



# Observations on Bank Resolution Practices and the EU Proposal Vienna Initiative 2

## ***Introduction***

Over the last few years, representatives of the IFIs (the EBRD, the EIB, the IMF and the World Bank) have been involved in a large number of discussions relating to bank supervision and resolution for cross-border banks. They have seen which of the issues have been particularly difficult and how cooperation between national authorities has actually developed in practice. Assessments of home and host authorities have provided additional insight. This experience from the field - identifying the gaps between good intentions and practical implementation - should be put to use when discussing the new framework for crisis management and resolution.

This paper discusses a number of issues, where the field experience of the IFIs as well as of national authorities and banks could provide useful insights relevant to the emerging European countries. The ambition is to highlight these issues from the joint perspectives of a host and home countries and - where possible - suggest how to move forward. An early draft of the paper was discussed in a workshop in London on September 12, 2012, hosted by the EBRD with participants from home and host country supervisors, central banks and fiscal authorities as well as by key parent banks. An earlier draft of this paper was also discussed at the Vienna Initiative 2 Full Forum meeting in Brussels on November 9, 2012.<sup>1</sup>

## ***Background – the present European discussion***

A number of initiatives are currently moving the discussion on bank resolution forward. The European Commission adopted a legislative proposal on bank recovery and resolution (the Bank Recovery and Resolution Directive) on June 6, 2012. The harmonisation of the European legislation in this area should ensure that future bank failures could be managed with minimal disruption for financial stability and public finances. Given the present diversity in European resolution legislation and practice, the importance of such harmonization cannot be overestimated. The proposal aims to equip national authorities as well as banks with the necessary tools and powers to undertake preparation for future crisis and to address bank failures that cannot be avoided. The proposal also creates mechanisms for cross-border cooperation between authorities and banks in preventative actions as well as during resolution.

The creation of resolution colleges is one concrete way of addressing the coordination problem in resolution of cross-border banks. However, many aspects of the proposed cross-border cooperation arrangements are untested and give rise to a number of issues that need to be further addressed. How should responsibilities and burdens be shared between countries and how should conflicts of interest between countries be dealt with in an efficient

---

<sup>1</sup> Notwithstanding its participation in the Vienna 2 Initiative, the European Commission may have different views on issues discussed in this paper.

and fair manner when they arise? On a conceptual level, the decision making process proposed in the draft directive might lead to an undesirable mismatch between the decision making competencies and responsibility for the fiscal and financial stability consequences of these decisions.

More recently, a European banking union has been proposed. The structure of the banking union was set out by the Commission before the June 2012 European Council and further in the report of the Presidents of the European Council, the Commission, the Eurogroup, and the European Central Bank of 26 June 2012. Completing the banking union to deliver a single supervisory mechanism (SSM), a common system for deposit guarantees and an integrated crisis management framework will require much further work. On September 12, 2012, a roadmap to achieve the SSM by the end of 2012 was presented, setting out the necessary decisions to be taken by the European Council and by the European Parliament. The ECB was named as the single European supervisor. On December 13, 2012, an agreement was reached on the governance of the SSM and on the principal distribution of tasks between the SSM and the national supervisors. Changes to the EBA regulation are foreseen, in particular as regards voting modalities, to ensure equitable and effective decision-making within the single market. Non-eurozone member states wishing to participate in the SSM will be able to do so by entering into close cooperation arrangements. The SSM is planned to start on March 1, 2014 or twelve months after the entry into force of the legislation, whichever is later.

The banking union proposal suggests the establishment of a centralized resolution authority. Once the SSM has come to work, a centralized resolution authority should be a natural next step, along with common safety nets and fiscal backstops. In December 2012 the European Council called upon the European Commission to submit in the course of 2013 a proposal for a single resolution mechanism for participants in the SSM, to be examined by legislators with a view of adopting it before the spring of 2014.

A full-fledged banking union embracing all Member States should indeed address most of the issues discussed in this paper. Implementation, however, is likely to take time, and meanwhile existing problems need to be addressed adequately. And as long as some countries remain outside the banking union (because they cannot join as non-EU countries or because they choose not to join as EU countries outside the euro zone) the dilemmas pointed out in this paper will need to be addressed in order to ensure a level playing field in the newly emerging regulatory structure. Including the non-EU countries in a cooperative agreement with the SSM should be a matter of priority.<sup>2</sup>

In a time of large regulatory changes, banks feel uncertainty about how the new regulatory structure is going to affect them in practice and when this is going to happen. Such uncertainty may be unavoidable, because political processes take time, but it carries a cost to society, since it delays necessary investment decisions and possibly hampers credit expansion. Furthermore, cross-border banks suffer from regulatory authorities in home and host countries implementing the new regulations in different ways and at different speeds. Harmonization through the work in colleges is key to addressing this problem.

