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Proposal for a Directive on Recovery and Resolution of Credit Institutions and Investment Firms

The European Commission has published its long awaited proposal for a Directive establishing a framework for the recovery and resolution of banks and investment firms in the EU. The proposed Directive delivers on the EU's commitments to the G20 to introduce legislative reform and can also be seen as a first step in the process of achieving Banking Union in the EU, as announced by Commission President Barroso recently.

The idea of Banking Union is a political one and the concept may ultimately encompass a variety of legal instruments designed to achieve closer EU integration of banking. Measures which are likely to be considered further at EU level as part of Banking Union include: an integrated system for the supervision of cross-border banks, a single deposit guarantee scheme, and an EU resolution fund. It is possible that the Commission may produce proposals in these areas during the Autumn.

The recovery and resolution powers under the proposed Directive are divided into three main areas: prevention, early intervention and resolution. Intervention by the authorities will become more intrusive as a situation deteriorates.

The deadline for implementing most of the provisions in the Directive through national legislation is set at 1 January 2015. The provisions relating to the 'bail-in' of liabilities should be applied as of 1 January 2018.

This note explains some of the main points in the proposal. Readers should consult the proposed Directive and the Commission's Impact Assessment for its full terms.

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Scope

The general scope of the Directive is wide and wider than, for example, the scope of the resolution powers conferred by the Banking Act 2009. The Directive generally is addressed to:

- Banks
- Investment firms
- Other financial institutions that carry on one or more prescribed financial services activities (for example, asset management, custody, payment services, corporate finance) and which are subsidiaries of a bank or investment firm and as such are within the scope of consolidated supervision exercised in relation to the bank or investment firm
- Parent and holding companies with a subsidiary that is a bank or investment firm
- Financial holding companies and non-financial companies that are part of groups that contain banks and investment firms
- Branches of 'third country' banks or investment firms (subject to specific provisions that determine whether in particular circumstances the Directive powers are exercisable)

The scope of the Directive is comprehensive in respect of deposit taking banks. Investment firms that are required to maintain a basic capital requirement of €730,000 are also within the scope. Together, banks and '€730,000 investment firms' are referred to as "institutions". Other types of investment firm (for example, a portfolio manager) may fall within the scope of the Directive if they are within the description given in article 1(b) which refers to financial institutions that are subsidiaries of a bank or of an investment firm that has a basic capital requirement of €730,000. Finally, the Directive extends to certain non-financial entities that are holding companies of groups that qualify for consolidated supervision, for example, under the Conglomerates Directive and where the parent or holding company entity has subsidiaries that are banks or investment firms.

There are a few provisions that enable national authorities to choose to limit the application of the Directive. Only "institutions" have to draw up recovery plans on a solo basis. However, each of the 'resolution tools' (for example, asset transfer and bridge bank) must be exercisable in relation to the widest categories of financial entities captured within the scope of the Directive. The intention is that as well as applying resolution tools to individual firms, national authorities should also be able to resolve failing groups containing financial firms.

The proposed EU resolution regime is not, therefore, confined to banks but extends to investment banks that are subject to a minimum own funds requirement of €730,000 and in some circumstances asset managers and other investment firms that hold clients funds or assets. It remains to be seen how, in the UK, the resolution regime proposed under this Directive will work alongside the Special Administration regime for investment banks established under the Banking Act 2009. Non-financial companies can be subject to resolution if they are parent or holding companies that have subsidiaries that are banks or '€730,000 investment firms'.

The application of the Directive to branches of non-EEA, third country, banks and investment firms is described in the section entitled "Safeguards in the case of partial transfers" below.

Resolution authorities

Member States must appoint one or more "resolution authorities" to apply the resolution tools and exercise the resolution powers. A resolution authority may also be a "competent authority". So, for example, it would, in theory, be possible for the FSA and its successor bodies to be appointed as resolution authorities. However, currently, and probably for the future, the UK resolution authority will be the Bank of England (upon which resolution powers are currently conferred by the Banking Act 2009). It is also possible for a government finance ministry to be appointed as the resolution authority (a "competent ministry"). Where the competent ministry is not a resolution authority, all decisions of the designated resolution authority have to be taken in consultation with the finance ministry.

