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Making Distress Resolution Procedures for Banks in Europe Credible

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MAKING DISTRESS RESOLUTION PROCEDURES FOR BANKS IN EUROPE CREDIBLE

By Daniel Wenne & Rolf Åbjörnsson[1]

The 2007–09 financial crisis highlighted the need for a regulatory framework to improve the capacity for the "too big to fail" banks to be resolved without systemic disruption and taxpayer exposure to the risk of loss. In a functioning market every bank, regardless of its size and complexity, must be able to exit the market without putting the financial system and broader economy at risk. Resolution, which is an alternative to corporate insolvency proceedings, provide a means of restructuring or winding-up a bank that is failing and whose failure could create concerns as regards the public interest. This article examines the main features of the Bank Recovery and Resolution Directive and addresses the question whether the Directive is likely to deliver the mechanism to ensure that banks and large financial groups can be resolved.

1. BACKGROUND

The 2007–09 financial crisis highlighted the need for an effective legal, institutional, and regulatory framework for resolution of failing banks, as well as an international coordination framework for the systemically important banks (SIBs). As the Governor of the Bank of England has famously put it, global banks are "global in life, but national in death"[2]. However, most countries have generally chosen to "kick the can down the road" in terms of implementing effective resolution and recovery regimes to ensure the orderly restructuring or winding-up of failing banks or financial institutions.[3] As a result, banks were subject to general corporate bankruptcy proceedings which did not take into account the speciality of banks and the speciality of bank failures. This led national authorities to freeze and seize assets located in their jurisdiction in order to pay creditors and depositors.[4]

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2 Mervyn King, quoted by Adair Turner, Press conference, 18 March 2009.

3 The article uses the term *bank, financial institution* and *institution* interchangeably. Thus, the reader should note that the term refers to deposit-taking institutions as well as investment banks and other credit institutions conducting trading activities. For a comparative study see Wenne, D., *A comparative study of the features of a lex specialis for distress resolution procedures for financial institutions* (LL.M. thesis, Queen Mary, University of London, Centre for Commercial Law Studies, 2013).

4 Alexander, K., *Bank Resolution and Recovery in the EU: enhancing banking union?*, (2013) 14 ERA Forum, 81, 82.

Although there is no technical definition of the term "resolution", Randell describes it as "special arrangements for the winding-up or restructuring of a failing bank by virtue of powers that go beyond the general powers conferred by the normal insolvency law applying to companies"[5]. A well-designed resolution regime provides the national authorities with options that can be executed quickly in order to avoid bailing-out[6] banks, or the issue of blanket guarantees of the liabilities of the bank.

The free movement of capital, establishment and services have made it easier for European banks to set up subsidiaries and branches in other Member States of the European Union (EU).[7] The integration in financial markets may pose a threat to international financial stability should one of these banks fail. Therefore, the European Commission presented a draft proposal for a European Directive establishing a framework for the recovery and resolution of credit institutions and investment firms on 6 June 2012.[8] On 15 April 2014 the European Parliament adopted the Bank Recovery and Resolution Directive (BRRD).[9]

In Sweden, the implementation of the Directive will result in either the amendment or the replacement of the Swedish Government Support to Credit Institutions Act[10] ("Support Act"), (swe: *Lag om statligt stöd till kreditinstitut*). The Support Act, which is a result of a fast-track legislation, was enacted as a response to the turmoil on the financial markets and the failure of Carnegie

5 Randell, C., *Legal Aspects of Bank Resolution: Designing the Powers and Solutions* (Paper for conference on "Operational Aspects of Bank Resolution and Restructuring", at the European Bank for Restructuring and Development, London, 19 March 2012), 1.

6 Bail-out means bringing in money from the outside to assist a bank in distress, in order to avoid insolvency.

7 See Article 49, 56 and 63 of the Treaty on the Functioning of the European Union (TFEU).

8 Commission Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280 final. See Regulation (EU) No 806/2014 of the European parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

9 The Regulation (EU) No 806/2014 entered into force on 19 August 2014. The final text of the Regulation (EU) No 806/2014 of the European Parliament and the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council was adopted by the European Parliament on 15 July 2014.

10 SFS 2008:814.

Investment Bank. Although the Support Act provides the Government, or the designated resolution authority, currently the National Debt Office (swe: *Riksgälden*), with a large toolbox to deal with distressed systemically important financial institutions, ("SIFIs"), there are few mandated procedures and therefore little predictability.[11] In contrast, non-systemically important financial institutions are subject to normal corporate insolvency proceedings found in the Bankruptcy Act of 1987[12] (swe: *Konkurslagen*).

The purpose of this article is to analyse whether the BRRD is a credible step towards making European banks resolvable. It starts by discussing the role and efficiency of corporate insolvency law. Further, it discusses why a distress resolution procedure for banks is needed. It then describes the BRRD. This article then assesses whether the BRRD is a credible step towards making European banks resolvable by comparing it with existing procedures for dealing with and resolving distress and insolvency of banks with a focus on the UK and US as "model countries". Finally, it makes some concluding remarks.

2. THE ROLE AND EFFICIENCY OF CORPORATE INSOLVENCY LAW

Insolvency[13] has generally been used to describe the situation when a debtor is unable to pay its obligations as they fall due.[14] In corporate insolvency laws there are two generally accepted tests of insolvency. The first test, "cash flow insolvency", is the inability to pay obligations as they fall due.[15] The second test, "balance sheet insolvency", occurs when liabilities exceed assets.[16] For banks, however, these two tests are not sufficient to use as triggers for the initiation of insolvency proceedings, as bank insolvency proceedings must commence much earlier.[17] Further, the first test does not take into account that a bank must be able to meet repayment demands as they occur under normal circumstances.[18]

11 For a critical review see Wenne, D., *When should a bank enter resolution and through which mechanism could an insufficiently solvent bank be returned to balance sheet stability – with particular emphasis on Swedish rules* (LL.M. thesis, Uppsala University, Department of Law, 2014).

12 SFS 1987:672.

13 For the purpose of the discussion that follows, the term "insolvency" will be used as it is discussed in the international literature concerning banking and finance law. Under the Swedish Bankruptcy Act, a legal or natural person is judged to be insolvent if it is unable to pay its obligations when due and that this incapacity is not merely temporary, Chapter 1, Section 2, Item 2.

14 Campbell, A., Lastra, R., M., *Definition of Bank Insolvency and Types of Bank Insolvency Proceedings* in Lastra., R., M (eds), *Cross-Border Bank Insolvency* (Oxford University Press 2011), 29.

15 Ibid.

16 Ibid.

17 See Hüpkes, E., G., H., *The Legal Aspects of Bank Insolvency – A Comparative Analysis of Western Europe, The United States and Canada* (Kluwer Law International 2000), 12.

18 Banks typically hold short-term liquid liabilities in the form of bank deposits and longer-term

It has therefore been said: "a bank is insolvent when the bank regulator says no".[19] However, this is sometimes a matter of controversy and as a matter of "good policy", the bank should be declared insolvent when the market value of its net worth reaches zero.[20] At this stage, direct losses are only suffered by shareholders and not by uninsured creditors and the insurance funds.[21]

Another definitional issue is the difference between insolvency and illiquidity. In a panic, it will be hard to distinguish an insolvent bank from an illiquid bank. Illiquidity occurs in a situation when a bank is solvent but experiences temporary cash flow liquidity problems as it holds both short-term and longer-term illiquid funds.[22] Normally, a "liquidity test" can be performed in order to determine whether the bank is unable to pay its obligations as they fall due. Lastra and Campbell describe the situation of bank illiquidity as an indicator of technical insolvency[23], or a situation which can quickly turn into insolvency if assets are sold at a loss value or "fire-sale" prices. An insolvent institution that continues to operate will most likely run into liquidity problems. In the 2007–09 financial crisis it became clear that the valuation of various assets turned out to be a difficulty, hence, creating uncertainty whether banks were illiquid or insolvent.

