Liquidation of Banks: Towards an ‘FDIC’ for the Banking Union?

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). 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”. 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.

This briefing looks at the key differences between the US and the Banking Union resolution and liquidation framework (Section 1) including differences in terms of funding arrangements (Section 2). In view of recent liquidation and resolution experiences, the briefing further assesses what an EU insolvency regime would bring to the Banking Union both in terms of small and medium-size banks’ resolution (Section 3) and in terms of strengthening the existing BRRD resolution framework (Section 4). The briefing finally outlines (Section 5) the key building blocks of an EU liquidation regime for the Banking Union.

1. Comparing the US FDIC and the Banking Union resolution and insolvency frameworks

Since its creation in 1933 in the aftermath of the Great Depression, the Federal Deposit Insurance Corporation (FDIC) has developed a crisis management framework for most deposit-taking institutions (with the exception of credit unions, see below) combining supervision, resolution, liquidation and deposit insurance functions in a single federal institution. That framework was further complemented by Dodd-Frank which implemented the FSB Key Attributes of effective resolution with respect to Financial Holding Companies. In the EU, those functions are scattered across different authorities and legal frameworks at European and national level.
Towards an EU FDIC for the Banking Union?

1.1 The EU and the US insolvency frameworks: what are the key differences?

In the EU, “resolution” and “insolvency” are conceptually distinct and subject to different frameworks. Resolution is governed by the Bank Recovery and Resolution Directive (BRRD) and carried out in the Banking Union by the Single Resolution Board (SRB) on the basis of the Single Resolution Mechanism Regulation (SRMR). Insolvency is not harmonised and is left to national law. While resolution aims to avoid systemic disruption by preserving the critical functions of failing institutions, insolvency proceedings focus on dealing with the creditors of failing non-systemic institutions in accordance with the applicable creditor hierarchy. Non systemic institutions are therefore liquidated the same way as other companies, unless national law provides for a bank-specific regime (See Table 1).

In the US, both “resolution” and “insolvency” of deposit-taking credit institutions are included in a single bank insolvency framework that offers both resolution and liquidation tools. In the US, all insured institutions are resolved or liquidated under the Federal Deposit Insurance Act (FDI Act) that provides the FDIC with ‘resolution’ powers (purchase and assumption transaction or P&A, and bridge bank (see section “Insolvency proceedings and liquidation” below) and liquidation powers. For the purpose of determining which tools are to be used in a specific case, the FDIC performs a least cost analysis to compare the cost of liquidating the failing financial institution to the costs of bids received from other interested institutions (See Box 1).

<table>
<thead>
<tr>
<th>Box 1 - The ‘least cost principle’ in the US</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Liquidation requires the FDIC, in its capacity as receiver of the failed financial institution, to pay off insured depositors up to the current insured amount and dispose of the assets, if no acceptable bids are received. If an acceptable bid is received, all deposits or insured deposits are transferred to the acquiring institution.</td>
</tr>
<tr>
<td>Since 1991, the FDIC can only choose the least costly option to the Deposit Insurance Fund when resolving a failing financial institution. Prior to 1991, the FDIC could consider other factors, such as the availability of local banking services and banking stability, before making its final selection, as long as the bid was less costly than liquidation.</td>
</tr>
<tr>
<td>The least costly method is the method for which the net present value, using a reasonable discount rate, of estimated costs to the FDIC are the lowest. In most cases, the FDIC will receive at least one bid that is less costly than the estimated cost of liquidation. Savings over estimated liquidation costs occur for a number of reasons, such as the acquirer pays a premium or the assets are sold to an acquirer at a higher price than that estimated by the FDIC staff”.</td>
</tr>
<tr>
<td>Source: FDIC resolution handbook</td>
</tr>
</tbody>
</table>

While BRRD subjects all credit institutions and financial holding companies to the same resolution framework, the resolution regime in the US differs depending on the legal entity (See Table 1). The US insolvency and resolution framework caters for three types of legal entities:

- Insured credit institutions are subject to the FDI Act that combines both liquidation and resolution options, subject to a ‘least cost’ test;
- Financial holding companies are governed by Dodd-Frank which has introduced a special resolution framework. They are resolved by the FDIC if a financial stability test indicates that proceedings under the US Bankruptcy Code would pose a problem to financial stability. Where that is not the case, financial holding companies will subject to bankruptcy proceedings;
- Liquidation of credit unions (member-owned financial cooperatives) do not fall within FDIC’s remit but with the National Credit Union Administration (NCUA). The NCUA insures deposits of credit unions. As part of its crisis management function, the NCUA may take control of a credit union (conservatorship). That conservatorship may lead to a merger with another credit union or a liquidation by the NCUA.
Looking at the key differences in the EU and in the US and their common objectives, a recent FSI Insights paper by the FSI (Financial Stability Institute) has proposed the following definition of resolution and insolvency. Those definitions highlight the importance of the financial stability or depositor protection objectives assigned to resolution and insolvency:

- The guiding objective of resolution is to preserve a bank’s critical functions: the “intended outcome is continuity of those functions in some form”.
- “The guiding objective of insolvency is to wind up and liquidate the operations of the bank rather than to preserve specific operations for reasons of financial stability. Even if operations are maintained - for example, because parts of the business are sold in the liquidation - the guiding objective of such a sale is to maximise creditor value or minimise costs, in particular to the deposit insurer, rather than to preserve the functions per se”.

**Figure 1: US and EU insolvency framework**

1.2 Focus on resolution

In addition to the Federal Deposit Insurance Act that governs the insolvency framework of insured banks (i.e. deposit-taking institutions), the Dodd-Frank Act has broadened the resolution powers of the FDIC with respect to financial institutions\(^1\) that are considered systemically relevant. For non-bank financial institutions to be resolved under Dodd-Frank, they need to be determined ‘systemic’ on a case by case basis by a government department (the Financial Stability Oversight Council, FSOC). In the absence of such determination, those institutions are restructured under Chapter 11 or liquidated under Chapter 7 of the US Bankruptcy Code\(^2\). While resolution under the Dodd-Frank Act aims to preserve financial stability, the

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\(^1\) Other than deposit-insured bank that are subject to the FDIC act.

\(^2\) A new Financial Institutions Bankruptcy Act (FIBA) has been passed in April 2017. FIBA introduces a Chapter 14 which relies on specialised bankruptcy judges to perform the reorganisation of a large, complex financial intermediaries over the course of a week-end. As explained by Cecchetti and Schoenholz (CEPB), Chapter 14 curtails the regulatory discretion under Dodd-Frank that permits the FDIC to favour one creditor over another (subject to the no-creditor worse-off principle). Under FIBA, funding mechanism that are available under Dodd-Franck (see below, Part 2 of that paper on funding arrangements) would not be available.
objective of normal insolvency proceedings under the Bankruptcy Code is to maximise firms’ value so that creditor’s losses are minimised.

Both the BRRD and the Dodd-Frank Act implement the FSB Key Attributes of effective resolution for financial institutions. In its purpose the BRRD is very similar to the resolution regime under Dodd-Frank, but the implementation of resolution tools in both frameworks differ:

- **Dodd-Frank Act** is limited to transfer of critical functions to another entity followed by an orderly wind-down of the residual failed bank (i.e. closed-bank process) while the BRRD allows resolution authorities to restructure a bank as a going concern (e.g. recapitalisation by applying the bail-in tool, i.e. “open-bank bail-in”);

- In terms of resolution strategies, Dodd-Frank relies on a single point-of entry (SPOE) strategy at the level of the holding company. The SPOE strategy entails the appointment of the FDIC as receiver for only the SIFI’s top-level U.S. holding company. As receiver, the FDIC would establish a bridge financial company and transfer to it the operations of the failed U.S. holding company, including its ownership of its operating subsidiaries, which would continue their operations uninterrupted. In contrast, the SRB is able to implement both single point of entry and multiple point of entry strategies to cater for the different business models of European banking groups.

