Progress in bank recovery and resolution; a new legislative and institutional framework since 2015

The last financial crisis laid bare the need to develop a new and effective framework for institutions that not only operate within the compass of the European Union but further afield too. In this context the resolution system has improved substantially and meant the introduction of a new raft of legislation whereby the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF) were established within the orbit of the banking union.

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1. Public financial support and its effects

It was an exceptional financial crisis, not just because of the high number of institutions affected, but also due to the fact that most of them had to deal with their problems via government bail-outs.

Across Europe, the volume of state aid deployed in the context of the financial and economic crisis between 2008 and 2015 for the set of 28 EU member states as a whole totalled 1.95 trillion euros. Around 465 billion was provided in the form of recapitalisations (3.2% of EU GDP in 2015), 189 billion in measures against non-performing assets (1.3% of EU GDP in 2015), 1.19 trillion in maximum guarantees granted (8.1% of EU GDP in 2015) and 105 billion in liquidity measures (0.7% of EU GDP in 2015)[1].

On a Spanish level, total public funds employed by the Fund for Orderly Bank Restructuring (the FROB) towards restructuring the banking system amounted to 59 billion euros[2]. Even so, it should be added that this figure was topped off with a contribution of 19.6 billion euros by the Deposit Guarantee Fund, which was funded in this case by the credit institutions themselves. In addition to this, over recent years the liquidity of institutions has been propped up by State guarantees and extraordinary liquidity lines to the value of 178 billion euros (practically all of which has already been recouped along with its interest and what remains outstanding is essentially the guarantee granted by the State for Sareb bonds -where Sareb is the Company for the Management of Assets proceeding from Restructuring of the Banking System for 50.8 billion euros, of which 7.3 has already been redeemed-).

The lion's share of the figure for state funding in Spain comprises 54.3 billion euros that was injected to recapitalise 11 credit institutions in all[3] and which was intended to head off any impact detrimental to the stability of the financial system that might have been caused by their liquidation. The most notable processes that have meant the biggest cost in outright funding terms were 22.4 billion for BFA/Bankia, 13.9 for Catalunya Banc, 11.1 for Banco CAM and 10.2 for NCG Banco. When viewed in relative terms, however, the institutions that have received the most aid in relation to their balance sheets clearly emerge as Banco de Valencia (28%), Catalunya Banc (18%), Banco CAM (16%), CCM (15%) and NCG Banco (14%).

(1) Source: The 2016 Scoreboard - Aid in the context of the financial and economic crisis/ State Aid Scoreboard 2016/ European Commission.

(2) Source: the FROB, as of October 2016.

(3) Grupo BFA, CX, NCG Banco, Banco de Valencia, Banca Cívica, CajaSur, Banco Gallego, Banco Mare Nostrum, Banco CEISS, Grupo Cajatres and Liberbank

Although, quantitatively speaking, this is a far smaller figure than those cited above, in second place come the guarantees granted by the FROB in disinvestment processes or support for mergers involving institutions[4]. The estimated loss under this heading reached 2.4 billion euros. These guarantees can be grouped together into two broad categories: firstly, asset protection schemes (EPAs in Spanish), where the FROB assumes a percentage of the losses on loan portfolios or property foreclosures, and secondly, indemnity undertakings for institutions that have acquired others undergoing resolution, which are in the main associated with legal contingencies.

In third place the rest can be accounted for by the FROB's investment in Sareb, via the underwriting of shares and subordinated debt of 2.2 billion euros.

Returning to the global scene now, the triggering of state bail-outs gave rise to a set of negative externalities for the economy as a whole. In most cases the situation in financial markets and the need to respond urgently forced public authorities to inject such sums of public money into their banking systems, which in all certainty prompted the following effects.

