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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Single Resolution Mechanism

NOTE

Abstract

The introduction of a Single Resolution Mechanism would be a major step forward in the formation of a fully fledged banking union. The success of this mechanism will depend, to a large extent, on its implementation. It is important that the entity responsible for resolution has a broad set of tools available and that it can use these when needed. This means that any potential conflict of interest should be avoided as well as political interference. For this reason we propose a separate entity responsible for the resolution mechanism. Simultaneously we argue that common insolvency rules are necessary, that the Single Resolution Mechanism should take precedence over national legislation and that resolution plans are drafted on the level of the holding. These aspects are necessary to ensure that national interests do not disrupt the notion of a European Single Resolution Mechanism. For this reason we also argue that Single Point of Entry resolution strategies are preferred over Multiple Point of Entry resolution strategies.

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INTRODUCTION

The European Council[1] has recently agreed on and the European Commission[2] has announced additional steps in the direction of a more integrated, balanced Economic and Monetary Union. One important aspect with respect to ensuring financial stability will be the introduction of a Single Resolution Mechanism.[3] Since global financial stability, cross-border banking and preserving a national resolution authority (sometimes referred to as **financial trilemma)** are hard to combine, resolution *'is not well defined at a cross-border level'.*[4] The trilemma is even more pressing when banks have a larger international exposure and when they are operating in a monetary union. When banks will be supervised under the umbrella of a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) is therefore the appropriate next step. Such a mechanism ensures that when a bank fails under a SSM, the failure can be resolved in an appropriate manner. This is underlined by a review of major cross-border bank failures, which revealed that national resolution powers are often inadequate, leading to costly, inefficient and sometimes ineffective national interventions.[5] So the adoption of a SRM could prove to be a major step forward in this respect.

However, with respect to the implementation a number of questions remain. In this note three aspects in particular are discussed. First of all, there is the question whether this resolution mechanism should be linked to existing entities or whether a new entity should be created. Second, there is the question whether the SRM should be of a generic nature or whether common insolvency rules are necessary. Finally, we consider the connection between the SRM and national resolution mechanisms.[6] After discussing these three questions we focus on the broader strategy a supranational Resolution Authority should take. We argue that a **Single Point of Entry resolution strategy** is to be preferred over a Multiple Point of Entry resolution approach.

Throughout this note we always have **Systemically Important Financial Institutions (SIFIs)** in mind. These are typically large and complex banks engaging in cross-border activities. These international banks are so large and interconnected that a failure severely harms other banks and the real economy. Smaller and domestic banks are not the subject of this note. It is our view that at present a SRM which covers all banks is hardly feasible. Since cross-border banks pose the largest threat for financial stability in case of bankruptcy, the regulation of these banks at a supranational level should take precedence.

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1 See European Council, EUCO 205/12, 14 December 2012; http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf.

2 See Commission Communication, 'A blueprint for a deep and genuine economic and monetary union', COM(2012) 777 final/2, Brussels, 30 November 2012; http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf.

3 See EUCO 205/12, paragraph 8 and 11 and COM(2012) 777 final/2, Section 3.1.3 A Single Resolution Mechanism.

4 See Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR: *'The theory highlights the importance of what they call financial trilemma - the conflict between three objectives - preserving national autonomy, fostering cross-border banking, and maintaining global financial stability.*'

5 Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

6 See Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM/2012/280; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0280:EN:NOT.

1. A NEW INDEPENDENT ENTITY

One of the key questions in the design of the SRM is whether the SRM task should be linked to an existing or newly created entity. When designing a properly working resolution mechanism, it is necessary to ensure that all involved authorities are able to cooperate and will cooperate. Ensuring cooperation can only be done by having clarity on what is being supervised, what are the procedures, who supervises, who is responsible for resolution and what are the risks.[7] There are three reasons why a separate entity should deal with the SRM task: i) speed; ii) independence; and iii) clarity and transparency.

When dealing with a bank at risk, time is of the essence. Procedures should be swift because delays may undercut efforts to preserve assets and increase the likelihood of systemic consequences.[8] In practice this can be achieved by having clear procedures, resolutions plans and 'Living Wills'.[9] These resolution plans provide the blueprint of a resolution and specify possible SRM authority action. To work in practice it is important that national interests cannot contaminate the resolution process. National authorities nearly always place a priority on national objectives.[10] This leads to the notion of independence.

It has been noted that resolution in practice often led national authorities to consider objectives other than those strictly related to financial stability (which should come first) such as minimising the cost borne by national taxpayers, safeguarding the domestic system while disregarding the broader market and being soft towards national champions. Having a truly **independent entity** is for these reasons important. National supervisors are always under pressure from national political capture so the final responsibility should be taken by an entity at the European level. An entity at the European level should be less prone to particular national interests.

