BRIEFING

Public Hearing with Elke König, Chair of the Single Resolution Board

ECON on 16 June 2015

The aim of this note is to briefly present the state-of-play of a selection of topical subjects related to bank resolution, including topics that Ms König has been invited to discuss during the hearing. The note is prepared in advance of the first regular public hearing as referred to in Regulation (EU) No 806/2014.

Set-up of the Single Resolution Board (SRB): recent developments

On 1 January 2015, the SRB became operational as an independent EU Agency, following the **appointment of its management team**. All nominees had been approved by Parliament on 16 December 2014. Ms *Elke König* became Chair, and Mr *Timo Löyttyniemi* became Vice-Chair and will manage the Single Resolution Fund (SRF). The other four board members are Mr *Mauro Grande* (in charge of strategy and policy coordination), Mr *Antonio Carrascosa*, Ms *Joanne Kellermann*, and Mr *Dominique Laboureix* (all in charge of resolution planning and decisions). All appointments are for a **limited term**: the Chair for an initial three years, renewable once for a further five years; the Vice-Chair and Board Members for five years, non-renewable.

On 25 March 2015, the SRB published its **draft annual budget plan for 2015,** which sets out that the total expenditures are estimated to amount to EUR 22 million, 55% of which are related to staff, 30% related to rental fees and the cost of equipment, and the remainder to other operating expenditure. All expenditure is fully covered by **contributions from the banking industry**. The SRB aims to employ 122 staff by the end of 2015.

The SRB is the **central decision-making body** in the network of designated national resolution authorities which are empowered to apply, as of 1 January 2016, the full set of resolution tools (sale of business; bridge institution; asset separation, and bail-in) and exercise the resolution powers according to the Bank Resolution and Recovery Directive (BRRD).

In the current phase, until the beginning of 2016, the SRB can put its main focus on **setting up its own** structures – it is currently in the process of recruiting personnel for positions on middle management and staff level, on establishing a constructive cooperation with national resolution authorities, and on collecting information for the elaboration of resolution planning and the assessment of resolvability.

Crisis management decisions are based on complex economic assessments and require staff with the appropriate expertise. The set-up of the Single Resolution Mechanism is also challenging as it needs to build up its **structures from scratch**, both on central and on national level

All **other legal provisions regarding the SRB's tasks and capacities** (resolution planning, early intervention, resolution actions and application of resolution instruments, including the bail-in of shareholders and creditors) will only apply from 1 January 2016 onwards, provided that until then

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the BRRD has in all Member States been transposed into national law (see below) and the conditions for the transfer of contributions to the Single Resolution Fund are met (see below).

On 25 March, the SRB held its first plenary meeting, which was attended by representatives of all national resolution authorities of the Eurozone Member States. During this first plenary meeting, the SRB discussed its working priorities and adopted administrative decisions.

Progress on implementing the relevant legal framework

As regards the **implementation of the BRRD into national law**, the Commission disclosed in a press release published on 28 May 2015 that it requested Bulgaria, the Czech Republic, France, Italy, Lithuania, Luxembourg, the Netherlands, Malta, Poland, Romania and Sweden to fully implement the BRRD, as the **deadline** for the transposition of these rules into national law (31 December 2014) has already **elapsed**, yet those 11 EU countries have so far failed to implement the rules.

Key elements to the functioning of the SRF, namely the transfer of the contributions collected by the national resolution authorities to the fund and the **mutualisation** of the financial resources available in the national compartments, are regulated in a related **Intergovernmental Agreement** between participating Member States that complements the SRM Regulation.

The SRF shall ensure that the restructuring of failing credit institutions can be financed without recourse to taxpayers' money. The SRF shall be available as of 1 January 2016, which, however, requires that until then all Member States have **ratified** the IGA. So far, the IGA has only been ratified by two Member States: Latvia and Slovakia.

On 10 June 2015, EBA published technical advice on delegated acts relating to the target level and the initial period for the contributions to the SRF.

