

Vienna 2 Initiative

Observations on the proposed Directive for Bank Recovery and Resolution (BRRD) and the Single Resolution mechanism (SRM) ¹

On June 28, the Council set out its position on the proposed Directive for Bank Recovery and Resolution (BRRD). Negotiations with the European Parliament will follow with the aim of getting the Directive adopted before the end of the year. On July 10, the Commission published the proposal for a Single Resolution Mechanism (SRM) for the Banking Union. The BRRD and the SRM are the two pillars of the European bank resolution procedures. In discussing these pillars, the Working Group perspective reflects its composition of home and host banks and authorities in the CESEE countries as well as of the International Financial Institutions (IFIs). The conclusions of the working group build on reports previously published by Vienna 2 on Supervision and on Resolution and on the working group report on the Single Supervisory Mechanism (SSM) from April 30, 2013 (www.vienna-initiative.com). The report has also benefitted from a discussion in the Vienna Initiative Full Forum in Brussels on October 21-22, 2013.

- *The countries of Central, Eastern and South Eastern Europe (CESEE) have today very different starting points in relation to the banking union.* There are euro area members (Estonia, Slovakia, Slovenia and Latvia in the near future), EU members outside the euro area (Bulgaria, Croatia, Czech Republic, Hungary, Lithuania, Poland and Romania) and non-EU members (Albania, Belarus, Bosnia and Herzegovina, Kosovo, Macedonia, Moldova, Montenegro, Russia, Serbia, Turkey and Ukraine).
- *In many CESEE countries banks headquartered in Western Europe play a central role for the national financial systems.* Subsidiaries or branches of these banking groups are in many of the host countries considered to be systemic while still being small in relation to the balance sheet of the banking group. Subsidiaries and branches often rely on substantial parent bank funding, although efforts to create local funding markets are underway. In some of the countries outside the euro area domestic lending in euro has been extensive.
- *CESEE countries have a clear interest in a complete and successful European banking union.* The interdependence of the banking systems makes sound supervision and financial stability in the banking union critical to all CESEE countries. Maintaining financial stability in CESEE host countries is also of interest to the ECB and the SSM. Ensuring a proper role for countries that are not yet part of the banking union will contribute to the banking union's success.

¹ The working group consisted of representatives from the Austrian and Polish regulatory authorities; parent banks including Erste, Intesa Sanpaolo, Societe Generale, Raiffeisen and Unicredit; the IMF, the World Bank, the EBRD (Chair) and the EIB (Observer). Comments on the first draft of this document were also received from the Ministry of Economy of Hungary, the Bank of Albania and KBC.

Considerations concerning the BRRD

- *In bail-in procedures, more precise conditions for the use of discretionary powers by national authorities should be developed.* It is recognized that some discretion is needed since the funding pattern of banks may vary between countries, particularly in the degree of deposit funding. Although discretion may result in unequal treatment of some creditors in a cross-border bank crisis, it might in certain cases be necessary to preserve national financial stability. Discretionary decisions by local resolution authorities concerning bail-in of certain liabilities should take into due consideration spillover consequences in other jurisdictions.

However, the vague criteria suggested for the use of discretionary power (risk of widespread contagion, not bail-inable within reasonable time, loss of other creditors is higher than loss of creditors bailed-in) give rise to uncertainty, and that uncertainty will increase the cost of funding for banks. Large deposits flow quickly across borders in a crisis and expected or suspected differences in bail in procedures will affect these flows. Prolonged periods of uncertainty about bail-in procedures may have substantial effects for the credibility of the financial system.

The list of bail-inable liabilities and the conditions for discretionary actions must be further specified. It is important that the rules are sufficiently harmonized and consistent across countries. The ESRB may help to develop specific criteria for the exclusion of liabilities from bail-inable debt and under what circumstances exclusion may be justified. How well the bail-in procedures will turn out to work in practice will be important for the amount of backstops needed (see below).

- *There is a risk that the absence of credible backstops will make the market doubt whether a major cross-border crisis can be handled adequately.* National backstops will be credible when the sovereign has a sufficiently solid balance sheet. But this is not always the case. The absence of credible backstops may incentivize market participants to withdraw from providing liquidity to the market and in that way contribute to deepening a crisis. When national funds are gradually built up, credibility may increase. But full credibility will not be attained until a common backstop is agreed upon. The ESM has already started to work as part of a common backstop for the Euro-area (given its role in macro programs), but the issues of legacy remains to be fully sorted out and the role of the ESM as a common fiscal backstop must be established politically. For countries outside the Euro-area the ESM has no role, at least so far. The issue of credible backstops for countries outside the Euro-area needs to be addressed.

