Comment
		MREL	TLAC	
1	Common equity	●	●	Absorbs first loss
2	AT1	●	●	Capital instrument subject to write-down or conversion at PONV (Basel III, CRD IV)
3	T2	●	●	Capital instrument subject to write-down or conversion at PONV (Basel III, CRD IV)
4	Other sub debt	◐	◐	Other sub debt with remaining maturity greater than 1 year counts towards MREL
5	ST senior debt	○	○	Does not count as MREL or TLAC
	LT senior debt	●	◐	Counts as MREL (if RA does not exclude from bail-in) Counts as TLAC if subordinated to operating liabilities
	Derivatives	○	○	Net amount of derivatives is subject to bail-in but such net amount does not count towards MREL
6	Uninsured deposits	◐	○	>1 year remaining maturity: can be included in MREL, if they are deposits of large corporations; Counts as TLAC if insured deposits have preference over uninsured
	Insured deposits	◐	○	Insured deposits are not subject to bail-in, but loss in liquidation may count towards MREL
	Secured obligations	○	○	Not subject to bail-in, not included in MREL, not included in TLAC

Some member states (e.g. Germany) have taken the statutory route. In connection with implementing the BRRD they have effectively transformed senior debt into intermediate debt, i.e. a class that is senior to subordinated debt but junior to customer obligations, such as corporate deposits and derivatives (Bundes Finanz Ministerium, 2015).<sup>48</sup> This facilitates using

<sup>48</sup> The ECB has issued a mostly favourable opinion of the German proposal. It considers that the subordination of senior unsecured debt would “facilitate resolution action and the implementation of the FSB’s TLAC proposals” by virtue of 1) minimising “the risk of compensation claims under the ‘no creditor worse off’ principle”; 2) making “the bail-in of unsecured bank debt instruments... more effective and credible to market participants,” which should reduce “the need to have recourse to the

senior debt to meet MREL and TLAC requirements. Essentially, the German approach amends by statute the rights that creditors might be able to exercise in the future, if the bank were to become insolvent. Greece has made similar arrangements.

In contrast, other member states (e.g. Italy) have implemented the BRRD in a manner such that senior debt remains *pari passu* with derivatives, corporate deposits and even liabilities excluded from bail-in (e.g. operating suppliers, excluded short interbank deposits). In such cases, bailing in the senior debt would place a disproportionately high burden of loss on senior debt holders, whilst other creditors in the same class (e.g. derivative counterparties) would be treated more favourably. This could give rise to a material risk of successful legal challenge or valid compensation claims due to the “no creditor worse off than in liquidation” safeguard (or NCWO), which broadly requires respect of the creditor hierarchy and equal treatment of similarly situated creditors.<sup>49</sup> The larger the deviation from the creditor hierarchy, the greater the NCWO risk. As a result, such *pari passu* debt does not qualify for TLAC in most circumstances<sup>50</sup> and might be subject to limits in meeting MREL requirements.

More importantly, differences in national implementation of the BRRD mean there will not be a single creditor hierarchy for banks across the EU. Consideration should be given to converging towards one over time along the lines of the German law, so as to create a class of ‘intermediate’ debt that meets the TLAC standard for subordination.<sup>51</sup> At a minimum, there should be EU-wide standards for what makes a circumstance ‘exceptional’.

*Bail-in of derivatives.* The BRRD subjects the obligation of the failing bank to non-defaulting counterparties under derivatives contracts to bail-in after giving consideration to netting and collateral agreements. In concrete terms, the resolution authority will estimate close-out amounts that may be due from the failing bank to non-defaulting counterparties, taking into account the replacement cost that the counterparty might incur. The resolution authority will then deduct any collateral that the failing bank had pledged to the non-defaulting counterparty to arrive at a final unsecured amount due to the non-defaulting counterparty. It is this amount that will be subject to bail-in (written down or converted to equity).<sup>52</sup>

Note that the bail-in of derivatives may yield little or no increment to CET1 capital, once the effects of netting and collateral are taken into account. For this reason the resolution authority

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resolution fund,” thereby “promoting adequate pricing of risk on the side of investors”; and 3) allowing banks to “use some of their already-issued debt instruments to meet the TLAC requirement”. While the ECB acknowledges that the subordination of senior unsecured debt could have adverse consequences (notably on “pricing and capital requirements for holding senior unsecured bank bonds” and on financing costs for banks), it nonetheless implicitly calls for the German proposal to serve as the basis for a common EU-wide framework. See (ECB, 2015). For other comments welcoming the German position, see (FitchRatings, 2015) (Euromoney, 2015).

<sup>49</sup> (Ministero dell'Economia e delle Finanze, 2015). The Italian law gives preference to corporate deposits but leaves senior debt *pari passu* with derivatives. For a discussion of the problems the Italian proposal could create, see (Bschor, 2015) and (ClearyGottlieb, 2015).

<sup>50</sup> G-SIBs in some member states may be permitted to count such debt towards TLAC up to 3.5% RWA in cases where the resolution authority may, under exceptional circumstances, exclude or partially exclude from bail-in all liabilities excluded from TLAC. See Section 11 of the TLAC Term Sheet.

<sup>51</sup> This need not take immediate effect (so as to leave rights of current creditors unaffected) but could be deferred to a later date (say [2022]), possibly with grandfathering privileges for any issues that are currently outstanding but maturing after [2022].

<sup>52</sup> Article 49, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).



may choose to exempt the derivatives contracts from close-out and bail-in on the ground that “the application of the bail-in tool to those liabilities would cause destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in”.<sup>53</sup>

*Bail-in of deposits.* It should be stressed that the power to bail in the bank’s liabilities extends all the way up the creditor hierarchy. In particular, deposits are eligible for bail-in.<sup>54</sup> However, the whole purpose of TLAC and MREL – coupled with the preference given to deposits under the BRRD -- is to avoid getting to the point where deposits would be bailed in (for bailing in deposits is likely to interrupt critical economic functions and may adversely affect financial markets and the economy at large).<sup>55</sup>

If it becomes necessary to bail in deposits, careful planning will be required to minimise the disruption that the bail-in of deposits would cause. In particular, arrangements will have to be made (and be made known to depositors) regarding the amount and availability of funds in their deposit account. Note that for insured deposits, the depositor should retain the full amount (the deposit guarantee scheme will assume any losses attributable to the insured deposits). The issue will be whether the depositor continues to have access to his funds so that he may continue to use their account to make and receive payments.

*The role of the DGS.* The role of the DGS should be separate and distinct from that of the resolution fund. The former’s sole objective should be to protect insured deposits and such liability in the context of resolution should not exceed the losses under normal insolvency proceedings.<sup>56</sup> The introduction of retail and SME depositor preference together with the imposition of MREL materially reduces the risk of retail and SME deposits and the claims that could be made against the DGS, particularly if the authorities do not exercise forbearance and initiate resolution promptly at the point of non-viability (PONV).<sup>57</sup> The objective of the resolution fund is to facilitate resolution more generally and to indirectly absorb losses, provided investors have already borne losses equivalent to 8% of the bank’s liabilities (see above).