BRRD provides for resolution tools that feature in the FDI Act (i.e. sale of business, bridge bank or P&A transactions). Dodd Frank gives the FDIC the same broad powers, in its capacity as receiver as it has in the same capacity under the FDI Act, but P&A is not likely to be used under DFA because of the nature of the systemic financial institutions that fall within its scope. Implementation of the SPOE resolution strategies under Dodd-Frank is predicated on the following reasons: (i) G-SIBs are too large, and their balance sheets too complicated for quick P&A to be an option; (ii) The resolution of G-SIBs has an inherent international dimension that is less of a problem when it comes to the resolution of a small and medium-sized U.S. bank. In contrast, BRRD covers a much wider range of institutions.

Importantly, the US and the EU framework **differ with respect to the use of the bail-in tool, its design and the implementation of bail-in buffer** (i.e. MREL and TLAC standard). In the EU, the ‘bail-in’ tool is one of the four resolution tools laid down in the BRRD that the SRB and national resolution authorities may apply to any credit institution. For that purpose, the BRRD requires banks to comply with MREL requirements (Minimum requirements for own funds and eligible liabilities) that are determined by resolution authorities on a bank-by-bank basis and may include, where appropriate, a subordination requirement⁵.

Unlike the BRRD, Dodd-Frank does not include explicit statutory bail-in powers. In substance, however, the FDIC’s powers can achieve a comparable outcome. As this is the case under the FDIC Act, as explained in the IMF assessment of the US resolution framework, “the FDIC as receiver has the power to determine claims in accordance with the statutory hierarchy. Through the claims process the FDIC can terminate the claims of equity holders and creditors, and pay them lesser value in accordance with the statutory hierarchy, so that such persons bear losses arising from the covered firm’s failure”. Put it another way, creditors of failing financial institutions and insured deposit institutions would suffer loss through write-down of their claims as part of a liquidation process of the residual failed institution.

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³ i.e. The capitalisation of a newly established entity or bridge institution to which certain assets and liabilities from the entity in resolution have been transferred (“closed bank bail-in”) as opposed to a recapitalisation of the entity in resolution (“open bank bail-in”).

⁴ BRRD lays down four resolution tools: (i) the sale of business tool; (ii) the bridge institution tool; (iii) the asset separation tool and (iv) the bail-in tool.

⁵ The subordination requirement sets how much of the MREL requirement will have to be met with subordinated liabilities (those ranking below traditional senior debt and liabilities that are expected to be excluded from bail-in). The TLAC requirement should be met in principle with subordinated debt instruments, while for the purposes of MREL, subordination of debt instruments could be required by resolution authorities on a case-by-case basis to the extent it is needed to ensure that in a given case bailed in creditors are not treated worse than in a hypothetical insolvency scenario (which is a scenario that is counterfactual to resolution).
In the US, TLAC requirements only apply to US G-SIBs⁶ in line with internationally agreed standards, as part of a single point of entry strategy (See above). The US framework does not include “MREL” requirements for insured depository institutions, which are EU specific. For a comparison between the TLAC standard and MREL requirements, See EGOV Briefing “Loss absorbing capacity in the Banking Union: TLAC implementation and MREL review”, July 2016).

Both the SRB and the FDIC under Dodd Frank benefit from a large degree of discretion when allocating losses through use of the bail-in tool (or the equivalent US approach). In the US Title II of Dodd-Frank grants the FDIC “broad discretion to treat similarly situated creditors differently without a clearly defined standard to protect disfavored creditors against arbitrary FDIC action” according to the US Treasury. This broad degree of discretion is being challenged by the US Treasury. As emphasised by a February 2018 US Treasury report, “where the FDIC uses this authority to privilege short-term unsecured creditors over long-term unsecured creditors, it would arguably be providing the short-term creditors with a bail-out at the expense of the long-term creditors”. While the Single Resolution Fund would compensate creditors that have suffered greater loss through bail-in under the BRRD that they would have had the bank been subject to an insolvency procedure (‘the no creditor worse off’ safeguard) because other pari passu liabilities have been excluded from bail-in, such compensation mechanism is not provided for under Dodd-Frank. Creditors that suffer increased loss (e.g. as a result of the FDIC departing from the pari passu treatment) could sue the FDIC for damages.

As illustrated below, the key similarity of the US and EU framework is that the largest institutions in both jurisdictions fall under a special resolution regime but with a different scope (scope in the US: large Financial Holding Companies that meet a financial stability test, scope in the EU: all credit institutions that meet the public interest test), outside of which liquidation is the default option. The key difference is that in the EU, the liquidation of non-systemic institutions will fall under national insolvency laws and will be managed by national authorities, including judicial authorities, whereas in the US, the FDIC will typically be the managing authority in charge of the insolvency process (the receiver) for most insured depository institutions and non-bank institutions will be subject to insolvency proceedings under applicable provisions of the Bankruptcy Code⁷.

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⁶ I.e. Top-tier U.S. bank holding companies identified by the Federal Reserve as U.S. global systemically important banking organizations (G-SIBs) (covered BHCs). Requirements also apply to U.S. intermediate holding companies (covered IHCs) of foreign G-SIBs with at least $50 billion in U.S. non branch assets.

⁷ These will be court-led, in contrast to the FDIC-managed proceedings for banks under the FDIA.
Towards an EU FDIC for the Banking Union?

Table 1: Comparison between the US and EU resolution and liquidation framework

<table>
<thead>
<tr>
<th>Category</th>
<th>US</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US bank holding companies</strong></td>
<td>Liquidated under the US bankruptcy Code</td>
<td>Liquidation</td>
</tr>
<tr>
<td>Resolved by the FDIC under the</td>
<td>Bridge Bank (Closed-bank 'Bail-in')</td>
<td>Resolved under the BRRD by the SRB where the 'public</td>
</tr>
<tr>
<td>Dodd Frank Act if liquidation</td>
<td></td>
<td>interest test' is met</td>
</tr>
<tr>
<td>has serious adverse effect on US</td>
<td></td>
<td>All BRRD tools including open bank bail-in</td>
</tr>
<tr>
<td>financial stability</td>
<td>Purchase and assumption (i.e. transfer and sale of</td>
<td>For credit institutions that meet the ‘public interest</td>
</tr>
<tr>
<td></td>
<td>business)</td>
<td>test’, resolution under the BRRD</td>
</tr>
<tr>
<td>Insured depository institutions</td>
<td>Bridge bank</td>
<td>For credit institutions that do not meet the ‘public</td>
</tr>
<tr>
<td>‘Resolution’ where less costly</td>
<td></td>
<td>interest test’, proceedings under applicable national</td>
</tr>
<tr>
<td>than paying out depositors</td>
<td></td>
<td>insolvency law</td>
</tr>
<tr>
<td>Liquidation if least cost</td>
<td>Liquidation (depositors are paid off)</td>
<td>Tools available under national insolvency law</td>
</tr>
<tr>
<td>principle is not met</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: EGOV

1.3 Focus on insolvency proceedings and liquidation

The most common tool used by the FDIC for failing insured depository institutions is “purchase and assumption”. A Purchase and Assumption (P&A) transaction is a “resolution transaction in which a healthy institution purchases some or all of the assets of a failing institution and assumes some of the liabilities, including all insured deposits”. P&As take different forms that include “whole Bank” P&As, P&As “with shared loss”, bridge bank P&As where the FDIC acts temporarily as the acquirer. Those instruments are summarised below (See table 2). While tools are to a large extent similar, importantly, the BRRD does not feature “loss-sharing” transactions which have been extensively used by the FDIC during the financial crisis (See Part 2).

