

## EMEA Centre for Regulatory Strategy European Requirements on Recovery and Resolution published



### European Requirements on Recovery and Resolution published

#### Executive Summary

On 6 June 2012 the European Commission (EC) published its long awaited draft directive on recovery and resolution of credit institutions and investment firms, including extensive powers for resolution authorities to bail-in a wide range of liabilities. The scope of the requirements to produce Recovery and Resolution Plans is broad, covering all credit institutions and investment firms subject to the Capital Requirements Directive (CRD) as well as financial holding companies. The EC has included simplified obligations for certain institutions, which we expect national authorities to use to exclude a number of firms. However, the flexibility available to national authorities to do this will depend on EC delegated acts which will specify more detailed criteria for inclusion. The introduction of the directive, and the scale of the involvement of the European Banking Authority (EBA) in both the implementation and ongoing management of all aspects of the recovery and resolution regime in Europe, is a clear indication that a more pan-European approach to crisis management in the financial services sector is intended.

Many of the core elements are similar to the current UK regulatory requirements in respect of:

- the core resolution objectives against which the resolution authorities will act;
- the conditions and triggers for resolution;
- the need for each institution to produce recovery plans;
- the requirement for resolution authorities to produce resolution plans, based on information and analysis produced by the institution (although there are differences in relation to the contents and approach which are considered in more detail below); and
- safeguards against partial property transfer.

However, the directive also includes a number of proposals which will require changes to the UK approach. The primary areas of difference from the current UK approach or areas where the proposals will require changes are summarised below. Further details are given in the body of the document.

- The directive requires recovery and resolution plans to be prepared with reference to stress scenarios defined by the EBA. UK recovery and resolution planning is currently not performed by reference to specific defined scenarios.
- Group recovery plans will need to be drawn up by the parent institution and submitted to the consolidating supervisor along with the individual recovery plans for institutions subject to consolidated supervision. The production of recovery plans below the group level could create an additional burden for institutions.
- The directive puts particular emphasis on early intervention during the recovery stage and introduces the notion of a 'special manager', which can be appointed by a national competent authority to replace the existing management in the case of the 'significant deterioration' of a financial institution. This is highly controversial amongst some European countries.
- Intra-group financial support, which is a key element of the EC's recommendations regarding group level recovery, is also a contentious issue among member states, with Germany and the UK both raising concerns about the impact such a rule would have on risk taking amongst financial institutions and insolvency law.

- Group resolution plans will be drawn up by resolution colleges led by the Group level resolution authority and including the resolution authority of each member state covered under consolidated supervision as well as the EBA as an observer. Although the EC has stressed a preference for a joint decision to be reached amongst relevant competent authorities, the EBA will have the power to intervene in the decision-making process. The mediation role for the EBA is likely to be highly controversial with several countries, including the UK, strongly against this in the consultation phase in early 2011.
  - The directive includes significant developments regarding resolution funding. Member States will be required to have adequate financing arrangements in place, with a target resolution fund of 1% of insured deposits raised from contributions from authorised institutions on an *ex ante* basis over a ten year period. This will be a significant change to UK practices and is likely to increase the burden on firms. Where *ex ante* contributions are not sufficient, the directive also provides for *ex post* extraordinary contributions and borrowing powers enabling Member States' resolution funds to borrow from one another, effectively taking the EU one step closer to an EU-wide resolution fund.
  - Resolution authorities will be required to have an exhaustive range of resolution tools, and even countries such as the UK which have recently updated their legislation will have to amend their current framework. In the case of the UK, this will include adding an asset separation tool to allow certain assets to be transferred and managed in a stand-alone asset management vehicle; and a bail-in tool. Bail-in in particular has attracted a lot of recent attention. This will allow national competent authorities to write off, or dilute, existing equity, and either reduce claims of creditors or convert eligible liabilities into equity in order either to recapitalise an institution in resolution or to assist the transfer of assets to a bridge institution. The EC has stopped short of specifying a minimum amount of bail-inable debt a firm must hold, instead stating that this should be a 'sufficient amount of eligible liabilities expressed as a percentage of total liabilities'. However, it remains to be seen how flexible this assessment will be, as the EBA must develop regulatory technical standards which will specify the detailed criteria by which 'sufficient' will be judged. This will likely be based on the firm's size, business risk and the potential systemic impact of failure.
  - The directive introduces a temporary stay on the rights of creditors and counterparties to close out, accelerate or otherwise terminate contracts until 5pm the following business day to facilitate the ability of the authorities to transfer. Currently the UK does not have such a power.
  - Currently the UK authorities have limited resolution powers in relation to branches of third country institutions. While it is envisaged that member state authorities and EU resolution colleges will work in cooperation with third country resolution authorities, the directive includes proposals to allow member state resolution authorities to apply resolution tools to national branches of third country institutions where separate resolution is necessary for reasons of financial stability or the protection of local depositors.
- In all of the above, the EBA will play a significant role through the preparation of approximately 28 technical standards and guidelines, as a non-voting attendee of all resolution colleges, as a mediator between resolution authorities and through relations with third country resolution authorities.
- The remainder of this document provides a more detailed summary of the directive.
- ### 1. Introduction
- On 6 June 2012 the EC published its long awaited draft directive on recovery and resolution for credit institutions and investment firms in the EU. The directive is the output of the work that the EC has been conducting on crisis management since 2008 which has included a number of discussions and consultations with relevant stakeholders. It is required to be transposed into national law by 31 December 2014 (with the exception of the requirements relating to bail-in which are required to be implemented by 1 January 2018) and contains around 28 instances where the EBA is required to produce technical standards or guidelines.
- This document is not intended to be a detailed summary of the issues or challenges that may be faced in transposing the directive into national law but rather is intended to provide a high-level summary of the proposals contained in the directive. We also highlight those areas where the proposals either go beyond or change the current position in the UK.