*Resolution authorities should implement write-down or conversion of investor obligations in accordance with market principles.* Regarding the terms on which bail-in occurs, resolution statutes mandate that the resolution authority allocate losses in line with the independent valuation of the

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<sup>53</sup> Article 44, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>54</sup> Note that BRRD distinguishes the three categories of deposits: uncovered deposits of large corporates, uncovered deposits held by natural persons and SMEs (preferred), and deposits covered by Deposit Guarantee Scheme (super-preferred).

<sup>55</sup> The BRRD does not mandate protection for large corporate deposits. However, such deposits are a substantial part of the payments system – they may include payments due to employees’ salaries or due for goods and services to others, including SMEs, or amounts due and payable on other corporate liabilities. Bailing them in may therefore cause wider economic damage.

<sup>56</sup> However, the DGS Directive allows member states to use its funds for resolution, in the last instance to prevent a bank failure, and when certain conditions are met. Article 11, OJ 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0049&from=EN>).

<sup>57</sup> The deposit guarantee schemes might be further integrated within the Eurozone. See Gros (2015) for a discussion of the European Commission’s November 2015 proposal for a European Deposit Insurance Scheme.

bank's assets and liabilities, subject to a provision that no creditor should become worse off than it would have been under liquidation according to ordinary insolvency proceedings.<sup>58</sup>

The challenge is to find a practical way to implement the legislation. A full valuation may not be either timely enough or exact enough to allocate loss at the resolution weekend. This creates the risk that forbearance will have to be exercised whilst the valuation is completed, that stabilisation may not succeed and/or that compensation would be due to creditors under the 'no creditor worse off' provision.

Accordingly, the resolution authority may find it efficient to accept a provisional valuation.<sup>59</sup> This should be sufficient to decide the most critical issue at the point of non-viability: where bail-in should stop (i.e. which classes of liabilities should be bailed in). If bail-in extends to a portion of a class (as it does in our example), it should be exercised for the class as a whole – in all probability that will be a necessity to ensure there is no realistic possibility of a successful legal challenge to the bail-in action. That will assure equal treatment of creditors within the class as well as a degree of conservatism in the valuation. Most importantly, such a valuation will allow the resolution authorities to proceed with the bail-in and then move on to the other tasks required to assure successful stabilisation.

There is general agreement that 'strict seniority' should be the principle on which liabilities should be written down and/or converted into common equity. However, there are two schools of thought as to what strict seniority means:

- Strict seniority in the allocation of loss: no loss should be imposed on a class senior to a junior class, unless that junior class has been written off completely and extinguished. For example, no loss should be imposed on AT1 capital unless common equity has been written off and extinguished.
- Strict seniority in the allocation of cash generated from the estate of the failed bank. This corresponds to the treatment of claims in ordinary insolvency/bankruptcy. Under this approach claims remain in force. At the point of entry into insolvency, creditors are given receivership certificates as evidence of their claim on the estate of the failed institution and a stay is placed on payments to holders of such certificates. As the insolvency practitioner winds down the entity in administration, cash may be generated and a dividend to creditors declared. Such dividends are distributed to holders of receivership certificates in order of strict seniority, i.e. certificates evidencing senior debt receive all cash generated by the estate until the claim of the senior debt holders (including accrued interest) is paid in full. Then, cash is paid to holders of certificates evidencing subordinated debt, etc. Any residual cash remaining after all liabilities and administrative expenses have been paid accrues to the holders of receivership certificates evidencing common stock.

In our view, the second approach is preferable, especially if implemented via receivership certificates. In aggregate the outstanding certificates can absorb loss during the entire resolution process. Moreover, such receivership certificates are comparable to what debt-

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<sup>58</sup> Article 47 and 48, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>59</sup> Article 36, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

holders in a normal corporate bankruptcy would receive and are consistent with the ‘true-up’ requirements called for when a provisional valuation is employed.<sup>60</sup>

*Enforceability.* For bail-in to be effective, it must be legally enforceable. For domestic issuance under domestic law in the bank’s home country, this should be the case. Under the BRRD this will also be the case for instruments issued in another member state or under the laws of another member state. However, for instruments issued in third countries and/or under the law of a third country (e.g. dollar-denominated senior debt issued in the US under New York law), investors may seek and receive an injunction from a court in the third country to prevent the bank’s resolution authority from bailing in the liability in question.

To assure that liabilities eligible for bail-in are in fact capable of being bailed in should the need arise, the BRRD requires banks, from the date of respective national implementation of the Directive, to insert into all new issues of senior debt/eligible liabilities such contractual terms that indicate that the instrument is subject to write-down or conversion, if the bank enters resolution.<sup>61</sup> Over time this would assure that the resolution authority could enforce bail-in against all eligible liabilities.

MREL/TLAC. For a bank to be resolvable, there has to be a reasonable assurance that the amount of reserve capital will be sufficient to replenish the bank’s CET1 capital to a level where the bank is not only solvent but able, given sufficient access to liquidity, to continue operation whilst restructuring under the aegis of the resolution authorities. Determining the level of reserve capital therefore requires one to take a view on: i) what constitutes the correct target for CET1 capital after replenishment/recap; and ii) what is the likely state of CET1 capital at the point at which the authorities initiate resolution.<sup>62</sup> Note that it is vital that this replenishment occurs at the bank level. Bail-in at a parent holding company will not in and of itself recapitalise the subsidiary bank or enable the subsidiary bank to continue to perform critical economic functions, unless the capital created at the parent level can be effectively down-streamed to the banking subsidiary (see Box 2). To facilitate the recapitalisation of the subsidiary bank(s), the TLAC standard includes a framework for external TLAC to be down-streamed to a G-SIB’s material subsidiaries in the form of internal TLAC.<sup>63</sup> This internal TLAC is pre-positioned on the balance sheet of the subsidiary bank. The host resolution authority of the subsidiary bank will trigger internal TLAC instruments at the PONV, in coordination with the home authority. Losses are up-streamed to the parent company. This approach means that the subsidiary bank can be recapitalised without having to enter into resolution itself.

As to the target for CET1 after recap, a conservative standard is to assume that CET1 should be replenished so that the bank-in-resolution meets not only the Basel III minimum requirement (4.5% of risk-weighted assets), but also fills the capital conservation buffer (2.5% of RWAs) and possibly some or all of the surcharge on SIFIs currently 1-2.5% of RWAs. This would assure that the bank-in-resolution started the restructuring phase with CET1 capital at the threshold at which a bank outside resolution would be permitted to pay dividends or make

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<sup>60</sup> Article 36 (10 and 11), OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>61</sup> Article 55, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

<sup>62</sup> (Huertas 2015).

<sup>63</sup> See Sections 16 to 19 of the TLAC Term Sheet.

distributions without restrictions.<sup>64</sup> More importantly, it will help ensure that the bank is sufficiently well capitalised to command market confidence. This will be necessary to ensure that counterparties continue to trade with the resolved bank and provide funding to it.