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8 - I.e. loss absorbency is achieved though the bridge transaction and compensation payable to creditors rather than a separate tool.

9 - Shared loss are typically distressed assets of the failing institution that otherwise might not appeal to potential acquirer.
Table 2: Insolvency instruments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Main features</th>
<th>BRRD</th>
<th>National insolvency law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer or sales (a) to (d)</td>
<td>Insured deposits are transferred to a healthy bank. Deposit insurance funds may be used to provide the acquirer with cash equalling the difference between the assumed deposits and the market value of the transferred assets (subject to any least cost test)</td>
<td>BRRD resolution tools include the sale of business tool (full or partial transfer)</td>
<td>Possible under some EU Member States law in normal insolvency proceedings (in the absence of public interest test). Possible use of DGS funds to finance a transfer governed by DGS Directive Article 11(6) - See next section</td>
</tr>
<tr>
<td>(a) of deposits and cash</td>
<td>The acquirer assumes part of the liabilities (the deposits) and receives cash and/or cash equivalent</td>
<td>Partial transfer under the sale of business tool</td>
<td>Possible under some EU Member States law in normal insolvency proceedings.</td>
</tr>
<tr>
<td>(b) of the whole or part of the bank</td>
<td>The acquirer assumes liabilities, including the deposits, and receives some or all the assets of the failed bank (i.e. purchases the assets by taking on liabilities)</td>
<td>Full transfer under the sale of business tool</td>
<td>Possible under some EU Member States law in normal insolvency proceedings.</td>
</tr>
<tr>
<td>(c) with loss sharing</td>
<td>The liquidator agrees to share with the acquirer certain losses (or potentially profits) arising from assets acquired</td>
<td>Not directly possible under the BRRD (i.e. limited use of the Single Resolution Fund)</td>
<td>Possible under some EU Member States law in normal insolvency proceedings. Subject to State Aid</td>
</tr>
<tr>
<td>(d) with loan pools</td>
<td>Similar loans or assets are grouped to enable potential acquirers to submit separate bids for each pool</td>
<td>Partial transfer under the sale of business tool</td>
<td>Possible under some EU Member States law in normal insolvency proceedings.</td>
</tr>
<tr>
<td>Bridge bank</td>
<td>A temporary bank, generally operated by a public authority that acquires the assets and assumes the deposits (and potentially other liabilities) of a failing bank</td>
<td>BRRD Directive includes the bridge bank tool</td>
<td>Possible under some EU Member States law in normal insolvency proceedings.</td>
</tr>
</tbody>
</table>

Source: EGOV based on FSI

The US regime can be described as a “free-standing bank insolvency regime” with administrative proceedings (as opposed to a Court-based proceedings) whose objective is to protect depositors through prompt pay-out or preserving access to deposits (within the least cost test) that protects the funds of the FDIC and then to maximise returns for creditors, as in all insolvency regimes. In the EU, national insolvency widely differ from one Member State to another, as summarised in Table 3. As in the US, some EU insolvency regimes are bank specific and administrative (e.g. Greece, Italy, Slovenia) while other regimes (e.g. France and Germany) are court-based.

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10. It must be noted that the transfer of assets at a discount price to an asset management vehicle under BRRD and state aid rules may achieve the same economic result.

11. The Commission has commissioned a report on Member States insolvency law. That report, to be published in spring 2019, would provide a comprehensive insight into insolvency tools available under national law.
Table 3: Types of insolvency regimes

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of regime</th>
<th>Proceedings</th>
<th>Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Corporate insolvency law</td>
<td>Court-based</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Germany</td>
<td>Corporate insolvency law</td>
<td>Court-based</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Spain</td>
<td>Corporate insolvency law</td>
<td>Court-based</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Greece</td>
<td>Free-standing bank insolvency regime</td>
<td>Administrative</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Italy</td>
<td>Free-standing bank insolvency regime</td>
<td>Administrative</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Free-standing bank insolvency regime</td>
<td>Administrative</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Free-standing bank insolvency regime</td>
<td>Court-based</td>
<td>Maximizing returns for creditors</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Modified corporate insolvency law</td>
<td>Court-based</td>
<td>Protecting insured depositors</td>
</tr>
<tr>
<td>United States</td>
<td>Free-standing bank insolvency regime</td>
<td>Administrative</td>
<td>Maximizing returns for creditors</td>
</tr>
</tbody>
</table>

Source: EGOV based on FSI Insights n° 10

In the US, discussions are under way to replace Dodd-Frank Act by a special bankruptcy chapter applicable to financial institutions. In a report published in February 2018 (‘Orderly Liquidation Authority and Bankruptcy reform’), the US Treasury advocates a complete overhaul of Dodd-Frank, that “created a resolution authority that confers far too much unchecked administrative discretion, could be misused to bail-out creditors and runs the risk of weakening market discipline”. It is suggested to “preserve the key advantage of the existing bankruptcy process - clear, predictable, impartial adjudication of claims - while adding procedural features tailored to the unique challenges posed by large, interconnected financial firms”. Under this approach, a financial company could file for bankruptcy and petition the court for approval to transfer most of its assets and certain liabilities to a bridge company.

1.4 Focus on deposit insurance

In the EU, the role of Deposit Guarantee Scheme is primarily paying out deposits¹² (pay-box function) although the DGS Directive provides for alternative use (e.g. early intervention as this is the case in Inter-institutional Protection Schemes or for purposes other than pay out that protect insured deposits in insolvency or resolution).

In contrast, in the US, the deposit insurer (i.e. the FDIC) is also a “receiver” (i.e. a liquidator) and only pays off depositors (pay-box function) in the absence of less costly alternatives, including transfer and bridge banks as outlined above (see Section on insolvency tools above). According to the IADI (International Association of Deposit insurers), DGS in the EU act as “receiver/liquidator” only in a few Member States (HR, FR, RO).

¹² Article 11(1) of the DGS Directive: “The financial means referred to in Article 10 shall be primarily used in order to repay depositors pursuant to this Directive”.

The DGS Directive also recognises that DGS funds may be used for purposes other than payout in resolution or insolvency, as a national option under Article 11(6): “Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned”. Where Member States avail of this option, national DGS may be used to fund P&A transactions along the lines of the US FDIC.

### Table 4: Comparison between the FDIC and EU DGSs

<table>
<thead>
<tr>
<th>Function</th>
<th>US</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early intervention</td>
<td>Open Bank Assistance no longer applies(^{14})</td>
<td>Option under national law in accordance with the DGS Directive</td>
</tr>
<tr>
<td>Pay box function</td>
<td>250,000 dollars</td>
<td>100,000 euros</td>
</tr>
<tr>
<td>Pay box function</td>
<td>Ex ante funding: Target level of 1.35%(^{15})</td>
<td>Ex ante funding: Target level of 0.8%(^{16}) of covered deposits</td>
</tr>
<tr>
<td>Funding of ‘resolution’ or ‘insolvency proceedings’</td>
<td>Possible use of the Deposit insurance, subject to the “least cost principle”, by the FDIC</td>
<td>Resolution under BRRD (i.e. public interest)</td>
</tr>
<tr>
<td>Funding of ‘resolution’ or ‘insolvency proceedings’</td>
<td></td>
<td>DGS to contribute to the funding of resolution had covered deposits been written down to absorb losses in the bail-in cascade (Article 109(1) of BRRD)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>National law (i.e. no public interest)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Member States option under Article 11(6) of the DGS Directive. That option conditions the use of DGS to finance a transfer of deposits to the least cost principle</td>
</tr>
</tbody>
</table>

Source: EGOV

In resolution, in accordance with Article 109 of BRRD, the DGS is liable for the amount by which covered deposits would have been written down or suffered losses had covered deposits been included in the scope of bail-in. It must be noted that bail-in of covered deposits is unlikely given the covered deposits preference in BRRD.

