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Recent Developments in Bank Resolution – Can Bridge Banks be Resolved?

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Introduction

The international bank resolution framework agreed at the level of the Financial Stability Board ("**FSB**") and the G 20 is focused on solving the "too big to fail" conundrum. A central objective is that bank resolution regimes should enable authorities to force shareholders and creditors to bear the losses incurred by the bank, thereby avoiding or reducing claims on taxpayer's funds, as well as avoiding contagious systemic effects on the financial system. To this end, the Bank Recovery and Resolution Directive 2014/59/EU ("**BRRD**") introduced four resolutions tools, namely:

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

The bridge bank tool is functionally akin to the sale of business tool. Rather than immediately transferring the systemically important parts of the bank in resolution to a private buyer, these parts are transferred to an entity set up by the resolution authority specifically for the purpose of maintaining the bank's critical functions. Where a bridge bank is established, the assets and liabilities which are not transferred to it remain in the failing or 'bad' bank which has to be wound up in a conventional insolvency proceeding. Recent examples of the application of the bridge bank tool include *inter alia*:

- Andelskassen JAK Slagelse in Denmark
- Banca Marche, Cassa di Risparmio di Ferrara, Banca Etruria, CariChieti in Italy
- Banco Espirito Santo S.A. in Portugal

Bridge banks are an interim solution

As the name of the tool indicates, the bridge bank institution tool is an interim solution. Article 41(2) BRRD provides that a bridge bank must be operated with a view to maintaining access to critical functions and its sale to one or more private sector purchasers when conditions are appropriate. Accordingly, Article 41(5) BRRD provides that– if the bridge institution has not merged with another entity, no longer meets the requirements relating to a bridge institution or has not sold all or substantially all of its assets, rights or liabilities to a third party and the respective resolution authority has taken a decision that the bridge institution is no longer a bridge institution for one of these aforementioned reasons – then the resolution authority must terminate the operation of the bridge institution as soon as possible and in any event two years after the date on which the last transfer from an institution pursuant to the bridge resolution tool was made. This deadline may be extended for one or more additional one-year periods where such an extension is necessary to ensure

the continuity of essential banking or financial services and to support the outcome of transferring the bridge bank into private ownership (Article 41(6) BRRD).

This begs a question as to the available options of a resolution authority in the event that it is not able to facilitate the sale of the bridge institution, or all of the assets of such institution, on commercial terms within the deadlines as set out by the BRRD. Of particular interest is the question whether – and if so under which circumstances – the respective resolution authority could apply the BRRD resolution tools (for example bail-in tool) to such bridge bank?

Powers of re-transfer and transfer to an asset management company

Before answering the foregoing questions it should be noted that pursuant to Article 40(5) BRRD, the respective resolution authority may exercise the power to transfer assets and liabilities more than once (provided the possibility of such re-transfer and the subject of such re-transfer had been stated expressly in the instrument by which the initial transfer was effected). This might for example be used to make sure that the total value of liabilities transferred to the bridge institution (from the 'bad' bank) does not exceed the relevant total value of rights and assets both at the initial transfer as well as afterwards.

An example where a re-transfer was effected is the re-transfer of bonds by the Banco de Portugal in the resolution proceeding of Banco Espirito Santo S.A. The power of subsequent re-transfer can be exercised by the respective resolution authority independently from the conditions for resolution as provided for by Article 32 BRRD. Accordingly, the resolution authority does not need to re-establish whether these criteria are met in respect of the bridge bank, in particular if the institution is failing or likely to fail. Instead, the power of re-transfer is arguably best viewed as the continuation of the powers of resolution exercisable in relation to the original bank put into resolution. Such a re-transfer power may be viewed as the more specific and limited mechanism by which for example a bridge bank that was judged to be inadequately capitalized could have its capital improved so that it met applicable regulatory standards. Further, it could be seen as an indication that the alternative possibility of applying resolution powers to a bridge bank is not contemplated by BRRD.

Although the power to re-transfer liabilities between a bridge bank and bad bank is not conditional on there being fresh grounds to satisfy Article 32 BRRD it is nonetheless a power that a resolution authority has to exercise with due regard to administrative law principles such as no unfair or non-justified discrimination.

