

## The Authors



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## Abstract

On 27 June 2013, the Council of the European Union agreed on its position regarding bank resolution.

Following this confirmation, the European Parliament published the Bank Recovery and Resolution Directive<sup>1</sup> (BRRD) on 15 May 2014.

As we shall see, this Directive constitutes a major shift in the role of the authorities. Authorities will now be empowered to take direct action on financial institutions under resolution, and monitor minimum requirements for own funds and eligible liabilities.

This briefing note presents an overview of the BRRD, highlighting its key components, along with a brief summary of the technical standards and guidelines issued by the European Banking Authority (EBA).

## BRRD: Prevention, Intervention and Resolution

As specified in the Directive, the financial crisis highlighted the lack of adequate regulatory tools for dealing with unsound or failing institutions. As a consequence, the European Union made a commitment at the November 2008 G20 summit in Washington, DC, to review the resolution regime and bankruptcy laws. This new regime aims to ensure 'an orderly wind-down of large complex cross-border financial institutions'<sup>2</sup>.

The BRRD reflects this new resolution regime – but goes a major step further. Indeed, once resolution has to be initiated, it is, in fact, too late. As such, the Directive commences by outlining a process for the prevention of financial failure. Should the institution fail to implement these measures or reestablish sound financial stability, the authority then has the power to intervene directly in the strategic and business decisions required to rectify the financial situation. If these measures prove insufficient, the financial institution will then be placed under resolution. Resolution will involve restructuring by the authority, through the use of identified resolution tools, to maintain the critical functions of the bank and restore viability of specified parts of the institution, while remaining parts are liquidated under normal insolvency proceedings.

## Prevention

The main prevention measure implemented by the Directive is to request recovery plans from financial institutions to be updated at least on an annual basis. The recovery plan requires the management to prepare for a crisis or event of financial instability – this process should ensure that appropriate measures are in place to be enacted in a timely manner. The recovery plan should outline in detail the actions and operations to be taken to sell or liquidate non-critical operations, and to ultimately restore the institution's financial stability. Even timely recapitalisation should be considered, along with a set of indicators outlining when each recovery measure should be taken. The guidelines on the range of scenarios to be used in the recovery plan were issued on 18 July 2014<sup>3</sup>.

<sup>1</sup> / Bank Recovery and Resolution Directive (2014/59/EU)

<sup>2</sup> / Press release, Council of the European Union: "Council agrees position on bank resolution", 27 June 2013

<sup>3</sup> / Draft Guidelines on the range of scenarios to be used in recovery plans, EBA

The resolution authority will also contribute to the prevention process by preparing a resolution plan, outlining the measures to be implemented should the institution be likely to fail. As for the recovery plan, the resolution plan outlines in detail the set of measures, responsibilities and time frames of each measure to be taken.

Communication of the plans will be necessary to ensure effective implementation and avoid adverse effects on the financial system. The BRRD therefore outlines the need for an appropriate communication plan by both the resolution authority and the institution.

## Intervention

The introduction of direct intervention from the authorities in the management of a financial institution is one of the major implications of the BRRD. While this intervention will only be initiated if the institution is failing or likely to fail, it still represents a seismic shift.

In addition to directly instructing the institution to sell or liquidate assets or to restructure its legal composition, as of 1 January 2015 the resolution authority will have the authority to replace the management of the financial institution, without the consent of its shareholders.

## Resolution

The Directive outlines four types of resolution tools that may be used in the event of a failing institution.

The first tool is the sale of shares or businesses that are not critical to the continuity of the institution. The second is the creation of a temporary structure (e.g., a bridge institution), designed to hold the shares or other ownership institution or its assets with a view to maintaining access to critical functions, enabling acquisition by a third party in the most optimal way. The third measure must be used only in conjunction with another resolution tool, as it consists of the separation of under-performing assets.

Following the financial crisis, creditors are now required to bail-in and renounce a partial or complete liability. This is to ensure that

taxpayers no longer have to pay the costs of resolution. The concept of bail-in is therefore the fourth resolution tool outlined in the Directive.