In the UK the appointment of the Bank of England as the single resolution authority under the Directive suggests there will be some further complexity in the regulatory arrangements due to be established under the Financial Services Bill. For example, a number of investment firms will, on the face of it, fall under the aegis of the Bank of England as the resolution authority, whereas the day to day supervision of most investment firms may be exclusively reserved for the Financial Conduct Authority. Banks will be prudentially supervised by the Prudential Regulatory Authority; the Financial Conduct Authority will regulate their conduct, whilst they will be subject to the powers of the Bank of England in relation to resolution powers. The exercise of any resolution power will have to be carried out in consultation with HM Treasury.

Recovery plans

Articles 5 to 8 require banks and investment firms ("institutions") to draw up and maintain 'recovery plans' that set out the management actions that could be taken in the event of a deterioration in the financial condition of the institution. This has to be reviewed at least annually or following any material change in, for example, the legal or organisational structure of the institution. Recovery plans have to be tested against a range of solo and group wide stressed scenarios.

In the case of a group which is subject to consolidated supervision, a further group-wide recovery plan must be drawn up either by the parent undertaking or by a group bank or investment firm.

The supervisor (not the resolution authority) of a bank or investment firm must assess the adequacy of a recovery plan and must require deficiencies to be remedied within 3 months, failing which it must take action which could include requiring the bank or investment firm to reduce its risk profile or change its business strategy.

Article 4 contemplates that the content, detail and stress testing of recovery plans may be modified having regard to the nature, size and circumstances of the institution.

Resolution plans

Articles 9 to 12 require resolution authorities (not supervisors) to draw up a 'resolution plan' for each bank and investment firm. The resolution plan must demonstrate, taking account of its circumstances and the options for applying the resolution tools, how the critical and core business lines of the firm could be legally and economically separated and enabled to continue.

Group resolution plans must also be drawn up setting out how the resolution powers could be exercised in relation to the group as a whole.

Articles 13 to 15 require resolution authorities to assess the "resolvability" of institutions and groups. Central to this assessment is whether an institution or group is resolvable without having to resort to extraordinary public support and whether it would be possible to liquidate institutions under normal insolvency procedures or resolve institutions using a resolution tool and without this giving rise to significant adverse consequences for the financial system.

If a resolution authority determines that an institution or group is not resolvable then it must notify the institution and require remedial steps to be taken. If the measures taken are considered insufficient, then the resolution authority may itself take measures that could include requiring changes to the legal or operational structures of the institution or requiring the institution to set up a parent financial holding company in the EU. The latter power could be exercised where a bank is part of a non-financial group and where it is desirable to set up a separate holding company to control the institution so as to enable the resolution powers to be used in ways that would not have an adverse impact on the non-financial part of the group.

Intra-group support arrangements

Articles 16 to 22 require the law of Member States to facilitate intra-group financial support agreements. The scope of these provisions extends to groups that are headed by a bank or investment firm in a Member State and other groups containing financial undertakings that are subject to consolidated supervision under the Conglomerates Directive.

The intention is to ensure there are no impediments under national law to the establishment of intra-group support arrangements that could be drawn on to address financial difficulties of the entity receiving support. There is no compulsion to establish such arrangements but it might be expected that national resolution authorities or supervisors may encourage groups to put such agreements in place. No agreement can be entered into without the approval of the relevant supervisor who must also be satisfied that none of the parties are in breach of the capital or liquidity requirements or are otherwise at risk of insolvency. It is possible for national law to provide for such agreements to be submitted for the *ex ante* approval of shareholders. Where such approval is given, then the management of the entities must be free, if needed, to implement the agreement without further recourse to the shareholders.

National authorities may oppose the implementation of an agreement if for example, doing so would jeopardise the liquidity or solvency of the entity providing support. It is unclear whether the Commission intends the Directive regime to exclude other intra-group support arrangements or whether national law may continue to permit groups to decide to put in place such arrangements without complying with the Directive's requirements. Nor is it clear what will happen to existing intra-group arrangements as the Directive does not provide transitional measures.