A system where deposit guarantee schemes and resolution remains national, while the supervision moves to the European level under the auspices of the European Central Bank is not viable. Such a system is not incentive-compatible. National authorities would be willing to bet on support by the ECB hoping the institution would survive.[11] The ECB may find itself trapped. It would see the problems and call for action but it might have only limited supervisory powers (while resolution was to be done on national level).[12]

This leads to the conclusion that ultimately, the decision on remedial actions and resolution should be taken on a European level and independently. Independence also implies that the SRM task should be decoupled from other supervisory responsibilities.[13] Supervisors have responsibilities other than resolution such as licensing and day-to-day supervision. A separate Resolution Authority allows for judging the situation from a fresh and detached perspective. This separation is similar to the principle of separation employed in the

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7 Schoenmaker, D. (2012), Banking Supervision and resolution: The European Dimension. DSF Policy Paper, no. 19.

8 Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

9 Avgouleas, E., Goodhart, C. and D. Schoenmaker (2012), Bank resolution plans as a catalyst for global financial reform. Journal of Financial Stability.

10 Herring, R. (2007), Conflicts between Hoe and Host Country prudential Supervisors, in D. Evanoff, J. Raymond LaBrosse and G. Kauffman (eds), International Financial Instability: Global Banking & National Regulation, Singapore: World Scientific, 201-220.

11 Schoenmaker, D. and D. Gros (2012) A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

12 Schoenmaker, D. and D. Gros (2012) A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

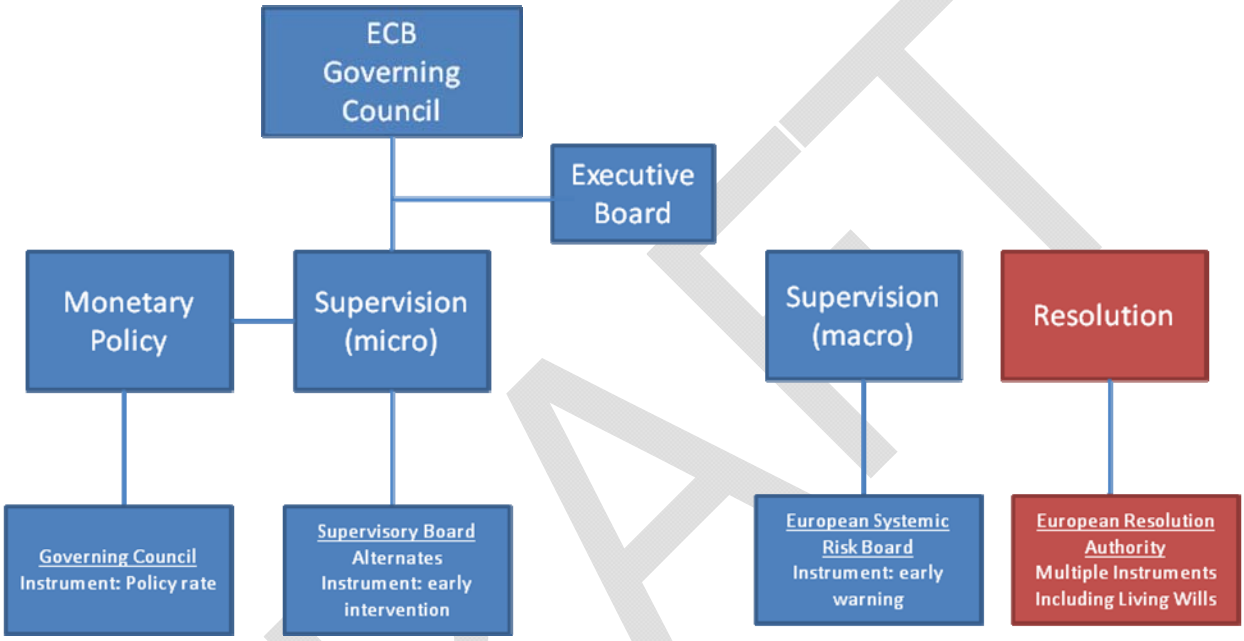
13 Advisory Scientific Committee (2012), Forbearance, Resolution and Deposit Insurance, Reports of the Advisory Scientific Committee No. 1, Frankurt.

banking sector where the responsibility for doubtful loans is shifted from a loan officer to a designated credits department.[14]

The status of the Resolution Authority should remain independent of the ECB. Moreover independence of the ECB itself provides the best chance of sufficient detachment. A resolution authority as separate entity should help make the SRM also more transparent. The Resolution Authority has only one responsibility and this responsibility is not muddled by adding it to another entity.

In figure 1, the recommended institutional setup is displayed.

Figure 1: Future distribution of tasks – An overview



Source: Author's elaboration; this figure is an update of an earlier overview.[15] The parts in red indicate the Resolution Authority.