---

<sup>2</sup> The banking union will be subject to a separate Vienna 2 report in the spring of 2013. By then, more details on the ECB and EBA working modalities will be known.

### ***Financial sectors in emerging Europe***

Emerging Europe is in the focus of the Vienna 2 Initiative. Typically, the financial sectors in emerging European countries are bank rather than market oriented, banks being the main suppliers of traditional banking services. This relative simplicity may help to make resolution discussions easier to handle than they are elsewhere. But emerging European countries, as well as EU member states in Central, Eastern and South Europe, also have some specific features, which considerably complicate a resolution procedure:

- they are typically net importers of savings from other countries,
- these savings (apart from FDI) are to a large extent mediated by subsidiaries and branches of their EU parent banks,
- the subsidiaries (or branches) are often considered to be of systemic importance in the host countries,
- the subsidiaries and branches rarely borrow independently in the international markets, but rather get their funding (in excess of locally sourced deposits) via their parent banks,
- subsidiaries are legally standalone entities, subject to national supervision. However, in many cases they rely on the parent bank not only for capital and funding support, but also for all major strategic and financial decisions.

### ***Supervision and resolution***

Issues of resolution are closely tied to issues of supervision. Host countries are expected to participate in the resolution of cross-border banks, for instance by avoiding ring-fencing and by providing support *inter alia* from public funds if needed. But their ability to influence supervision in non-crisis times is limited and dependant on the decisions of the home supervisor. This is legally evident in the case of branches, but in substance often also for subsidiaries, because subsidiaries are usually dependent on their parent banks for their corporate governance and business structure. Furthermore, information sharing between home and host may be insufficient. There is a recognized conflict between distribution of power between home and host supervisors, as laid down in EU legislation, and the desire in practice to have the host countries participate in resolution.

This situation is partially due to the fact that cross-border banking - and in particular the systemic importance of branches and subsidiaries in host countries - has become much more important than could be foreseen when the balance of power between home and host was introduced into the EU legislation. Today, host countries have a reason to demand stronger influence on decision making in supervision and resolution. With little influence on decisions, it will be hard to explain to domestic taxpayers why their money should be used in the resolution of cross-border banks, should all the mechanisms for avoiding this set out in the draft Commission Directive fail. To the extent that additional supervisory powers are to be delegated to home countries or to the European level these issues gain even more in importance.

There may be various ways to move this process forward. The Nordic-Baltic MoU from August 2010, which rests on the recommendations of the EU-wide MoU of 2008, states that host countries should participate in resolution and possible burden sharing agreements depending on the relative size of the branch or subsidiary in question, but

also depending on their responsibility for supervision in non-crisis times. A model for how the two factors should work is part of the MoU.

The Nordic-Baltic MoU may illustrate what has been possible to achieve so far. But in the long run this is clearly not sufficient. MoUs are not legally binding and may not work as intended under stressed conditions. A firm legal backing for the influence of host countries in non-crisis times - and in resolution procedures - is needed.

*If host countries are to participate as expected in resolution procedures, they must be assured adequate influence in the decision-making in the normal non-crisis work of the supervisory colleges. And this influence must have an EU legal backing.<sup>3</sup>*

### **Host countries in colleges**

As observed above, supervision and resolution are closely tied together. Cooperation between home and host authorities in supervision will make cooperation in resolution easier.

There are several ways in which the host countries' position in the supervisory colleges may be strengthened within the present legal framework. Obviously, practical questions of information sharing and participation in discussions are important. All countries, whether home or host, should have timely access to supervisory information - and more detailed information needed for resolution planning - to make a proper and timely assessment of a crisis situation. However, despite the provisions on exchange of information included in the MoU of 2008 and in the EBA guidelines, during the crisis there were cases of insufficient flow (or no flow at all) of information about the situation of parent banks and measures under consideration by home authorities.