Moreover, it is important to distinguish between an insolvent and illiquid bank, as an illiquid bank could be put into insolvency by creditors under general insolvency law, even though it is otherwise financially healthy.[24] In a situation where an insufficiently solvent bank has liquidity problems, such problems could be addressed through inter-bank borrowing or by the central bank injecting liquidity into the bank through its role of lender of last resort (LOLR). It is important to determine whether a bank is insolvent or illiquid in order to assess whether early intervention procedures should be put in place by the authorities. However, the crisis highlighted that an economically insolvent bank is not always declared legally insolvent by the responsible authorities. The authorities seem to be reluctant in letting a clearly insolvent bank fail, and have instead offered financial assistance in order for it to continue its business.

highly illiquid assets which are more difficult to sell and borrow against on short notice.

19 In corporate insolvency proceedings, the creditors can initiate insolvency proceedings whereas the bank supervisors typically have the power to commence bank resolution.

20 Lastra, R., M., *Northern Rock, UK bank insolvency and cross-border bank insolvency* (2008) 9 Journal of Banking Regulation, 165, 172.

21 Under the Swedish Support Act, the cost of resolution is funded by a "Stability Fund" financed by a fee on banks.

22 Campbell, A., Lastra, R., M., *Definition of Bank Insolvency and Types of Bank Insolvency Proceedings* in Lastra., R., M (eds), *Cross-Border Bank Insolvency* (Oxford University Press 2011), 31.

23 A situation when the value of liabilities exceeds market value of assets.

24 This is not the case in Sweden.

3. THE SPECIAL CHARACTERISTICS OF BANKS AND THE NEED FOR *LEX SPECIALIS*

The banking industry is, in contrast to other businesses, subject to strict public regulation. This is a result of the nature of the banking business, as banks act as payment intermediaries, provider of credit to the economy, deposit takers and are subject to banking secrecy rules.[25] In addition, there is a financial fragility associated with banks, which can be found in the structure of banks' balance sheet: (i) low cash to assets (fractional reserve banking); (ii) low capital to assets (high leverage); and (iii) maturity mismatches (between short-term liquid liabilities and longer term highly illiquid assets).

Furthermore, uncertainty or lack of confidence in the financial system, as well as the difficulty to distinguish illiquidity from insolvency, are the aspects that could give rise to systemic risks. As depositors are not generally in a position to monitor and assess the financial conditions of their bank, any rumour that the bank is no longer in a position to meet its liabilities is likely to result in a "bank run".[26] Although there is no general definition of systemic risk, it has usually been defined as the risk that financial difficulties at one or more banks spill over to a large number of other banks or the financial system as a whole.[27] Furthermore, the failure of non-bank financial institutions can create contagion as well.[28]

Additionally, the 2007–09 financial crisis demonstrated the close linkages between financial stability and the health of the real economy. The situation in the Eurozone clearly demonstrates how a banking crisis can become a sovereign debt crisis. In a number of sovereigns, banks have been more or less dependent on their sovereigns for recapitalisation through the central bank's

25 Lastra, R., M., *Central Banking and Banking Regulation* (London School of Economics and Political Science 1996), 73.

26 A number of small to medium sized investment banks in London and elsewhere reported to have suffered deposit withdrawals, following the collapse of Barings Bank, see Crockett, A., *Why is Financial Stability a Goal of Public Policy* (1997) 4, Federal Reserve Bank of Kansas City Economic Review, 7, 11.

27 Lastra, R., M., *Legal Foundations of International Monetary Stability* (Oxford University Press 2006), 138–139. See also Scott, H., S., *Capital Adequacy Beyond Basel: Banking, Securities and Insurance* (Oxford University Press 2005), 19.

28 There are two types of contagion: price contagion, which occurs when a large institution must sell assets quickly resulting in a decline in assets value throughout the financial system; liquidity contagion, arises in situations when a financial institution wanting to, or having to, sell securities, have difficulties in finding buyers at prices corresponding to conventional economic values, Wihlborg, C., *Developing Distress Resolution Procedures for Financial Institutions* (SUERF – The European and Money Finance Forum 2012), 11.

lender of last resort assistance.[29] Further, most deposit guarantee schemes in Europe are substantially unfunded and therefore dependent on sovereign support.[30] In Ireland, for example, the authorities announced a state guarantee of all subordinated liabilities of the Irish banks.[31] In short term this had the effect of stabilising the outflow of funds from Irish banks. However, it quickly became clear that the guarantee had an effect on the creditworthiness of Ireland itself. The difficulty to fund itself in the sovereign debt markets led Ireland in November 2010 to accept financial support from the EU and the International Monetary Fund (IMF). This has led to a negative spiral in Europe as the previous Basel Capital Accords encouraged the banking sector to buy sovereign bonds.[32]

In some jurisdictions, banks are treated like other corporations and are therefore subject to general corporate insolvency proceedings (*lex generalis*). With some modifications for financial contracts, netting, and set-offs, corporate insolvency proceedings could apply to banks as many aspects of bank liquidation such as the calculation of assets, the verification of claims and the distribution of assets will be handled largely in the same manner as a liquidation of a company.[33]

For a number of reasons, however, corporate insolvency proceedings are often unsuitable for handling the resolving of insolvent banks.[34] Firstly, corporate insolvency proceedings are often too time-consuming to be applied to banks, where speed has been embraced as essential. Secondly, there are differences in the "regulatory threshold", when insolvency proceedings may be commenced. For banks in financial distress it is important that insolvency proceedings commence at a very early stage in order to achieve a structured and orderly

29 In contrast, Iceland was not in a position to bail-out the Icelandic banks because of the scale of the bank's assets significantly exceeded Iceland's financial resources.

30 Randell, C., *European Banking Union and Bank Resolution* (2013) 7(1) Law and Financial Markets Review, 30, 31.

31 See the report of the Commission of Investigation into the Banking Sector in Ireland "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland". See also the House of Lords European Union Committee's report "The euro area crisis".

32 In the Eurozone, commercial banks hold the lion share of Greek sovereign bonds. Accordingly, a Greek sovereign debt restructuring could threaten the solvency of some of these institutions and have widespread repercussions in the Eurozone, lecture held by Lee Buchheit at Queen Mary, University of London, 22 January 2013.

33 See Hüpkes, E., G., H., *Insolvency – why a special regime for banks?* (2005) 3 Current Developments in Monetary and Financial Law, International Monetary Fund, 1, 6.

34 See International Monetary Fund and the World Bank, *An overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency*, (International Monetary Fund and the World Bank, 17 April 2009), 21.

resolution. Accordingly, there is a risk that corporate insolvency proceedings do not permit the commencement of insolvency proceedings early enough. Thirdly, it may require the bank to halt its business and freeze its payments. Fourthly, it may lead to costly sales of assets and "fire sales" in order to share out the proceeds among creditors. Finally, corporate insolvency proceedings are mostly concerned with the interest of creditors, whether or not that is the best outcome for the society and financial stability.