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\(^{13}\) This is the case of Italy according to Commission’s impact assessment of the DGS Directive. The Commission is preparing a survey identifying key differences in national insolvency law across Member States. This report, to be published in spring, will provide insight into the use of that option under national law.

\(^{14}\) Under the Open Bank Assistance (OBA), an insured institution “in danger of failing” receives assistance from the FDIC in the form of direct loans, contributions, deposits or asset purchases. This resolution option ceased being used after 1992, but was used exceptionally in 2008 with Citigroup and Bank of America. This is no longer available since the Dodd-Frank Act.

\(^{15}\) The US Deposit Insurance Fund, which stood at $52.4 billion or 1.22 percent of insured deposits prior to the crisis, went into a deficit of $8.2 billion by end September 2009. Dodd-Frank raised that level to 1.35% (to be reached by end September 2020).

\(^{16}\) The DGS Directive provides for exceptions to the 0.8% target level for Member States with a high degree of consolidation in their national market. In that case, the target level may be reduced up to 0.5%. That derogation has not been authorised by Commission so far.
1.5 Focus on supervision and resolution planning

> Supervisory functions

The FDIC is the primary federal supervisor for state-chartered banks and savings institutions that are not members of the Federal Reserve System. The FDIC portrays its role as deposit insurer and supervisor as “complementary”. With respect to banks that do not fall within its primary responsibility, the FDIC as insurer for insured depository institutions, review examination reports and other available information from the primary federal supervisors (e.g. OCC or Fed). The FDIC particularly performs off-site monitoring and on-site examinations for institutions with more than $10 billion in assets. In addition, the FDIC has the authority to “conduct special (backup) examination activities” for institutions for which is not the primary federal regulator.

In the Banking Union, resolution and supervision are attributed to different institutions (ECB and SRM) and are, substantially, distinct functions to cater for conflicts of interests concerns. Examination powers of the SRB is circumscribed to its resolution function. According to its work programme, the SRB plans to develop on site examinations for resolution planning purposes in 2019, “with a view to building over time an in-house capacity while cooperating at the same time with the ECB to reap potential synergies in this domain”. Prudential information that pertains to the SSM supervisory function are transmitted by the SSM to the SRB either automatically or upon request depending on the type of information. That cooperation and information exchange is governed by a MoU between the Single Resolution Board and the European Central Bank.

It must be noted that, where the SSM does not make that assessment, the SRB, as part of its resolution tasks, may declare that a bank is failing or likely to fail. In case the SRB declares a bank to be failing or likely to fail, the SRB would de facto make a supervisory judgement, which might, where appropriate, call for a broader supervisory function.

> Coordination between Resolution Authorities and Supervisors

For the purpose of its supervisory function, the FDIC has established information sharing procedures with the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System and Federal Reserve banks. In particular, an Interagency Memorandum of Understanding on Special Examinations signed in 2010, allows the FDIC in coordination with a depository institution’s primary supervisor (i.e. OCC or FED) to conduct a special examination to determine the institution’s condition for insurance protection purposes. As emphasised by the FDIC, early access to failing depository institution supervisory information allows FDIC’s operational departments “to understand the failing institution and begin assessing assets and operations to determine the resolution marketing strategy”.

While exchange of information between the SRB and the ECB is governed by a MoU, the SSM does not provide an early assessment of failing or likely to fail decisions to the SRB. As explained at the November 2018 ECON hearing by the Chair of the SSM, “it will be extremely risky and could be very damaging for a bank just because it has weaknesses at a certain moment to start drafting failing or likely to fail decisions that are circulated”. The SRB is nevertheless made aware of draft “failing or likely to fail” decisions before it is circulated to Supervisory Board members, on confidentiality grounds. In addition, pursuant to Article

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17 At national level, article 3(3) BRRD states that MS may ‘exceptionally’ provide for the supervisor to be a resolution authority, provided there are adequate structural arrangements in place to ensure operational independence and avoid conflicts of interest.

18 For the purposes of carrying out its tasks, the SRB has the power to conduct “all necessary on-site” examinations in accordance with Article 36 of the SRM Regulation. This includes inspection without prior announcement.

19 A revised version has been agreed upon in June 2018. That new MoU, in particular, provides for an automatic exchange of information on a continuous basis, without any explicit request or justification, regarding information explicitly mentioned in the annex of Memorandum. The previous MoU provided for exchange of information on a voluntary basis (in the absence of an explicit request).

20 In accordance with Article 18(1) of the SRM Regulation, “The Board, in its executive session, may make a [Failing or Likely to Fail] an assessment only after informing the ECB of its intention and only if the ECB, within three calendar days of receipt of that information, does not make such an assessment. The ECB shall, without delay, provide the Board with any relevant information that the Board requests in order to inform its assessment”.
27(1)(h) of BRRD, this is for the ECB, as part of its early intervention power, to collect all necessary information to update the resolution plan and for valuation purposes. That information is transmitted to the SRB.

> Resolution Planning

Differences in supervisory functions also extend to resolution planning. In accordance with BRRD, the SRB is in charge of adopting resolution plans for all banks falling within its remit. In contrast, in the US, the responsibility for preparing resolutions plans (‘living wills’) primarily falls with financial institutions following supervisory guidance (See guidance for the 8 largest banks). This difference of approach also holds true with respect to disclosure. While resolution plans are kept confidential in the EU, resolutions plans in the US consist of two parts: a confidential section that contains supervisory and proprietary information submitted to US agencies and a public section made available by the FDIC.

2 Comparing the US and the Banking Union financing arrangements

2.1 Solvency support

Solvency support may come from different sources: (i) resolution funds under the BRRD or DGS funds to the extent permitted under national law (see above) or deposit guarantee funds for insured depository institutions in the US and (ii) use of other sources of public funds (i.e. bail-out), with limitations imposed by BRRD and state aid.

> Use of resolution or deposit insurance fund

Conditions for using resolution or deposit insurance funds to absorb losses differ widely in the US and in the EU:

• In the EU, use of the Single Resolution Fund to absorb losses in lieu of creditors is conditional on the bail-in of 8% of liabilities, including own funds under Article 44(5) of BRRD
• In relation to insured deposit institutions, the US framework does not provide for hard wired limits. Interventions of the FDIC must be predicated on the ‘least cost principle’ being complied. In that respect, it must be noted that the absence of statutory bail-in power and MREL requirement in the US (See Part 1) does not lend itself to any hard wired requirements for the amount of losses that should be borne by creditors (though effectively the least cost test caps the amount by which uninsured creditors can be shielded from loss by FDIC funds). Under “loss sharing arrangements” (See above, Part 1), the FDIC takes on the risk of some loss in relation to transferred assets (i.e. with the purchaser), rather than requiring creditors to absorb losses in relation to their claims. In the absence of loss-sharing agreements, the purchaser would have to assume the risk of greater losses.
• When it comes to the resolution of financial institution under Dodd-Frank, financing arrangements may be called upon but only in the context of liquidity financing (see next section).

