BRIEFING

European Parliament

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

ECON on 2 April 2019

This note is prepared in view of a regular public hearing with the Chair of the Single Resolution Board (SRB), Elke König. The briefing addresses (i) recent supervisory developments or state of play with resolution cases (Carige, NordLB, Novo Banco and ABLV), (ii) summarises a recent General Court decision ('Banca Tercas') regarding the use of DGS in a preventative manner under State aid, (iii) points to regulatory developments regarding the completion of the Banking Union (resolution financing, EDIS and liquidation regime), (v) and comments on other policy developments and publications of the SRB. The briefing also (iv) summarises two external papers on "stock taking of the SRB's activities over the past years: what to improve and focus on".

I. Update on recent supervisory developments and resolution cases

Carige

On 2 January 2019, the ECB's put **Banca Carige** into "temporary administration", after the bank failed to raise around € 400 million capital and most of its board stepped down. On 8 January, Banca Carige issued a press release announcing initiatives that the temporary administrators took, in particular as regards a proposal submitted to the Voluntary Scheme for redefining subordinated debt terms, a due diligence process initiated for further reducing the portfolio of non-performing exposures (NPEs), the state-backed guarantee accessed to support the bank's medium-term funding, and, announced only as a residual option, a precautionary recapitalisation[1]. On 6 March 2019, the Italian Senate approved a set of support measures that had already passed the Chamber of Deputies.

On 27 February 2019 Banca Carige disclosed a Strategic Plan which proposes reducing the Bank's risk profile and redefining its business model. The plan foresees reinforcement of capital by €630 million (namely through a capital increase), reduction (by sale) of NPLs, investments in IT, focusing on regions that are wealthier than Italian average and SMEs requiring more agile banking structures ("lean digital operating model"). The plan also provides for the reduction of around 1050 employees (or full-time equivalents) and 100 branches, as well as a scenario of a business combination[2], aiming for the acquisition by an investor (binding offers foreseen for Q2 2019).

On 13 March 2019 Moody's completed its assessment of Carige's rating. The rating agency explains that its baseline credit assessment (BCA) for Banca Carige, which captures the bank's liquidity and solvency risk profile as well as forecasts and the bank's operating environment, points to a highly speculative investment:

[1] The press release states "It should be noted that the precautionary recapitalisation referred to in the press release of the Council of Ministers is to be considered as an additional measure for the protection of customers, to be activated only as a residual option".

[2] See in particular slides 37 and 38 of the Carige presentation of its Strategic Plan and references in the accompanying press release. In fact, the Financial Times notes that Carige has to find a buyer "by next month".

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"***A very high probability of government support for deposits and a high probability of government support for senior debt*** *result in three notches and one notch of uplift respectively from the BCA. The ca BCA reflects Moody's view that* ***the bank will continue to require external support to ensure its viability***. " (our emphasis).

So far, the Italian government has not announced any precautionary recapitalisation. A precautionary recapitalisation would have to be limited to the capital shortfall established in stress tests or asset quality review, confirmed by the ECB (BRRD Article 32(4)).

For more background information on the Banca Carige case, please see a previous EGOV briefing.

NordLB

On 2 February 2019, the German bank Norddeutsche Landesbank (NordLB), which is in public ownership (some 63% are owned by the federal states of Lower Saxony and Saxony-Anhalt, the rest by savings banks), issued an ad-hoc announcement of price sensitive information that points to significant losses amounting to EUR 2.7 billion (after taxes) in 2018 and capital levels that as a result thereof will fall below the supervisory minimum level. In a press release issued on the same day, NordLB furthermore welcomed the decision of the German Savings Banks Association to contribute to a solution for strengthening NordLB's capital position.

The losses that NordLB has announced for its financial statements for 2018 are mainly related to additional risk provisioning required for its portfolio of non-performing loans (NPLs). As a decisive measure to reduce its NPLs, NordLB had decided to sell a significant ship financing portfolio to an external investor, the loans contained in that portfolio are mainly non-performing.

An open question is whether the capital increase by the banks public owners will be classified - and subsequently assessed - as State aid, in which case the bank would have to come forward with a new[3] credible restructuring plan.

For more details on this case, please see previous separate EGOV briefing.

Novo Banco

In a hearing on 20 March 2019 before the Portuguese competent parliamentary committee (COFMA), the Bank of Portugal Vice Governor in charge of resolution explained that Lone Star, the current main shareholder of Novo Banco, requested EUR 1.149 million to cover losses in Novo Banco[4]. The request is made in the context of the "capital contingent mechanism" agreed by the Portuguese Authorities and Lone Star as part of the sale agreement of Novo Banco in October 2017.