Early intervention and appointment of special manager

Articles 23 to 25 prescribe a set of so-called 'early intervention' powers that should be deployed by supervisors (not resolution authorities) if a bank or investment firm does not meet or is likely to breach the Capital Requirements Directive (Directive 2006/48/EC). Under the proposed revision of this Directive –"CRD4" – the relevant obligations that, if breached, could trigger early intervention will include, as well as the own funds requirements, the liquidity and leverage provisions. The proposed Directive contains no specific quantitative benchmark that would trigger the availability of early intervention (for example, a firm's assets relative to its liabilities falling below a given percentage ratio) but this is something that could be developed by the European Banking Authority (the "EBA") under implementing measures.

The early intervention powers that must be available to supervisors include the ability to require management to contact potential purchasers of the business. Article 24 goes on to provide a power for supervisory authorities to appoint a "special manager" where there is a significant deterioration in the financial condition of a bank or investment firm, or if there have been serious irregularities or breaches of law or regulations, or if the other early intervention measures prove ineffective.

A special manager replaces the existing management of the entity and has all the powers of management. The duty of a special manager is to take all measures to promote solutions that will address the financial condition of the entity and restore the sound and prudent management of its business. It appears that this duty supplements the duties of managers and directors under company law, except to the extent that the fulfilment of those duties may conflict with the duty imposed on special managers under the Directive, in which case the duties of the special manager under the Directive take precedence.

The appointment of a special manager is a potentially powerful and highly intrusive measure. Another approach would be to allow the appointment of a special manager alongside existing management. Article 24(8) provides that the appointment of a special manager is not to constitute an enforcement event under either the Collateral or Settlement Finality Directives.

Objectives, principles and conditions for resolution

Articles 26 to 29 set down the objectives of resolution and the conditions in which the resolution powers may be exercised. The objectives of resolution are now well rehearsed and include the protection of public funds, the avoidance of contagion risk and the protection of depositors. The objectives also include the protection of client funds and assets. The latter is particularly relevant to custodians and investment firms that fall within the scope of the resolution powers.

The conditions for resolution in article 27 require that the bank or investment firm is "failing" or likely to "fail" and failure is then defined as amounting to one or more prescribed circumstances that include a breach or anticipated breach of the firm's capital requirements or that the institution will, in the near future, be insolvent on a balance sheet or cash flow basis. A firm is also failing if it requires extraordinary public financial support which for this purpose is taken to exclude such support given in the form of a general state guarantee of central bank liquidity facilities or a state guarantee of newly issued liabilities (for example, a state guarantee of new deposits).

Where a firm such as a portfolio manager is a subsidiary of a bank or of an investment firm, then article 27 provides that resolution action may only be taken in relation to the portfolio manager if both its financial condition and the condition of its parent bank or investment firm meet the criteria for resolution. In the case of institutions that are part of groups that are within the scope of the Directive, the general rule is that resolution action may only be taken if the article 27 conditions for resolution are met both (i) by the parent entity of the group and (ii) by the subsidiary that is the subject of the resolution action and is an investment firm or bank.

Article 28 sets down some general principles to govern resolution. These include the principle that senior managers of a resolved institution should bear losses under civil or criminal law that are commensurate with their individual responsibility for the failure of the institution. Although not clear, it seems that this provision will require Member States to ensure that their civil or criminal law provides a means of penalising directors of failed firms where it can be shown that they have been responsible for the failure. This may have to involve a very significant extension or modification of the law relating to directors' duties and also the duties of approved individuals under the regulatory system. In practice it may prove very difficult to apportion individual responsibility for the failure of a financial institution.

A further article 28 principle is that creditors should not bear losses that are greater than if the bank or investment firm had been wound-up under normal insolvency proceedings. This is the same "no creditor worse off" principle that is contained in the Banking Act 2009 and which is derived from the protections afforded by the Charter of Fundamental Rights.

Valuation

Having set out the principles and conditions for the exercise of resolution powers, the Directive proceeds to a further preliminary issue, the need for resolution authorities to act on the basis of a fair and realistic valuation of the assets and liabilities of the institutions to which the resolution tools may be applied. Article 30 stipulates that the valuation should be carried out by an independent valuer but acknowledges that urgency may not allow this and hence resolution authorities may, if necessary, themselves carry out the valuation in accordance with the principles set down in article 30. National law must preclude the possibility of a valuation being subject to judicial review. Instead, any challenge to the validity of a valuation will have to be part of a wider challenge to the exercise of the decision to apply a resolution tool.