To protect the financial stability of the markets, covered deposits are excluded from the bail-in measures. The European Committee also protects small creditors (legal or natural) by giving them a preferred status over senior uncovered creditors and subordinated creditors. During the European Institute for Regulation Convention, the hierarchy of credits was outlined by the Fonds de Garantie et de Dépôts et de Résolution (FGDR)<sup>4</sup> :

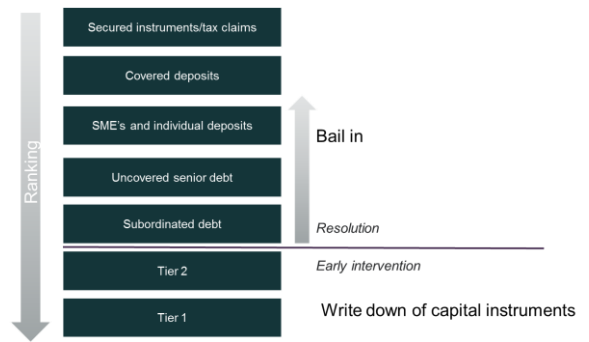


Figure 1

In the event of failure, the bail-in measures should contribute to cover the losses by at least an amount of 8% of total liabilities (including own funds) and 20% of Risk-Weighted Assets (RWA). As highlighted in Figure 1, the contribution of each creditor or shareholder will depend upon the nature of the liability. Needless to say, this is a material contribution but is designed to ensure that financial soundness can be restored. Covered deposits are excluded from the bail-in measures, as they are covered through the deposits and guarantee scheme (aggregate deposits of each debtor up to €100,000). This bail-in procedure is a prerequisite for the institution to be able to apply for resolution funding.

Figure 1 also highlights that equity could be fully or partially written down. In light of these measures, on 11 November 2014 the EBA published draft guidelines on the treatment of shareholders in bail-in or write-down and conversion into capital instruments<sup>5</sup>. Depending on the net asset value of shareholder claims, equity will be either fully or partially written down.

The impact on shareholders will be either through the write-down or through dilution by the conversion of liabilities into equity. The conversion of liabilities into equity is also outlined in a dedicated

<sup>4</sup> / Bail-in and resolution financing within BRRD, FGDR, EIFR, March 2014

<sup>5</sup> / Draft Guidelines on the treatment of shareholders in bail-in, EBA

consultation paper outlining guidelines on the rate of conversion of debt into equity in bail-in<sup>6</sup>.

2015 to provide notification of this first contribution request to financial institutions.

## Resolution financing arrangements

If the losses cannot be completely absorbed by eligible liabilities, the institution may appeal for contribution from the resolution funds.

However, this will only be possible if the loss absorption by shareholders and creditors is above 8% of total liabilities, and its contribution is limited to 5% of total liabilities. It is to be noted that derogative conditions are outlined in the Directive. Of course, these arrangements do not come without a cost. The resolution funds are indeed funded by the institutions active in the Member State of the resolution authority. The relevant guidelines are to be drafted by the EBA by 3 July 2015. However, in anticipation, the European Commission released a draft delegated act on 21 October 2014.

The resolution fund shall represent 1% of all covered deposits by 31 December 2024. The draft delegated act outlines the calculation of annual contribution as follows:



Figure 2

In this calculation, average liabilities exclude covered deposits (covered by the Deposit Guarantee Scheme) and own funds. As we can see, the contribution depends greatly on the characteristics of the financial institution itself and its assessed riskiness (Figure 2). It is to be noted that small institutions will contribute to a lesser extent, at a fixed price or lower than proportionate contribution.

Even though the contribution will be calculated by the resolution authority, it is advisable that institutions begin to prepare and assess what their contribution could be. Indeed, the first contribution will be requested as early as 31 December 2015. The delegated act gives the resolution authority until 30 November

## Resolution authorities

The attentive reader will have noted the use of the term *resolution authority*, rather than *prudential authority*, in this text. In addition to the obligations of the financial institutions, the Directive also outlines the roles and responsibilities of supervisors. To ensure appropriate preparation and intervention range, the Directive requires resolution authorities to be independent from authorities responsible for prudential review. In practice, however, the resolution authority will be a dedicated department of the relevant central bank.

In line with the Single Supervisory Mechanism, institutions supervised by the European Central Bank (ECB) will be supervised at the European level for resolution purposes. To enable this level of supervision, the Single Resolution Mechanism (SRM) was agreed on 19 December 2013. In line with the SRM, a separate fund (the Single Resolution Fund) will be created to aggregate the contributions of the Member States' institutions to the resolution funds.