The sale agreement between the Portuguese authorities and Lone Star foresees that the acquirer would inject a total of EUR 1.000 million in Novo Banco, of which EUR 750 million at completion and EUR 250 million within a period of up to 3 years. The terms agreed also included the contingent capital mechanism[5], under which Fundo de Resolução, the Portuguese resolution fund (FdR), as a shareholder, undertook to make capital injections whether certain cumulative conditions related to i) the performance of a specific portfolio

[3] NordLB was already subject to a State aid decision that was based on another restructuring plan. At the end of the year that also marked the end of the restructuring period (2016), the bank actually reported a loss of EUR 1.96 billion.

[4] As explained in the hearing, in 2018 and under the same mechanism, FdR paid EUR 792 million to Lone Star. The total of losses covered by the mechanism were EUR 2.662 million and the amounts necessary to maintain Novo Banco ratios was of EUR 1.149 million. As such, as explained at the said hearing, Novo Banco losses are being covered only up to the level necessary to maintain the capital ratios, as foreseen in the sale agreement.

[5] Under this mechanism, the FdR can be asked to inject funds in Novo Banco if the assets covered by the mechanism loss value and up to the level necessary to maintain the capital ratios at a certain level. The mechanism is capped at EUR 3.98 million in an eight year horizon. Usage of the mechanism is continuously monitored by a Committee and a Valuation Agent.

of assets[6] and ii) the capital levels of the bank going forward materialised. The completion of the sale was also made conditional on a liability management exercise covering the senior bonds of Novo Banco and subject to bondholders' acceptance having created CET1 of at least EUR 500 million[7].

The sale of Novo Banco was the last step of a highly discussed resolution process. Indeed, in March 2014, BES was the third-largest Portuguese banking group, with EUR 76.600 million of assets, EUR 37.300 million in customer deposits, EUR 13.700 million in debt issued and EUR 4.200 million in resources from other credit institutions. It was present in four continents and in 25 countries, employing almost 10.000 people[8]. In 2014, an audit carried out by the Bank of Portugal concluded that the group was in a serious financial condition. On 30 June 2014, the Common Equity Tier 1 ("CET1") of BES stood at 5.0%, below the minimum requirement set by the Bank of Portugal at 7%. It revealed heavy losses in its results for the first half of 2014 and suffered a significant fall in deposits.

The Portuguese authorities decided to put BES into resolution in early August 2014. The resolution led to the creation of a bridge bank (Novo Banco), held by FdR, to which the sound business activities of BES were transferred. The residual assets and liabilities remained within BES, including shareholders and junior bondholders, thus fulfilling the burden sharing requirements of the EU Commission 2013 Banking Communication and the existing Portuguese resolution regime. Novo Banco was capitalised through a State loan to the FdR of EUR 4.899 million. Along with other commitments relating to winding down of the bad bank, the future disposal of Novo Banco, salary and bonus caps and an acquisition ban, the aid granted was considered compatible with the Treaty. The resolution led to a parliamentary committee of inquiry in Portugal and numerous litigation cases.

In November 2014, Novo Banco was found to have a capital shortfall of EUR 1.398 billion in the adverse scenario of the ECB comprehensive assessment exercise[9]. In December 2015 the State aid decision was revisited and Portugal rendered new and more stringent commitments, namely the mandatory segregation of core and non-core assets, key performance indicators and targets to dispose of the non-core assets. A first attempt to sale Novo Banco failed in September 2015. In January 2016 Banco de Portugal, acting as resolution authority, relaunched the sale process and sold 75% of Novo Banco to Lone Star in October 2017 (FdR retained 25% of Novo Banco). The Commission scrutinised the sale process and found it compatible with State aid rules[10]. The ECB withdrawn BES banking licence on 13 July 2016. BES is currently under judicial liquidation.

ABLV

On 24 February 2018, the ECB published the non-confidential version of its Failing-or-Likely-to-Fail assessment adopted on 23 February 2018 regarding ABLV Bank, AS. The assessment lays out developments in the liquidity position of ABLV Bank and the supervisory assessment undertaken by the ECB, which ultimately led to its conclusion that the entity was 'failing or likely to fail'.

That assessment is subject to confidentiality and professional secrecy rules. Omitted information makes it difficult to fully understand the ECB's conclusion that there "*is, or there are objective elements to support a determination that the entity will, in the near future, be unable to pay its debts or other liabilities as they fall due*"'.