Main risks and vulnerabilities in the EU Banking sector

The EBA risk dashboard is part of the regular **risk assessment conducted by EBA**, reporting on the main risks and vulnerabilities in the EU Banking sector. The latest update published on 3 June 2015 (Risk Dashboard Q1 2015) is based on Q4 2014 data and takes into consideration the evolution of a set of key risk indicators from 55 EU banks.

Some of EBA's key findings are:

- In Q4 2014, EU banks' capital positions remained strong, with a Common Equity Tier 1 ratio of 12.1 per cent, representing an increase of 50 basis points compared to 2013.
- The quality of banks' loan portfolios remained weak. Compared to year end 2013, the impairment ratio of loans slightly decreased by 20 basis points to 6.6 per cent.
- Return-on-equity remains subdued and is materially below banks' average cost of equity. The average return on equity steadily increased from zero in 2011 to 3.6 per cent per year at year-end 2014.
- In 2014, at EU level, deposits increased more than loans. The average loan-to-deposit ratio therefore decreased further in Q4 2014 to 108.6% which is the lowest ratio since 2009.

(for further information please also see Annex 2).

On 9 June 2015, the rating agency **Standard & Poor's cut its credit ratings on several European commercial banks**. S&P lowered its ratings on Deutsche Bank AG, Royal Bank of Scotland NV and Commerzbank AG to triple-B-plus, three notches above junk territory. For RBS and Commerzbank, that marked a one-notch downgrade, but it was two for Deutsche Bank. Barclays PLC got a one-notch downgrade to A-minus, and UniCredit Bank AG by two levels to triple-B.

S&P said the ratings actions reflect the introduction of well-formed bank resolution frameworks in those countries, the continuing regulatory impetus to have banks with systemic importance hold sizeable capital buffers, and reduced prospects for government intervention in any potential crisis.

Box: Resolution case - Hypo Alpe Adria / HETA

Hypo Alpe Adria, a regional bank from Carinthia, had to be nationalised by Austria during the financial crisis after its rapid and largely uncontrolled expansion into the Balkans, which was backed by access to cheap funding due to public guarantees, ended in huge losses. At the time of its nationalisation, the bank held total assets of approximately EUR 43bn.

The rescue operation was temporarily approved by the Commission on 23 December 2009 which at the same time opened an in-depth investigation. On 3 September 2013, the Commission finally approved a plan for an orderly wind-down of the bank, according to which some of its operative parts were to be sold while all other assets were to be put into a bad bank and liquidated over time; in addition to the EUR 4.4bn that Austria had already invested into the recapitalisation of the bank, the Commission also signed off to the use of further state aid specifically for the wind-down process, namely a maximum of EUR 5.4bn of contingent capital and EUR 3.3bn in liquidity support. To the same end, *Hypo Alpe Adria* was finally transformed into a bad bank (HETA Asset Resolution AG).

A subsequent quality review of the assets revealed that further significant write-offs were necessary. As stated in the press release of 1 March 2015, Austria decided against providing further capital, as the required amount would have exceeded the Commission's limit for additional state aid measures.

In the course of events, Austria became the first Member State to apply a bail-in according to the rules of the BRRD. By the enactment of BaSAG (Federal Act on the Recovery and Resolution of Banks) on 1 January 2015, the BRRD rules had been transposed into Austrian law, allowing Austria's Financial Market Authority FMA to initiate the resolution of HETA on 1 March 2015 and to impose a reasoned 15 months temporary moratorium on debts payments as a first step to allow for a proper valuation of the financial situation and thereafter to decide on the haircut which will be applied to the holders of senior debt.

HETA will surely become a test case for bail-in procedures, and FMA will potentially face legal disputes with HETA's debtors; Commerzbank, for example, filed a lawsuit, having written down its engagement by more than EUR 200m according to its Q1 report 2015.

As a direct consequence of FMA's decision to initiate the resolution of HETA, the German property lender *Duesseldorfer Hypothekenbank AG* (*DuesselHyp*), being exposed to some EUR 348m of HETA debt, ran into problems and was in urgent need of capital support.

The resolution of HETA resulted in a change of ownership at DuesselHyp: on 15 March 2015, the Association of German Banks issued a press release stating *"[The] problem has been resolved. The private commercial banks' Deposit Protection Fund is providing a guarantee and ring-fencing the Heta bonds to eliminate the immediate risks. The aim is a takeover ..."*.