To assess the financial stability of financial institutions, the Directive introduces the concept of Minimum Requirements for Eligible Liabilities (MREL). The MREL represents the proportion of own funds and eligible liabilities over total liabilities and own funds, for which the EBA issued the draft technical standards on criteria for determination on 28 November 2014<sup>7</sup>. Eligible liabilities have to meet five conditions<sup>8</sup>:

1. Instruments issued and paid-up;
2. Not owed to the institution itself;
3. Purchase was not funded by the institution;
4. Maturity greater than or equal to one year; and
5. Liability does not arise from a derivative or deposit which benefits by preference in the hierarchy of deposits (Figure 1).

The technical standards do not provide minimum criteria for all institutions but provide the formula to be applied, as outlined in Figure 3.

<sup>6</sup> / Draft Guidelines on the rate of conversion of debt to equity in bail-in, EBA  
<sup>7</sup> / Draft Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities, EBA

<sup>8</sup> / Article 45, Paragraph 4 of Directive 2014/59/EU.

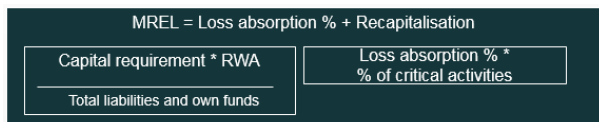


Figure 3

As we can see, the MREL is constituted of two key dimensions. First, loss absorption represents the capital requirements according to the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) framework. This capital will always be required to pursue the bank’s activities – the minimum loss absorption requirement is thus the capital requirement over total liabilities and own funds.

In the event of resolution, critical activities will have to be pursued and will require recapitalisation. This recapitalisation should be constituted by the same level of own funds as the loss absorption percentage. The recapitalisation percentage is therefore calculated as the loss absorption multiplied by the proportion of the bank’s critical activities. However, the MREL will be later adapted for the risk profile, systemic importance and level of funding through deposit guarantee funds.

According to the EBA, the MREL is globally compatible with the FSB-proposed Total Loss Absorbing Capacity (TLAC). However, as the EBA acknowledges, material differences are to be noted.

The first of these is that the technical standards determine the MREL on a case-by-case basis, whereas the TLAC determines a minimum requirement from 16 to 20% of RWAs. Secondly, the TLAC accepts only a limited amount of non-subordinated debt (2.5% of RWA, except that 16% of RWA can be covered without inclusion of the non-subordinated debt), whereas the eligibility criteria of the MREL is defined by the BRRD, which does not restrict the inclusion of non-subordinated debt. A third material difference resides in the ratio’s measurement, where the TLAC is measured as a percentage of RWA while the MREL is measured as a percentage of total liabilities (including own funds).

Finally, the FSB sets a target date of 1 January 2019, whereas the MREL will be applicable as of 1 January 2016 at the latest (depending on the date of national implementation). Figure 4 highlights the identified discrepancies between MREL and TLAC.

	MREL	TLAC
<b>Entry into force</b>	1 January 2016	1 January 2019
<b>Scope</b>	All credit institutions and investment firms	G-SIBS
<b>Ratio</b>	% of own funds and eligible liabilities	% of RWA
<b>Minimum level</b>	Pillar 2 Case-by-case	Pillar 1 minimum TLAC + additional Pillar 2 requirements on case-by-case basis
<b>Eligible instruments</b>	Eligible liabilities according to BRRD	Non-subordinated debt restricted to 2.5% of RWA
<b>Ranking</b>	SME and individual deposits benefit from a higher ranking than senior debt	Contractual subordination

Figure 4

The MREL determination is the responsibility of the resolution authority, but financial institutions should be ready to challenge and assess their financial soundness by measuring their MREL level.

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## How Can We Help?

With extensive experience and expertise in risk management and risk reporting, Avantage Reply is in the ideal position to assist our clients in the transition to the new resolution regime established by the BRRD.

Having already assisted a number of clients in recovery plan preparation, we have developed unique insights in how to best develop robust recovery plans that meet EBA requirements, as implemented by the Bank of England and the European Central Bank. Avantage Reply also provides services across other core elements of the BRRD, such as resolution funding, balance sheet management, capital adequacy and optimisation, and liquidity management.

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