[6] According to the Vice Governor of Bank of Portugal in charge of resolution, the mechanism covers impaired assets and other assets that are not considered core for the banking activity of Novo Banco.

[7] As referred in the Commission 2017 decision on the sale process (point 59), although the liability management exercise results were below target, Lone Star accepted to maintain its offer.

[8] Commission revised State aid decision on Novo Banco.

[9] Table 3, page 10.

[10] The Commission further considered the additional state interventions compatible with the Banking Recovery and Resolution Directive (BRRD) expressing that "*these changes have become necessary in the light of factual developments in order to implement the resolution process and do not fundamentally alter its nature. As the resolution process foreseeing the creation of a bridge institution and its subsequent sale was initiated in 2014, in order to preserve the unity and implementation of the initial resolution process, it should continue to be governed by the law applicable at the time, i.e. national law.* " (point 322).

Comparing this non-confidential version of the ECB's assessment to similar publications of public interest by the Single Resolution Board (SRB), it must be noted that the SRB in case of Banco Popular, another bank deemed 'failing or likely to fail', had to amend the amount of information disclosed, following the SRB Appeal Panel's decision that "[...] *such redactions make this document [the SRB's Provisional Valuation Report] almost unintelligible*" (see Appeal Panel's Final Decision in case 52/2017).

The Latvian ABLV Bank was directly supervised by the ECB since it was one of the three largest credit institutions in Latvia in terms of asset base. Though the published financial information indicated that the bank was well capitalised and profitable, the shareholders of ABLV decided at an extraordinary meeting on 26 February 2018 to voluntary liquidate the bank. The ECB withdrew its banking license in July 2018. In May, ABLV filed lawsuits against the ECB and the SRB[11] to annul the decisions taken by both institutions that led to the liquidation of the bank. In accordance with BBRD[12], the lodging of an appeal shall not entail any automatic suspension of the effects of the challenged decision. Decisions of resolution authorities are immediately enforceable. The appeals may give rise to indemnity. Proceedings are still pending for those cases.

Further background information on ABLV can be found in the EGOV specific briefing.

II. General Court decision on the use of deposit guarantee schemes in a preventative manner

On 19 March 2019, the General Court annulled a European Commission State aid decision[13] that ordered the Italian state to recover illegal aid granted to Banca Tercas by *Fondo Interbancario di Tutela dei Depositi* ('the FITD'), the Italian deposit guarantee scheme. In 2012 Banco Tercas was put under special administration as a result of irregularities identified by Banca d'Italia. In that context, in 2013, it received an offer by Banca Popolare di Bari ('BPB'), to subscribe Tercas capital. BPB attached a number of conditions to that offer, namely, that FITD would cover Tercas's deficit[14]. Both Banca d'Italia and FITD approved the operation, which was deemed less costly than reimbursing Terca's deposits.

The Court considered the Commission failed to provide sufficient evidence to support its assessment[15] that State aid[16] had been given to Tercas. The Court's decision is appealable. The Commission is said to be reflecting on possible next steps.

One may note that the Court decision directly refers to the 2013 Banking Communication. Point 63 of the said communication refers specifically to deposit guarantee schemes by mentioning "*Interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes do not constitute State aid. However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive*

[11] ABLV has a second case pending against the SRB on accounts of the SRB refusing to recalculate the banks' ex-ante contributions to the Single Resolution Fund.

[12] In particular article 85 of BRRD.

[13] Commission Decision (EU) 2016/1208 of 23 December 2015 on State aid granted by Italy to the bank Tercas (Case SA.39451 (2015/C) (ex 2015/NN)) (OJ 2016 L 203, p. 1). The text of the decision can also be found here.

[14] In fact, the intervention of BPB was more complex and involved (a) reduction of capital to zero, wiping out existing shareholders, (b) issuance of new shares for subscription by BPB (EUR 230 million), (c) EUR 265 million from FITD to cover Terca's losses, (d) two guarantees by FITD (EUR 35 and 30 millions) (see points 16 to 26 of the Court decision).

[15] The Court refers to "(...) *Commission had to have sufficient evidence to conclude that those measures were taken under the actual influence or control of the public authorities and that, accordingly, they were, in fact, imputable to the State* (...) *the Commission has failed to prove that other Italian public authorities were involved in the adoption of the measures at issue...* "

[16] The Court considers that State aid under article 107/1 of the Treaty must satisfy two cumulative conditions: "*it must be imputable to the State and be granted through State resources*". The Court considered the Commission has failed to provide evidence that the FITD acted under a public mandate or under the control of public authorities and that the funds rendered to Tercas were under public control. The Court argued that FITD acted in the private interest of banks and using money provided by banks to avoid (the most expensive option of) paying out Tercas' deposits (further details can be found in the Court decision, points 62 to 132). A Commission Q&A released at the time of its decision finds otherwise.

from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State. The Commission will assess the compatibility of State aid in the form of such interventions under this Communication.".