The emphasis on group resolution in the draft Directive constitutes an important step forward compared to the present situation, where any cooperation is more *ad hoc* in character. However, the key role of group level home authorities in establishing the group resolution and recovery plan (RRP) may raise some questions as to whether the interest of host authorities will be appropriately taken into consideration. The draft Directive proposes in Art 7 that group recovery plans should be prepared at the group level. The parent entity should draw up and submit to the consolidating supervisor a group recovery plan that includes a recovery plan for the whole group as well as a recovery plans for each institution that is part of the group. This implies that local supervisors will be involved only at the last stage, when the whole plan is close to being finished. To ensure adequate involvement of subsidiaries and host supervisors the recovery plan for each institution that is part of a group should be reviewed, assessed and approved by local competent authorities before submitting it to the parent.

The resolution colleges will probably involve higher-level supervisors and also participants from other authorities, in particular resolution and fiscal authorities. This is because when a resolution college moves into crisis mode, trouble has already begun and the risk of public money becoming involved has increased. The powers of the group level resolution authority to establish the composition of a resolution college seems

---

<sup>3</sup> Compare the Vienna Initiative 2 note "Observations on Cross-border Supervisory Practices" of October 18, 2012. The note is available at [www.vienna-initiative.com](http://www.vienna-initiative.com).

reasonable. But the group level resolution authorities discretion in the selection of participants to the meetings of colleges provided for in Art 80.3 of the draft Directive should be challenged. It is imperative that high level representatives from countries where group entities are systemic for the national financial system should participate and have an important say in resolution college meetings – as indeed provided for in the draft Commission Directive. Decisions taken within the colleges might have a significant impact on branches or subsidiaries operating in their countries.

*The right of host countries to obtain relevant and timely information and to participate in the work and decision-making process within supervisory and resolution colleges should be implemented in practice.*

### ***Decision-making power and the responsibility for financial stability***

Actions taken by authorities in one country should not lead to instability in another jurisdiction. According to the draft Directive, actions taken by the group level resolution authority should always take into account their impact on the financial stability in the Member States where the group operates. Conflicts of interests between the home and host authorities may appear if branches or subsidiaries are systemic in a host country but not in a group as a whole. Moreover, the home authorities may disregard the interest of a host country if branches or subsidiaries in the host country constitute only a minor part of the whole banking group. Therefore decisions, which may be reasonable for the home country, may be highly destabilizing for the financial system in the host country. Examples of such decisions may be the selling of units or closing of business in a bank that is systemic in a host country.

The draft Commission Directive provides a new and possibly better base for discussions of how to handle such conflicts of interest and how to resolve cross-border banks, trying to take account of both home and host country interest in a balanced way. Art 13 of the draft Directive seems to address this issue adequately. This cooperative approach is worth full support. However, from a host country point of view, some important problems remain and will have to be addressed.

The draft EU Directive proposes to give further power to the competent home resolution authorities and to the EBA (e.g. in the area of recovery and resolution plans) – but to the EBA also a new governance structure, still to be discussed in detail. The group-level resolution authority is put in the lead of recovery and resolution issues related to all parts of the banking group, with resolution colleges designed to ensure cooperation with host-resolution authorities and the EBA tasked with mediating potential conflicts of interest. While suitably avoiding uncoordinated resolution, this arrangement runs the risk of leaving home resolution authorities in practice with too much influence over decisions that affect financial stability and potential fiscal costs of bank resolution in host countries. Left unchecked, such mismatches between powers to make decisions and responsibility for the consequences would likely lead to resolution decisions that unintentionally disadvantage host countries. It is therefore imperative that home-authorities work particularly closely with their counterparts in countries where affiliates are systemic and that home-authorities' powers are curbed by well-informed, impartial, and effective mediation. In addition, it would be advisable to have safeguards in place in case the so far untested decision making process does not work as intended in practice.

Mediation can address potential conflicts of interest between home and host authorities in resolution. The Commission proposal on resolution gives a new and much extended role to the EBA as a binding mediator. The EBA mediation can indeed play a constructive role in breaking the deadlock between home and host authorities and should work to diminish the home bias in supervisory and resolution colleges. However, the regulation that establishes the EBA prohibits it from adopting decisions that impinge on the fiscal responsibilities of Member States (Regulation No. 1093/2010, Article 38). Since resolution decisions could well entail temporary or permanent fiscal costs, there would in many cases be no institution with a mandate to mediate. Resolution would yet again become an uncoordinated, ad-hoc process with all the attendant inefficiencies.

Moreover, it might be difficult for EBA decisions on resolution disputes to be seen as sufficiently impartial as long as they are taken by a board composed of the heads of national competent authorities - existing legal provisions that board members act independently and in the sole interest of the whole union notwithstanding. In practice and following the current regulation, at the first stage decisions in mediation are taken by a *mediation panel*; then they are accepted or rejected by the whole board. This makes the process time consuming and may be disadvantageous in times of crisis. Another challenge is for the EBA to keep abreast of all relevant information to be in a position to take well-founded decisions at short notice. In a crisis situation this will be very difficult and national supervisors will always have an information advantage.