However, the situation of *DuesselHyp* sheds light on the importance of the interconnectedness of banks and underlines that suitable resolution measures for one ailing bank can easily affect the financial situation of other banks.

A detailed summary of this complex case is published on the websites of Austria's Federal Ministry of Finance.

Regulatory treatment of sovereign exposures

On 10 March 2015, the **European Systemic Risk Board** (ESRB) published a report in which it examines the **regulatory treatment of sovereign exposures** of banks and insurance companies with the aim of finding potential sources of systemic risk, and, where necessary, identifying macro-prudential policy options to mitigate them.

The two main types of risk stemming from sovereign exposures are said to be **credit risk and market (devaluation) risk**. However, in particular when it comes to the former, the report notes that current and upcoming banking regulation gives sovereigns especially preferential treatment compared with other issuers. Notable examples of this include low or 0 % risk weightings on certain sovereign exposures, the exemption of zero-risk-weighted sovereigns from restrictions on large exposures, and the low haircuts applied to government securities when used in collateralised transactions.

In the empirical section, the report presents some stylised facts regarding euro area banks' sovereign holdings. The data show a considerable degree of home bias. Looking at the development over time, this home sovereign-exposure declined from early 2000 to late 2008, when it started increasing again until it stabilised in 2014, with the increase being less marked in non-stressed countries.

The report's final chapter presents policy options such as stricter Pillar 1 capital requirements, removing the large exposures exemption, allowing supervisors to change capital requirements over the cycle, and enhanced Pillar 2 and Pillar 3 requirements. The report highlights that the Banking Union might contribute to solving the problem of the sovereign-bank nexus. However, the report gives no ranking of the policy measures, nor a more detailed impact assessment.

EBA definition of the "likely to fail" trigger

In order to promote convergence of EU resolution practices, on 26 May 2015 the **European Banking Authority** (EBA) issued the Final Guidelines on failing or likely to fail, i.e. defined the circumstances which should trigger resolution measures. Those Guidelines will in the future be an important point of reference both for the SRB and national resolution authorities.

The conditions for resolution are already set out in the BRRD. Article 32(4) provides that an institution should be considered to be failing or likely to fail:

- in case of an infringement that would justify the withdrawal of authorisation;
- if the value of its assets is lower than that of its liabilities;
- if it is unable to pay debts or other liabilities as they fall due;
- or if there is a need for extraordinary public financial support.

The EBA has now provided further guidance on this matter:

The **core objective** of the Guidelines is to **address the lack of a European harmonised approach** to the interpretation of circumstances when institutions should be deemed as failing or likely to fail. The Guidelines aim to promote the 'convergence' of approaches by further specifying the circumstances related to infringements, imbalances between assets and liabilities, and illiquidity, but do not further specify situations in which extraordinary public financial support is needed.

The Guidelines are **without prejudice to the authorities' discretion to decide**, on the basis of the facts and circumstances of each specific case, whether the conditions for resolution are fulfilled.

Essentially, this means that the list is not exhaustive as not every eventuality may be foreseen and the relevant authority still decides in each case.

The determination whether an institution is failing or likely to fail should largely be based on the following **"objective elements"**:

- capital position
- liquidity position
- any other requirements for continuing authorisation such as governance arrangements and operational capacity.

The above elements should be considered along with:

- results of supervisory measures or early intervention measures
- outcome of recovery plans
- results of the valuation of an institutions assets and liabilities.

The assessment of those objective elements will usually be carried out by the competent authority in the course of a **supervisory review and evaluation process (SREP)** performed in accordance with SREP Guidelines published by EBA on 19 December 2014. The outcomes of the SREP assessment will be reflected in the overall SREP assessment supported by the overall SREP score assigned to an institution. The SREP requires competent authorities to have **an up-to-date view** on the risk profile of a bank, governance arrangements, its business model and strategy, and the adequacy of available own funds and liquidity resources to cover the risks to which the bank is or might be exposed and consequently its overall viability position.