According to the Court, State aid under article 107/1 of the Treaty must satisfy two cumulative conditions: "*it must be imputable to the State and be granted through State resources.*" In that case law, the Court considered that the Commission failed to provide evidence that the FITD acted under a public mandate or under the control of public authorities and that the funds rendered to Tercas were under public control. The Court argued that FITD acted in the private interest of banks and using money provided by banks to avoid (the most expensive option of) paying out Tercas' deposits (further details can be found in the Court decision, points 62 to 132)[17]. A Commission Q&A released at the time of its decision finds otherwise.

The Court further adds that the fact that private interests of the banks coincide with a public interest is also not a definite argument to consider an intervention done in the public interest[18] ("public mandate") and that the FITD early intervention powers were not mandated or enshrined in law (points 99 to 106 and 154[19]). The Court also refers to funds for the voluntary scheme being available on call (as opposed to committed in advance) as a further argument to support its opinion that funds were not "public funds" for State aid purposes (point 153 of the Court's decision)[20].

Commenting on the Court's decision, Andrea Enria in a hearing before ECON said that the Supervisory Board had briefly discussed the ruling and "*(...) the potential role of DGSs in playing a function in cases of banks that go into difficulties in a pre-emptive fashion could be a very important change in the overall framework. Of course we need to read carefully what the Court said but this is an important development.*"

The Court decision may have broader implications. It questions whether and to what extent "voluntary" guarantee schemes or additional intervention instruments permitted under a number of guarantee schemes in accordance with the DGS Directive, should qualify as State aid. A qualification as State aid may trigger, according to the 2013 Banking Communication, "burden sharing arrangements", i.e. loss absorption by equity holders and creditors[21]. The criteria to assess whether that is the case are, in the Courts' view, those of the Treaty and require analysing whether the decision can be imputable to the State and whether the State can direct usage of funds ("public funds"). To that end, the Court namely reflects on the autonomy of the decision making bodies of the scheme and evaluates whether the funds are obtained on the basis of a mandatory provision in law.

III. Completing the Banking Union

In keeping with the 4 December 2018 Eurogroup conclusions, work is being conducted on (i) resolution financing and (ii) EDIS. Looking ahead, the Chairs of the SRB and the SSM also emphasised the importance of bringing about a harmonised EU liquidation regime to further complete the Banking Union.

For additional information, see EGOV Briefing "Completing the Banking Union" (Update February 2019).

[17] « *Or, le fait qu'un secteur mette en place un système privé d'assistance mutuelle ne constitue pas en soi un indice de l'implication de l'État.* (...) *les interventions de soutien, telles que celles en cause en espèce, ont une finalité différente de celle des remboursements des dépôts en cas de liquidation administrative forcée et ne constituent pas la mise en œuvre d'un mandat publique*". (points 97 and 106 of the Court decision).

[18] Point 99 of the decision.

[19] *L'obligation des membres de FITD de contribuer à l'intervention décidée par ce dernier ne trouve donc pas sa source dans une disposition réglementaire, comme lorsqu'il est spécialement mandaté par l'État pour gérer des contributions faites par les membres au titre de la garantie légale des dépôts des déposants, mais dans une disposition statutaire, de nature privée, qui préserve l'autonomie de décision des membres du FITD.* » (point 154 of the Court decision).

[20] This seems to be still currently the case (as FITD expresses in its website "The Voluntary Scheme has its own financial resources, set at the maximum of 300 million euro, which the participating banks are committed to supply at call to carry out interventions.").

[21] As noted in the 2015 State aid Commission decision "although Banca Tercas' existing shareholders were fully written down at the time, subordinated creditors did not make any contribution to the cost of restructuring, as is required under **burden-sharing principles"**

Resolution financing

The Eurogroup agreed in June 2018 to step up work on a "possible framework for liquidity in resolution, including on the possible institutional framework". The 4 December 2019 Eurogroup mandated further work on solutions, with input of relevant institutions, to be done during the first half of 2019 and reporting expected by June 2019. For further background information, see EGOV briefing 'Banking Union: towards new arrangements to finance banks under resolution?" (July 2018).