The scope of the directive is relatively wide and applies to groups and to individual firms within a group. The scope as specified is:

- credit institutions and investment firms, using the same definition as CRD IV;
- financial institutions or firms subject to consolidated supervision under a credit institution or investment firm;
- financial holding companies, mixed financial holding companies, mixed activity holding companies; and
- branches of institutions headquartered outside the EU.

The EC has included simplified obligations for certain institutions which we expect national authorities to use to exclude a number of firms. However, the flexibility available to national authorities to do this will depend on EC delegated acts which will specify more detailed criteria for inclusion.

The implementation of the proposals in the directive will be complicated and require amendments to a number of aspects of national law. This fact is acknowledged by the EC and is why a directive has been considered the most appropriate means of introducing the requirements over a Regulation.

The introduction of the directive, and the scale of the involvement of the EBA in both the implementation and ongoing management of all aspects of the recovery and resolution regime in Europe, is a clear indication that a more pan-European approach to crisis management in the financial services sector is intended. More detail on the role of the EBA is provided in section 4 below.

## 2. Summary of proposals

The main requirements of the directive are:

- All member states will be required to designate a **resolution authority** with sufficient expertise and resources to manage bank resolutions.
- All in-scope entities will be required to produce **recovery plans** and provide information and analysis to the resolution authorities to allow them to produce **resolution plans**.
- Arrangements may be put in place for the provision of **intra-group financial support** in a recovery situation.

- Competent authorities will have **early intervention** powers available in a crisis situation to require institutions to take a wide variety of actions. The authorities will also be able to appoint a special manager to temporarily run the institution in the place of management.
- **Resolution triggers** are harmonised and, for reasons of financial stability, will allow authorities to place an institution in resolution before it is balance sheet insolvent.
- The resolution authority will be provided with a set of specific **resolution tools and powers**. These include tools to: allow elements of the business to be sold without normal approvals (sale of business tool); allow assets and liabilities to be transferred to a newly established bank owned by the authorities (bridge institution tool); place certain assets and liabilities into an asset management vehicle to be managed in an orderly manner (asset separation tool); and a power to write down the claims of unsecured creditors or convert them to equity (bail-in tool).
- **A temporary stay** on the rights of creditors and counterparties to close out, accelerate or otherwise terminate contracts with the failing institution until 5pm the following business day.
- **Safeguards** to protect counterparties by preventing partial transfers that would involve the splitting of linked liabilities or other linked arrangements.
- **Resolution colleges** will be required for each institution led by the home resolution authority and including the EBA. Depending on the status of cooperation agreements, this will also possibly apply to those foreign headquartered firms with two or more subsidiaries established in the EU.

- A framework for cooperation with resolution authorities **outside the EU**, including powers in relation to branches in the EU. The EBA will be able to recognise third country resolution proceedings or refuse to recognise them (e.g. where they disadvantage depositors in the EU).
- Member states will be required to build up a **resolution fund** equivalent to 1% of covered deposits over 10 years.

Member States are required to transpose the requirements of the directive into national law by 31 December 2014 with the exception of the requirements relating to bail-in which are required to be implemented by 1 January 2018. The implementation date specified in the directive appears to be realistic based on the timetable specified throughout of mid-2013 for a number of the technical requirements to be produced by the EBA.