One way to overcome these problems could be to replace legally binding mediation by EBA with EBA mediation pronouncements. There would be strong presumption that pronouncements would be followed by all relevant parties, but no legal obligation.<sup>4</sup>

Given these challenges, it would be prudent to supplement the EBA mediation process with safeguards for host countries, in cases where the EBA mediation process fails to work as intended in practice. Again, the rule and strong presumption would be that everybody follows EBA's mediation pronouncements, but, for example, under a "comply or explain" procedure the host country supervisor would retain its right for unilateral action in the domestic market. It would have to give an explanation if actions were in conflict with the result of the mediation. Some further thoughts - and possibly an EU legal backing - should be given to what explanations might count as reasonable.

*The lead role of group-level authorities in resolution needs to be balanced by close involvement of hosts with systemically important affiliates and effective mediation in the case of conflicts of interests with host countries. Current legal constraints on EBA's ability to act as a mediator need to be addressed. In any event, safeguards for host countries should be considered so that they are protected in case the mediation process does not work as intended in practice. Introducing a "comply or explain" procedure would be one possibility.*

### **Systemic branches and subsidiaries**

Issues relating to systemic branches and subsidiaries in host countries will have to be further considered. Banks in the EU are free to establish subsidiaries or branches

---

<sup>4</sup>This document does not cover the macroprudential policy issues. Such aspects and the related role of the ECB will be considered in the forthcoming Vienna 2 working group on the banking union from the emerging European perspective.

wherever they like in the union. Host countries supervise subsidiaries, but home country authorities are responsible for supervision and resolution of branches, even those that are systemic in host countries. This may leave host authorities with little or no real power over material parts of their financial system, which is not an acceptable situation. Clearly, the influence of host countries in the supervision (and resolution) of systemic branches must increase.

One way to address this problem is to agree that branches above a certain size relative to the host country market could, at the initiation of the host supervisor, be transformed into subsidiaries in a joint coordinated action with the home supervisor. This would apply to existing branches, but also cover the case where subsidiaries are transformed into branches. Such transformation would simply not work without the permission of the local supervisor. Determining what should be the critical size of a branch is, of course, difficult. What is systemic may differ between countries and may also change over time. A simple rule, defining the maximum size of a branch in relation to the local market should however be sufficient. In order to avoid discretion by local supervisors, such a rule should have an EU legal backing.

*Host country rights and responsibilities in the supervision and resolution of systemic branches must increase. One possible way to address this problem is to require branches of above certain size to be transformed into subsidiaries and fall under supervision of host authorities. Agreeing on the threshold size of a branch relative to the local market could be a way forward.*

### ***Intra-group support***

The draft Directive provides an improved basis for discussions of intra-group transfers, when such transfers may be necessary to address a difficult situation. The draft Directive also introduces a number of safeguards for the transferring country, which constitute considerable improvements relative to previous conditions. In particular, the ultimate power of the supervisor of the transferor to prohibit or restrict financial support in a crisis situation is important. However, such decisions can be challenged and brought to the EBA for mediation (Art 21.4 of the draft Directive).

This, however, raises the same questions as previously discussed concerning the mediation process. The potential for disagreement could be reduced by developing general principles on what is and what is not acceptable intra-group support before a crisis situation arises. Art 19 of the draft Directive is a good reference point in this regard. And a “comply or explain” procedure may provide an additional safeguard.

*Further attention must be given to potential conflicts of interest between home and host if the proposal on intra-group support shall work as intended.*

### ***Burden sharing dilemmas***

The establishment of Recovery and Resolution Plans together with the new tools of resolution suggested in the Commission proposal (and already available in some countries) should minimize the need for public money in the resolution of banks. Domestic resolution funds, financed ex ante by banks, should be set up. For cross-border

banks, the need to decide on how costs of resolution or financial support should be split between countries should, at least in principle, be lesser than before.

Yet the possible need for intervention with public money should not be ignored. Experience shows that, once a bank reaches the resolution stage, it may be too late to avoid the use of public funds. And at that stage incentives will be substantial for authorities supervising cross-border banks to push risks or costs over to others, for instance by transferring assets or ring-fencing. If issues of how to handle public money have not been discussed at this stage, it is likely to be too late.