In relation to insured depository institutions, the FDIC may absorb losses by means of a “shared loss” P&A where the FDIC, as receiver, agrees to share losses on certain types of assets with an acquiring institution. During the financial crisis, the FDIC offered a loss sharing agreement whereby the acquiring institution accepts a certain percentage of the losses, depending on the bid. In the absence of such agreement,

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21 Pursuant to Dodd-Frank and the Federal Deposit Insurance Acts, all bank holding companies with consolidated assets of at least $50 billion; non-bank financial companies (NBFC) that are subject to supervision by the Federal Reserve Board (FRB) (including systemically important insurance holding companies) and IDI with total assets of $50 billion are required to prepare, and update on an annual basis, plans for their rapid and orderly resolution.

22 Shared loss assets are typically distressed assets of the failing institution that otherwise might not appeal to potential acquirers without some sort of incentive or protection from losses. Under a shared loss option, the FDIC splits defined losses and expenses on certain assets with the
requirements for resolutions to be least cost would mean that losses would be allocated to shareholders and as appropriate unsecured and uninsured creditors. In accordance with the FDIC resolution handbook, “The FDIC usually agrees to absorb a significant portion (for example, 80 percent) of future disposition losses on assets that have been designated as shared loss assets for a specific period of time (for example, three to five years”). For the FDIC, the economic rationale for loss sharing arrangements is that retaining shared loss assets in the banking sector would produce a better net recovery than would the FDIC’s liquidation of the assets.

Operations of the FDIC are backed by a credit line from the US Treasury. Looking at the US experience in successfully resolving around 500 banks without triggering financial instability, the President of the ECB emphasised that “an orderly resolution of this magnitude was possible in the US because of confidence in a well-functioning resolution framework. And the presence of the Treasury backstop was fundamental in creating this confidence”. In the EU, backstop to the SRF that will amount to the size of the Single Resolution Fund (i.e. 60bn) is being worked out, in accordance with the December Euro Summit conclusions. See EGOV briefing “Completing the banking union”, December 2018.

Other sources of public funding

In the EU, use of public funds is permitted under Article 44 of BRRD in exceptional circumstances after the bail-in of 8% of the creditors’ liabilities and the contribution of the Single Resolution Fund for 5% of the total liabilities. Those alternative sources of funding may include the ESM Direct Recapitalisation Instrument. Public funds may also be used in the EU as part of a “precautionary recapitalisation” or guarantees under Article 32 of BRRD. See EGOV Briefing on precautionary recapitalisation, July 2017.

Under Dodd-Frank, use of tax-payer money to bear losses in resolution is explicitly ruled out. In addition, under the “open bank assistance resolution method” an insured depository institution in danger of failing was able in the past to receive assistance from the FDIC in the form of direct loans, contributions, deposits, asset purchases, or the assumption of liabilities. OBA was used in 2008 with Citigroup and Bank of America. Dodd-Frank eliminated that resolution method.

2.2 Liquidity resolution financing under Dodd-Frank and BRRD

In terms of liquidity financing, the Dodd-Frank Act established an Orderly Liquidation Fund (OLF) at the US Treasury. OLF is a liquidity facility that the FDIC may draw upon - subject to terms set by the Treasury - to lend to the financial company that is being resolved (‘in receivership’). In practical terms, the facility takes the form of obligations issued by the FDIC and may be provided when private-sector liquidity is unavailable and subject to repayment plan approved by the Treasury. That facility must be strictly commensurate to the size of the bank and its value. OLF is currently being reviewed in the US. In a report

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23 The FDIC is authorised to borrow for working capital from the Federal Financing Bank, a government entity under the supervision of the Secretary of the Treasury. The FDIC also has authority to borrow up to $100 billion for insurance losses from the U.S. Treasury. The law requires the banking industry to repay any FDIC funds borrowed from the Treasury over a period of several years.

24 BRRD Article 56 permits the use of “government financial stabilisation tools” (i.e. public equity support tool and temporary public ownership tool) after a 8% bail-in. This tool is not available under the Single Resolution Mechanism Regulation for Euro-area Member States.

25 The DRI has been introduced in December 2014. DRI may be used in very specific circumstances to directly recapitalise financial institutions, as a last resort instrument when all other instruments, including bail-in as mandated by the BRRD, have been applied and after the Single Resolution Fund (SRF) has been used. It must be noted that the backstop to the SRF would replace the DRI instrument that would no longer be available, in accordance with the Eurogroup’s terms of reference on the backstop (December 2018).

26 The US Treasury describes the facility as follows: “the FDIC issues obligations to Treasury, the proceeds of which are deposited into the OLF, and the FDIC can use the proceeds to make OLF loans to the bridge company. In addition, the FDIC may issue loan guarantees to facilitate private sector lending to the bridge company”.

27 The OLF cannot provide any amount greater than 10 percent of the assets of the bank until the Secretary and FDIC have agreed on a plan and schedule for repayment. Once the FDIC has completed a fair value estimate of the total consolidated assets of the bank, advances under the OLF are limited to 90 percent of the amount of such value.
dated February 2018, the US Treasury suggests to better frame the use of OLF to eliminate any risk of unrecovered OLF loans\textsuperscript{28}.

In the Banking Union, liquidity financing may be provided by the SRF irrespective of whether 8% of creditors’ liabilities have been bailed-in. The Banking Union framework has been qualified by the Chair of the SRB as “being geared towards addressing solvency issues more than liquidity” (see April 2018 conference). That source of funding is capped by the size of the SRF, its backstop and the amount of ex post contributions that the SRF may raise. In that respect, the SRB pointed out that “support to individual banks in stress easily count triple billion figures. Precisely for this reason, FSB guidance recommends establishing temporary public backstop funding mechanisms. Such a tool currently does not exist in the Banking Union (BU), which is a missing piece in the overall framework”.

In September 2018, the Chair of the SRB further outlined how those liquidity arrangements should be structured:

- The SRF would not be able to provide liquidity to a firm in resolution to the extent necessary: “While the SRF can play a role in providing liquidity, the role can only be limited, given the SRF’s size, even if secured by a common backstop. We should however be mindful that the SRF was primarily designed for capital restoration”;
- Central banks are the best placed to provide that liquidity. The SRB emphasises in that respect that “only viable and solvent institutions in resolution should be supported with funding” (which is a prerequisite for accessing central bank money);
- “The creation of a new sovereign-bank nexus should be avoided” according to the SRB. This would mean that guarantees to central banks’ financing, where appropriate, should not be provided by national Member States where the problem bank is located.

For further background information, see EGOV briefing “Banking Union: towards new arrangements to finance banks under resolution?” (July 2018).