### 3. Impact on the UK

The directive is intended to introduce a common framework for dealing with the recovery, restructuring and orderly dissolution of financial institutions in the EU. A number of the proposals therefore mirror requirements which are already in place in the UK. The areas which are broadly consistent with provisions that are already in place in the UK include:

- the requirement for a resolution authority to be designated, which in the UK is the Bank of England;
- the core resolution objectives against which the resolution authorities will act;
- the conditions and triggers for resolution;
- the need for each institution to produce recovery plans;
- the requirement for resolution authorities to produce resolution plans, based on information and analysis produced by the institution (although there are differences in relation to the contents and approach which are considered in more detail below); and
- safeguards against partial property transfer.

However, the directive also includes a number of proposals which will require changes to the UK approach. The primary areas of difference from the current UK approach or areas where the proposals will require changes are summarised below.

#### 3.1 Scope of application

The scope of the directive is wider than the current position in the UK, particularly in relation to investment firms, and is therefore likely to require extensions to the scope of the requirements for the production of recovery and resolution plans in the UK, to the Banking Act 2009 (including the powers under the Special Resolution Regime), and to the Special Administration Regime for investment firms. At present the powers available for the resolution of investment firms are much more limited than for banks. Moreover, in CP11/16 the FSA limited the requirement to produce recovery and resolution plans to full scope BIPRU €730k firms with assets greater than £15 billion.

The exact scope of the directive following the transposition into UK law will depend on the way in which the UK authorities apply the provisions for simplified obligation for certain institutions (Article 4) contained in the directive.

Member states will have the power to take action in relation to branches of institutions established in a third country which is independent of the actions of the third country resolution authorities, including the ability to disregard their actions where they are felt to be detrimental to the interests of EU depositors. This will be a significant change for the UK where currently the authorities have limited powers to deal with the branches of foreign entities.

#### 3.2 Recovery and resolution plans

The directive includes requirements to produce recovery and resolution plans on an ex ante basis, which is in line with the current UK requirements. However, there are specific areas where the directive goes beyond the current UK requirements, some which could potentially give rise to significant extra work even for those institutions which consider their plans relatively well advanced.

##### 3.2.1 Recovery plans

The areas where the current proposals in the directive on the preparation of recovery plans differ from the approach in the UK include:

- the recovery plan will be based on a range of scenarios developed by the EBA in consultation with the European Systemic Risk Board and will set out actions in each of these scenarios. This differs from the UK approach which is more focused on the development of recovery options which could be used in any situation rather than in specific scenarios;
- the directive sets out specific actions that the competent authorities could require the institution to take including reductions in the risk profile, changes in strategy or changes in funding model. In the UK this is not specifically laid out in conjunction with recovery planning but it is possible that the FSA could achieve much the same outcome using current powers; and
- the directive specifically requires a group level recovery plan and a plan for each entity subject to consolidated supervision. This will potentially be a significant extra burden for institutions operating a subsidarised structure in the EU rather than a branch structure.

### 3.2.2 Resolution plans

The directive is consistent with the approach taken in the UK in that it requires institutions to produce resolution information, data and analysis rather than a resolution plan. The responsibility for the preparation of the resolution plan will fall to the relevant resolution authority. The areas where the current directive differs from the approach in the UK include:

- the resolution plan will be based on a range of scenarios developed by the EBA in consultation with the European Systemic Risk Board and will set out actions in each of these scenarios; and
- the home resolution authority will be required to gather information in relation to the group and all subsidiaries subject to consolidated supervision and transmit the information to the EBA and to the resolution authorities of the subsidiaries subject to consolidated supervision. This will potentially impose a significant burden on the home authority in coordinating information and ensuring that only information which is relevant is transmitted to host resolution authorities.

The group resolution plan is intended to take the form of a joint decision between the group resolution authority and other relevant resolution authorities. In the event of a disagreement between these parties any of the resolution authorities may refer the matter to the EBA for mediation.

### 3.2.3 Assessment of resolvability

Resolution authorities, in consultation with other competent authorities are required to assess the extent to which institutions and groups are resolvable. The definition applied is consistent with that set out by the Financial Stability Board<sup>1</sup> in that an institution is considered resolvable if it is feasible and credible for the resolution authority to apply different resolution tools and powers to the institution without giving rise to significant adverse consequences for financial stability and having regard to the continuity of critical functions.

The directive sets out a number of actions that can be taken in the event that the institution is not considered to be resolvable. These include inter alia requiring the institution to draw up service agreements, imposing exposure limits, requiring the divestment of specific assets, or requiring changes to legal or operational structures including the establishment of a parent financial holding company in the EU.