Furthermore, a large number of banks with cross-border activities have become so big that they are now regarded as SIBs as they tend to be "Too Big To Fail" (TBTF), too complex and too interconnected to fail. The failure of a SIB means that its international activities may fall in a large part on depositors, investors, counterparties and economies of other countries. Lastra describes SIBs as "institutions that are so important for the functioning of the financial system that their problems (in particular their failure) can trigger systemic risk"[35]. The Financial Stability Board (FSB) defines SIBs as banks "whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption in the wider financial system and economic activity"[36]. Thus, a key issue is whether both home and host states regard the bank as systemically important.

4. CROSS-BORDER BANK INSOLVENCY

Cross-border banking has increased greatly in the last decade, as banks have been setting up branches and subsidiaries with centralised funding that is distributed within the financial group under a global strategic plan. Cross-border banking can either take place in subsidiaries or branches. A subsidiary is a host country legal entity with its own capital buffer. It is therefore subject to the host country regulation, supervision and legislation. In contrast, a host country branch is an integrated part of the home country bank, accordingly it is subject to home country regulation, supervision and legislation.

Cross-border bank insolvency raises two concerns. On the one hand, there is a need for harmonisation of bank insolvency rules and regimes. On the other hand, there is a need to facilitate coordination between insolvency proceedings involving different jurisdictions. Such coordination is conditional upon which of the principles, universality or territoriality that is adopted.

35 Lastra, *Supra*, n 27, 209.

36 Financial Stability Board Recommendations and Time Lines, *Reducing the moral hazard posed by systemically important financial institutions* (Financial Stability Board, 20 October 2011), 1.

Universality of insolvency proceedings means that one jurisdiction conducts the insolvency proceedings. All assets and liabilities of the parent bank and its foreign branches are wound up as one legal entity. In contrast, territoriality means that local branches are treated as separate entities. As a result, insolvency proceedings are initiated in each country where the bank has a branch or holds assets.

At the EU level, the Directive 2001/24/EC on the reorganisation and winding up of credit institutions[37] ("Cross-border Bank Insolvency Directive"), takes a universality approach to cross-border banks with foreign branches. The main drawback, though, is that the Directive is of limited scope and does not apply to subsidiaries.[38] Consequently, it is not possible to transfer assets from a sound subsidiary to a weak subsidiary, a transfer that would benefit the group as a whole. Also, the Directive does not apply to third countries.

The US approach to cross-border bank insolvency is somewhat inconsistent.[39] On the one hand, US bank insolvency law is territorial with respect to US branches of foreign banks. This means that local assets are ring-fenced for the benefit of local US creditors. On the other hand, it is universalist with respect to domestic banks with foreign branches. This means that the Federal Deposit Insurance Corporation (FDIC) collects and realises all assets and liabilities of the failed bank in order to pay off domestic depositors first. Subsidiaries of foreign banks are subject to the same regulation as domestic banks.[40] The Dodd-Frank Wall Street Reform and Consumer Protection Act[41] ("Dodd-Frank Act"), provides that the FDIC, as receiver, shall coordinate to the extent possible, the orderly liquidation of any covered financial company that has assets or operations in a country other than the US.[42] This illustrates, as Lastra describes, "the difficulties of reaching a common international platform with regard to the liquidation of multinational banks"[43].

A common solution to the cooperation and information problems has been the signing of a Memorandum of Understanding (MoU) between the bank's supervisors in the home and the host states, stating that the bank's host super-

37 Directive 2001/24/EC of the European Parliament and the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

38 Insurance companies and securities brokers do not qualify for the Cross-border Bank Insolvency Directive.

39 Lastra, *Supra*, n 20, 176. See International Banking Act of 1978, Pub L No 95–369, 97 Stat 607.

40 Bliss, R., R., Kaufman, G., G., *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, (2006) Federal Reserve Bank of Chicago, 1, 25.

41 Pub L No 111–203 (2010).

42 Section 210(a)(1)(N).

43 Lastra, *Supra*, n 20, 176.

visor will step aside and allow the home authorities to lead the resolution process.[44] However, the drawback with these memorandums is that they are signed on a voluntarily basis and therefore do not constitute legally binding documents.[45] In other words, MoUs are only worth the paper they are written on and, as the recent financial crisis illustrated, the absence of a cross-border framework addressing the failure of a bank with foreign branches resulted in most countries applying the territoriality approach.[46] This is a consequence of the domestic focus of most insolvency laws, giving priority to domestic creditors in the collection and distribution of assets.[47] The territoriality approach, however, resulted in ring-fencing problems in countries with a domestic branch of a foreign bank as the authorities of that country claimed jurisdiction over the branch's assets.[48] Ring-fencing were often done, notwithstanding that the resolution or insolvency laws of the bank's home country may have taken a universality approach, treating the bank and its branches as a single entity to resolution under the law of the home state.[49]

The view to national interest rather than global interest has become a problem when dealing with SIBs. Although, most home regulators have developed resolution regimes for cross-border management groups for all relevant Global-SIBs, there is currently no international standard for resolution of cross-border banks. In addition, information sharing is missing in many jurisdictions, thus undermining the effective implementation of group-wide resolution strategies.[50] Similarly, few authorities have the ability to support home regulators in implementing a group-wide resolution.[51] Paul Tucker, former deputy manager at the Bank of England (BoE), and chair of the FSB's steering group on resolution, sums up as follows: "independent, host-country resolutions executed in an uncoordinated way around the world would not only break the distressed

44 See Watt, M., *Hinging on Trust*, (2013) 26 Risk, 23, 23.

45 Claessens, S., Herring, R., J., and Schoenmaker, D., *A Safer World Financial System: Improving the Resolution of Systemic Institutions* (International Centre for Monetary and Banking Studies, Centre for Economic Policy Research, Geneva Report on the World Economy, 12 July 2010), 38.

46 Article 1(2) of the UNICITRAL Model Law on Cross-Border Insolvency exempts banks from its scope of application.

47 Krimminger, M., H., *Deposit Insurance and Bank Insolvency in a Changing World: Synergies and Challenges* (2005) 4 Current Developments in Monetary and Financial Law, International Monetary Fund, 1, 12.

48 See Randell, C., *The FSB's "Key Attributes": The Road to Cross-Border Resolution of Financial Institutions* (Discussion Draft 12.06.12, Presented at the Cross-Border Resolution Symposium, London, 18 June 2012), 5.

49 Claessens, Herring, and Schoenmaker, *Supra*, n 45, 38.

50 Watt, *Supra*, n 44, 24.

51 Ibid.

banks into bits, by being uncoordinated, it might create confusion and destroy some of the surplus value held in host countries that could help out the home regulator as it resolves the parent group"[52].

Work on development of international standards for resolution of cross-border banks is currently taking place in a number of international organisations. In October 2011 the FSB presented their "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("Key Attributes"). The framework constitutes a new internationally agreed standard for resolving failing SIFIs in a way that protects vital economic functions and minimises the use of taxpayers' money. However, the Key Attributes is a non-binding framework focused on cooperation and information sharing. What is needed though is an international treaty setting out clear triggers for early intervention procedures, and mutual recognition of insolvency and resolution proceedings.[53]

5. THE BANK RECOVERY AND RESOLUTION DIRECTIVE

5.1 BACKGROUND

On 6 June 2012 the European Commission published a draft proposal for a Directive establishing a framework for the recovery and resolution of credit institutions (Bank Recovery and Resolution Directive), (BRRD)[54], and on 10 July 2013 it presented a proposal for a Regulation establishing a uniform regime for resolving banks (Single Resolution Mechanism), (SRM)[55]. The BRRD was adopted on 15 April 2014 by the European Parliament, and the SRM was approved by the European Parliament on 15 April 2014 and by the European Council on 15 July 2014.[56] Consequently, Member States will be re-

52 Ibid.

53 The FSB's report to the G20 on Progress and Next Steps Towards "Ending Too Big To Fail" (TBTF Report) of September 2013. On 29 September 2014, FSB launched a public consultation on a set of proposals to achieve the cross-border recognition of resolution actions and remove impediments to the cross-border resolution.