On the one hand, the mere likelihood of a systemically important institution potentially being bailed out encouraged the creation of incentives that were perverse to proper handling of risk by institutions and moreover undoubtedly fuelled the problem of 'moral hazard'. All of this worked in favour of generating conditions whereby the institutions had to run their business and in which not all of them 'played' by the same rules. There is no doubting that those that were perceived as more likely to receive government aid if needs be were better-placed to obtain better and more straightforward financing terms compared to the other institutions which apparently did not have such an expectations-based 'safety net' to rely on. And on the other hand, this produced adverse feedback in terms of the relationship between the banks and the sovereign risk of countries, since the cost would mean the public accounts taking a new hit.

The injection of public money into the system put considerable pressure on the budgets of countries and caused the crisis to change tack away from the institutions and towards the member states themselves. In several European countries the financial crisis sparked major turmoil in sovereign bond markets and more specifically went as far as threatening the very resilience of the euro.

The eurozone crisis and the various responses that occurred in different countries only helped to fuel the relationship of interdependence between the banks and national governments themselves. Moreover, the different solutions applied worsened the already existing fragmentation in financial markets even more, which unquestionably prompted disruptions in lending to the real economy.

Today we can say that considerable headway has been made since then. Supervision has been reinforced and brought into line and requirements stiffened. Between 2011 and 2015 the CET1 ratio for EU banks rose from 9.7% to 12.6%.

According to a European Commission simulation, the benefits for the real economy of greater capital requirements such as those brought in under CRD IV and the new rules on internal recapitalisation (bail-in) produce a macroeconomic benefit that amounts to between 0.6% and 1.1% of the EU's annual GDP, while the macroeconomic costs of these reforms come to 0.3% of GDP.

Yet, despite such progress, after the crisis a new institutional and legislative framework was clearly called for which could provide a response to future banking crises while breaking off the relationship between banks and member states; a new resolution framework which could temper adverse externalities and shift the cost of banking failures away from citizens and, first and foremost, onto the shareholders and creditors of beleaguered institutions.

(4) Source: FROB

2. New legislative and institutional framework

The aim of new regulation since 2008 has been to lay down prudential norms for institutions by enhancing consumer protection, as well as to establish rules for bank resolution. The Bank Recovery and Resolution Directive (2014/59/EU BRRD), Regulation (EU) No. 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms (the Single Resolution Mechanism Regulation or "SRMR"), the Deposit Guarantee Schemes Directive, and European Commission Delegated Acts which are based on technical standards and guidelines of the European Banking Authority (the EBA) together make up the set of rules for the European Union as a whole on planning for resolution and execution of it, together with application of the Deposit Guarantee Scheme.

In Europe the Bank Recovery and Resolution Directive and the Single Resolution Mechanism (SRM) became effective with full powers in January 2016. One of the core objectives of this new bank resolution framework consists of smoothing orderly resolution of banks and investment services firms without giving rise to severe disruption of the availability of funding to the real economy in the financial system.

Just as the SSM (Single Supervisory Mechanism) was established in November 2014, having its headquarters in Frankfurt and comprising the European Central Bank and the competent national authorities (national central banks), the European Union approved the Resolution Regulation and created the SRM, which is the second pillar of the European Union. Cross-border by nature, it endows the resolution authority with extensive powers and resolution tools to step in when the conditions for resolution apply. Furthermore, on a preventive level, the resolution authority is required to draw up resolution plans which provide details of how the institution should undergo resolution if necessary so that the resolution objectives are satisfied while taxpayers are guaranteed that they will not have to foot the bill for the resolution.

The aim of creating and developing the Single Resolution Board (SRB) is to establish a powerful decision-making unit that is independent and centralised, and which ensures that decisions on resolution are taken effectively and swiftly across all of the EU member states, thereby avoiding uncoordinated action and minimising the adverse impact on financial stability, while confining any need for aid from public funds to a last resort and guaranteeing the same rules of play for everyone.

The SRB is in charge of exercising powers of resolution for the most significant credit institutions, be they Spanish or from the other countries in the Banking Union, as well as cross border groups. This basically means the 14 major banking groups as regards Spanish banks, as well as a further 114 eurozone institutions.