In the UK liquidity financing in resolution is provided by the Bank of England whose objective is to provide liquidity "in the necessary scale" and "for a sufficient period of time" to allow the firm to make the transition to market-based funding. This support is backed by the UK Treasury. At the ECON hearing in April 2018, Vitor Constâncio explained that the ECB needs a way to finance failing banks while they are being resolved, quoting the British and U.S. models as possible examples: "*The UK and U.S. have [...] a solid, whole process of resolution that includes those liquidity problems during that period of time, and I hope that Europe will get to some solution to this problem*".

In the absence of a Euro area treasury, alternative solutions are being thought through. As explained by the ESM at an online seminar on liquidity and resolution held in February 2019, the objective is to provide sufficient assurance to the ECB and national central banks on the quality of collateral. In that respect, the following public and private solutions are being discussed.

Public solutions being considered include the following:

- A guarantee provided by Member States. Guarantee provided by Member States have been suggested in a paper commissioned by the ECON Committee as a temporary solution pending the completion of the Banking Union[22]. This solution has been discarded by the Chair of the SRB, as going against the very principle of the Banking Union. It would also further reinforce the sovereigns-banks loop;
- A guarantee provided by the Single Resolution Fund. That solution has been put forward in a paper commissioned by the ECON Committee[23];
- A guarantee provided by the ESM. That solution would, according to the ESM, require a change to the ESM treaty;
- Using SRF bonds as collateral for repos. Under this proposal, the SRB would, according to politico, issue and hold long term bonds, instead of selling them to investors. The SRB could then lend bonds to a troubled bank in need of collateral. The banking industry - throughout contributions to the SRF - would face higher levies as the SRF would need to pay interest on the bonds issued by the SRB. The banking industry (i.e. the SRF) would ultimately bear the risk of a default.

According to the ESM, an alternative "private solution" is being tested. Under that proposal, the ECB would be able to use as collateral a "collateral pool" consisting of a proportion of High Quality Liquid Asset (within the meaning of the Liquidity Coverage Ratio) of banks of the Banking Union. Those unencumbered assets would remain ('earmarked') in banks' balance sheet. It has been suggested that those assets be 0% risk-weighted to make up for their use as collateral. The size of that collateral pool has been reported to amount to €284 billion (or 1% of banks' assets).

For further background information, see EGOV Briefing "Towards new arrangements to finance banks under resolution? (July 2018).

[22] See Maria Demertzis, Inês Gonçalves Raposo, Pia Hüttl, Guntram Wolff (Bruegel). The authors suggest that the involvement of national treasuries along with an ESM guarantee would be appropriate as long as the Banking Union remains incomplete. Once banking union is completed, the said guarantee should be provided a 'euro-area fiscal body with recourse to the SRF.

[23] See Willem Pieter de Groen (CEPS). The paper proposes an European Central Bank liquidity facility with a Single Resolution Fund-guarantee as an alternative solution for providing liquidity to banks in resolution.

EDIS (European Deposits Insurance Fund)

The Eurogroup set up in December 2018 a "high level working group" at the level of Ministries of finance' deputies to further progress on EDIS. As EDIS "interacts with many other policies and parts of the Banking Union", the Eurogroup assigned a broad mandate to the high level working group. That working group was reported to mainly discuss three key issues:

> The "architecture" of the banking union, including the regulatory treatment of sovereign exposures and ring-fencing in the Banking Union;
> The sequencing, and whether the two-stage approach suggested by the October 2017 Commission's Communication on the Banking Union should be followed[24];
> Conditionality, i.e. which specific benchmark should be met for a Member State to access EDIS

This working group will prepare an interim report in April. The Eurogroup will report back to the Euro-summit in June.

Liquidation regime

As part of its July 2018 assessment of the Euro-Area, the IMF recommended to entrust the Single Resolution Board (SRB) with administrative liquidation powers, along the lines of the US Federal Deposit Insurance Corporation (FDIC). Based on the FDIC experience, this would mean entrusting the SRB with insolvency tools akin to resolution to deal with failing banks that do not meet the public interest test. At the December ECON hearing, the Chair of the SRB portrayed that FDIC model as a way to wind up small and medium-size institutions while protecting insured depositors. As the Chair of the SRB put it, "*the ultimate goal [...] must be to have in place an EU liquidation regime alongside an EU resolution regime*".

In the same vein, the Chair of the SSM identified, in its introductory remarks at the European Parliamentary Week in February 2019, "Banking Union – Challenges Ahead", a framework for bank liquidation, as one of the "remaining steps towards completing the banking union": "*We are still missing a common framework for bank liquidation, enabling a smooth managed exit of defaulted banks from the market, as is the case in the United States, for instance*".