### 3.3 Intra-group financial support

As noted above, the directive focuses in great detail on the interaction between parent and subsidiary entities within the EU. Connected with this, the directive provides that intra-group financial support arrangements may be put in place between entities on an ex ante basis. These agreements will require the approval of the regulator of the entity providing the support and will also be subject to shareholder approval.

### 3.4 Early intervention

The directive sets out a number of actions that the national authorities could take as part of an early intervention such as requiring institutions to implement actions from their recovery plan. The directive also proposes early intervention in relation to the liabilities of the entity by proposing a power to require the institution to seek to restructure liabilities with their creditors. The most far reaching of the early intervention proposals in the directive is to allow the appointment of a special manager to run the institution in a crisis. The manager would temporarily replace the management of the institution and have a statutory duty to take all necessary measures to promote solutions to redress the financial situation of the organisation.

In the original consultation on the directive which took place in early 2011, several Member States opposed the notion of the special manager. The UK was strongly opposed to the proposal on the basis of potential conflicts in relation to the on-going supervision of the entity and the concern that the appointment could imply a state guarantee of the institution.

### 3.5 Resolution tools

The directive sets out four resolution tools:

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

The sale of business and bridge institution tool are consistent with powers which already exist in the UK Special Resolution Regime. However, the asset separation and bail-in tool are new tools which would need to be added to the UK toolkit.

Consistent with the UK regime the directive proposes that the elements of the institution that remain after the application of the resolution tools be wound down under normal insolvency law but subject to a requirement that services continue to be provided to any transferee.

<sup>1</sup> [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)



### 3.5.1 The asset separation tool

The asset separation tool provides for a dedicated asset management vehicle to be set up as a subsidiary of one or more public authorities into which assets can be transferred. Asset managers would be appointed and the assets managed with a view to maximising value through eventual sale or unwind. This tool can only be used if the market for the assets in question is such that the liquidation of the assets under normal insolvency proceedings could have an adverse effect on the financial market.

It is likely that this tool would have most applicability to specific investments, loans or elements of a trading book which can potentially be managed down over time for value. However, we would expect that the scale of the assets that could be transferred would be subject to natural constraints of funding and appetite of the public authority in question to have these assets effectively on their balance sheet, albeit via a subsidiary entity.

### 3.5.2 The bail-in tool

Bail-in provides a means to recapitalise a bank in resolution by writing off, or diluting, existing equity, and either reducing claims of creditors or converting eligible liabilities into equity. The directive provides significant additional detail on how the EU bail-in regime will be structured.

In particular, it clarifies:

- which liabilities will not be eligible for bail-in<sup>2</sup>;
- the treatment of derivatives under a bail-in;
- that there will be a minimum requirement for eligible liabilities (to be determined by resolution authorities; the EBA will review harmonisation of this approach and report to the Commission by 1 January 2018);
- the high-level 'mechanics' of how a bail-in would be implemented;
- the need for firms to develop a business reorganisation plan within one month of the use of a bail-in; and
- the contractual recognition of bail-in.

Market participants have expressed a range of views on the potential impact of a bail-in regime, in particular how it may affect debt market behaviours.

However, as evidenced by comments from the Bank of England, it is clear that global resolution authorities see bail-in playing a critical role in facilitating the resolution of large-cross border financial institutions:

*"[...] resolution authorities in a number of countries are exploring how to execute 'top-down' resolutions of complex groups, employing bail-in of debt issued by the holding company or top-level operating company. The US and UK have been working together very constructively in planning how to operationalise that strategy [...]"*

*Paul Tucker, Deputy Governor, Financial Stability, Bank of England<sup>3</sup>*

*"Top down bail-in may provide a viable strategy for the resolution of complex groups that span many markets, jurisdictions and currencies and we have been working together with other authorities in the UK and US to see how to make that strategy operational."*

*Andrew Gracie, Director, Special Resolution Unit, Bank of England<sup>4</sup>*

In light of the directive, firms will need to assess (i) implications for existing liabilities and (ii) implications for future debt issuance.

Implications for existing liabilities include identifying the existing liabilities would be bail-in-able under the directive's proposals and considering what actions should be taken to manage reactions from the debt markets and rating agencies.

Implications for future debt issuance include understanding what, if any, actions will need to be taken to meet the proposed minimum requirement for eligible liabilities which may need to incorporate both a structural and jurisdictional analysis and the fact that any eligible liability, additional Tier 1 instrument or Tier 2 instrument governed by non-Member State law will be required to include a contractual recognition of bail-in<sup>5</sup>;

From a legislative and regulatory perspective, detailed work will be required to understand and develop the legal, accounting and tax mechanisms and treatments for bail-in as conceived in the directive.