On the other hand, in Spain the other institutions that are not under the umbrella of the Single Resolution Board are in the charge of the Spanish resolution authorities. This means the FROB itself, in its capacity as Executive Resolution Authority, in conjunction with the Bank of Spain (for credit institutions) and the CNMV (for investment firms) to carry out preventive efforts. These total 54 credit institutions (of which 38 are credit cooperatives) and around 40 investment firms (the bulk of which are small in size, given that 29 of them have total assets of under 100 million euros)[5].

Together with the National Resolution Authorities, the SRB also works on designing policies and standards to implement the existing legal framework, in particular the Directive and the Regulation.

(5) Data as of February 2017.

On the other hand, within the context of this framework the Single Resolution Fund (SRF) was set up as a mechanism for financing resolution. The SRF pools together the funds coming in from all of the member states and thus protects taxpayers while also facilitating the same rules of play in all the member states.

2.1. Resolution planning and plans

As the Directive itself states, the role of the Single Resolution Mechanism is pro-active; this is not about waiting for a resolution incident to arise, but rather a question of the SRB cooperating with National Resolution Authorities and focussing on resolution planning and preparing it to head off the potential adverse effects of a banking failure on both the economy and financial stability.

The SRM began its resolution planning work right from when it was created in 2015. One of the key tasks of the SRB and the National Resolution Authorities (NRAs) is designing resolution plans. These plans are drawn up within Internal Resolution Teams (IRTs) in the same way as the Single Supervisory Mechanism works through Joint Supervisory Teams (JSTs). The IRTs comprise personnel drawn from the SRB and the NRAs. Their aim when designing the plans is to determine the institution's critical functions, identify and find a solution for impediments to resolution being possible, and to prepare the institution for potential resolution should this become necessary.

The resolution plan picks out the characteristics of the institution and describes the resolution strategy that is preferable for it, including what tools would be used in the event of resolution. Both the Directive (art. 10) and the Regulation (art. 8), as well as the EBA's technical standards take account of what content resolution plans ought to include:

- A summary of the plan itself.
- A summary of the most significant changes that have happened at the institution since the last informative dossier was filed.
- A demonstration of how the key functions and core areas of activity might be separated legally and economically from other functions to the extent that this could become necessary so as to ensure continuity in the event of the institution failing.
- An estimate of how long each major aspect of the plan would take to execute.
- A detailed description of the assessment of the appropriateness of the resolution carried out.
- A description of the measures required to tackle or remove obstacles to the resolution being viable.
- A description of the processes to determine the value and chances of commercialising the key functions, core areas of activity and assets of the institution.
- A detailed description of the arrangements in place to ensure that the information required is up-to-date and available to all resolution authorities at any time.
- An explanation by the resolution authority of how the resolution options are to be financed.
- A detailed description of the various resolution strategies that can be applied depending on the different potential scenarios and the applicable timeframes.
- A description of key interdependencies.
- A description of the options for protecting rights of access to payment and clearing systems, and other items of infrastructure and, where possible, indication should be given of the portability of customer positions.
- An analysis of the repercussions of the plan on the institution's employees, including an assessment of associated costs and a description of the measures envisaged to set up procedures for consulting personnel throughout the resolution process, while taking account where appropriate of national systems for dialogue with social agents.
- A plan for communications with the media and the public, as well as a description of the essential activities and systems to maintaining the ongoing functioning of the institution's operational processes.
- And, where applicable, any option that might have been expressed by the institution in connection with the resolution plan.

Moreover, the Resolution Directive itself, which has been transposed in all of the member states, demands that banks comply with the minimum requirement for own funds and eligible liabilities (MREL), and that this be included in plans, so that they can absorb losses and recapitalise to allow the institution to continue to pursue its critical economic activities both during and after its moment of crisis. The setting of the MREL is thus an integral component in the task of resolution planning. The MREL is key to ensuring that resolution will work for institutions. Merely by setting suitable MREL levels we can make sure that institutions will have sufficient capacity to soak up losses and allow the resolution authorities to protect critical economic functions properly without having to use taxpayers' money.