Resolution tools

The resolution tools are prescribed in articles 31 to 40 and are:

- The sale of the business tool
- The bridge institution tool
- The asset separation tool
- The bail-in tool

Member States can confer additional powers that can be used by national authorities where an institution meets the conditions for resolution and provided such additional measures do not impede group resolution. It is not clear where this leaves the option of whole or partial nationalisation, something that has been used in the UK in relation, for example, to Northern Rock, Royal Bank of Scotland and Lloyds Bank. It may be that nationalisation should be viewed as being a measure that lies entirely outside the scope of, and unaffected by, the Directive as it involves the use of public funds or government balance sheets to take institutions into temporary public ownership.

1. Sale of Business

The 'sale of the business tool' in article 32 enables a resolution authority to effect a whole or partial transfer of shares (or other ownership instruments) or assets and liabilities or a combination of equity and assets/liabilities. The sale should be on commercial terms and the Directive requires the resolution authority to conduct open and fair marketing to achieve a sale. Shareholder rights are disapplied as are, for example, requirements for shareholder approval of a transaction under the Listing Rules. The transferee enjoys the access rights of the transferor to payment, clearing and settlement systems (but not, it seems, trading systems) as well as rights to carry on business under a single market passport. The resolution authority can bypass the normal procedures regarding pre-approval of a change of control of a regulated firm. Any market disclosure of price sensitive information that would otherwise have been required can be delayed pending the completion of the transaction.

2. Bridge Institution

The bridge institution tool enables a resolution authority to transfer the assets, rights or liabilities of an institution under resolution to a bridge entity without having to comply with any requirements for shareholder approval and without having to comply with the Listing Rules. The intention is that a resolution authority should be able to carve out from a failed institution liabilities, assets and rights that will comprise a solvent new institution that is under the control of the public authorities. In this way it may prove possible for a bridge bank (or bridge investment firm) to continue to provide services to the failed firm's customers including access to their deposits. This may be feasible if the resolution authority is able to leave behind liabilities or troubled assets so that the bridge bank can operate with sufficient good assets to support a temporary continuation of the business. A bridge institution is intended to be temporary, initially for a period of 2 years after which, if it has not been sold, it has to be wound up. Where liabilities are transferred, the relevant creditors become creditors of the bridge institution. Creditors and shareholders whose property, rights or liabilities are not transferred have no claim on the bridge institution (but may stand to be compensated under the "no creditor worse off" principle).

3. Asset separation

The asset separation tool enables a resolution authority to transfer assets to an asset management company that can hold the assets and eventually sell them with a view to maximising their value and/or ensuring the business of the institution is wound down in an orderly manner. Transfer to an asset management vehicle is only possible where the market for the assets is such that if they were liquidated under normal insolvency procedures, there would be an adverse effect on the financial market. The intention is, for example, to protect other market participants from the consequences of there being a forced sale of illiquid assets that could impact on the value of such assets more generally.

4. Bail-in

The 'bail-in' tool can be used either to recapitalise an institution so that it meets the requirements for authorisation, or, in conjunction with the bridge institution tool, so as to convert to equity or reduce the amount of claims or debt instruments in order to provide capital for the bridge institution. To use the bail-in tool for the first purpose, the resolution authority has to be satisfied that there is a realistic prospect that it will restore the soundness and viability of the institution.

The scope of the liabilities that can be reduced or written off is comprehensive and extends to any liabilities other than those prescribed in article 38(2) that excludes deposits up to the amount of their guarantee under the Deposit Guarantee Directive; secured liabilities; holding of clients funds and assets; liabilities with a maturity of less than one month; employee fixed remuneration (variable bonuses may therefore be written down/off); trade debts for the provision of services; tax and social security contributions.

The Commission considers it necessary to ensure that institutions maintain an aggregate amount of liabilities that could be bailed-in in order to aid resolution authorities in re-organising the business through the use of a bridge institution. The amount of bail-in liabilities that should be held by institutions is to be left to national authorities and must be an aggregate amount derived from the percentage of the total liabilities of the institution that do not qualify as own funds. Accordingly, institutions will be required to carry a prescribed minimum level of eligible liabilities. In its explanatory memorandum, the Commission suggest that an appropriate aggregate amount could be 10% of an institution's total liabilities (excluding regulatory capital).