\textsuperscript{28} Limitations under consideration include: i) Loan guarantees of private funding should be preferred over direct lending; (ii) The FDIC should only lend funds or provide loan guarantees if it charges an interest rate or guarantee fee set at a significant premium; (iii) Lending - where loan guarantees are not possible - should be secured by “high level quality asset” and limited in time.
Table 5 - Funding of failing banks

<table>
<thead>
<tr>
<th>Funding type</th>
<th>USA</th>
<th>Banking Union</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dodd-Frank (resolution)</td>
<td>BRRD</td>
</tr>
<tr>
<td>Prevention</td>
<td>No</td>
<td>Precautionary recapitalisation funded by Member States</td>
</tr>
<tr>
<td></td>
<td>No longer available since Dodd Frank</td>
<td></td>
</tr>
<tr>
<td>Liquidity financing</td>
<td>OLF (Orderly Liquidation Fund) limited to the size of banks’ balance sheet</td>
<td>Single Resolution Fund Emergency Liquidity Assistance subject to State Aid rules</td>
</tr>
<tr>
<td></td>
<td>n.a.</td>
<td></td>
</tr>
<tr>
<td>Loss absorbency</td>
<td>No</td>
<td>Single Resolution Fund after 8% bail-in</td>
</tr>
<tr>
<td></td>
<td>Federal Deposit Insurance subject to the least cost principle</td>
<td></td>
</tr>
<tr>
<td>Use of public funds</td>
<td>No</td>
<td>Only after bail-in of 8% of the bank’s liabilities and use of the SRF for 5% of the banks’ liabilities</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Backstop</td>
<td>Federal Budget</td>
<td>60bn provided by the ESM</td>
</tr>
<tr>
<td></td>
<td>Federal budget</td>
<td>National budget</td>
</tr>
</tbody>
</table>

Source: EGOV

3. Does the EU need a harmonised liquidation regime?

3.1 Clarifying the link between resolution and insolvency

As evidenced by recent liquidation cases, whether the resolution of a bank (that has been deemed failing or likely to fail) is in the public interest or whether a bank should be liquidated in the absence of a public interest has been assessed differently at the EU and at national level. The definition of normal insolvency proceedings\(^\text{29}\) under BRRD is very broad in scope, and may therefore include “self-liquidation” and insolvency tools akin to resolution.

> The Veneto banks case

The Veneto banks - which did not pass the SRB’s ‘public interest test’ that is required for a bank to be ‘resolved’ at the EU-level - have been liquidated through a special insolvency procedure under Italian law (see for a detailed analysis, a separate EGOV briefing). That special insolvency procedure involved ‘resolution’ tools including transfers and bail-in\(^\text{30}\) and state aid. Although the SRB concluded that the

\(^{29}\) Article 2(47) of BRRD defines normal insolvency proceedings as “collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person”.

\(^{30}\) On 25 June 2017 the two banks were wound down with the transfer of the performing business (performing loans, financial assets, deposits and senior debt) to Intesa San Paolo (ISP) subject to the injection of cash and the provision of guarantees by the Italian government (see below), the transfer of the non-performing portfolio to SGA, the vehicle formerly used for the liquidation of Banco di Napoli, and the bail-in of equity and subordinated shareholders, which remain in the entity into liquidation.
resolution was not warranted in the ‘public interest’, the Commission indicated that EU state aid rules foresee the possibility to grant State aid to mitigate economic disturbance at regional level.

The Veneto banks cases have made clear that, depending on national insolvency law, resolution actions may be undertaken at national level outside of the BRRD framework, despite the absence of a ‘public interest’ determined at EU level by the SRB. Such actions remain subject to the EU State Aid framework, but not to more restrictive conditions under the BRRD. This is what Andrea Enria, Chair of the European Banking Authority (EBA) called “two different definitions of “public interest” [...] one at the EU level and another one by national authorities”. In that respect, Silvia Merler (Bruegel) recommended in a paper commissioned by the European Parliament more clarity over the role that the concepts of critical functions and public interest play in Member States’ decisions. The current diversity in national insolvency frameworks was seen as “a source of uncertainty about the outcomes of liquidation procedures”.

For the purpose of clarifying the link between resolution and liquidation, the recently agreed BRRD2 package makes it clear that banks that are likely to fail but not resolved in the absence of a “public interest” shall be “wound up in an orderly manner in accordance with the applicable national law”. In that respect, it must be noted that an EU liquidation regime would provide a harmonised framework for orderly wind-up procedures.

> The ABLV Case

The ABLV case gave rise to two divergent decisions: the liquidation of ABLV in Latvia and an insolvency “reorganisation” proceedings (“suspensions de payment”) of its subsidiary in Luxembourg. That Luxembourg court decision highlights that the liquidation process for a banking group with legal entities in more than one Member State leads to the application of different national insolvency law frameworks. For further background information on the ABLV case, see EGOV briefing (“Further harmonising EU insolvency law from a banking resolution perspective?”, May 2018).

Against this background, the Chair of the SRB stressed that “The failing or likely to fail (FOLF) assessment does not automatically link to the criteria for insolvency/liquidation. Only by raising national bank insolvency procedures to a common standard we can clarify the line between resolution and insolvency and eliminate wrong incentives”. The FOLF assessment is not necessarily compatible or aligned with the grounds for insolvency under national insolvency laws, which may be focused more narrowly on balance sheet solvency and the ability to pay debts as they fall due as was the case in Luxembourg.

3.2 A “unified, transparent and predictable resolution regime” (IMF FSAP)

In its June 2018 FSAP on the Euro Area, the IMF has called for a “unified, transparent and predictable resolution regime”. According to the IMF, the existing framework provides incentives for Member States to resolve systemic banks under national bank insolvency regimes, creating an “uneven playing field across the banking union in terms of banks’ funding costs”. The IMF suggests a complete overhaul of the EU resolution framework along the following lines:

- The SRB should not only be a “resolution authority” but also avail of “an administrative bank liquidation tool”. This tool would allow the resolution authority to appoint a liquidator and commence proceedings;
- Aligning loss sharing requirements in resolution and state aid rules;
- At the same time, introducing a “financial stability exemption” to deal with systemic crisis in a more “flexible” way. This would mean departing from the 8% bail-in requirements for accessing the SRF and public funds, under “strict governance arrangements”.

It must be noted that the Intergovernmental agreement on the transfer and mutualisation of contributions to the Single Resolution Fund the use of the Single Resolution Fund makes it “contingent upon the permanence” of the SRM and BRRD bail-in requirements.
Towards an EU FDIC for the Banking Union?

This framework is expected to provide a consistent set of rules while better framing “flexibility”. According to the IMF, flexibility is currently “found in national alternatives to resolution, subject to less strict loss sharing requirements under state aid rules than in the SRM” that may “undermine the coherence of the regime”.

3.3 Managing the failure of medium-size bank in a more effective way across the Banking Union

In the EU crisis management framework, liquidation or orderly wind-down under national insolvency proceedings is the default-option to deal with failing banks. Resolution only takes place when a public interest test is met. As emphasised by the Chair of the SRB in a speech of January 2017: “most banks are now in such a shape that we can say with confidence that their failure would not endanger financial stability and that they can be resolved if they fail - like any other business in the market economy – through regular insolvency procedures. The extra safety net of resolution is only for the few, not the many”. In that respect, reacting to the Veneto banks case, Andrea Enria, Head of the EBA, pointed to the very high bar for resolution: “The decision that there was no EU public interest at stake in the crises of two ECB-supervised banks that were hoping to merge and operate in the same region with combined activities of around €60 billion sets the bar for resolution very high”. This would render the application of insolvency regimes more common as opposed to the BRRD resolution framework. This also means that in most cases, dealing with failing bank is left to national law and national competent authorities or Member States. In that respect, it must be noted that a “high bar for resolution” would ultimately result in a greater misalignment between supervision carried out at European level as part of the Single Resolution Mechanism and crisis management done at national level (because banks subject to the SSM may not meet the public interest threshold for resolution).

In that context, there may be an interest in ensuring that insolvency regimes are an effective option for managing the failure of banks in an expeditious and orderly manner at EU level. Against this background, the Chair of the Financial Stability Institute (FSI) noted in a speech that “There is a strong case to consider the creation in Europe of a common insolvency regime for financial institutions that are not subject to resolution. That regime should include common rules, perfectly compatible with the spirit of the resolution framework that would be applied by a single administrative authority. Following the example of other jurisdictions, that administrative authority could well be the SRB in order to ensure consistency of action in managing the crisis of different types of financial institution” (F. Restoy, October 2010).