If possible, the speed towards the common backstop should be accelerated. Parallel to this, the ongoing work at the international level on improved Loss Absorption Capacity should be acknowledged and encouraged.

- *Interests of non-EU countries in resolution should be adequately taken into consideration.* The banking systems of many non-EU countries are closely tied to

parent banks in EU-countries. The financial stability of these countries should be considered in the resolution of a relevant EU bank. Formal procedures for the participation of non-EU countries in the resolution process must be developed and the institutional setup for a mediation to handle conflicts of interest must be established.

- *For cross border banks, local Recovery Plans could be developed as fully integral parts of group recovery plans and jointly approved by group and local supervisors.* Recovery Plans are considered by banks to be useful in spite of demanding considerable resources. They are, however, developed on a group level with a top-down approach. In addition to those group Recovery Plans local Recovery Plans should be prepared to cover the case where a subsidiary, which is systemic in the local market, runs into trouble. Asking for additional capital from the parent bank may not be feasible or at least not the only solution in such a case. Similarly, the sale of subsidiary in a host country need not be the only measure to deal with a crisis situation provided for in a group Recovery Plan.

Local recovery plans and should always be well synchronized with group-level recovery plans. They can be presented in Crisis Management Groups and in Supervisory Colleges to form a platform for an early discussion on resolution matters.

Local authorities, being responsible for national financial stability, should develop local Resolution Plans on the basis of the local Recovery Plans delivered by relevant subsidiaries (valid for the case of “multiple points of entry” resolution strategy). This should be done in close cooperation with group level resolution authorities (the Board of the SRB) and plans should be closely coordinated with group resolution plans. Resolution funding needs on the subsidiary level and the availability of local fiscal backstops should be added to this discussion. Possible local bail-in limitations should also be discussed.

Considerations concerning the SRM – SSM countries and opt-ins

- *All elements of the banking union - common supervision, common resolution, common safety nets and (eventually) a common fiscal backstop - are required for its effectiveness.* With regards to the safety nets, in the absence of a common EU wide deposit guarantee scheme a further harmonization of deposit guarantee schemes across the EU is essential. Although the political process may require sequencing, being well prepared for future crises and helping overcome the current euro area crisis necessitates all elements being in place. Establishing only common supervision would be a concern to all Vienna 2 members - supervisors, central bankers, IFIs and commercial bankers. Common resolution and its financing are seen as critical elements of a functioning banking union. It is fundamental to speed up the completion of the steps leading to a full banking union. Many of the problems presently discussed relate to the transition period rather than to the steady state

situation.

- *A transparent and independent resolution mechanism is important for the credibility of the banking union.* Conflicts of interest could appear in many cross-border resolution cases. Agreed and transparent resolution procedures and clear accountability of the management of the SRM are important to create long run confidence in a common resolution mechanism.
- *The voting power in the SRM Executive Sessions should be balanced.* The SRB board, the EC and the ECB together hold the majority of the votes according to the original Commission proposal on the SRM. In the following discussions both the EC and the ECB have been reluctant to participate as voting members in the executive sessions – the Commission has the final say anyhow and the ECB is the supervisor. Whatever the outcome of these discussions, the majority of the SRM central function in the executive sessions should be kept since resolution should have the common interest in focus. The decision making process within the SRM should reflect the need for more centralization and the Euro-wide dimension. The voting power should be split in a manner, which does not emphasize the issue of home-host relationships.
- *It is unclear how the procedures of the SRB will allow for quick decisions if necessary.* Some resolution procedures may be handled without time pressure. But some will need quick decisions, perhaps over a weekend, as indeed has been observed during the financial crisis of 2008 and onwards. A procedure for quick decisions needs to be established and communicated and the relations to other authorities in such cases must be specified. All cooperation in crisis resolution should be tested in crisis management exercises to show whether it will work in practice.
- *The conditions under which the Commission may act independently in a resolution case without consulting the SRM Board should be further specified.* Normally, the Commission will decide after careful assessment by the SRM Board. But, as one way of obtaining quick decisions, the Commission (according to the SRM proposal) can act without the assessment of the Board. This procedure raises several questions. How will the Commission judge whether a bank should be subject to resolution? Who will provide the analysis to support a decision taken by the Commission? And making the Board responsible for decisions taken by the Commission on its own will raise questions of accountability. The division of power and responsibility between the Commission and the SRM Board should be further clarified in this respect. Similarly, the division of responsibility between the Commission and the ECB with regard to assessments of non-viability need to be clarified.
- *In most crises, the provision of central bank liquidity tends to play an important role.* Indeed, as observed during the liquidity squeeze in 2008, the provision of euro-liquidity was crucial to handle the problems in the first stages of the crisis. Discussions with the ECB on euro-swap facilities for countries outside the euro-region have started and should be encouraged.