If the bail-in tool were implemented in isolation then this could, in theory, confer an advantage upon equity holders. Accordingly, resolution authorities have to assess the extent of the losses that shareholders should bear and cancel shares or bring about dilution of a commensurate value. This requirement is supplemented by a provision setting out the hierarchy that must be applied in writing down and bailing-in claims that begins with common equity followed by additional tier one and tier two debt instruments and then other eligible liabilities.

Write down of capital instruments

The bail-in tool exists alongside a more general requirement on resolution authorities in article 51 intended to ensure that holders of common equity and holders of debt instruments that qualify as additional tier one or tier two capital are effectively wiped out through a cancellation of shares or write down to zero of the debt instruments. This provision underscores the rupture and finality of a business where any of the resolution tools are deployed. In practice, resolution is, in any event, only likely to occur when the equity value of the institution is zero or very close to zero. For holders of tiers one or two capital instruments who must also be wiped out, the only possible mitigation would be if they could show that in the counterfactual of normal insolvency they would stand to receive some value and hence will qualify for compensation.

The write-down power in article 51 can also be used by a supervisory or resolution authority in order to restore the viability of the institution or if the institution receives extraordinary public support. In this circumstance (which would appear relevant to a rescue of an institution via nationalisation) it is possible for the authorities to ensure that equity and regulatory debt holders share the 'pain' of the use of public finance.

If the write down power were used to restore the viability of an institution (not in receipt of extraordinary public support), then it is not clear how the equity and debt holders would be affected. Completely wiping out additional tier one and tier two debt capital would not seem compatible with restoring viability.

The mandatory write down of capital instruments by a resolution authority may not be necessary where the instruments contain contractual terms that bring about the same effect. The proposed legislative power for national authorities to write-down tier one and tier two instruments will come into force on 1 January 2015. It is unclear whether institutions will have to maintain a contractual provision to this effect from an earlier date and in particular the commencement of CRD4 that is due with effect from 1 January 2013.

Ancillary resolution provisions

The Directive makes provision (article 58) for the resolution authorities to be able to enforce the continued or new provision of services (for example, IT services) to an institution that is undergoing resolution. However, this power is only available in relation to other group entities that provide services.

Resolution actions that affect property or liabilities that are located in a different Member State must be effective under the law of the Member State in question. Where property or rights and liabilities are governed by a non-EU 'third country', the person exercising control of the institution under resolution must take all necessary steps to ensure a transfer or other action is effective.

Article 57 provides that the exercise of a resolution power must not in itself be a contractual ground for termination or the declaration of a default or the acceleration of obligations.

The Directive contemplates that resolution authorities may adopt a one-stage or a two-stage procedure for the implementation of resolution tools. In a two-stage process the resolution authority may announce that an institution meets the conditions for resolution. In this event a resolution authority may also want to impose a moratorium on payment obligations of the institution and may suspend termination rights in relation to financial contracts of the institution (articles 61 and 63). This suspension and moratorium applies until 5 PM on the business day following the publication of the notice. The moratorium on payment obligations does not apply to obligations to depositors (up to the limit of the guarantee) and it is not clear how the authorities might, in these circumstances, manage an uncontrolled run on a bank by retail depositors left able to make withdrawals from ATMs following the announcement that a bank is in resolution but before the measures are actually taken. In a one-stage resolution process the taking of a resolution action and publication are simultaneous and hence this problem should not arise.

Safeguards in the case of partial transfers

The Directive makes provision for important safeguards for creditors and counterparties of institutions to which resolution measures are taken. The first refers to partial transfers of property or the partial application of the bail-in tool to liabilities. Shareholders and creditors whose property is not affected by a transfer must receive, in respect of their claims, at least the value they would have received if the institution had been wound up under a normal insolvency procedure.

Second, the Directive provides safeguards to ensure the protection of security, netting and set-off where there is a partial transfer of the institution's assets and liabilities thus risking, for example, the separation of a secured liability from the property over which the liability is secured or separating liabilities and claims that are subject to set off. The safeguards appear to be modelled upon those which are provided for under the Banking Act 2009.