54 Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010. Commission document No COM(2012)280 final.

55 Proposal for a Regulation of the European Parliament and the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council. Commission document No COM(2013)520 final. The legal basis for the BRRD is Article 114 of the Treaty on the Functioning of the European Union.

56 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms

quired to implement most of the requirements of the Directive by 31 December 2014, with exception for the provision relating to the bail-in tool, which is subject to longer transposition period and do not need to be implemented until 1 January 2016. The Directive applies across all 28 Member States of the EU. It harmonises rules relating to the resolution of banks across the Union, and provides for cooperation among resolution authorities when dealing with the failure of cross-border banks. It essentially mandates for common resolution tools and resolution powers available for the national authorities of every Member State, but leaves discretion to national authorities in the application of the tools and in the use of national financing arrangements in support of resolution procedures. The BRRD is a minimum harmonisation directive. This means that, while the BRRD sets a threshold which national legislation must meet, Member States are permitted to adopt or maintain rules that are additional to those laid down in the Directive or in the technical standards adopted under the BRRD. Further, the Directive is not intended to replace national insolvency laws. It rather aims to equip the banking supervisory authorities with "adequate tools at Union level to deal effectively with unsound or failing credit institutions and investment firms"[57]. However, certain regulatory and mediation tasks are conferred on the European Supervisory Authority (European Banking Authority), (EBA).[58] The SRM Regulation, by contrast, is a centralised power of resolution.[59] It establishes a Single Resolution Board with powers that can be exercised by national resolution authorities under the BRRD framework. Although the SRM Regulation is applicable across all 28 Member States, it only covers banks whose home supervisor is the ECB, euro-area Member States and non-euro-area Member States which choose to cooperate closely with the ECB in banking supervisory matters.[60]

and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council. See also Regulation (EU) No 806/2014 of the European parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

57 Directive 2014/59/EU, Recital 1.

58 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

59 See Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

60 See Article 2 Regulation (EU) No 806/2014. Sweden and the United Kingdom have indicated that they do not consider entering a "close cooperation arrangement" in the foreseeable future.

The BRRD specifies five objectives for regulators when exercising their powers under the Directive: (i) to ensure the continuity of critical functions; (ii) to avoid a significant adverse effect on the financial system and maintaining market discipline; (iii) to minimise the use of public funds; (iv) to protect depositors; and (v) to protect clients' funds and assets.[61] In addition, the BRRD will apply to all EU credit institutions, certain investment firms[62], financial groups and conglomerates. Its scope of application is identical to the Capital Requirements Directive[63] (CRD), which harmonises capital, liquidity and governance for financial institutions including banking groups and investment firms.

Furthermore, the Directive requires each Member State to designate one or several resolution authorities that are required to be public administrative authorities, in order to exercise the resolution powers. It is for the Member State to decide which authority or which authorities it finds best suited for the tasks, in terms of expertise, resources, and operational capacity to manage bank resolutions and cross-border issues.[64] Nevertheless, Member States have to ensure that there is a separation between the resolution function and other functions of that authority, given the likelihood of conflicts of interest that might otherwise arise.

5.2 PREPARATION AND PREVENTION

Article 5–12 of the BRRD contains rules relating to the recovery and resolution plans.[65] Each institution is required to draw up and maintain a recovery plan, colloquially known as "living wills", for its orderly winding-up, breaking-up and for dissolution in the case the bank find itself in serious financial distress.[66] Groups will be required to draw up recovery plans at group level as well as for the individual institutions within the group. The recovery plans will include information regarding business strategy, corporate governance structure, access to contingency funding sources, continuous access to financial markets structures, and risk management. Also, the plans shall include an analysis of how and when a bank may apply for the use of central bank facilities, and identify those assets which would be expected to qualify as collateral. The plans shall not assume any access to receipt of extraordinary public financial support, ie

61 Directive 2014/59/EU, Recital 5.

62 Investment firms that are subject to initial capital requirements of €730,000 as defined under Article 28(2) of Directive 2013/36/EU, see Article 2(3) of Directive 2014/59/EU.

63 Directive 2013/36/EU and Regulation (EU) No 575/2013.

64 Article 3 of Directive 2014/59/EU.

65 The European Banking Authority (EBA), and the Commission will develop and draft regulatory technical standards addressing a range of scenarios.

66 Article 5(1) states that recovery plans shall be considered as a governance arrangement within the meaning of Article 74 of Directive 2013/36/EU.

LOLR. The resolution authority shall consider whether the submitted plan is likely to restore the viability and financial soundness of the institution without causing any significant adverse effects on the financial system.

Similarly, the resolution authority will be required to develop resolution plans for groups and for each institution that is not part of a group subject to consolidated supervision. The resolution plans should identify any material impediments to resolvability, take into consideration relevant scenarios and include an analysis of how and when an institution may apply for the use of central bank facilities. Moreover, it should include details about group structure, interbank exposures and critical and core business lines. The resolution plans shall contribute to "resolvability assessment", in which the resolution authority determines whether there are impediments to its resolution and requires the bank to take the necessary action to restructure itself with a view to resolvability.[67] Group resolution plans shall include both a plan for resolution at the level of the parent undertakings or institutions subject to consolidated supervision, and for each institution of the group.[68] These resolution plans shall contribute to "group resolvability assessments", in which the various authorities responsible for the resolution of a financial group determine whether there are impediments to its resolution and require the group to take the necessary action to restructure itself with a view to resolvability. The role of the EBA is to mediate disputes between the national supervisory authorities.[69]

5.3 EARLY INTERVENTION

Article 27–30 of the BRRD give the competent authorities the power to intervene in cases where a bank's financial situation or solvency is not met 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 is likely to be breached. The competent authorities have the power to require the management to implement the arrangements set out in the recovery plan, draw up an action plan and remove and replace one or more board members or managing directors. Furthermore, the competent authorities can convene a shareholder's meeting to adopt urgent reforms and request the institution to draw up a plan on restructuring of debt with its creditors.

67 Article 15 of Directive 2014/59/EU.

68 Article 16 of Directive 2014/59/EU. Conflict of interest between home and host authorities may appear if branches or subsidiaries are considered systemic in the host country but not in the home country.

69 Article 18(9) of Directive 2014/59/EU.

One controversial part of the Directive is the power to appoint a temporary administrator to replace the management of the institution, in a situation where there is a significant deterioration in the financial situation or a serious violation of law. The temporary administrator may be given all the powers of the management body of the institution, including the authority to exercise all the administrative functions of the management body. The role and the functions of the temporary administrator is to ascertain the financial position of the bank, manage the business or part of the business of the bank with a view of preserving or restoring the financial situation of the bank and taking measures to restore the sound and prudent management of the business of the bank. However, the temporary administrator shall not be deemed to be a shadow director or a de facto director. Although the aim is to maintain the bank's going-concern and strengthen its financial position, the scope of the temporary administrator's power has been widely debated. Most concern has been raised regarding the objective of rescuing the bank and the rights of the shareholders. Hüpkes has argued, in earlier works, that the appointment of a temporary administrator is "only justified where it is improbable that the bank can otherwise be saved as an independent organisation"[70].