Article 42 BRRD refers to the need for resolution authorities to be able to transfer the assets of an institution under resolution or of a bridge bank to an asset management vehicle. Article 42(8) specifically contemplates an asset management vehicle acquiring assets from a bridge bank 'subsequent to the application of the bridge institution tool'. What seems to be clear from these provisions is that transfers of assets from a bridge bank to an asset management company should be permissible but without the bridge bank itself being placed into resolution. Such a transfer may only take place where one of the conditions in Article 42(5) is satisfied.

Resolving a bridge bank?

It is not obvious that the BRRD contemplates an exercise of resolution powers with respect to a bridge bank. Recital 65 of the BRRD states that "*the bridge institution should be operated as a viable going concern and be put back on the market when conditions are appropriate and within the period laid down in this Directive or wound up if not viable*." Similarly, the FSB's "*Key Attributes of Effective Resolution Regimes for Financial Institutions*" supports this position which is implied by Recital 65, in describing the purpose and functions of a bridge bank. Article 41(8) BRRD provides that where the operation of a bridge bank is terminated (including on the expiry of the prescribed time period), it must be wound up under conventional insolvency proceedings. Accordingly, it seems that the BRRD primarily contemplates either a sale of the bridge institution (or all or substantially all of its assets, rights or liabilities) to a third party or the winding-down of the bridge institution in conventional insolvency proceedings.

It is also notable that whilst the bail-in tool and the power of re-transfer share the same aim of restoring the balance sheet, conceptually they differ. The bail-in tool envisages the restructuring of the affected non-viable institution itself by re-shaping its balance sheet but without transferring its assets or liabilities to a different legal entity. By contrast, the bridge institution tool envisages that the balance sheet of the affected non-viable institution is re-shaped by transferring only certain assets, rights and liabilities to a different legal entity. Under this resolution tool, the power of re-transfer is the mechanism for the purposes of re-calibrating the scope of assets, rights and liabilities that are (ultimately) intended to be transferred to a third party. Hence, the power to

re-transfer could be seen as the more specific mechanism applicable for the bridge institution scenario, compared to the bail-in tool that is applicable for all BRRD institutions on a more general level.

Nonetheless, the BRRD does not expressly exclude the possibility of resolution powers being exercised with respect to a bridge bank, and there are reasons why a resolution authority should have the ability to place a bridge bank into resolution. The most straight forward argument is that BRRD applies to "*institutions*"; according to Article 41(1)(e) BRRD bridge institutions need to be authorised and have the necessary authorisation under the applicable national law to carry out its activities and are therefore defined as institutions within the meaning of the BRRD. Accordingly, the BRRD, including the resolution powers, apply to such entities. This approach is aligned with the purpose of the BRRD, namely the avoidance of contagious systemic effects, which arguably might occur where a bridge bank of systemic importance is failing and the authorities are not empowered to use the resolution tools.

Assuming a resolution authority was to view the resolution of a bridge bank as a feasible option, there would nonetheless be some limitations on its use. First, the relevant authorities would need to be satisfied that the bridge bank met the conditions for resolution in Article 32 BRRD, in particular that it was failing or likely to fail. The fact that it was proving difficult or impossible to bring about a sale of the bridge bank to the private sector would not it is suggested amount to 'failure' for this purpose. Nor should the prospect of the bank being placed into a conventional insolvency, as required upon the expiry of relevant deadlines under the BRRD of itself be evidence of a likely failure. In the absence of conditions satisfying Article 32, it would seem impermissible for resolution powers to be used to facilitate or encourage a potential sale of the bridge bank to the private sector, for example by bailing-in creditors of the bridge bank.

Conclusion

On balance we think the BRRD was not drafted in contemplation of a bridge bank itself being resolved. Instead, the BRRD probably assumes the bridge bank will be formed for a limited purpose and time, with the objective of being sold into the private sector. If that cannot be achieved within a reasonable timescale, the bridge bank is supposed to be wound up in a conventional insolvency proceeding. If a resolution authority were to consider resolving a bridge bank, it would need to ensure that it did so only where the conditions laid down in Article 32 BRRD were strictly satisfied and could not for example use the BRRD resolution powers for the ulterior motive of making a bridge bank more attractive to a potential private sector purchaser.

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