The safeguard provisions need to be read in conjunction with article 77, which provides that termination rights under financial contracts or rights under a "walk-away clause" cannot be exercised unless the institution is resolved by a transfer under a business sale or bridge institution transfer and the rights arise under a financial contract that is not transferred. Taken together with article 57, the Directive appears to provide that where property is transferred to a bridge institution or to third party purchaser under the sale of the business tool, the counterparty cannot use the transfer as a contractual pretext for termination or relying on a walk away clause but if the property is left behind, then a counterparty may do so. A walk away clause is defined in article 77 as including a term (such as that found in 2(a)(iii) of the ISDA Master Agreement) that enables a non-defaulting party indefinitely to suspend its obligation to make payments under the contract.

Relations with third countries

The Directive contains some potentially important provisions concerning relations with non-EU countries. First, it contemplates the negotiation of binding agreements with third countries that could be promoted by a Member State or by the Commission. Clearly, such intergovernmental agreements may take some years to materialise and in their absence article 85 confers upon the EBA the ability to 'recognise', on a case by case basis, third country resolution proceedings relating to a third country bank or investment firm that has a branch in an EU Member State or which otherwise has assets, rights or liabilities located in a Member State. If the EBA recognises such proceedings, then individual resolution authorities have to be enabled under national law to exercise transfer powers in relation to property governed by the national law of the resolution authority. But the EBA cannot recognise third country resolution proceedings if, for example, it considers that creditors, particularly depositors, would not receive equal treatment with third country creditors. This may, for example, require the EBA to consider the impact and coverage of depositor preference rules that exist under US and other third country laws.

The Directive also requires Member State resolution authorities to have powers to carry out a resolution of a domestic branch of a third country firm.

Financing resolution

The Directive contains provisions that require Member States to establish financing arrangements that will support the deployment of the resolution tools. Although the financing arrangements refer to the resolution of banks and investment firms, the proposals are somewhat 'bank-centric' in that, for example, the targeted level of funds to be built up over a ten year period is at least 1% of the deposits of all banks in the Member State. The resolution financing provisions contemplate the build-up of a fund that could be used to:

- Guarantee the assets or liabilities of the institution under resolution or a bridge institution or an asset management vehicle
- Make loans to the institution under resolution etc.
- Purchase assets of the institution under resolution
- Make contributions to a bridge resolution
- Make similar provision with respect to the purchaser where the business sale tool is used

It is unclear from the proposed Directive whether the resolution fund is to be used to absorb losses or whether it could also be used to provide more open-ended forms of liquidity support to a bridge bank or say the purchaser of assets from an institution in resolution. Contributions to fund the financing arrangements are to be risk based in accordance with parameters to be established under secondary legislation by the Commission.

It is expected that there should be mandatory borrowing and lending facilities between national financing arrangements and the mutualisation of arrangements where there is a resolution of a group. In these circumstances there is to be burden sharing among the relevant authorities that are involved in a group resolution.

Certain of the resolution financing provisions impact upon the deposit guarantee fund in a Member State. First, where resolution action is taken that "ensures that depositors continue to have access to their deposits", then the relevant deposit guarantee scheme is to be liable to contribute the resolution financing in an amount up to the amount of losses that it would have had to bear if the institution had been wound up under normal insolvency proceedings. So whenever a resolution action is taken that secures the continuation of access to deposits up to the guaranteed amount, the deposit guarantee scheme must contribute to the financing of the resolution up to the amount that it would have contributed in a normal insolvency.

Second, Member States may in fact rely upon the deposit guarantee scheme in their territory to act as the resolution financing mechanism. But where this is the case the members of the scheme must be able to reimburse the scheme immediately where it has been used to provide resolution finance and is also needed to meet the claims of depositors under the guarantee scheme.

If a resolution were, in combination, to require resolution financing and the reimbursement of depositors under the guarantee scheme, then if the "available financial means" are insufficient to cover both, the deposit guarantee scheme takes precedence.

It seems to be clear that under the Directive proposals firms could collectively have to contribute more to a resolution than if they were merely meeting the costs of the guarantee scheme. There appears to be no limit upon the amount that could be contributed by way of resolution financing.