That issue is being considered by Commission and the EP:

> The Commission has launched a study on the differences between bank insolvency laws and on their potential harmonisation (to be published in spring 2019). This study is being conducted in the context of a European Parliament Pilot Project on the Banking Union[25]. This report is expected to feed into the review of the Single Resolution Mechanism (Article 94(1)(e)) that requires the Commission to look into potential steps to harmonise insolvency proceedings);
> The EP ECON Committee has commissioned an external study on "Lessons from the United States for banking resolution in the Banking Union" to be published in spring 2019.

For further information, see EGOV Briefing "Liquidation of banks: towards an EU FDIC?" (February 2019)

IV. Summary of two external papers

ECON Coordinators asked the experts appointed to the standing panel on bank resolution to give a topical assessment of the SRB's past performance and a view on future priorities or areas that would call for increased attention. The European Court of Auditors published an early assessment in 2017 as to what has been achieved by the SRB (Special Report on the Single Resolution Board - "*Work on a challenging Banking*

[24] In that Communication, it is envisaged to introduce EDIS more gradually. More specifically, moving to the co-insurance phase could be conditional on progress achieved in reducing the level of NPLs and other legacy assets through an asset quality review.

[25] Creating a true Banking Union - Research on differences in bank related laws and regulations in Eurozone countries and the need to harmonise them in a Banking Union

Union task started, but still a long way to go"), which at that time pointed to a number of shortcomings (e.g. as regards resolution planning, the determination of loss-absorption capacities, and staffing).

Nicolas Véron

Véron first describes the difficult beginning phase of the SRM and SRB, arguing that the SRB has nevertheless been able to learn and adapt. Looking forward, he argues that the SRB must keep building up its capabilities, even as the EU policy framework for banking union and the treatment of bank failures continues to develop. Prior reforms are still being implemented, and could be subject to more comprehensive reforms in the future. Meanwhile, future SRB activity will be shaped by developments in EU State aid controls in the banking sector, as well as policy actions by banks and other stakeholders.

Véron identifies three areas that may warrant further parliamentary scrutiny. First, the SRB the SRB needs to build an autonomous ability to determine if a bank is failing or likely to fail, while avoiding unnecessary duplication of resources or processes with the SSM, which could be supported as necessary by on-site inspections. Second, he thinks that the SRB should develop its crisis preparedness beyond the ongoing process of resolution planning. Lastly, Véron suggests that legislators should consider reforming the SRB's governance framework so as to establish it further as an authoritative, operationally independent decision-making entity.

Rosa María Lastra, Costanza A Russo, and Marco Bodellini

The paper by Lastra, Russo, and Bodellini takes a legal perspective for the analysis of the SRB'S past performance and for the assessment of the challenges ahead. They argue that inconsistency and fragmentation along national lines still persist in the work of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), and a 'multi-layered' system of litigation adds to the complexity of the existing regime.

Looking forward, Lastra, Russo, and Bodellini first recommend that more specific criteria on how to inform the choice between resolution and liquidation be developed, as well as a more coherent interpretation of the concept of 'public interest' from the perspective of financial stability. Second, they argue that the provisions of the State aid framework with the provisions of the resolution regime in relation to public intervention should be aligned. Third, the authors echo the IMF's recommendation to introduce a financial stability exemption to the rigid application of the bail-in tool before the injection of public money can take place. Fourth, they see the need for a clear hierarchical system of claims to avoid investors resorting to a multiplicity of litigation strategies. Lastly, they recommend that the level of transparency and accountability of the SRB should be enhanced by the publication of a non-confidential version of resolution plans.

V. Other policy developments

SRB framework for valuation

On 19 February 2019, the SRB published its Framework for Valuation that shall provide independent valuers and the general public with an indication of the SRB's expectations regarding the principles and methodologies for valuation reports, in order to enhance their comparability and consistency in future resolution cases. The SRB writes that the Framework, based on Level 1 and Level 2 legal texts, has taken into account the main valuation methodologies that are generally considered best practices (in particular the discounted cash flow (DCF) method, as well as the market multiples method and the adjusted book value method).

The Framework addresses the three types of valuation reports that are needed in the resolution context:

- Valuation 1 (prior to resolution): valuation required to determine whether the conditions for resolution are met;

- Valuation 2 (prior to resolution): valuation required to determine the choice of resolution action (bail-in, bridge institution, asset separation, or sale of business);
- Valuation 3 (after resolution): valuation required to determine whether shareholders or creditors would have received better treatment under normal insolvency proceedings ("no creditor worse off' rule).