The overall SREP score will hence typically be a **key consideration** for a competent authority when determining whether a bank is failing or likely to fail. In principle, the overall SREP score has four positive grades to be applied to viable institutions (1-4) and one negative grade ('F').

Pursuant to the SREP assessment, the competent authority should hence assume that a bank is failing or likely to fail if that institution has either been rated with an **overall SREP score of 'F'**, or if it has been rated with an **overall SREP score of '4' but failed to comply with supervisory measures** requested in accordance with Articles 104 and 105 of Directive 2013/36/EU (e.g. a request to hold additional own funds, to apply a specific provisioning, or meet certain liquidity requirements), respectively if it failed to comply with other early intervention measures, in accordance to Article 27(1) of Directive 2014/59/EU.

ANNEXES:

1. Development of key indicators in the banking industry
2. Extract from Risk Dashboard Q1 2015 - Overview of the main risks and vulnerabilities in the EU Banking sector

Annex 1: Development of key indicators in the banking industry

Aggregate data on country level, based on ECB Consolidated Banking Data as per end of June 2014 and end of December 2013, and the European Commission's Spring Forecast 2015.

	Real GDP Growth		Total Assets per GDP		Loans, % of Assets		Loans, % of Deposits		Non-Performing Loans (NPL), % of Total Loans and Debt Securities		Impairment Charges per NPLs		Tier 1 Capital Ratio		Return on Equity	
	2014	2015 (f)	06/2014	12/2013	06/2014	12/2013	06/2014	12/2013	06/2014	12/2013	06/2014	12/2013	06/2014	12/2013	06/2014	12/2013
BE	1,0	1,1	253,2	243,0	66,4	66,2	118,3	118,4	4,8	5,3	29,6	29,3	15,5	16,4	9,4	6,2
DE	1,6	1,9	239,7	239,7	62,2	53,1	144,8	124,0	1,9	1,8	NC	42,8	14,5	15,2	5,6	1,3
EE	2,1	2,3	111,6	111,7	74,8	77,8	115,6	119,5	1,8	1,9	76,8	75,3	31,5	22,7	12,5	10,7
IE	4,8	3,6	283,7	451,8	58,7	43,1	133,4	153,5	17,8	18,4	57,6	57,2	21,6	17,3	-4,5	-13,2
ES	0,8	0,5	333,7	332,5	64,3	65,4	118,3	120,7	7,4	7,9	47,3	46,6	11,6	11,9	8,3	5,8
EL	1,4	2,8	201,1	202,4	67,6	68,0	115,6	120,7	26,4	24,2	51,6	50,4	16,0	13,2	n.a.	n.a.
FR	0,4	1,1	311,4	299,7	56,9	57,2	142,4	138,2	4,4	4,6	48,8	48,7	12,8	13,2	6,9	6,0
IT	-0,4	0,6	158,2	163,5	67,3	66,8	156,3	157,2	13,7	12,9	43,1	42,6	11,8	10,6	1,4	-11,5
CY	-2,3	-0,5	438,2	437,8	75,2	84,0	118,1	134,7	42,7	36,2	30,6	24,7	13,1	12,3	-54,4	-37,9
LV	2,4	2,3	117,4	124,2	76,0	70,1	105,2	102,7	4,5	5,6	83,6	79,3	17,3	16,5	7,3	8,8
LT	2,9	2,8	62,6	64,1	79,2	78,7	127,3	128,2	7,3	8,5	41,9	40,6	19,9	17,0	8,5	8,6
LU	3,1	3,4	n.a.	1585,1	72,1	71,1	179,0	182,4	n.a.	n.a.	n.a.	n.a.	18,5	21,3	7,8	6,5
MT	3,5	3,6	601,9	661,2	51,7	59,6	120,9	135,0	2,3	2,0	40,5	37,6	23,9	43,9	3,4	3,7
NL	0,9	1,6	380,7	378,5	73,3	73,7	145,3	146,2	2,5	2,7	38,2	41,0	14,4	12,9	5,3	5,0
AT	0,3	0,8	325,8	337,8	71,3	71,8	145,8	144,4	5,5	4,2	61,6	71,9	11,9	11,9	3,2	-0,7
PT	0,9	1,6	259,7	272,4	69,9	71,2	125,3	129,7	8,3	7,8	62,4	56,4	10,7	12,2	-6,0	-9,3
SI	2,6	2,3	109,9	119,1	71,4	70,0	114,5	122,3	17,1	17,1	63,0	61,3	14,5	12,9	-13,4	-90,3
SK	2,4	3,0	76,8	76,9	72,2	71,5	99,3	97,6	3,9	3,8	53,1	57,2	16,1	16,2	10,5	10,0
FI	-0,1	0,3	262,4	258,3	57,7	49,0	164,5	143,4	0,7	0,7	n.a.	n.a.	14,6	15,5	8,2	8,1