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<sup>64</sup> According to the Bank of England (2014, p. 21), “The goal of ensuring that the firm can operate unsupported means that the firm must be recapitalised to a level that is sufficient to restore market confidence and allow the firm to access private funding markets. This means that the level of capital held by the firm is likely to need to be higher than the minimum required for authorisation by the relevant supervisor.” The European Banking Authority (2014a) takes a similar approach as does the Federal Reserve Board (2015).

*Box 2. Where should bail-in occur?*

To be effective, bail-in has to occur at the operating bank level. It is the conversion of the obligations that the bank has issued to investors (one of which may be the bank's parent holding company) that serves to recapitalise the bank. The write-down or conversion of the parent holding company's debt held by third-party investors does not in and of itself recapitalise the subsidiary bank.

*Table 4. Bail-in at parent does not recapitalise the subsidiary bank*

a.) Parent holding company only      IC initial condition      BB bail-in at banks  
 LB loss (100) in bank sub.      BP bail-in at parent

Assets	IC	LB	BP	BB	Liabilities	IC	LB	BP	BB
CET1 in bank sub	100	0	0	100	CET1	100	0	100	100
Sub debt (T2) in sub	100	100	100	0	AT2	0	0	0	0
					T2	100	100	0	0
Marketable securities	50	50	50	50	Senior debt	50	50	50	50
Total	250	150	150	150	Total	250	150	150	150

b.) Bank subsidiarity

Assets	IC	LB	BP	BB	Liabilities	IC	LB	BP	BB
Loans	1000	900	900	900	CET1	100	0	0	100
Investments	1000	1000	1000	1000	Sub debt (T2) (AT1-0)	100	100	100	0
					Other customer obligations	300	300	300	300
					Deposits	1500	1500	1500	1500
Total	2000	1900	1900	1900	Total	2000	1900	1900	1900

Bail-in at the parent does of itself not affect the balance sheet of the subsidiary bank. The recapitalisation of the parent has no direct impact whatsoever on the level of CET1 capital in the bank subsidiary. This is illustrated in Table 4. Initially (see column IC), the parent has assets of 250 consisting of investments in the CET1 capital of its bank subsidiary (100), the T2 capital of the bank subsidiary (100) and marketable securities (50). The bank subsidiary then suffers a loss of 100 in its loan portfolio (see column LB). This reduces the bank subsidiary's CET1 capital to zero. At the parent level, its investment in the bank's CET1 capital is written down to zero, and this causes an equivalent reduction in the parent's own equity. This too falls to zero.

The parent now bails in the subordinated debt that it has issued to third-party investors (see column BP). Tier 2 debt falls from 100 to zero, and CET1 capital at the parent increases from zero to 100. That is all the bail in at the parent does. It does not create capital at the subsidiary level.

To recapitalise the bank subsidiary, it is necessary either to bail-in (via write-down or conversion) obligations that the bank subsidiary had previously issued to the parent, or for the parent to inject new equity into the bank subsidiary. The bail-in at the bank subsidiary is illustrated in column BB. The bank's T2 capital is converted into CET1 capital. The former falls from 100 to zero, whilst the latter rises from zero to 100. These changes are also reflected on the asset side of the parent only balance sheet. The critical issue, here, is that appropriate obligations are due from the subsidiary to the parent which can be written-down or converted under the

powers of the BRRD, or even as a consensual inter-company debt for equity swap. The nature of the inter-company obligation could be capital (AT1 or T2) or internal TLAC or MREL.

Alternatively, if the parent holding company's cash and marketable securities are to be the source of funds for the recapitalisation of the subsidiary bank, the parent will have had to take steps to assure that i) the cash would in fact be available, when the bank subsidiary reached the PONV/entered resolution, and ii) the cash would indeed be used to recapitalise the failed bank subsidiary.

The likely state of the bank's CET1 capital upon entry into resolution depends largely on whether the authorities initiate resolution ('pull the trigger') promptly at the PONV or exercise forbearance. If they do the former, there is a greater probability that the bank still has positive net worth and positive CET1 capital. In this case, a reserve capital requirement equal to the target described above is likely to be sufficient. In contrast, if the supervisor and/or central bank exercise forbearance, such a reserve capital requirement may be insufficient.

The BRRD meets the criteria outlined above. It requires each bank to maintain the amount of own funds and eligible liabilities at a minimum required level (MREL). As mentioned above, MREL is similar to, but not identical with, the total loss-absorbing capacity (TLAC) requirement being developed by the FSB for G-SIBs (see Table 2 above).<sup>65</sup>

The MREL requirement is bank-specific and takes into account any exclusion from bail-in that the resolution authority may have made. The BRRD empowers the bank's resolution authority to set the level of MREL for the bank, so that

the institution has sufficient eligible liabilities to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU and to sustain sufficient market confidence in the institution or entity. (EBA, 2014a).

In determining MREL the resolution authority should also take into account the individual bank's size, model (business and funding) and risk profile, as well as the extent to which DGS contributes to financing the resolution and the potential threat of bank's failure on the stability of financial system.<sup>66</sup> Taken together, these conditions are intended to assure that MREL provides

sufficient loss absorbing capacity ... [to] ... enable an orderly resolution, ensuring continuity of critical functions without recourse to public funds (EBA, 2014a).

Finally, it should be noted that the resolution authority has the option to impose the TLAC requirement as the means by which the bank should fulfil some or all of the bank's MREL

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<sup>65</sup> Note that a reserve capital requirement targets much more exactly the problem at hand, namely assurance that there will be instruments available to convert into CET1 capital, in the event that the bank goes into resolution, but has the disadvantage of discouraging banks from holding equity in excess of minimum requirements (and so making failure more likely in the first place). The FSB TLAC proposal (FSB, 2014) envisages that such "reserve capital" instruments would constitute at least one-third of TLAC, as does the Federal Reserve Board's NPR (2015) with respect to TLAC for bank holding companies.

<sup>66</sup> Article 44.6, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).

requirement. Resolution authorities within the EU should implement this option, at least for G-SIBs.

*Assuring the bank-in-resolution can reopen for business*

Although recapitalisation of the bank-in-resolution is necessary to stabilise the bank-in-resolution, it is not sufficient. To assure continuity of critical economic functions it is also necessary to assure that the bank-in-resolution:

- i. retains the authorisation(s) and licence(s) that it requires;
- ii. retains access to financial market infrastructures;
- iii. retains access to support services from affiliates and third parties;
- iv. does not incur termination of qualified financial contracts (QFCs), such as derivatives (the bank needs to remain hedged) and repurchase agreements (repos – the bank needs to maintain access to secured financing lines);
- v. has access to adequate liquidity; and
- vi. corporate deposits are protected, to the extent necessary to avoid consequential economic disruption to the payment systems, third-party suppliers, corporate employee salaries, etc.

For banks that are internationally active, these preconditions must be met, not only in the bank's home jurisdiction, but in all the jurisdictions in which the bank has material branches and/or subsidiaries. To achieve this, a certain degree of international cooperation among resolution authorities, central banks and supervisors will be required.