As the Bank Recovery and Resolution Directive sets out that the valuation reports shall be provided by independent valuers, the SRB highlights that the Framework does not restrict the independence of the valuer. Independent valuers will still have to exercise professional own judgement in a specific resolution case.

The Framework points to some specific challenges, in particular in the context of the Valuation 3, which is a hypothetical assessment of the outcome hade the failed bank been liquidated under normal insolvency proceedings. Such assessment will be performed on a 'gone concern' basis, it therefore has to take into account, for example, the specific legal and administrative costs of an insolvency procedure that would have to be covered by the insolvency proceeds. One of the challenges for a Valuation 3 assessment hence is that the costs of and time frame for normal insolvency proceedings vary materially depending on the insolvency regulation applicable in different Member States.

The Framework furthermore sets out that valuation estimates are by their very nature subject to significant uncertainty, valuers may therefore choose to provide a valuation range around the best estimate. The expected valuation range would be within a band of ± 5-10 % around the best estimate in order to be sufficiently informative for the decision-making process.

For a more detailed discussion of the challenges of valuation reports in the context of banking resolution, in particular as regards the relevance of "counterfactuals" (the hypothetical outcome under normal insolvency proceedings), also please see a previous briefing by Hellwig.

MREL policy

In January 2019, the SRB published its MREL policy for the most complex banking group. While this MREL policy is based on BRRD1 (the existing framework), the SRB has been willing, according to its Chair, to "raise the bar in terms of banks' resolvability and MREL targets to prepare the grounds for future regulatory changes in the context of the Banking Package" (BRRD2). In that respect, the 2018 MREL policy includes in particular the following requirements:

- Application of MREL at individual level. The SRB will not only set binding targets at "consolidated level" (i.e. for the banking group as a whole) as this was the case under the 2017 MREL policy, but also at "individual level" (i.e. for subsidiaries of a banking group). The SRB will be prioritising the most relevant entities;
- Binding subordination requirements will be defined "for all banks with a consolidated target at increased level". This means that the SRB will move from informative benchmarks towards subordination requirements[26].

In the resolution planning cycle of 2019, the SRB expects to adopt more than 100 group-level MREL decisions, and to determine MREL targets for over 530 individual entities.

[26] The SRB requires a minimum level of subordinated instruments, depending on the size and systemic importance of banks. In adherence to global TLAC standards, banks which have been identified as global systemically important institutions (G-SIIs) will be required to maintain a minimum percentage of subordinated instruments equal to 16% of RWA plus the CBR; banks identified as other systemically important institutions (O-SIIs) and other resolution entities will be expected to fulfil a minimum percentage of subordinated instruments equal to 14% of RWA plus the CBR.

Asset encumbrance

In an article on the gaps that still exist for the funding of a bank resolution, published in September 2018, Elke König wrote that from a market discipline perspective it is important to rely on the bank's assets and secured financing, which requires a close monitoring of the banks' asset encumbrance.

Asset encumbrance refers to balance sheet items that are subject to arrangements that restrict a bank's ability to freely transfer or realise them, which is important if assets shall be used as collateral to obtain liquidity from Central banks. The asset encumbrance ratio therefore provides information about the ability of banks to switch from unsecured to secured funding if under stress (such as in a resolution scenario).

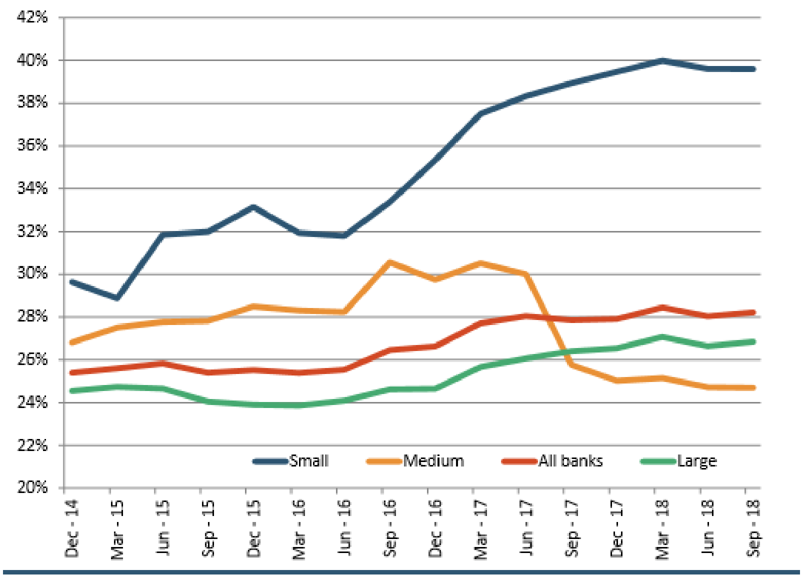
The European Banking Authority (EBA) regularly publishes information on the asset encumbrance ratio in its Risk Dashboard, the most recent version referring to data for the third quarter 2018.