In addition, insolvency tools akin to resolution may make insolvency a more feasible option for medium-sized banks for which resolution may not be credible because they lack sufficient loss-absorbing capacity. For this purpose, it has been argued that bail-in and MREL requirements are ill-suited to banks that cannot easily tap capital markets to issue subordinated or convertible liabilities to meet requirements for a sufficient amount of bail-in-able debt. As emphasised by the FSI, 70% of significant banks under direct supervision by the SSM are not listed, 60% have never issued convertible instruments and 25% have not issued subordinated debt either. (Speech of the FSI Chair, F. Restoy).

Against this background, it has been considered that “the effectiveness of the new resolution framework could require the banking system to be organised into two well defined segments. The first one would be composed of systemic financial institutions with active participation in capital markets that would be subject to the resolution procedures, including bail-in, in case of failure. The second segment would be composed of truly unsystemic institutions that would be subject to regular insolvency procedures” (FSI, March 2018). By analogy with the US framework that also includes a specific framework for credit unions (See Part 1), consideration may also be given to a bespoke framework governing EU mutuals.

32 Not all banks under direct supervision by the SSM are nevertheless “significant” in terms of balance sheet as 3 major banks of each Member States, in particular, need to fall with ECB direct supervision.
4. Importance of an EU insolvency regime for the BRRD resolution framework

4.1 Treating all EU creditors the same way

While conceptually distinct under the EU framework, resolution and insolvency law are intrinsically linked. Resolution builds on national insolvency for the purpose of using resolution tools (e.g. partial transfer) and applying the ‘No Creditor Worse Off’ principle. As illustrated in figure 2, use of resolution tools involve to a large extent national insolvency law. For further background information on the role and importance of national insolvency law in resolution and steps taken at EU level to further harmonise insolvency law for banks, see EGOV Briefing (“Further harmonising insolvency law from a banking resolution perspective?” May 2018).

In the absence of a harmonised regime for banks’ insolvency law, the NCWO principle would not result in similar outcomes across the Banking Union in case of the resolution of a cross-border group. By way of example, a creditor in the subsidiary in country A could be treated differently to a creditor of the same banking group located in country B, where the creditor hierarchy differs materially. As clarified by EBA, the NCWO assessment has to be performed at the level of each group entity subject to resolution measures. That NCWO assessment would compare the treatment received by creditors in the course of the resolution action with the treatment they would have received under normal insolvency proceedings. For that purpose the national insolvency law that would be applicable had those entities entered normal insolvency proceedings should be taken into account. Given Member States’ discrepancies in insolvency law, the SRB “strongly encourage[d] legislators to harmonise national insolvency laws, in order to create a level-playing field”. The BRRD has harmonised the ranking of claims for the purposes of applying the bail-in tool, but national differences still exist as reported by the SRB (See EGOV Briefing (“Further harmonising insolvency law from a banking resolution perspective?” May 2018)).

Figure 2: Role of insolvency law in resolution proceedings

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33 The EU resolution framework aims at protecting creditors which must not be “worse off” than under liquidation (‘No Creditor Worse Off’ principle). The SRB is tasked with assessing whether shareholders and creditors would have received a better treatment under insolvency proceedings than in resolution.
Facilitating cross-border resolution

Harmonisation of insolvency law, in particular the ranking of creditors across the Union, would also facilitate cross-border resolution. As the Chair of the SRB put it in April 2019 in her Eurofi statement, “in the current framework insolvency is clearly entity-specific as is NCWO” [...]. In that respect, the SRB called for further harmonisation of insolvency law to facilitate resolution planning for cross-border banking groups within the Banking Union. Absent such framework, the SRB warned against the risk that “the focus during the resolution of banking groups will have to remain at entity level”. This statement echoes the concerns voiced by Commission already in its 2009 Communication on crisis management: “the fundamental obstacle to cooperative resolution of a cross-border group is, inter alia, rooted in the territorial nature of insolvency law. If insolvency law is national, domestic authorities have a legitimate – as well as a strong political – interest to ring-fence the national assets of an ailing bank in order to protect national deposits and maximise the assets available to the creditors of the national entity”. This analysis led the Commission in 2009 to recommend further harmonisation of insolvency law as a necessary pre-condition to bring about a single resolution authority in the EU.

The ABLV case also raises the issue as to whether insolvency proceedings need to be coordinated when it comes to the liquidation of a group active in different Member States. In that respect, the 2009 Commission communication on crisis management (‘an EU Framework for Cross-Border Crisis Management in the Banking Sector’) noted that ‘as a minimum [...] an EU bank resolution framework should be supported, by a binding framework for cooperation and exchange of information between courts and insolvency practitioners responsible for proceedings relating to affiliated entities in a banking group’.

The Commission suggested an integrated treatment of banking groups in the context of a harmonised EU insolvency regime for banks (See box 2). Such integrated treatment was seen as a necessary step to “fully address the problems associated with the separate entity approach under national insolvency law”. For the Commission, this project could take the form of a separate insolvency regime that would replace the otherwise applicable national regimes, for the winding up of cross-border banking groups. Harmonisation of substantive insolvency law would be in any case challenging. As Commission put it in its 2009 Communication, “the difficulty and sensitivity of such work should not be underestimated. Insolvency law is closely related to other areas of national law such as the law of property, contract and commercial law, and rules on priority may reflect social policy [...]”.

**Box 2: 2009 Commission’s plan in relation to an insolvency regime for banks**

A harmonised EU insolvency regime for banks

Techniques for a more integrated treatment of groups in insolvency might assist in addressing some of the inequities that might arise from winding up highly integrated banking groups on a separate entity basis. There is a growing body of academic and professional opinion that suggests that separate entity insolvency cannot adequately deal with complex corporate structures where form does not follow function, and that international work on the harmonisation of insolvency rules is now needed. Without such harmonisation, it will remain very difficult to re-structure a cross-border banking group.

**Source:** 2009 Commission communication on crisis management (‘an EU Framework for Cross-Border Crisis Management in the Banking Sector’)
5. What would an ‘EU’ FDIC mean in the context of the Banking Union?

At the 6 December ECON hearing, the Chair of the SRB advocated a “framework which links on the one hand depositor protection (i.e. DGS Directive) and on the other hand gives the chance to unwind small and medium size banks under national insolvency proceedings effectively protecting the client”, referring to the FDIC. Adopting the US FDIC model in the Banking Union would imply further harmonisation on three fronts: (i) an EU bank insolvency framework; (ii) further supervisory functions for the SRB and (iii) a European Deposit Insurance Scheme underpinned by further harmonisation of the DGS Directive.

5.1 A harmonised EU bank insolvency framework

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 that respect, based on the FDIC experience, the Chair of the SRB advocated an administrative procedure that was seen as more predictable (See Box 3).

Based on the US experience, an EU FDIC would consist of three pillars:

- Insolvency tools that may limit the extent to which DGS (and ultimately EDIS, where appropriate) may be used, including purchase and assumption transaction and bridge banks. The SRB as a liquidation authority would be deciding whether deposits should be paid off or whether alternative tools should be used, on the basis of a “least cost principle”, where appropriate (see below);
- DGS or an European Deposit Insurance Scheme, where appropriate, to finance both the use of insolvency tools or the paying off of depositors, whichever is the least costly option;
- An enhanced supervisory function for the SRB, where appropriate.

In addition and by analogy with the US framework for credit unions, the issue is raised as to whether some categories of EU banks should be subject to an ad hoc system.