*Authorities should take steps to assure bank-in-resolution can retain authorisation(s) and license(s).* For the bank-in-resolution to continue in operation, it is necessary for the bank to retain its authorisation(s) and license(s). In other words, the entry of the bank into resolution should not result in the revocation of the bank's license and a requirement for the bank-in-resolution to reapply for a license. Instead, a process should be in place to treat the entry into resolution as a change-in-control process, with control passing from the owner of the bank to the resolution authority and pre-approval of the resolution authority as 'fit and proper' to run the bank in resolution.

This will generally be the case for domestic banks or institutions headquartered in the banking group's home country, but may give rise to issues for internationally active groups. It is particularly important that host-country authorities not take the decision of the home country to place the bank into resolution as the occasion or justification to:

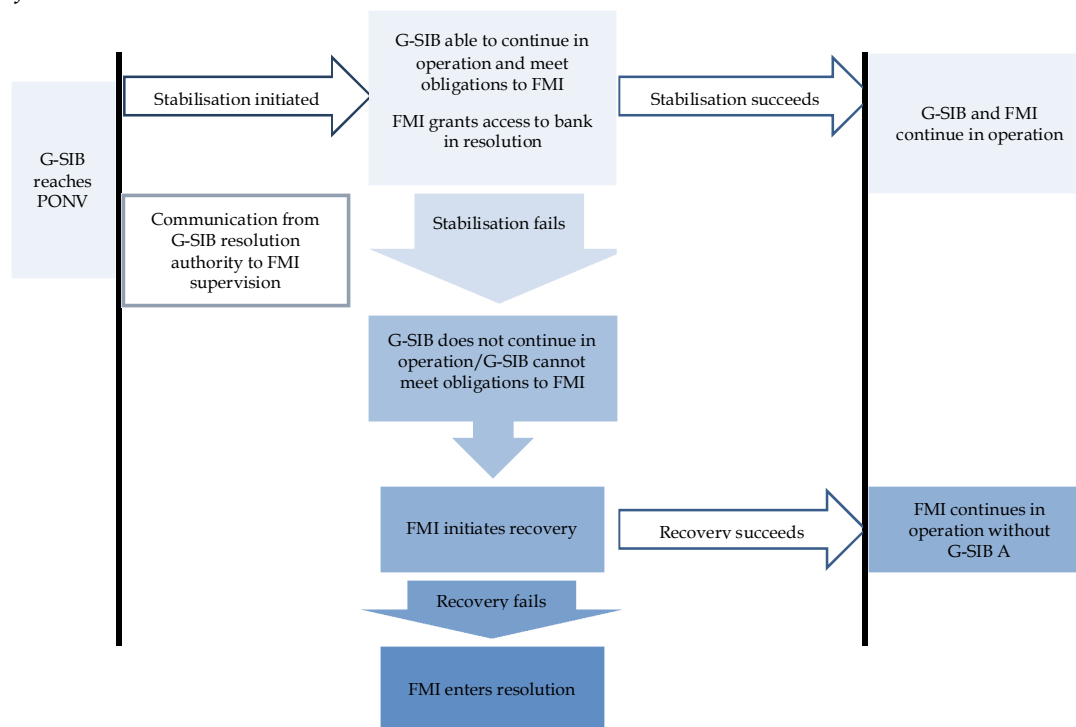
- place the bank-in-resolution's branch in the host-country into a separate and distinct resolution proceeding,<sup>67</sup> or
- place the bank-in-resolution's subsidiary in the host country that meets the host-country's threshold requirements into resolution.

*Authorities and FMIs should assure that the bank-in-resolution continues to have access to FMIs, such as payment systems, securities settlement systems and central counterparties.* If the bank-in-resolution is to function normally upon reopening for business after resolution, it will certainly need access to FMIs. Otherwise, it will not be able to make or receive payments, settle securities transactions or conduct derivative transactions.

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<sup>67</sup> For a discussion of this possibility see (Lee, 2014).

Figure 4. Continuity requires more than recap: Bank needs to retain access to financial market infrastructures



Source: Author.

To assure that continuity is in fact preserved, the resolution regimes for banks should be coordinated with those for the FMIs (see Figure 4). In particular, the FMI should not be allowed to exclude a bank from the FMI solely on the basis that the bank or one of its affiliate entities has gone into resolution. Provided the bank-in-resolution has continued to make payments as due to the FMI (i.e. there has been no default on a cash obligation by the bank), the FMI should delay excluding the bank-in-resolution from the FMI as well as delay initiating loss allocation mechanisms within the FMI (the ‘waterfall’) for a period to allow the resolution authority to indicate that it has a) recapitalised the bank and b) assured adequate liquidity for the bank. With such assurance, the FMI can keep in force the membership of the bank in the FMI. That will not only facilitate the resolution of the failed bank, but help assure that the FMI remains robust.

*Resolution plans should ensure that the bank-in-resolution retains access to services from affiliates and third parties.* To function effectively, the bank-in-resolution will require operational services such as IT infrastructure and transaction processing. Where these are provided externally by third parties, contracts should ensure that the entry of the bank into resolution will not cause an immediate disruption of service.

Where the services are provided internally, steps need to be taken to assure that such services will continue to be provided to the bank-in-resolution. This should be the case where the services are provided within the bank that goes into resolution. The recapitalisation of the bank creates the basis for operational continuity that focuses on provision of the critical services, and hence enables continuity of the bank as a whole. However, if a bank receives services from another affiliate within the group, the supervisor and resolution authority of that bank will want to assure itself that such services will continue to be provided, even if the service recipient or the service provider enters resolution.



One possible method is to create a separately incorporated service company that will house the service capabilities for the group and contract with third parties as necessary for provision of services to the group. This service company would be capitalised and financed so that it had sufficient working capital to pay all of its expenses for a certain period, and contracts with service recipients within the group would be drawn so as to assure that the service company continued to provide service, even if the recipient entity were to enter resolution.

*Resolution plans should assure that qualified financial contracts do not terminate upon entry of the bank or any bank affiliate into resolution.* Certain obligations, known as qualified financial contracts (QFCs), may pose a barrier to resolution.<sup>68</sup> Upon an event of default, the claim becomes immediately due and payable (it is exempt from the stay on payments to creditors). If the claim is not repaid, the holder of such obligations has the right to liquidate any collateral that the bank may have pledged to it and to keep the proceeds of such sale in satisfaction of the obligation. If the proceeds of the sale are insufficient to repay the obligation, the holder has an unsecured claim on the bank in default for the difference. If the proceeds of the sale are greater than the amount of the obligation, the holder returns the excess to the bank in default.

The two principal types of qualified financial contracts are repurchase agreements<sup>69</sup> and derivative contracts. Together these instruments account for a significant share of a bank's balance sheet, particularly for banks with heavy involvement in trading activities. The obstacle to resolution stems from the fact that the lender or non-defaulting derivatives counterparty has the right to sell the collateral pledged to it upon an event of default. When selling the collateral, the lender/derivatives counterparty is primarily interested in getting a price sufficient to repay the loan with interest. Beyond that point any proceeds belong to the borrower. As a result, the lender may be inclined to accept offers for the collateral that effectively give up much if not all of the haircut that the lender had originally imposed.