In September 2018, the EBA also published its fourth annual report dedicated to asset encumbrance, finding that the ratio has steadily increased since 2014, though that was not yet seen as an issue of immediate concern. Higher levels of encumbrance are generally reported in countries with large covered bond markets, high shares of central bank funding, or high shares of repo financing.

Averages on country level are in any case not very telling, as there is a wide dispersion of the asset encumbrance ratio across banks. In the third quarter 2018, for example, banks in the 5th and 95th percentiles show values well below 5% respectively well above 50%. The situation therefore has to be assessed individually at bank level.

In general terms the EBA data suggests that the gap between the asset encumbrance ratio of small banks versus that of large banks has increased over time (see graph 1).

Graph 1: Asset encumbrance ratio of European banks (EBA sample), by size class, from 2014 to 2018



Source: EBA Risk Dashboard, data for 3Q 2018

Resolution planning

The SRB 2019 work programme, unveiled on 12 November 2018, points to "*The year 2019 will see significant progress in resolution planning, **both in the scope of banks covered by plans and in their content**. **Banking groups previously not covered will be addressed by new plans**, leading to the **adoption of a total of 113 resolution plans in the 2019 resolution planning cycle**.*

Resolution planning seems to have already achieved significant headways. In a speech in Dublin, in January 2019, Ms. Konig noted that "***Now that we have resolution plans in place for all of our institutions, the work of the SRB has also begun to focus on fine-tuning each plan so that it is truly ready to be sprung into action at short notice**.*" SRB's planning manual has been updated. A public version is expected to be published later this year.

Resolution planning is one of the core competences of the SRB. In her initial intervention before ECON on 6 December 2018 Elke Konig noted that: "*Resolution planning is an essential element for achieving resolvability of banks and without doubt, it constitutes the bulk of our activity involving concentrated efforts, resources and time*." She also mentioned that "***Resolution planning is a process, not a product**. (...) the quality of resolution plans will be improved progressively until 2020, but to be clear: The implementation of MREL and the removal of impediments will be an ongoing and ambitious task for banks and our message to banks remains unchanged: **the sooner you start, the better."*** (emphasis in the original text).

It must be noted that the European Court of Auditor's Special Report on the SRB, published in 2017, flagged that resolution plans are "still very much a work in progress").

Deposit Guarantee Schemes: the EBA recent opinion in the context of Brexit

On 1 March 2019 EBA issued an opinion addressed to the competent authorities under the Deposit Guarantee Schemes Directive calling for enhanced action to ensure deposits of UK credit institutions branches operating in the EU continue to be adequately protected after the UK's withdrawal from the EU[27].

As EBA points out "*The UK's intended approach (...) means that, in the absence of any action taken by the competent authorities, depositors at branches set up by UK credit institutions in the EU will lose coverage, unless these branches join a local DGS in the EU. Therefore, (...) such branches should be required to join a local (EU) DGS subject to the requirements of the national law (...)*[28] thus inviting, *de facto*, branches of UK banks in the EU to join EEA DGS. The opinion also addresses correlated issues, such information to be provided to depositors in cases of changes to affiliated DGSs.

[27] EBA points out that the expected impact of Brexit to depositors should be low but cautions that *"(...) the UK's Bank of England published a consultation paper, which proposes that EEA branches of UK credit institutions will no longer be protected by the UK DGS. This would be in line with the UK's current policy of not covering branches of UK credit institutions in third countries. (...) on 28 February 2019 the Bank of England confirmed their intentions in the 'near-final' post-exit rules and standards.* In the UK pre-final rules explanations it is stated that "*2.36 After exit, deposits held by UK firms' branches in the EEA will not be protected by the FSCS, but may be protected by the relevant EEA State's deposit guarantee scheme depending upon the depositor protection regime in that EEA State.*".

[28] EBA opinion further adds that "*This is based upon the assumption that, if no protection is provided to these branches by the UK DGS, that would clearly mean that their protection is not equivalent to the protection offered by the DGSD, and so no further checks of equivalence would be needed.*"