5.4 RESOLUTION

In order to trigger resolution, the resolution authority must assess that three conditions are met: (i) the competent authority or resolution authority determines that the institution is failing or is likely to fail; (ii) there is no reasonable prospect of private sector or supervisory action preventing failure within a reasonable timeframe; and (iii) resolution action is necessary in the public interest.[71]

If all of the conditions are met, Member States shall ensure that the resolution authorities may appoint a special manager to replace the management body of the bank. The special manager shall have all the powers of the shareholders and the management body of the bank in order to take all the measures necessary to promote the resolution objectives and implement resolution actions according to the decision of the resolution authority. Where necessary, the special manager has the powers to increase the capital, reorganise the ownership structure or prepare a takeover by a financially sound institution. In this regard it could be argued that its role may interfere with the property rights in contravention of Article 1 of Protocol No 1 of the European Convention on Human Rights, (ECHR), and Article 17 of the Charter of Fundamental Rights of the European Union.

70 Hüpkes, *Supra*, n 17, 58.

71 Article 32 of Directive 2014/59/EU.

There are four resolution tools available to restore a failing institution or a holding company: (i) the sale of business tool; (ii) the bridge institution tool; (iii) the asset separation tool; and (iv) the bail-in tool. The resolution authorities may either apply the resolution tools singly or in conjunction. However, the asset separation tool is only exercisable in conjunction with another resolution tool. It is for the resolution authorities to decide which tool to use, although it shall have regard to the resolution objectives in using the tool that best achieves the objectives in the specific case. Moreover, before the resolution tools are used, an independent valuation of the assets and liabilities of the institution shall be carried out.

The sale of business tool gives the resolution authorities the power to transfer from an institution under resolution to a purchaser: (i) shares or other instruments of ownership; and (ii) all or any assets, rights or liabilities.[72] The only requirement that the Directive sets out is that the transfer must be made on commercial terms. As a result, the resolution authorities can use the sale of business tool without obtaining the consent of the shareholders or any third party other than the purchaser.

In situations where it is not possible to find a purchaser, the resolution authorities are given the power to transfer shares and all or specified assets, rights or liabilities, or a combination of these, to a temporary bridge institution.[73] The bridge institution, which is a legal entity wholly or partially owned by one or more public authorities, is set up in order to preserve the going-concern value of the bank's critical functions. It is, however, a temporary solution and the resolution authorities shall therefore operate the bank with the intention of selling it when the conditions are more appropriate, and within a two-year period.

The asset separation tool gives the resolution authorities the power to transfer assets, right or liabilities to an asset management vehicle, which is a legal entity wholly owned by one or more public authorities.[74] The transfer may take place without obtaining the consent of the shareholder of the bank or any third party, and without complying with any procedural requirements under company or securities law. An asset management body shall manage the assets with a view to maximise their value through an eventual sale or orderly wind-down. If a sale is not possible, the asset management body shall ensure that the business is wound down in an orderly manner. This tool may only be used if the assets are of such a nature that liquidation under normal insolvency proceedings could have an adverse effect on

72 Article 38(1) of Directive 2014/59/EU.
73 Article 40 of Directive 2014/59/EU.
74 Article 42 of Directive 2014/59/EU.

the financial market; a transfer is necessary to ensure the proper functioning of the bank; or such a transfer is necessary to maximise liquidation proceeds.[75]

The difficulties with effecting a rapid transfer or finding a suitable purchaser have lead European policymakers to advocate a new type of resolution mechanism, which has come to be known simply as "bail-in". The bail-in tool, which was first introduced in the FSB's Key Attributes, has been greeted by regulators and market participants. Bail-in operates through a mechanism whereby claims of the bank's subordinated creditors, and some of its senior creditors, are written down ("haircut"), or converted into equity at the point of non-viability. Bail-in can be used either separately or in combination with one of the other resolution tools. Accordingly, the possibility of writing down or converting capital instruments is not a resolution tool in the narrow sense but is a further option available to the resolution authorities under the BRRD. It does not provide any liquidity injections, so the bank must be creditworthy in order to survive as no counterparty would voluntarily deal with an insolvent bank.[76] Therefore, only insufficiently solvent banks can be subject to the bail-in tool.

The first step is to write down common equity tier 1 (CET 1) capital in proportion to the losses, ie to reduce the principal amount.[77] If this is not enough to achieve the resolution objectives, the next step is to write down additional tier 1 (AT 1) capital instruments or to convert these to CET 1 capital. A further possible stage would be to convert tier 2 (T 2) capital to CET 1 capital or to write it down.[78] Certain liabilities are, however, excluded such as covered deposits, secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes, and liabilities with an original maturity of less than seven days. Derivatives' liabilities may be excluded in exceptional circumstances where it is deemed necessary and proportionate to ensure the bank's critical functions and its core business lines or financial stability. According to the BRRD there is prohibition on any contribution being made from resolution funds unless at least 8 per cent of the outstanding liabilities of the firm have been recapitalised by shareholders and eligible creditors.[79]

75 Article 42(5) of Directive 2014/59/EU.

76 Gleeson, S., *Legal Aspects of Bank Bail-ins*, (2012) Special Paper 205, LSE Financial Markets Group Paper Series, 1, 3.

77 Article 46 of Directive 2014/59/EU.

78 CET 1, AT 1 and T 2 denote different classes of capital instruments, distinguishable in terms of quality and, following from that, their treatment by regulators. Shares issued by a public limited company are an example of CET 1 instruments. AT 1 instruments include indefinite debt securities with no fixed payment or redemption incentives, whereas subordinate loans with an original maturity of at least five years count as T 2 instruments.

79 Article 44(5)(a) of Directive 2014/59/EU.

6. OVERALL ASSESSMENT OF THE BANK RECOVERY AND RESOLUTION DIRECTIVE

6.1 INTRODUCTION

At present, many Member States of the EU have no resolution powers or resolution authorities at all. Those Member States which do have resolution powers often have no power to recognise actions by authorities in other Member States.[80] The BRRD represents a major step forward from the status quo, as it introduces a set of reasonably comprehensive national resolution powers coupled with arrangements for mutual recognition of resolution action. However, for resolution to become a realistic possibility it would be necessary to consider a regulatory reform. The following sections of this article assess four key issues of resolution of banks under the Directive: preparation and prevention; group resolution; trigger for resolution; and resolution tools. The following section is based upon the current developments in the US, UK and EU for resolving banks in distress. Since the BRRD is a minimum harmonisation directive, national authorities will be able to retain more specific tools and powers than those set out in the Directive in order to handle banks in distress. Although the US and UK resolution regimes are viewed as models, one has to bear in mind that national banking systems differ significantly. For example, few countries resemble the banking system in the US, with its large number of relatively small regional banks, or the UK banking system, with a small number of very large and globally active institutions.[81] Nevertheless, in order to make the financial system less unstable and easier to deal with, further options are needed, including: higher capital and equity requirements for any institution likely to prove systemically important together with requirements for long-term debt; and enhanced transparency and regulatory oversight of the system.