The loss of the haircut has two effects – first, it increases the loss that the bank-in-resolution has to incur and increases the probability that bail-in will have to extend beyond investor obligations to unsecured customer obligations such as deposits. That would compromise continuity. Second, the sale of the securities pledged under repurchase agreements is a source of contagion from the bank-in-resolution to financial markets and potentially to the economy as a whole. If the sale results in the loss of the haircut, it may imply a decline in the market price and a fall in income and capital at all the institutions in the market that hold such securities in their trading (mark-to-market) book. This effect is amplified, if the securities sold serve as a reference in the valuation of Level 2 or Level 3 assets. Hence, the sale of securities pledged by the bank-in-resolution can pose significant problems for the market as a whole.

Similar problems arise in connection with derivatives contracts. Under netting agreements, the counterparty to the bank-in-resolution can terminate the derivatives contracts that it has with the bank-in-resolution. Upon termination the non-defaulting counterparty (NDC) calculates a close-out amount that the bank-in-resolution would owe under the netting contract. In making

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<sup>68</sup> For a discussion of the impact of QFCs on resolution, see Roe (2011).

<sup>69</sup> Under a repurchase agreement, the lender buys securities from the borrower, who enters into a commitment to repurchase at the maturity of the agreement the securities at a fixed (and somewhat higher) price than the lender originally paid to the borrower. This difference in price is the economic equivalent of interest on a loan. The securities transferred to the lender by the borrower are the economic equivalent of collateral. The price paid by the lender for the securities is at a discount or 'haircut' to market value. This haircut serves to protect the lender against loss in the event that the borrower fails to repurchase the securities at the agreed price upon maturity. In effect, the haircut protects the lender against a possible fall in the price of the securities purchased from the borrower.

this calculation, the NDC is allowed to use its replacement cost. In other words, the NDC makes the calculation not at the mid-market rate that the bank-in-resolution had used to value its contracts but at the end of the bid-offer spread that favours the NDC. This increases the amount due to the NDC, and this large(r) amount becomes immediately due and payable upon an event of default by the bank-in-resolution.

Under margining agreements, the bank-in-resolution may have pledged collateral to the NDC as security that it would in fact be able to pay the amount due the NDC, if close-out were invoked. Under the terms of the derivative contract, the NDC has the same rights as the lender under a repurchase agreement to sell the collateral in satisfaction of its claims and to keep the proceeds. Accordingly, the same issues arise in connection with collateral pledged in connection with derivative contracts as those related to repurchase agreements (see above).

To avoid these problems, resolution regimes envisage placing a stay on the ability of lenders under repurchase agreements and counterparties to derivative contracts to exercise their rights of termination. The purpose of the stay is to allow the resolution authority to arrange for the bank-in-resolution to be in the position to meet its obligations under the contracts. Either the bank-in-resolution is recapitalised via bail-in, or the resolution authority transfers the contracts to a bridge bank that will continue in operation.

This is at best a partial solution. The stay may not be enforceable in foreign jurisdictions or for transactions concluded under foreign law. Relying solely on a stay also leaves open the possibility that the lenders and/or counterparties would elect to terminate as soon as the stay expires. What is needed is a mechanism that assures that they will not. Nor does the stay alone cure the complications that arise, if a bank's parent holding company has guaranteed the performance of the bank subsidiary under such contracts. In such cases, the entry of the parent holding company into resolution or bankruptcy can trigger termination of repurchase agreements and/or derivative contracts under the cross-default provisions usually found in such contracts. This gives rise to the adverse effects described above and may obviate the so-called single point of entry approach to resolution (see below).

Perhaps the simplest way to overcome the barriers to resolution posed by qualified financial contracts is to exclude the entry into resolution as an event of default and to limit the right to terminate to the actual failure by the bank-in-resolution to meet a cash obligation due in full and on time. In any event, steps should be taken to eliminate the ability to terminate contracts at the bank level, unless there is a default at the bank level. The entry of a parent holding company into resolution or bankruptcy should not trigger cross-default provisions in qualified financial contracts at the bank level.

*Resolution plans should assure that the bank-in-resolution has adequate liquidity. Continuity of critical operations can only be assured, if the bank-in-resolution has access to adequate liquidity.*

The liquidity demands on the bank-in-resolution could be very large indeed. As soon as the bank-in-resolution opens for business, there is the very strong likelihood that any funds provider entitled to withdraw its money will do so. Additionally, inflows of cash into the bank-in-resolution are likely to decline dramatically. Where possible, clients of the bank-in-resolution will have changed their settlement instructions to stop their counterparties from paying in money to their accounts at the bank-in-resolution.

Consequently, for stabilisation to succeed, the bank-in-resolution must have lined up adequate sources of liquidity prior to re-opening for business. Collateral is key. Once the bank has entered resolution, any provider of liquidity is likely to insist that this is done on a fully

collateralised, super-senior basis in a manner analogous to the provision of debtor-in-possession financing in US Chapter 11 bankruptcy proceedings.

The framework for such a liquidity facility needs to be put in place well in advance of the bank being put into resolution. The framework should cover four factors:

- (i) *The priority of the liquidity facility relative to other liabilities on the bank in resolution.* As a practical matter, liquidity facilities to the bank in resolution will need to be on a super-senior basis so that they would have priority in liquidation over all unsecured creditors.
- (ii) *The pool of collateral backing the facility.* As a practical matter this should be a charge over the unencumbered assets of the bank in resolution, including without limitation the investments of the parent bank in its subsidiaries. Any proceeds from asset sales should go towards repaying the facility.
- (iii) *The allocation of loss, should the bank in resolution fail to repay the facility and the liquidation of the collateral prove insufficient to repay the facility.*
- (iv) *How and where the bank in resolution might draw on such a liquidity facility.* Whilst private sources of funding are preferable and should be maximised to the extent possible, such sources are unlikely to be able to fully meet the liquidity and funding requirements of a large bank, particularly a G-SIB. For such firms, an effective public-sector backstop mechanism is necessary in order to promote market confidence in the bank-in-resolution and to encourage private sector counterparties to provide (or continue to provide) funding to the bank-in-resolution. Of course, the availability of a public-sector funding mechanism may pose moral hazard risk, and authorities will have to ensure that such funding is provided in a way that minimises this risk.

To facilitate the possible arrangement of liquidity to a bank-in-resolution, it would make sense for the authorities to require banks whilst healthy to:

- *Assure that they can seamlessly transfer collateral pledged to one lender (e.g. a repo provider) to another.* Much of the demand for liquidity at the bank's re-opening for business will come from lenders who are secured, but who would prefer to avoid the possible complications that could arise if the resolution process were to become disorderly. Repayment of such lenders should bring about the immediate return of the collateral pledged to such lenders.

This should be done on the basis of repayment versus release, so that the bank in resolution regains control over the collateral pledged to the lender being repaid at the same time that the repayment occurs. This will facilitate the ability of the bank-in-resolution to pledge the returned collateral to the new liquidity provider.