- *Opt-in countries should be covered by the common backstop, if and when such backstop becomes available.* In the SRM resolution discussions and decisions, opt-in countries will participate on equal terms with Euro-Zone countries (which should provide a strong incentive to opt-in). It seems reasonable that opt-ins should also pay for and have access to the common backstop. Further work is needed to reduce legal and other obstacles to making the ESM available as a backstop also to opt-in countries.

It should be kept in mind that backstops (whether national or common) are not meant to be a funding mechanism for ailing banks but a mechanism for providing funds for systemically relevant parts of a group once all other means of resolution funding have been exhausted.

Considerations concerning the SRM – non-opt in and non-EU countries

- *Resolution is a European matter.* Decisions by the Board may deeply affect the financial stability of non-opt in and non-EU countries and their interests should also be carefully considered. In a broad European context, there is a need for shifting the perspective and attitude from a national to a European level. To achieve this, countries outside the SRM group must be involved in resolution procedures from the start and the SRM decision-making process must be transparent to all.
- *For non-SRM countries, the SRM offers a single point of contact for resolution discussions with SRM countries.* This is an improvement relative to the situation where home country resolution would remain national, as the SRB will provide a mechanism to ensure consistency of positions of involved authorities. For non-SRM countries, there will be one counterparty to deal with in the Euro-area.
- *The participation of non-SRM countries in the SRM resolution procedures should be subject to separate and harmonized agreements.* The banking systems of the non-SRM countries are to a large extent tied to the banking systems of member countries and decisions made by the SRB may have serious consequences for the functioning of the financial systems in non-SRM countries. Cases where subsidiaries are small relative to the whole group but big in relation to the local market are of particular concern. The resolution authority “should take into account the impact on the group as a whole and on financial stability in other affected jurisdictions, and undertake best efforts to avoid taking actions that could reasonably be expected to trigger instability elsewhere in the group or in the financial system” (KA 3.9). To make this work in practice, agreements should be made to assure early participation of non-SRM national authorities in the SRM resolution procedures.

EU countries that are not participating in the SRM are already assured a place in the resolution colleges. Their role in relation to the SRM may however be further specified. The procedures for a tighter cooperation with non-EU countries should

also be further specified in the SRM framework and agreements need to be formalized.

There is an important practical aspect to this. For the SRM, having *ex ante* consultations with many host countries is cumbersome, particularly in a stressed situation. The relations between the SRM and the non-SRM countries (whether EU or non-EU countries) need to be harmonized and consistent and the formal procedures for cooperation set out in advance.

- *For non-EU countries, the cooperation with the EBA should be strengthened.* The non-EU CESEE countries are potential EU candidates with banking systems closely tied to EU countries, which makes the EBA natural as a node for developing contacts. Explicit formal lines of contact should be established as part of the work of supervisory colleges if not already existing. Participation in relevant resolution colleges should be made possible by EBA guidelines on the functioning of resolution colleges. The EBA assessments of equivalence of compliance of supervision and confidentiality provisions in non-EU countries as a prerequisite for cooperation in colleges should be accelerated. Changes in the legal base for the EBA, which would allow a more active role in involving non-EU countries, should be considered.
- *Relations with the ECB as the Single Supervisor and with the SRM must also be developed.* The ECB as a Single Supervisor exists from November 2013 onwards and its supervisory model and functions are under rapid construction. The SRM is not yet an existing entity. The new institutions will naturally focus on the ESM and the EU member countries. But procedures for handling the relations with non-EU countries should be agreed as a part of the build up process of the new Single Supervisor and of the SRM, and resources should be provided for this. The IFIs and the Commission may have a role to play in developing workable cooperation agreements.²

² Inspiration could be sought in the models of cooperation used by the European Commission in sectors like energy and transport.

http://www.energy-community.org/portal/page/portal/ENC_HOME/ENERGY_COMMUNITY/Milestones,

http://europa.eu/rapid/press-release_IP-08-382_en.htm,

<http://www.eesc.europa.eu/?i=portal.en.rex-opinions.15764>