Given the uncertainties of how the new regulatory structure will work in practice, it is not surprising that issues of burden sharing are sensitive. Host countries may feel at a disadvantage in discussions with home countries, which take a more prominent role in the resolution of cross-border banks. A clear division of competences and responsibilities between home and host authorities must be established for this uncertainty to disappear. Sequencing in this regard is crucial. Assurance of the adequate participation of host countries in supervisory and resolution seems to be a precondition to open up for discussions on burden sharing.

Even though agreements on risk or cost sharing will be difficult to achieve in advance, partially because all crises are different, being prepared *ex ante* for what may be needed to agree upon *ex post* is recognized to be a good idea. Principles and procedures for crisis management and resolution can and should be discussed in advance. As this inevitably involves questions of potential burden sharing, fiscal authorities must participate and play an important role.

Some initiatives in this field have already been taken, notably the MoU of 2008 and the EFC-AHWG Report. Recommendations included in these reports should be followed when Member States share costs of a crisis action, i.e. those costs should be shared on the basis of equitable and balanced criteria which take into account both the economic impact of the crisis in the countries affected and the balance of supervisory power of home and host supervisors.<sup>5</sup>

In April 2010 the EFC-AHWG presented a *Report on European policy coordination framework for crisis prevention, management and resolution, including burden sharing arrangements*, which recommended developing a common EU approach. It was clearly recognized that no *ex ante* formulas for the sharing of costs in a temporary bank takeover should be aimed for, but only procedures for the rapid handling of such costs, should the need appear. According to the roadmap that accompanied the Report, the Cross Border Stability Groups should carry out crisis management exercises that would help develop concrete agreements between home and host countries, including processes for the handling of cross border risks or costs. The EFC should develop practical procedures at the EU level for *ex post* burden sharing based on the results of the simulation exercises. The recommendations of the EFC-AHWG Report, including burden-sharing arrangements, were welcomed by the ECOFIN in its Conclusions on crisis prevention, management and resolution adopted in May 2010. However, due to the present euro zone crisis, the process has been delayed.

---

<sup>5</sup> The Nordic-Baltic MoU provides an example of how this discussion could be moved one step forward.

The Commission draft Directive on bank recovery and resolution proposes to establish in each Member State privately financed resolution funds that could be used in a resolution process. Each fund would have the right to borrow from funds in other member states and group-resolution would have access to funds in all involved member states, according to the draft Directive. This structure clearly involves a kind of ex ante burden sharing agreement, the details of which are still to be discussed. Parallel to this process, burden sharing agreement will also need to be developed with non-EU countries where EU banks operate.

*Important issues of burden sharing are not handled in the draft Directive and need further attention. Being prepared ex ante for what may be needed to agree upon ex post is recognized to be a good idea. One way of getting prepared is to agree upon principles and procedures for ex post burden sharing for cross-border banks along the lines decided by the Ecofin in 2010. However, assurance of the adequate participation of host countries in supervisory and resolution seems to be a precondition to open up for discussions on burden sharing.*

### **Proposed resolution tools**

The draft *Directive* introduces a wide range of resolution tools and resolution powers, which could be applied to resolving banks. Of particular interest is the *bail-in* tool. Further thought may have to be given to how this tool could apply to banks operating in emerging European countries, which rely primarily on local deposits for funding. According to the proposal, institutions should have a sufficient amount of liabilities in their balance sheet that could be subject to the bail-in. The minimum level would depend on the risk profile and sources of funding of each institution. Harmonised application of the minimum requirement at the EU level is to be ensured by Commission delegated acts. According to the Commission an appropriate percentage of total liabilities, which could be subject to bail-in, could be equal to 10% of total liabilities (excluding regulatory capital). Time constraints and structure of the financial markets in emerging European countries may make it rather difficult to issue new bank debt in proper time and amount in order to meet these new requirements. Other alternatives, such as increasing capital requirement or making funding from the parent bank bail-inable, may have to be considered. This does not seem to be in contradiction to the draft Commission Directive, but some practice has to be established to increase certainty.

Besides, the minimum level of “bail-inable” debt should perhaps be adapted to a low-risk, deposit-funded banking model, which dominates in this part of Europe.

Questions concerning the demand for “bail-inable” debt by international and domestic investors also remain, most certainly for the banks of emerging Europe. For all banks, the willingness of investors to buy the new instruments will depend on how the risk profile of the issuing banks will actually change, and this issue is still under debate.

*The regulations concerning bail-in need to be further developed to account for conditions in small and yet undeveloped domestic capital markets.*