Another of the key aspects to bear in mind in resolution planning is access to financial infrastructure. The risk of losing this is an impediment to resolution being possible that should be examined in resolution plans. One of the reasons for analysis of this kind is that critical functions cannot be maintained (and this is one of the goals so as to able to pull off a resolution) without access to financial infrastructure.

2.2. Measures to take early action and recovery plans

Article 11 of Law 11/2015 of 18 June on the recovery and resolution of credit institutions and investment firms, which is the Spanish transposition of the BRRD, regulates early action procedure, where this is understood to mean that applied to an institution when it cannot comply with solvency rules.

One of the chief instruments for early action is the recovery plans that will have to be drawn up by all institutions. Whereas under previous rules recovery plans only had to be prepared by those institutions that were going through difficulties, this obligation now extends to all institutions, as it is predominantly preventive in nature. The plan must give consideration to measures and actions to be implemented by the institution to re-establish its financial position if this should suffer any substantial deterioration.

The plan and updates of it are to be approved by the institution's administrative body, thence to be reviewed by the competent supervisor. It must include a set of quantitative and qualitative indicators which shall be used as benchmarks for taking action envisaged. Under no circumstances can it presuppose access to public financial assistance. The competent supervisor will review the plan and any updates of it bearing in mind the possibilities it presents of maintaining or restoring the institution's viability swiftly and effectively. In particular, without detriment to any other measures that they may implement within the remit of their oversight duties, the supervisor may require the institution to take steps to: a) scale down its risk profile, including liquidity risk, b) facilitate the timely implementation of recapitalisation measures, c) review its strategy and structure, d) alter funding strategy so as to enhance the soundness of core areas of activity and key functions or e) apply changes to its system of corporate governance.

Early action measures (which are adopted by the supervisory authority rather than by the resolution authority) mean that it becomes easier to manage problems right from their onset and before the institution fails. The Directive itself sets out a set of qualitative triggers for applying early action measures.

Yet reaching potential trigger situations does not automatically lead to early action measures being applied. The supervisory authority must be called on to investigate the situation in greater depth to confirm at what point trigger scenarios have been reached and to analyse whether such measures are called for. If the decision is not to implement them, the supervisor will have to justify them not being used and outline the grounds for this.

If early action is triggered, the supervisors can apply a series of provisions to prevent the institution's financial and economic situation from worsening.

The supervisor must in all cases advise the Resolution Authority when trigger situations have been reached and the conditions satisfied for early action measures, regardless of whether they are applied or not. This information can galvanise the power invested in the Resolution Authority to require that the institution approach potential buyers to pave the way for its possible resolution or else facilitate some kind of alternative measure involving the private sector and which heads off the failure of the institution and avoids resolution.

2.3. Resolution of an institution

And what exactly does applying resolution to an institution involve? Resolution consists of restructuring it using resolution tools to safeguard public interests, among these the continuity of critical functions, financial stability and keeping the cost to taxpayers to a minimum.

What is ultimately sought is to achieve the **resolution goals**, which both the Directive itself and the Regulation outline thus:

- Ensuring the continuity of critical functions.
- Avoiding any adverse effect on the stability of the financial system, and in particular preventing contagion, including as regards market infrastructure and conserving market discipline.
- Protecting public funds by minimising dependency on extraordinary public financial assistance.
- Protecting depositors who are covered by the Deposit Guarantee Fund and investors covered by the Investment Guarantee Fund.
- Protecting customer assets and liabilities.

Similarly, when pursuing resolution goals both the SRB and the National Resolution Authorities will try to keep down the cost of resolution and avert any destruction of value except where this is required in order to attain the resolution goals.