- *Keep track of their unencumbered assets and assure that they can be pledged as collateral.* To the extent that the bank-in-resolution has unencumbered assets, these can potentially serve as collateral for the liquidity provider, if the bank-in-resolution can provide documentation as to their amount. This will only be possible, if the bank-in-resolution can retrieve such information from systems established well before the supervisor pulled the trigger to resolution, such as those that might be used to support the development of a so-called collateral budget.<sup>70</sup> The provider of funding may have to

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<sup>70</sup> A collateral budget would "track - in current market value terms - the amount of unencumbered assets available to the bank, and estimate the amount, timing and location of the cash the bank could realise, if it were to sell the asset or use the asset as collateral to raise funds from private lenders and/or

be willing and able to accept a broad range of unencumbered assets, given that the bank-in-resolution may have relatively few high-quality liquid assets available to secure funding.

- *Put in place pledge agreements that could be activated, if the bank were to enter resolution.* This will assure that the potential liquidity provider can rapidly obtain control over the collateral that the bank-in-resolution has available to pledge.
- *Conduct periodic ‘fire drills’ to test operational procedures required for a rapid pledge of collateral to a liquidity provider.* If a bank does enter into resolution, liquidity provision to the bank-in-resolution must function without a hitch. To assure that it does, if required to do so, it makes sense to rehearse the concrete steps that the bank-in-resolution would have to take to pledge assets to a liquidity provider. The bank may also wish to consider (and the supervisor may require) the bank to pre-position collateral with the central bank, especially during the recovery phase (possible run up to resolution).

The above steps are the minimum that can and should be done whilst the bank is healthy so that liquidity provision can proceed smoothly, if the bank does enter resolution. However, more could be done in advance, both to assure that the bank had unencumbered assets to serve as collateral as well as to set the terms and conditions on which a liquidity provider might extend credit to a bank-in-resolution.<sup>71</sup>

Finally, a word on documentation. As noted above, the first step is to assure that the liquidity provider can take a pledge over collateral assigned by the bank-in-resolution to the liquidity provider. As a practical matter, this has to be established well before the bank enters resolution. Ideally, the authorities should also indicate the terms of a draft framework agreement under which liquidity could be provided to the bank in resolution, if a decision were made to provide the facility. This would include covenants on the bank-in-resolution, such as: i) a requirement that any proceeds from the sale of assets should go towards paying down the facility; ii) a prohibition on paying any dividends or making any distributions to the holders of proceeds notes (see above) until such time as the liquidity facility has been fully repaid with interest; and iii) a prohibition on the bank’s pledging unencumbered assets as collateral to third parties without a corresponding reduction in the outstanding liquidity facility or a waiver from the provider of the liquidity facility.

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central bank under one or more of its normal lending facilities. Such a collateral budget should take into account the potential additional demands that counterparties will place on the bank to post collateral as the condition of the bank deteriorates as well as the possibility that lenders of collateral to the bank will run on the bank, just as lenders of cash (e.g. uninsured depositors) are withdrawing their funds. In particular, the bank should evaluate the probability that clients would curtail or cancel the ability of the bank to re-hypothecate to its lenders the securities that the client has pledged to the bank.” (Huertas, 2014b, p. 31).

<sup>71</sup> On asset encumbrance, see (CGFS, 2013). From the standpoint of the bank-in-resolution, the greater the amount of unencumbered assets the bank has, the greater the potential funding the bank can obtain. One place to start is to assure that the bank restricts pledges of collateral to the trust for its covered bonds and securitisation issues to the minimum required under the indentures to such instruments. But that may not be enough to assure that the bank has unencumbered assets to offer as security to a liquidity provider to the bank-in-resolution. Consequently, it may make sense to put limits on the encumbrance that a bank may incur whilst healthy so that it has some collateral in reserve, should it enter recovery or resolution.

Note that such a draft framework agreement need not imply that the authorities themselves would provide liquidity to the bank-in-resolution. In particular, the central bank need not provide credit to any institution that it considers unviable, and the central bank should make clear that meeting the conditions set out in the framework agreement are a necessary but not necessarily sufficient condition for the central bank to provide credit to the bank-in-resolution.

However, setting out the terms of a framework agreement in advance is a step towards what might be called “constructive certainty”. This has two advantages. First, it puts holders of the bank’s investor obligations on notice that if the bank-in-resolution does obtain a liquidity facility, it will be on a collateralised basis and that the bank-in-resolution will have to fully repay the facility before it can make distributions or pay dividends to the holders of proceeds notes. That in turn should induce investors to demand information from the bank regarding the amount of its unencumbered assets as well as limit the pledge of such assets to the pools backing the bank’s covered bonds and/or securitisation issues.

Second, setting out the terms of the framework agreement may make it possible for private-sector lenders to participate in the liquidity facility to the bank-in-resolution, for it outlines what the authorities are likely to permit the bank-in-resolution to do as well as the additional covenants that the lender would enjoy.

### **2.3 Resolution plans should create a safe exit**

Stabilising the bank-in-resolution is the first and most important step towards assuring that the failure of the bank will not significantly disrupt financial markets or the economy at large. But stabilisation is not the end of the story. The goal of the resolution authority in the restructuring phase is to work itself out of a job: either to sell the bank to a third party, to return the bank to the private sector or to wind the bank down. To do so, the resolution authority will need the appropriate powers and be able to draw upon previously completed analyses and plans. Clarifying the rights of creditors during the restructuring process can also accelerate the restructuring as well as facilitate the sale of “reserve capital” instruments to investors.

*Resolution regimes should assure that the resolution authority has adequate powers.* During the restructuring phase, the resolution authority must determine the future course of the bank-in-resolution. It is therefore vital that the resolution authority have the same type of powers as an administrator or insolvency practitioner has in normal bankruptcy proceedings, including the ability to sell lines of business, individual subsidiaries or the bank as a whole.

The BRRD provides for this. It authorises the resolution authority to take control of the bank under resolution. The resolution authority can take all business decisions, including without limitation removing or replacing senior management, or transferring the bank (or all or any of the bank’s rights, assets and liabilities) to a purchaser. To exercise such powers, the resolution authority need not obtain any additional approval or consent, or file notification prior to taking the actions.

*The resolution authority should be prepared to act quickly.* Even if the stabilisation has been successful, the resulting bank may be brittle. Although the amount of MREL will be calculated so as to provide an ample cushion of capital for the bank-in-resolution (see above), customers may nonetheless shift their business away from the bank-in-resolution, and the bank’s key employees may depart. If this were to occur, the franchise value of the bank-in-resolution could quickly erode.

For this reason, the resolution authority may need to move quickly to sell assets, lines of business or even the firm as a whole to third parties who have the capital strength and funding

necessary to sustain the business on an ongoing basis. Indeed, as part of its resolution planning, the resolution authority should form an idea of the assets that it could sell and to whom, with the most logical candidates for rapid sale perhaps being transactions involving the assets and/or businesses that the bank may have identified in the recovery phase but failed to complete.