As the bail-in regime matures, and its implications are more fully understood by the market, attention will need to be paid to changes in market behaviour. In particular, the minimum requirement and the exclusion of certain types of liabilities could cause behaviours to be incentivised in a way not anticipated in the directive.

<sup>2</sup> Guaranteed deposits; secured liabilities; any liability linked to client assets or client money, or to a fiduciary relationship; liabilities with an original maturity of less than one month; a liability to an employee's salary and benefits (excluding variable remuneration); a liability linked to the provision of goods or services essential for operational continuity; a liability to tax and social security authorities.

<sup>3</sup> Resolution: a progress report, speech given by Paul Tucker, 03.05.12

<sup>4</sup> US and UK eye reaction to bank failure, Financial Times, 20.05.12

<sup>5</sup> NB: The directive states that failure to include such a provision will not prevent a resolution authority from bailing-in an eligible liability.

### 3.6 Restrictions on termination

The Bank of England does not currently have the ability to impose a temporary stay on the termination of financial contracts. The directive proposes giving resolution authorities the right to temporarily suspend until 5pm the following business day the termination rights of counterparties where these rights would arise solely from an action of the resolution authority. Following the period of the temporary restriction, those counterparties who have had their contracts transferred to another entity would not be able to exercise their termination rights by virtue of the transfer but rather can only do so on the subsequent occurrence of a specified event of default or non-performance. If the contract remains with the institution in resolution, the counterparty may exercise their termination rights in accordance with the contract following the end of the temporary restriction.

### 3.7 Resolution funding

The directive includes proposals requiring Member States to put in place resolution financing arrangements to be used for supporting specified reorganisation and resolution activities when market funding is not available. Member States will be required to have adequate financing arrangements in place, in particular a resolution fund, with a target of 1% of deposits insured by the Deposit Guarantee Scheme (DGS) in their territory to be reached over a ten year period. This should be raised through ex ante contributions from authorised institutions, pro-rated based on an institution's liabilities and adjusted in proportion to the risk profile of the institution, in accordance with certain criteria to be specified by the EC by means of delegated acts. Resolution financing can be arranged through the DGS or through separate funding arrangements. While EU discussions on requiring ex ante funding of DGSs as part of the revision of the Deposit Guarantee Scheme Directive are ongoing, the FSCS is currently funded ex post. Whether the UK were to raise resolution financing through the FSCS, or through other means, requiring an ex ante fund of this size will be a significant change to UK practices and is likely to increase the burden on firms.

Where ex ante contributions are not sufficient, the directive also provides for ex post extraordinary contributions and borrowing powers. Significantly, it proposes that Member States' resolution funds will be able to borrow from (and be obliged to lend to) other Member States' resolution funds. This effectively takes the EU one step closer to an EU-wide resolution fund and raises the prospect of Member States potentially having to pay out from their funds in the event of failures in another Member State.

### 3.8 Group resolution and resolution coordination

The directive breaks resolution coordination into two categories: firstly, within the EU, referred to as cross-border coordination and secondly, outside the EU, referred to as third country coordination.

The group level resolution authority for an institution will be required to establish a resolution college in the EU. The college will be made up of the group level resolution authority, the resolution authorities from any member state in which a subsidiary subject to consolidated supervision is established, the EBA and competent ministries (e.g. HM Treasury) will be members of the college. The resolution authorities for subsidiaries in countries outside the EU may also attend meetings.

In the absence of relevant cooperation agreements with a third country, a European resolution college will be required to be established for groups headquartered outside the EU and which have two or more subsidiaries incorporated in the EU.

## 4. Role of the EBA

The directive as drafted contemplates a significant role for the EBA in the development of the detailed technical requirements implementing the directive, in the operation of the overall crisis management framework both within the EU and in relations with third country regulators in respect of EU headquartered institutions. The directive requires the EBA to:

- participate in resolution colleges (depending on the way in which the simplified obligations requirements in Article 4 are applied by Member States, the number of colleges in which the EBA is required to participate could be significant);
- mediate and make decisions in the case of disagreements between home and host resolution authorities; and
- develop approximately 23 technical standards and 5 sets of guidelines by the beginning of 2015.

The requirement for the EBA to act as mediator was specifically consulted on in early 2011 and, perhaps unsurprisingly, views were split between the larger Member States which were opposed to the idea and some of the smaller ones which supported the EBA taking on this role. The way in which this role is undertaken will be a critical element of the smooth operation of an effective recovery and resolution framework in the EU.

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