2.3.1. Conditions for applying resolution to an institution

Even so, for a resolution to be performed a set of conditions must be met which the Resolution Authority must decide on:

- The institution is not viable or there is a chance it will fail;
- no oversight or private sector measure exists that is capable of re-establishing the viability of the institution within a short space of time and
- resolution should be necessary to the public interest; in other words, the resolution goals would not be achieved to the same extent if the institution were liquidated via insolvency procedure.

2.3.2. The decision-making process in triggering the resolution of an institution

The process of analysing whether the conditions have been satisfied to determine if an institution should undergo resolution entails a series of steps. After consultation with the SRB, the European Central Bank decides whether the bank is viable or there is a likelihood of it becoming viable. The SRB can also make such an assessment after notifying the ECB of its intention and only if the ECB has not carried out an assessment of this kind in the three days after receiving this information. The ECB will provide data on the bank for the SRB to help inform the assessment process. The SRB will be ultimately responsible for deciding whether there is no alternative to resolution and if the latter is necessary to the public interest.

If the institution then satisfies the conditions, the SRB will trigger resolution of it whereby the resolution scheme has to be adopted which establishes what resolution tools are to be applied to the institution and, if necessary, whether the Single Resolution Fund will be used. Prior to putting the institution through resolution, the resolution scheme is sent to the European Commission (EC) and will only become effective if there is no objection from the EC or the Council within 24 hours after they have received it.

2.4. The powers conferred upon the Single Resolution Board

Since January 2016 the SRB has been fully operational to execute resolution tasks and has been endowed with a raft of powers for such purpose. The Regulation includes a broad range of powers throughout the articles in it, among which are:

- Having access to information for preparing resolution activities
- Appointing a special administrator which entails taking control over an institution undergoing resolution, including powers to replace its management team. If the resolution authority decides to resolve the institution, it will be crucial to have control over it so as to be able to implement the resolution measures effectively. This point takes on increased importance if there is any suspicion of fraudulent conduct that might have led to the institution failing.
- Exercising claims and powers with respect to shareholders and the management team. So as to achieve the goal of taking control, the resolution authority has the power to replace the management team and officers.
- Power to transfer shares, claims, assets and liabilities.
- Changing the maturity of eligible bonds for use in internal recapitalisation (bail-ins) and to convert them into shares or write down their principal.
- Cancelling or writing down the nominal value of stock held by shareholders without their consent. So as to be able to overcome the obstacles that relate to the shareholder structure, one of the key powers consists of the capacity to exercise all rights and powers with regard to shareholders without their consent. This means, among other aspects, that the Resolution Authority can swiftly replace the number of legally required votes or implement corporate measures to create a new structure for the institution.

2.5. Resolution tools

The Directive, the Regulation and EBA guidelines include and specify the tools available to the Resolution Authority to carry out resolution:

- The sale of business tool, which enables the total or partial sale of the institution's business and is covered in articles 38 and 39 of the BRRD and art. 34 of the SRMR (Regulation (EU) No. 806/2014).
- Setting up a temporary bridge bank, to which part or all of the institution is transferred and which can be either wholly or partially publicly owned, as referred to in arts. 40 and 41 of the BRRD and art. 25 of the SRMR.
- The asset separation tool, whereby assets, claims and liabilities can be transferred to an asset management vehicle either wholly or partly belonging to one or more public authorities and which is controlled by the Resolution Authority. This is covered in art. 42 of the BRRD and art. 26 of the SRMR.
- And finally the internal recapitalisation or "bail-in" tool, as an effective mechanism to ensure that the chances of the costs of resolving a non-viable institution being shouldered by taxpayers are kept to minimum viable. It must also guarantee that systemically important financial institutions (SIFIs) can undergo resolution without putting financial stability at risk. It pursues this goal by ensuring that shareholders and creditors of the failed institution suffer the relevant losses and assume their part of the costs arising from its non-viability. It therefore represents a powerful incentive for shareholders and creditors of institutions to take a hand in its health in normal circumstances and addresses the recommendation by the Financial Stability Board for there to be statutory powers within the framework of resolution to write down and convert the value of debt as an additional option on top of other resolution tools. The bail-in tool is covered in arts. 43 to 55 of the BRRD.