For those businesses that the bank-in-resolution cannot immediately sell, the resolution authority will have to decide whether to keep the business going (in the hope that it can be sold later) or to wind the business up.<sup>72</sup> The most pressing problem is likely to be liquidity – how can the bank-in-resolution fund the assets that remain on its books? Without funding, liquidation is practically the only choice open to the resolution authority. With funding, the resolution authority has the opportunity to conduct restructuring in a more orderly, but nonetheless rapid manner.

*Clarifying the rights of creditors can accelerate restructuring* and help assure that creditors are in fact no worse off than they would have been under liquidation. In economic terms, the bailed-in creditors are collectively the owners of the bank-in-resolution. They have a claim (in order of seniority) on the cash flows that the bank-in-resolution may generate, once any official liquidity facility is repaid. But the bailed-in creditors do not have primary decision rights over the restructuring process. This rests with the resolution authority, and the resolution authority need not seek approval of its resolution plan from the bank or its creditors.

In general, resolution regimes provide that creditors should be no worse off than they would have been under liquidation. To the extent that a creditor is worse off, it has a claim for compensation. To limit the possible amount of such claims and to induce creditors to play an active and constructive role in the restructuring process, it may therefore make sense to accord creditors some of the same rights that they would ordinarily enjoy in a bankruptcy proceeding for a non-financial corporation, particularly in the case where investors have obtained receivership certificates during the stabilisation phase.<sup>73</sup>

Since such rights would accrue to creditors as a class, banking organisations as well as resolution authorities may find it advantageous to put in place a mechanism to allow creditors to function as a class. Ideally, such a mechanism would be put in place whilst the bank is healthy so that it could function immediately upon the entry of the bank into resolution.<sup>74</sup>

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<sup>72</sup> Such a wind-down can be on a solvent or insolvent basis.

<sup>73</sup> See Annex 2 for a specification of the kind of right that it might include.

<sup>74</sup> Such a mechanism might include:

- a registry of the owners of the instruments in the class;
- a process to allow for transfers of ownership of the instruments in the class. Voting rights for matters affecting the class should be linked to the ownership of the instrument.
- a process to notify such owners of material information pertaining to the class, including any voting materials;
- an accelerated voting process;
- cram-down provisions. Approval by a supermajority (e.g. 75%) of the votes in a class shall bind the class – court-sanctioned schemes of arrangement under English law which bind a class of creditors (and so go beyond obligation-by-obligation consent solicitations) have much to recommend in this regard. One was successfully used to recapitalise the Co-operative Bank.
- a standing creditors' committee to represent the interests of the class vis-à-vis other classes and the resolution authority. Prior to the entry of the bank into resolution, the main functions of this standing creditors' committee would be to monitor the covenants that the instrument might

From a public policy point of view such a mechanism would enhance market discipline. In particular, it would reinforce to creditors that they were at risk if the bank entered resolution. They would be bailed in, not bailed out. From a creditor point of view, such a mechanism (particularly the standing creditors' committee) would facilitate monitoring (and so reduce the risk that the bank would enter resolution) as well as help reduce loss-given resolution.

### 3. Preparation is essential, if resolution is to succeed in practice

As the above discussion demonstrates, resolution may be feasible in concept, but has certain challenges to overcome, before one can be certain that resolution will succeed in practice. With respect to the bail-in tool, these challenges principally relate to the stabilisation phase. Triggering resolution in turn triggers the need to bail in the appropriate amount of eligible liabilities, avoid termination of qualified financial contracts, retain access to financial market infrastructures, and assure adequate liquidity, etc. all within 36 to 48 hours and all in coordination with authorities around the world.

Meeting these challenges will be easier, if steps have been taken during what might be called the runway period – by the authorities and by the bank itself -- to prepare for the bank's resolution. For the authorities, such steps would include:

- finalising the resolution plan and securing in advance all necessary approvals;
- commissioning an independent valuer to undertake the valuations required to make a determination that the bank should enter resolution and to evaluate the use of the bail-in tool; and
- developing the communications plan to the public at large as well as to all relevant stakeholders.

For the bank, such steps would include:

- running the bank in accordance with its recovery plan;
- preparing all data that the resolution authority would require in order to effect stabilisation of the bank, including without limitation:
  - the schedule of the bank's liabilities ranked according to the creditor hierarchy;
  - the netting agreements with the bank's principal counterparties (including any stay provisions) as well as an estimate of the value of the bank's net position if the counterparty were to close out against the bank;
  - the amount of collateral pledged to lenders to back the bank's secured funding;<sup>75</sup>
  - the amount and type of the bank's unencumbered assets as well as their eligibility for discount under normal central bank lending facilities;
  - a schedule of MREL instruments containing terms and conditions on which such instruments could be written down or converted into common equity;
  - such information as the independent valuer requires to make the valuations required under the BRRD; and

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contain and to exercise any rights that the creditors might have under such covenants as well as to negotiate possible debt for equity swaps.

<sup>75</sup> The bank should also take steps to remove 'excess' collateral from the pool pledged to the lender (i.e. collateral over and above the minimum amount necessary to secure the facility).

- up-to-date playbooks concerning how the bank would interact with service providers, financial market infrastructures and liquidity providers, if the bank were to enter resolution.

Should the distressed bank refuse or prove unable to perform these tasks on its own initiative, the supervisor should employ its early intervention powers to force the bank to do so.<sup>76</sup>

#### 4. Conclusion and Policy Recommendations

The BRRD puts in place a legislative framework that is consistent with the FSB's key attributes for effective resolution regimes. The BRRD therefore creates the potential to make banks resolvable and bring an end to the too-big-to-fail phenomenon. To realise this potential, EU member states have established institutions at national, eurozone and EU level to create and, if necessary, execute resolution plans for EU banks and banking groups.

This is a strong foundation. But it will not be enough to build an effective resolution regime. The authorities -- in the EU and in the third countries in which EU banks do business -- must be willing to put promptly into resolution any bank that reaches the point of non-viability, able to use the appropriate tools to stabilise the bank-in-resolution and ready to restructure the bank, once stabilised, so that it can exit resolution safely.

Planning and coordination hold the key to success. Resolution is a complex process, and the stabilisation phase has to be accomplished at great speed, if the continuity of critical economic functions is to be assured. Planning can establish what is likely to work and what won't. Planning can also identify (and possibly remove) the obstacles that stand in the way of turning "won't" to "will", so that one can be confident that, should it become necessary to pull the trigger, resolution will in fact make banks safe to fail.

It is in this spirit that this report has offered a number of policy recommendations. The four principal recommendations are:

1. *Create constructive certainty.* Each significant bank's crisis management group should develop and make known the 'preferred path' they intend to employ, if it becomes necessary to place the bank into resolution. This should not only evidence cooperation and coordination among authorities across borders but also reinforce with investors that they are at risk, if the bank fails.
2. *Respect the market.* For bail-in to work, the investor obligations most likely to be subject to bail-in (AT1 and T2 capital plus qualifying 'intermediate' debt) must function 'back to front'. Investors need to know, not only that they will be subject to loss, but what they might recover or at least the process by which they might recover some of their investment. The closer resolution gets to normal insolvency procedures the better the 'back' end of the instrument will function and the easier it will be to place the obligations with investors at the 'front'.