In terms of insolvency tools, “the administrative authority for insolvency procedures should be able to employ some of the instruments currently envisaged in the BRRD for banks in resolution, if that is most likely to preserve value for creditors – especially depositors – and minimise the impact on the (ultimately common) deposit guarantee scheme (Speech from the Chair of BIS Financial Stability Institute, F. Restoy). The principal bank-specific features of bank insolvency proceedings are summarised in Box 3.

Against this background, 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. 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). In addition, 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.

An EU bank insolvency framework could have a significant bearing on how resolution and resolution planning is designed and raises critical questions on how the BRRD and an EU insolvency framework should be best articulated:

- In terms of articulation of both frameworks, the issue is raised as to whether credit institutions and/or financial holding companies should be subject to either the BRRD framework or an EU liquidation framework, depending on e.g. their business models, size and systemic relevance. This

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34 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
approach has been suggested by the Chair of FSI (See Part 3 of that paper) that called for a more proportionate treatment of medium-size banks under the bail-in and MREL rules and better transparency and predictability with respect to bail-in;

- In relation to the **bail-in tool** the issue is raised as to whether banks that would be expected to be subject to an EU insolvency regime should be subject to the BRRD bail-in tool (i.e. open bank bail-in). It must be noted that bail-in under BRRD replicates the loss allocation that is possible in insolvency without putting a bank into an insolvency proceeding.

- In terms of MREL requirements, the issue is raised as to whether banks that would be expected to be subject to proceedings under an EU insolvency regime, should be required to hold additional bail-in buffer on top of own fund requirements to support a transfer in an insolvency proceedings. It must be noted that under the SRB MREL policy\(^\text{35}\), banks that are expected to be liquidated are not subject, as a general rule, to additional MREL requirements. In addition, in a liquidation regime similar to the US FDIC, the DGS may be used, where appropriate, to support a transfer. Against that background, the FSI argued that “there is no clear room for a “middle class” of institutions whose failure - and eventual liquidation - could be considered systemic but whose business model appears incompatible with the satisfaction of stringent MREL requirements as imposed by the resolution framework”.

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**Box 3: Principal bank-specific features of bank insolvency proceedings**

**Objectives:** the conventional insolvency objective of maximising value for creditors is frequently supplemented by a depositor protection objective, either as an explicit statutory objective for the liquidator, or by virtue of the general mandate of the administrative authority that conducts the procedure under a bank-specific regime. The resolution-specific objective of preserving financial stability, on the other hand, is often absent in insolvency since, where financial stability is a driving concern in the management a bank failure, resolution is the more appropriate approach.

**Opening of insolvency:** control by administrative authorities over the opening of proceedings, either as an exclusive competence or as a right to petition, contrasts with ordinary corporate regimes where the right to petition conventionally resides with creditors and management. Where the opening of insolvency is entirely under the control of an administrative authority, the possible grounds are generally broader than those for ordinary corporate insolvency.

**Role of administrative authorities:** even in court-based bank insolvency regimes, administrative authorities generally have some degree of involvement in, or oversight of, the conduct of the liquidation, even if indirectly through appointed representatives. This has no analogy in conventional corporate insolvency regimes (outside other regulated sectors such as utilities).

**Role of creditors:** the mechanisms for creditor negotiation and control that are a core feature of ordinary corporate insolvency are absent from, or reduced in, bank insolvency regimes.

Source: FSI Insights n° 10

\(^{35}\) “Where the preferred strategy at the level of the group is liquidation, MREL will be set at the level of the LAA, with no RCA. Nevertheless, the characteristics of a bank may change, including its risk profile and business strategy, and consequently the assessment of feasibility and credibility of the liquidation might be revised in the future. In such circumstances, the MREL target would be increased accordingly.”
• In terms of **scope of directly supervised banks**, should an EU liquidation regime be established, the SRB would be directly involved in the liquidation or resolution of medium/size banks that do not fall within its responsibility under the SRM Regulation. In accordance with the SRM Regulation, the SRB is directly responsible for (i) resolution plans of significant banks (i.e. banks directly supervised by the SSM) and cross-border banks and (ii) resolution decisions involving the use of the Single Resolution Fund with respect to all credit institutions.

### 5.2 A European Deposit Guarantee Scheme

As explained in Part 1, the US experience in dealing with failing banks shows how indivisible deposit protection and insolvency tools are. In that respect, the Core Principles for effective deposit insurance system, developed by the IADI (See Box 4) places a great emphasis on the importance of bank insolvency procedures to secure an efficient depositor protection. In that context, the question is raised as to whether the third pillar of the Banking Union that is being considered by the co-legislator - a European Deposit Guarantee Schemes - would benefit from an EU liquidation framework.

Differences in how national insolvency law is designed may have a significant bearing on the use of national DGS or a European Deposit Insurance Scheme. In some Member States ‘resolution’ actions are available under national insolvency law which may result in depositors not being paid off as they would be otherwise protected by means of a transfer of the deposit book from the failing bank to another bank. In other Member States, failing such insolvency framework, DGS or EDIS would step in to pay out depositors. Should an EU Deposit Insurance Scheme be introduced in the EU, differences in national insolvency law may lead to an unlevel playing field across the Banking Union. As a recent paper from Binder, Krimminger, Nieto and Singh36 puts it, “Disparity of national regimes for dealing with bank’s liquidation with the euro area may result in national differences in bank losses and the levels at which impairments affect claims having a material impact on the financial position of national DGS and EDIS”.

The establishment of a European Deposit Guarantee Scheme coupled with an EU insolvency regime raises critical questions with respect to the articulation and delineation between DGS and resolution funds and the design of the “least cost principle”:

• All banks currently contribute to the Single Resolution Fund while some banks would be resolved under an EU insolvency regime where DGS (and where appropriate EDIS) may step in subject to the “least cost principle, where appropriate”. It must be noted that the “least cost principle” in the US has been strengthened over time as discussed in Part 1, while Article 11(6) of the Deposit Guarantee Scheme (DGS) Directive provides for a less stringent financial cap for use of DGS

• Should an EU liquidation regime be introduced, the issue is raised as to whether resolution funds and DGS should be kept separate? Prior to BRRD, an IMF research paper suggested the establishment of an European Resolution Authority (ERA), “twinned or combined with a European Deposit Insurance and Resolution Fund”;

In addition, as emphasised by the Financial Stability Institute (FSI), “the choice of the national deposit insurer as liquidating authority may help achieve the depositor protection objectives that are core to its mandate”. At the same time, it must be noted that this arrangement could result in conflict of interest, i.e. the one responsible for the insolvency being the major or a significant creditor in the insolvency.

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36 « The choice between judicial and administrative sanctioned procedures to manage liquidation of banks : a transatlantic perspective », Binder, Krimminger, Nieto, Singh, November 2018.
Box 4: Core Principles for effective deposit insurance system

Principle 14 – FAILURE RESOLUTION

An effective failure resolution regime should enable the deposit insurer to provide for protection of depositors and contribute to financial stability. The legal framework should include a special resolution regime.

Essential criteria […]

2. The resolution regime ensures that all banks are resolvable through a broad range of powers and options. […]

4. Resolution and depositor protection procedures are not limited to depositor reimbursement. The resolution authority/ies has/have effective resolution tools designed to help preserve critical bank functions and to resolve banks. These include, but are not limited to, powers to replace and remove senior management, terminate contracts, transfer and sell assets and liabilities, write down or convert debt to equity and/or establish a temporary bridge institution.

5. One or more of the available resolution methods allows the flexibility for resolution at a lesser cost than otherwise expected in a liquidation net of expected recoveries.

Source: Core Principles for effective deposit insurance systems (IADI, 2014)

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