The Directive establishes that the bail-in tool can be applied to all liabilities that are not expressly excluded from internal recapitalisation. The following liabilities that are briefly mentioned are in fact expressly excluded according to art. 44 of the BRRD: covered deposits; client liabilities that are protected under the applicable insolvency law; liability that arises by virtue of a fiduciary relationship provided that the client is protected under the applicable insolvency law; liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days; liabilities with a remaining maturity of less than seven days; a liability to an employee, in relation to accrued salary, pension benefits or other fixed remuneration, or any liability to a trade creditor, tax and social security authorities, and deposit guarantee schemes.

The directive further establishes that in exceptional circumstances the resolution authority should be able to exclude certain liabilities either totally or partially from bail-in where:

- It is not possible to bail-in that liability within a reasonable time.
- Exclusion is necessary and is proportionate to achieve the continuity of critical functions and core business lines.
- Exclusion is necessary and proportionate to avoid giving rise to widespread contagion that could disrupt the functioning of markets, in particular as regards deposits held by natural persons and micro, small and medium sized enterprises.
- Application of the bail-in tool to those liabilities would cause destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

The bail-in tool always entails the institution carrying out a restructuring of its activities. Such a restructuring must be performed by its management team or else by the person who has been appointed by the Resolution Authority. This must be designed within one month of implementation of the bail-in. Over the following month both the Resolution Authority and the Supervisory Authority must evaluate and rubber-stamp the restructure plan's validity as regards its potential for re-establishing the institution as an ongoing concern. If it is found not to be valid, changes to the plan will be requested.

2.6. Additional financing for resolution

There is one aspect we must not lose sight of, and that is that, for the Single Resolution Mechanism to be credible, after the shareholders and creditors have assumed the initial losses, it should be possible to resort to some additional form of funding for the resolution. It is for this reason that the Single Resolution Fund was set up.

A set of requirements must be satisfied, however, to be able to use it in any event: i) the conditions for the resolution must have been satisfied, and ii) the resolution scheme must be adopted by the SRB. Nonetheless, the Single Resolution Fund must also never be used if there has not been a bail-in beforehand of 8% of the institution's liabilities and on top of this the contribution from the Fund is limited to 5% of total liabilities.

The SRF is to be split up into national compartments over a transitional period of eight years before becoming fully mutualised in late 2023. The funds will be gradually built up by the sector via contributions determined and collected by the National Resolution Funds.

The aggregate target size of the SRF is 1% of total covered deposits for all institutions in the EU member states. This is furthermore a moving target, given that the quantity of covered deposits varies over time.

Being thus financed by contributions from credit institutions and investment firms that are under the supervision of the European Central Bank, the fund has already been provided with 10,800 million euros and will have to have reached 1% of total covered deposits within the eurozone by December 2023 (a figure which will be clearly in excess of 55,000 million euros). As of July 2016, Spanish institutions had already contributed 1,420 million euros (which equates to 13% of the total).

Similarly, in Spain the National Resolution Fund has been set up which is managed by the FROB and consists of contributions from investment firms which are not included within the scope of the European fund. Its size is (as might be expected) considerably smaller. At present it has a little over two and a half million euros in it that have been contributed by 28 investment firms.

3. Conclusion

All the measures described the ultimate objective of ensuring an orderly resolution of failed institutions with a minimal impact on the real economy and the public finances. Under the umbrella of the Single Resolution Mechanism, the Single Resolution Board (SRB) in conjunction with the National Resolution Authorities (NRAs), which in Spain's case means the FROB, the Bank of Spain's resolution department and that of the CNMV, work in coordination with each other to achieve this end.

To conclude, the new European resolution framework endows the financial system with greater soundness. It removes the implied subsidy which underwrote the sector, obliges simplification of the structural complexities that plague the banks, and guarantees that financial stability is not rocked by potential crises among institutions.