In practical terms this means using the *a priori* valuation at the PONV to determine how far up the creditor hierarchy bail-in should extend; issuing receiver certificates to each class of liabilities subject to bail-in; and allocating any excess cash flow generated by the bank-in-

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<sup>76</sup> Article 27(1)(h) empowers the supervisor to acquire, including through on-site inspections and provide to the resolution authority, all the information necessary in order to update the resolution plan and prepare for the possible resolution of the institution and for valuation of the assets and liabilities of the institution in accordance with Article 36, OJ L 173 of 12.6.2014 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>).



resolution to creditors according to strict seniority (whilst treating creditors within each class equally). In addition, resolution authorities should seek to accord creditors during the restructuring phase some or all of the rights that creditors would have under normal insolvency procedures.

From a legislative perspective, consideration should be given to harmonising the credit hierarchy across member states so as to create an 'intermediate' class of obligations that are senior to subordinated debt but junior to operating liabilities, such as deposits and derivatives. This class would qualify as MREL.

3. *Maintain continuity.* In addition to requiring banks to take steps to maintain continuity of services, authorities should take steps to assure that a bank-in-resolution retains its authorisation(s) and license(s) and continues to have access to FMIs.
4. *Look after liquidity: Central banks should lend to solvent banks in viable condition on the basis of sound collateral.* Concretely put, central banks should refrain from offering to finance banks where shortfalls in capital have driven the bank to the PONV. There should be no forbearance. Banks reaching the PONV should be put into resolution, not given ELA. To facilitate such an outcome, responsibility for emergency liquidity assistance within the eurozone should be transferred to the ECB from national central banks. As an input to such a decision, the Single Supervisory Board should provide an opinion to the Governing Council of the ECB regarding the distressed bank's viability.

Conversely, once the bank-in-resolution has been recapitalised, it should have access to liquidity upon the security of sound collateral. Ideally, the recapitalised bank would be able to obtain such funding from private sources. Practically, however, it will not be able to do so unless it has the same access to central bank facilities as other banks. Denying the recapitalised bank access to such a backstop hardly inspires market confidence. Allowing such access signals to the market that the recapitalised bank again meets the minimum standards for authorisation.

To facilitate access to liquidity, banks will need to keep track of their unencumbered assets as well as be able to value and pledge such assets to potential (official and/or private) liquidity providers.

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## Annex 1. National competent (supervisory) and national resolution authorities

Member state	Supervisory authority	Resolution authority
Austria	Oesterreichische Nationalbank in cooperation with Financial Market Authority	Financial Market Authority
Belgium	Financial Services and Markets Authority	National Bank of Belgium
	National Bank of Belgium	Resolution College (part of National Bank of Belgium)
Bulgaria	Financial Supervision Commission	Bulgarian National Bank
Croatia	Croatian Financial Services Supervisory Agency (HANFA)	Croatian National Bank
Cyprus	National Bank of Cyprus	National Bank of Cyprus
	Cyprus Securities and Exchange Commission	
Czech Republic	Czech National Bank	Czech National Bank
	Ministry of Finance	
Denmark	Danish Financial Supervisory Authority / Finanstilsynet	Financial Stability Company
Estonia	Financial Supervision Authority	Ministry of Finance
	Eesti Pank	
Finland	Financial Supervisory Authority	Suomen Pankki / Bank of Finland
	Suomen Pankki / Bank of Finland	
France	Autorite des Marche Financiers	Autorite de Controle Prudentiel et de Resolution
Germany	BaFin	Federal Agency for Financial Market Stabilisation (FMSA)
	Bundesbank	
Greece	Department for the Supervision of Credit and Financial Institutions of the Bank of Greece	Bank of Greece -- Resolution Measures Committee
Hungary	Hungarian Financial Supervisory Authority	Magyar Nemzeti Bank (Central Bank of Hungary)
Ireland	Central Bank of Ireland	Prudential Analytics & Resolutions Division within the Central Bank
		Ministry of Finance
Italy	Bank of Italy	Bank of Italy

<b>Member state</b>	<b>Supervisory authority</b>	<b>Resolution authority</b>
Latvia	Financial and Capital Market Commission	Bank of Latvia
Lithuania	Lietuvos Bankas	Lietuvos Bankas
	Ministry of Finance	
Luxembourg	Commission de Surveillance du Secteur Financier	Not formally recognised by Luxembourg law (see notes)
Malta	Malta Financial Services Authority	Central Bank of Malta
	Central Bank of Malta	
Netherlands	Autoriteit Financiële Markten	De Nederlandsche Bank
	De Nederlandsche Bank	
Poland	Polish Financial Supervision Authority (KNF)	Bank Guarantee Fund
Portugal	Banco de Portugal	Banco de Portugal
Romania	Banca Nationala a Romaniei (NBR)	Banca Nationala a Romaniei (NBR)
	Financial Supervisory Authority (CNVM)	
Slovakia	Národná Banka Slovenska (Central Bank)	Národná Banka Slovenska
Slovenia	Banka Slovenije	Banka Slovenije
	Securities Market Agency (A-TVP)	
Spain	Banco de España	Fondo de Reestructuración Ordenada Bancaria
	Comisión Nacional del Mercado de Valores	
Sweden	Finansinspektionen	Riksgalden (Swedish National Debt Office)
UK	Prudential Regulation Authority	Bank of England

## Annex 2. Rights of holders of receivership certificates

To limit the possible amount of NCWO-claims for the resolution funds it may make sense to accord creditors some of the same rights that they would ordinarily enjoy in a bankruptcy proceeding for a non-financial corporation. Hence, the investors may receive receivership certificates during the stabilisation phase. These rights might include:

- The right of first refusal with respect to any significant sale of assets, line of business, material subsidiary or the firm as a whole. This would serve as a check on the resolution authority's selling such assets or entities at a fire sale price to the detriment of the creditors. This right would be exercised by class of creditor starting with the most senior and progressing to more junior categories, finishing with common equity.
- The right to use receivership certificates as the means of payment in connection with disposals by the bank-in-resolution either in connection with an original bid or in exercising their right of first refusal. Effectively, creditors could offer to exchange their claims on the estate of the bank-in-resolution for some portion of the bank's assets or business.
- The right of a junior class of creditors to buy out the next most senior class of creditors at par plus accrued interest. Such an offer satisfies the claim of the more senior class in full and allocates to the more junior class the ownership rights that the more senior class might have obtained.
- The right of a creditor class to present a plan for reorganisation of the bank-in-resolution (formation of Newco) that would:
  - provide for repayment in full of any official liquidity facility granted to the bank-in-resolution;
  - assure that Newco meets capital and liquidity requirements; including any requirement for reserve capital;
  - assure that the management and directors of Newco were fit and proper;
  - evidence that Newco has a sound, sustainable business model and
  - have the concurrence of other classes of creditors.

In sum, such a reorganisation plan should demonstrate that Newco meets threshold conditions. To the extent that such a plan involves the infusion of additional cash (e.g. to fund the issuance of additional capital instruments and/or to serve as a cash alternative to any exchange offer that might be made), the plan should be fully and unconditionally underwritten.



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