6.2 PREPARATION AND PREVENTION

Crisis preparedness and planning for failure is at the heart of new supervisory frameworks for banks and investment firms.[82] The introduction of living wills in the BRRD is a response to the challenge of complexity in resolving large financial institutions, as it engage supervisors in the Member States in a dialogue with these institutions *ex ante*, regarding how resolution might successfully be achieved *ex post*. The living wills set out a road-map that would enable national authorities to respond quickly and with certainty, thereby preserving continui-

80 Randell, *Supra*, n 30, 33.

81 Randell, *Supra*, n 5, 10.

82 Under Section 165 of the Dodd-Frank Act, certain large bank holding companies and non-bank financial institutions are required to develop and report periodically resolution plans in order to facilitate "rapid and orderly resolution in the event of material financial distress or failure".

ty in banking activity and the value in assets while at the same time protecting depositors. Similarly, it provides the resolution authorities with a better understanding whether banks in their jurisdiction are likely to be resolved at all. Practical resolution of banks require not just the correct legal powers but also the information, skills and structures to make resolution a reality. Although the living wills may provide the authorities with a better understanding of a bank's corporate structure, the nature and location of its assets and liabilities and the interrelationships between various members of the corporate group, its ability shall not be overestimated.

Firstly, given the volume of information and the complexity of many European banks' operations, it seems questionable whether the living wills can provide sufficiently detailed and accurate up-to-date information. For example, the first living wills under Title 1 of the Dodd-Frank Act were to be submitted to the FDIC by 1 July 2012. None of the plans submitted by the JP Morgan Chase & Co, Goldman Sachs Group Inc and Citigroup Inc satisfied the requirements. These banks were therefore required to submit new versions.[83] This suggests that the living wills do not properly address the TBTF problem, and that there is a risk that regulators, instead of pulling the resolution trigger, will allow troubled banks to submit new plans. Secondly, there will be real challenges in reconciling the different national interests and incentives, ensuring adequate access to information by all authorities in the EU. Thirdly, the role of the EBA in mediating disputes about resolution actions can be put in question by Article 38 of the EBA Regulation.[84] The provision set out in the Article provides that "the Authority shall ensure that no decision adopted under Article 18 [which relates to the actions in emergency situations] or Article 19 [which relates to settlement of disagreements between competent authorities in cross-border situations] impinges in any way on the fiscal responsibility of Member States". Finally, there is the challenge of co-ordination between the ECB as the new supervisory authority and the multiple resolution authorities at national level.[85] Although the ECB is required to exercise its power "in co-operation with the relevant resolution authorities" the challenges of organising this co-operation should not be underestimated.

6.3 GROUP RESOLVABILITY AND RESTRUCTURING

The 2007–09 financial crisis highlighted the problem of cross-border resolution of banks. Although the BRRD represent a major step towards making

83 See Hamilton, J., Torres, C., *Biggest Banks' Wind-Down Plans Seen Failing to Cut Risks*, Bloomberg, (New York, 16 June 2013).

84 Regulation (EU) 1093/2010 of the European Parliament and the Council establishing the EBA.

85 See Randell, *Supra*, n 30, 33.

European banks resolvable, it is unlikely to deliver the mechanism to ensure that large cross-border banking groups can be resolved. Firstly, the provision concerning group resolution plans raises the question whether Member States and their resolution authorities will have the necessary will to enforce the rationalisation of group structures, the speed with which any rationalisation will be achieved, and whether EBA will play an active role in leading reluctant Member States to adopt a more consistent and interventionist approach.[86] Secondly, the majority of large cross-border banking groups will not be resolvable other than through the bail-in tool, as a result of the difficulties with effecting a rapid transfer of assets, or finding a suitable purchaser.[87]

At the heart of the issue lies the question whether essential and non-essential financial services should be permitted to coexist within a single legal entity, and if not, the degree of separation of those activities that should be required.[88] There is no doubt that a separation would reduce the probability of bank failures and make resolution of deposit-taking and other essential activities easier.[89] In the US, the Glass-Steagall Act[90] banned commercial banks from a range of investment banking activities and securities trading on their own account. Accordingly, commercial banks were prohibited from investing in equities, derivatives and other complex structured products, as this would prevent commercial banks from being "contaminated" by different types of risk encountered in these activities.[91] Due to the liberalised view on financial regulation in the 1990s, banks were allowed to conduct both activities. However, Section 619 of the Dodd-Frank Act, known as the Volcker Rule, restricts deposit-taking banks from engaging in certain types of market oriented activity (proprietary trading).[92] A similar approach was emphasised in September 2012 in the UK by the UK's Independent Commission of Banking, also known as the Vicker's Report after its chairman Sir John Vickers. Consequently, in the UK, the Financial Services (Banking Reform) Act 2013 (the

86 Ibid.

87 Ibid, 34.

88 Ibid, 33.

89 For a different view, see Llewellyn, D., T., *Post Crisis Regulatory Strategy: A Matrix Approach*, in Browne, F., Llewellyn, D., T., (eds), *Regulation and Banking after the Crisis*, (SUERF – The European Money and Finance Forum, 2011), 37.

90 Banking Act of 1933, Pub No 73–66, 48 Stat 162.

91 See Ibid.

92 The rule prohibits any banking entity from engaging is short-term trading in securities, derivatives or commodity futures. Though, the rule is very controversial and the key concern, as expressed by the US Chamber of Commerce, is the ability to raise capital through corporate bonds, see Chon, G., *US Chamber of Commerce Urges Rethink on Volcker Rule*, Financial Times (London, 8 November 2013).

"Banking Reform Act") established a framework for ring-fencing providing for the separation of core activities (deposit taking) which must be carried out by ring-fenced bodies from excluded activities (trading in investments). In February 2013, the Parliamentary Commission on Banking Standards proposed that the regulator should be given a reserve power to require full separation of retail and investment banking in the case of an individual banking group—the "electrification" power. "Electrification" means that if a bank breaks through the fence the consequences could be severe, with the Prudential Regulation Authority (PRA) being able to step in and enforce separation by completely breaking up the bank.

As secondary legislation, the UK Government recently published "The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014"[93] which sets out the scope of the ring-fence, and "The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014" which defines the range of activities that may not be carried on by ring-fenced bodies.

The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 defines the forms of trading in securities and commodities that must be outside the ring-fence and imposes specific prohibitions on ring-fenced banks. The Order creates exceptions for: (a) ring-fenced banks' own risk management and funding; (b) transactions with central banks; and (c) the provision of simple risk-management services to customers.

The first exception is intended to permit ring-fenced banks prudently to manage their own risks. It therefore permits dealing in investments, including derivatives, provided that the sole or main purpose of the transactions is to hedge the risks of the ring-fenced bank or its subsidiaries. The second exception permits ring-fenced banks to trade with central banks, which will allow ring-fenced banks to access central bank liquidity in times of stress. The third exception permits ring-fenced banks to sell a narrow range of simple risk-management products to their customers. Complex derivatives will not be permitted inside the ring-fence and are typically used only by larger and more sophisticated corporate customers, which are often already multi-banked and so would have little trouble sourcing derivatives from a non-ring-fenced bank.

93 In a nutshell, the Order provides that only banks above a certain size will be required to be ring-fenced. It creates an exemption, excluding banking groups with less than £25 billion of core deposits from the definition of "ring-fenced body" (Article 12). It also exempts classes of institutions, such as insurers and credit unions that are captured by the definition of ring-fenced body in the Banking Reform Act because they accept deposits.

The Excluded Activities and Prohibitions Order creates a further excluded activity: dealing in commodities (Article 5). It also imposes a series of specific prohibitions on ring-fenced banks which are prohibited from having exposures to certain financial institutions. The prohibition protects ring-fenced banks against financial contagion in the financial system.