Annex 2: Overview of the main risks and vulnerabilities in the EU Banking sector

The following table, summarizing the main current risks in the banking sector, is an extract from EBA's Risk Dashboard Q1 2015 (with small modifications, in particular a shortened display of the reasoning):

	Bank risk	Risk drivers	Level of risk		Contributing factors/interactions (extractions)
			Level	Forward trend	
Capital	Credit risk	Asset quality, emerging markets, asset growth vs deleveraging		↓	Economic uncertainty remains high. Loan volumes are in general back to growth mode, with many exceptions. Asset quality has hardly improved, but NPL sales might lead to improvements.
Capital	Market risk	Risk of decreasing trading market liquidity, volatility, interest rates		↑	Geo-political risk remains high, including risks from elections. A potential interest rate increase in the US cannot be excluded.
Capital	Operational risk	IT risk, cost reduction, potential bank mergers		→	IT and internet related risks (incl. cyber-risks) remain high. Ongoing pressure on operating expenses as well as potential bank mergers might contribute to further increases in operational risk.
Capital	Concentration risk, IRRBB and other	Asset price bubbles, interest rates		→	Some banks still have large home-sovereign exposures. Risks of price bubbles in some asset classes exist. Increased collateral values due to higher asset prices might contribute to banks' additional risk-taking.
Capital	Reputational and legal	Misconduct		→	Misconduct remains a challenge, with negative impact on profitability. Further material litigation costs are expected, not all being covered by provisions.
Capital	Profitability	Margins, further cost reduction, potential bank mergers		→	Profitability remains subdued despite stable/partially improved impairment ratios due to contracting interest margins. Cost cutting and mergers might have medium-term positive impact.
Liquidity & Funding	Access to funding and maturity distribution	Primary and secondary market liquidity		→	Although banks have access to primary markets, issuance volumes remain volatile. Investor demand remained strong, but might be impacted by a US rate increase. Primary and secondary markets remain highly vulnerable to liquidity shocks.
Liquidity & Funding	Funding structure	Reliance on central bank and secured funding		→	Banks rely strongly on secured and central bank funding. Deposits remain stable (some exceptions mainly in the periphery). Material issuances of AT1 instruments, with more to come so that banks meet TLAC/BRRD requirements.
Environment	Regulatory and legal environment	Regulatory initiatives, structural reforms		→	Topics that might have material impact on business models include: TLAC/MREL requirements, Qualifying Securitisation, and Capital Markets Union. Structural reforms have made progress in some countries but remain highly vulnerable to political risk.
Environment	Fragmentation	Asset growth, asset quality, sovereign/ bank link, funding, supervisory fragmentation		→	Fragmentation still material in some respects: volume growth vs deleverage, asset quality, bank-sovereign link, funding, and supervision. Crossborder lending remains low. Bank mergers and supervisory convergence could lead to certain defragmentation.
Environment	Sovereign risk	Debt overhang		→	High risk of debt restructuring in some countries. General debt overhang reduces chances of fiscal policy supporting monetary measures in driving recovery and fighting deflation.

Level	High	Medium	Low	The level of risk summarises, **in a judgmental fashion, the probability of the materialisation of the risk factors and the likely impact on banks**. The assessment takes into consideration the evolution of market and prudential indicators, NSAs and banks' own assessments as well as analysts' views.
Trend	↑ Up	→ Stable	↓ Down	