The Order prohibits ring-fenced banks from having exposures to non-ring-fenced banks such as investment firms, globally systemic insurance firms and investment funds. It permits exposures to other ring-fenced banks, building societies, credit unions, recognised clearing houses and central counterparties (CCPs), investment firms that only offer advice and banks that are subject to the same restrictions as ring-fenced banks, such as small retail banks.

In the EU, the Liikanen Group appointed by the European Commission, has recently proposed that a version of this rule should be introduced at the European level for larger banks. The activities to be assigned to a separate entity would be proprietary trading of securities and derivatives, and certain other activities closely linked with securities and derivatives markets, if those activities amount to a significant share of the bank's business or can be considered significant from the viewpoint of financial stability, ie ring fence trading activities.

By requiring banks to separate deposit-taking activities from investment banking activities *ex ante*, it will be easier to resolve failing banks. As Randell states "[t]here is no doubt that the resolution of deposit-taking and other essential activities is made significantly more difficult if they have to be separated from other non-essential activities at the point of resolution"[94]. Similarly, a separation would undoubtedly make it easier for the bank and the resolution authority to draw recovery and resolution plans. However, unless business separation is mandated at a European level, the judgement when to enforce separation as a result of resolvability assignments will rest with Member States, who may pursue the issue with varying degrees of enthusiasm.[95] Also, the existence of different frameworks is problematic as it may provide incentives for regulatory arbitrage, ie financial institutions may have an incentive for forum shopping. Similarly, it may create unintended barriers for smaller banks and could affect international competiveness of a country's largest banks.[96] Accordingly, what is needed is European, as well as an international, standard in order to address the TBTF problem.

94 Randell, *Supra*, n 30, 33.

95 See Ibid.

96 See Katz, E., *UK Bank Ring-fencing: work in progress* (2011) 28 Journal of International Banking and Finance Law, 695.

6.4 TRIGGER FOR RESOLUTION

It seems inevitable that the trigger point for resolution must be set prior to normal corporate insolvency proceedings, and that some regulatory discretion may be necessary. Under the BRRD, the resolution authority can pull the trigger for resolution when it considers that an institution is failing or is likely to fail. According to the Directive, the condition is fulfilled when: (a) it infringes or is likely in the near future to infringe the requirements for authorisation; (b) when the assets of the institution are, or are likely in the near future, to be less than its liabilities; (c) when the institution is, or is likely in the near future, to be unable to pay its debts as they fall due or; (d) when the institution requires extraordinary public financial support. Additionally, there should be no reasonable prospect of private sector or supervisory action preventing the failure, and resolution action must be necessary in the public interest.

It is questionable whether condition (a), (b) and (c) are sufficient as trigger for resolution. Firstly, condition (a) that the bank infringes or is likely in the near future to infringe the requirements for authorisation, tends to overlap with the condition for early intervention. Early intervention measures may be taken in a situation where a bank infringes or, due 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 bank's own funds plus 1,5 percentage points, is likely in the near future to infringe the requirements as set out in the Capital Requirement Directive[97] or the Capital Requirements Regulation[98].[99] Consequently, the responsible supervisory authority should already at this stage be able to determine whether a bank infringes or is likely in the near future to infringe the requirements for authorisation, and thereby should enter resolution.

A similar approach is taken in the UK, where a bank should enter into resolution when the PRA forms the opinion that the bank is failing, or is likely to fail, to satisfy its threshold condition for authorisation under the Financial Services and Markets Act of 2000. This trigger for resolution gives the authorities both some relatively objective capital requirements and some subjective requirements. However, the drawback with such a trigger for resolution is that the subjective requirement gives rise to the risk of regulatory forbearance as the responsible supervisory authority may delay the triggering of the resolution as a consequence of TBTF, uncertainty of regulatory failure, or fear of legal challenge from shareholders, directors and creditors of the bank.

97 Directive 2013/36/EU.
98 Regulation (EU) 575/2013.
99 Article 27 of Directive 2014/59/EU.

Secondly, condition (b) when the assets of the bank are, or are likely in the near future, to be less than its liabilities, is not sufficient to use as a trigger for two reasons. Firstly, the valuation of assets in times of distress is undoubtedly very difficult. Secondly, resolution procedures must commence much earlier. A more favourable approach is that the bank should enter resolution when the market value of its net worth reaches zero, as direct losses are only suffered by shareholders at this stage.[100] An interesting alternative is the approach taken in the US, where capital triggers indicates the threshold for intervention.[101] The trigger points are defined in terms of three different capital ratios. Two ratios are based on the Basel rules' definition of risk-based Tier 1 and Tier 2 capital, whereas the third ratio is a simple leverage ratio defined as book value of tangible equity relative to total on-balance sheet assets.[102] When the Federal Deposit Insurance Improvement Act of 1991[103] (FDICIA), was enacted in 1991, it was argued that a capital intervention threshold would provide shareholders with an opportunity to raise sufficient new equity funding to lift the bank's equity ratio to an acceptable level.[104] Yet, the use of capital triggers resulted in much criticism in the aftermath of the crisis as capital triggers appeared to be a lagging indicator of a bank's financial health. In addition, capital triggers did not take into account the "hidden" nature of most of the risk that banks had put in off-balance sheet structures.[105] It turned out that banks that became insolvent had capital well above the bottom threshold level and also higher capital ratios than those of the successfully surviving banks.[106] Thus, what is needed is a trigger that is not based on the book value of equity to the book value of total assets.

Finally, condition (c) when the institution is, or is likely in the near future, to be unable to pay its debts as they fall due, does not take into account that a bank must be able to meet repayment demands as they occur under normal circumstances. Banks typically hold short-term liquid liabilities in the form of bank deposits and longer-term highly illiquid assets which are more difficult to sell and borrow against on short notice. Normally a "liquidity test" can be done in order to determine whether the bank is unable to pay its obligations

100 Lastra, *Supra*, n 20.

101 The Swedish Financial Crisis Committee concludes in its recent report that there is no need for introducing a trigger similar to the one used in the US, SOU 2013:6, 261–269.

102 Wihlborg, *Supra*, n 28.

103 PubL No 102-242, 105 Stat 2236.

104 Goodhart, C., A., E., *When should a bank enter resolution?*, (2012) 10 Journal of International Banking and Financial Law, 603, 604.

105 Krimminger, M., Lastra, R., M., *Early Intervention*, in Lastra R., M., (eds), *Cross-Border Bank Insolvency* (Oxford University Press 2011), 66.

106 Goodhart, *Supra*, n 104, 604.

as they fall due. However, uncertainty or lack of confidence in the financial system can turn a solvent bank into insolvency if assets are sold at a loss value or "fire sale" prices.

The conditions under the BRRD for when a bank should enter resolution tend to overlap. Furthermore, there is the risk that the conditions are too subjective and thereby gives rise to the risk of regulatory forbearance, as the authorities may delay the triggering for resolution. However, there remains much debate about the question when a bank should enter resolution. The leading authority on this matter, the FSB, opined in its Key Attributes that:

> "Resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out. There should be clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution."[107]

Although the Key Attributes was endorsed by the G20 at the Cannes Summit in November 2011, it is unfortunate that the first and second sentences appear to be mutually contradictory.[108] Since, as Goodhart points out, "there are always grounds for hope, waiting until a bank 'has no reasonable prospect of becoming [viable]' just about inevitably means that entry into resolution will be neither timely nor early"[109]. Applying the first sentence, waiting until there was "no reasonable prospect of becoming" viable, will result in little predictability and will also be strongly contested by shareholders and creditors as expropriation. Therefore, the second sentence requiring "timely and early entry into resolution" should be given priority over the first sentence. Nevertheless, the question remains of what constitutes clear standards or suitable indicators of non-viability.

Goodhart suggest that one trigger could be to let the market decide if a bank is non-viable. Thus, if the market believes that a bank is insolvent and likely to be non-viable, the bank will not be able to obtain liquidity in the money markets. If so, the bank will have to turn to the central bank for LOLR assis-

107 Section 3(1) of the FSB Key Attributes.

108 See Goodhart, *Supra*, n 104, 603, and Institute of International Finance, *Making Resolution Robust – Completing the Legal and Institutional Framework for Effective Cross-Border Resolution of Financial Institutions*, (2012), Institute of International Finance, 63.

109 Goodhart, *Supra*, n 104, 603.

tance. "Requiring such LOLR for, say, longer than five consecutive days could be taken as a threshold for early intervention"[110]. Unfortunately, however, the BRRD states that the need for LOLR assistance from the central bank should not, per se, be a condition that the bank is or will be, in the near future, unable to pay its liabilities.[111]

To sum up, it would have been preferable if the BRRD had included a trigger that entails a combination of quantitative (such as capital adequacy) and qualitative triggers (such as considerations of the impact resolution will have on markets, financial market infrastructure, and on the economy), that are considered predictable by the market participants, ie banks, shareholders, counterparties, and creditors.[112]

6.5 RESOLUTION TOOLS

The orderly resolution of a bank is essential in maintaining public confidence and minimising the risk of contagion. Therefore, once a troubled bank reaches the trigger point for resolution there should be mandated procedures in place as well as a clear toolbox. The resolution authority should use the tool that: (i) can be used without recourse to taxpayers' money; (ii) enables the bank as a going-concern following the initiation of resolution; and (iii) that does not significantly disrupt the financial markets or the economy at large. The resolution plan may provide some help in evaluating and determining which resolution tool that should be used.

The sale of business tool, the bridge institution tool and the asset separation tool are all classic resolution tools. However, all these tools raise the concern of what assets and which method that should be used to transfer assets of the troubled bank. The major concern is the treatment of creditors and the question how assets should be valued. Accordingly, it is important that there is a clear *ex ante* transfer policy set out so the resolution authority cannot "cherry pick" which assets and contracts to transfer.[113] Moreover, the resolution authority must make sure that the acquiring bank has the financial resources to acquire shares, or all or any of the assets, rights or liabilities from the bank under resolution. The time constraints when Lloyds TSB Group Plc's acquired HBOS Plc meant that the deal was done with minimum due diligence. How-

110 Ibid, 604.

111 Directive 2014/59/EU, Recital 41.

112 See Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Financial Stability Board, October 2011), 51.

113 See LaBrosse, J., R., *Save Banking, Not Banks: formulating standards for the use of bridge banks*, (2011) 6 Journal of International Banking and Financial Law, 344, 345.

ever, it was soon discovered that HBOS's finances were far from secure, and that its bad debts were on a scale that could hole the previously stable Lloyds TSB beneath the waterline. Just a month later, as part of its rescue operation for the UK banking system, Gordon Brown's government had to inject £17 billion into the merged bank, acquiring a 43,4 per cent share stake.

Transferring shares, or all or any assets, rights and liabilities to a bridge bank while a more permanent solution is found, has the advantage of buying the resolution authority some time. Yet, detractors of bridge banks maintain that the technique is not very useful in handling failures of large cross-border banking groups.[114] Therefore, it is important that the resolution authorities do not use the bridge bank tool in a manner that tend to "save" banks and managements. Also, it would have been preferable if the BRRD had considered the following points more thoroughly regarding the bridge bank tool: (i) that the resolution authority carries out a reasonable assurance of the future viability of the bridge bank that emerges; (ii) whether the bridge bank needs tangible capitalisation, and how it can meet capital requirements; (iii) if there is a capital injection, then there will be a need to have a repayment schedule; and (iv) how the bidding process for the bridge bank should be carried out within a present timeframe.[115]

The bail-in tool is likely to provide the most efficient resolution option. Bail-in was used to resolve the largest Cypriot banks, Bank of Cyprus and the Cyprus Popular Bank (also known as Laiki bank). The primary objective is to enable the bank to avoid a sudden and disorderly liquidation, by enabling it to continue in business as a going concern until it can be restructured or run down.[116] Accordingly, bail-in should not constitute an event of default that permits the creditor to accelerate or terminate financial contract entered into with the bank. The FSB has emphasised that the resolution authority should be allowed to exercise a temporary stay of up to 48 hours under netting arrangements.[117] By preventing a sudden stop of the bank's business, it reduces contagion and preserves critical functions. Moreover, while the bridge-bank preserves the going concern value of some, or all of the functions of the bank, it is not generally suitable for group structures or SIFIs as the authorities are in charge of the business. The bail-in tool has therefore been favoured as the bank remains as a going concern without the authorities being in charge of the bank. It has therefore been embraced as a more favourable tool than the other resolution tools, when dealing with banks or groups whose business is too complex or too international.

114 Ibid.
115 Ibid, 346.
116 Gleeson, *Supra*, n 76, 1.
117 Financial Stability Board, *Supra*, n 112, 72.

The bail-in tool is by far the most controversial element of the BRRD, and the debate has been centred on the level of discretion that should be left open to the resolution authorities in deciding the particulars of bail-in. By giving Member States too much discretion when applying the bail-in rules, as proposed in the BRRD, there is a risk that big wealthy Member States are using public funds for bail-out whereas smaller and poorer Member States will have no other option but to impose losses on creditors and depositors.[118] Moreover, although the bail-in tool is likely to provide the most efficient resolution option, it also raises the issues of the position of creditors holding the bailed-in debt. A sudden recapitalisation, devaluating the creditors' holdings, could itself be a channel for contagion. For this reason it is inappropriate, for example, to permit banks to hold bail-inable debt in each other.[119]

7. CONCLUSION

It became clear during the 2007–09 financial crisis that a country that has no bank resolution regime may have particularly acute difficulties in containing the effects of a bank crisis. The task of resolving a bank swiftly, and without allowing contagion to spread to other parts of the financial system, can be impossible if the authorities only have conventional corporate insolvency procedures at their disposal. In Europe, the free movement of capital, establishment and services have made it easier for European banks to set up subsidiaries and branches in other Member States of the European Union. However, many European countries do not have adequate bank resolution procedures or no resolution procedures at all. The BRRD, therefore, represents a major step towards making European banks resolvable. The Directive endeavours to secure co-ordination of national resolution authorities, but delivering the necessary co-ordination under crisis conditions is likely to be extremely challenging. Most national resolution authorities will continue to have different incentives. Consequently, it is questionable whether the BRRD will break the link between banks and their sovereigns. The sale of business tool, the bridge institution tool and the asset separation tool are all classic resolution tools. However, all these tools raise the concern of what assets and which method that should be used to transfer assets of the troubled bank. The bail-in tool is likely to provide the most efficient resolution option as it prevents a sudden stop of the bank's business. Nonetheless, it raises the issue of creditors holding the bailed-in debt, as a sudden recapitalisation, devaluating the creditors' holding, could itself be a channel for contagion.

118 Barker, A., *European Union Reaches Deal on Failed Banks*, Financial Times (London, 27 June 2013).
119 Armour, J., *Making Bank Resolution Credible*, ECGI Working Paper Series in Law (Working Paper No. 244/2014), 23.