Figure 1 stresses the independence of the Resolution Authority, here referred to as the *European Resolution Authority*, but in practice there will be some contact and even cooperation among the different supervisors and the Resolution Authority- be it only for information sharing. This connection is in practice unavoidable and even desirable. However, just as the supervisory tasks by the ECB should be independent from political interference,[16] so should the SRM be, i.e. able to function independently (within a clearly defined legal framework). *Ex post*, the Resolution Authority should be accountable to the Committee for Economic and Monetary Affairs of the European Parliament – comparable to monetary policy and economic supervision.

[14] Schoenmaker, D. and D. Gros (2012), A European Deposit Insurance and Resolution Fund – An update. DSF Policy Paper, no. 26.

[15] Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.

[16] Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.

2. COMMON INSOLVENCY RULES

Another issue to be discussed is whether the framework for the SRM should be generic or whether it would be necessary to establish common insolvency rules. A substantial body of research has identified the goals that good resolution procedures should meet.[17] One of these goals is particularly important for the discussion of insolvency rules: A good resolution procedure should lead to **predictable results**. Negative surprises cause uncertainty in financial markets, especially when induced by unexpected behaviour of regulators because they cast doubt over the rules of the game.[18]

Insolvency rules should be implemented at the European level. In part because providing leeway at the national level allows for regulatory arbitrage. On top of that, resolution on national level may cause conflicts of interests due to asymmetries between countries.[19] National authorities may differ in the amount of resources they have (human and financial resources). Some national authorities may even have insufficient resources to resolve a major cross-border bank failure. Also there will be differences in accounting (e.g. for tax purposes), legal and institutional infrastructures. The success of a resolution procedure should not depend on such differences in the accounting and of judicial procedures from one country to another within the euro area. Finally, different national resolution frameworks may induce a differential impact of similar resolution procedures.

These problems suggest that there is a lot to be gained by setting out clear common insolvency rules. Such an approach allows the Resolution Authority to prepare well and avoid disorderly insolvencies or improvised bailouts.

Most importantly, common insolvency rules allow for a good resolution plan because it starts from a clear premise: an insolvent institution where there is not doubt on what insolvency constitutes. Such a resolution plan is seen to be an essential tool to systemic stability.[20]

A resolution plan is a set of procedures which are followed during a resolution. The bank provides practical details such as persons involved in case of bank resolution (attorneys, administrators, etc.). At the same time it lists requirements for the financial institutions which are covered by the Resolution Authority. Such a plan should be updated annually. Detailed descriptions of such plans have already been proposed.[21]

The benefits of resolution plans are that these reduce moral hazard by making it clear that a cross-country bank can be resolved in such a way that losses are borne by or posed on the stakeholders of the bank while avoiding a systemic impact. It is important that the resolution plans are formulated for the cross-border bank as a whole and not only for the separate parts.

Common insolvency rules may be difficult to achieve, but a first major step should involve a harmonisation of current insolvency rules for those banks which fall under SSM and SRM.

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17 Hart, O. (2002), Different Approaches to Bankruptcy. Harvard Institute of Economic Research Dicsussion Paper No. 1903.

18 Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

19 Herring, R. (2007) Conflicts of interest between Home and Host Country Prudential Supervisors, in D. Evanoff, J. LaBrosse and G. Kaufmann (eds.), International Financial Stability: Global Banking & National Regulation, World Scientific Publishing, Singapore, 201-20.

20 Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

21 Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

In the best case, these insolvency rules should gradually become a common insolvency framework for all banks agreed upon by all Member States. Otherwise, the national legislators could adapt the national insolvency rules for the smaller banks which do not fall under the Single Resolution Framework. These national insolvency rules could then at a steady pace move towards the common insolvency rules.

3. CONNECTION WITH NATIONAL RESOLUTION MECHANISMS

A third issue which needs to be answered is how a SRM should be linked to already proposed national resolution mechanisms which of course should be harmonised as soon as possible. To be effective operationally, the SRM needs to take priority. This means that when a SIFI under the SSM fails, the European Resolution Authority has the ability to intervene and start the necessary resolution procedures. The national resolution mechanisms are then not applicable to banks falling under the European Mechanism. This separation of Resolution Authority (a Single Resolution Authority for cross-border banks and national authorities for national banks) helps avoiding conflicts of interest.

It is important that a clear, thoughtful and well defined legal framework is set up for this.[22] As mentioned above, in practice a Single Resolution Authority will likely be responsible for the largest banks (SIFIs) only. This distinction is motivated by practical concerns. To minimise regulatory arbitrage among the banks which do not fall under the SRM, we suggest that national rulemakers aim at harmonising national legislation and the guidelines of the SRM. In this view the establishment of a SRM is just another step towards a full-fledged banking union.

[22] Eijffinger, S. (2012), Monetary Policy and Banking Supervision. Monetary Dialogue with the ECB president, European Parliament, Brussels, December 2012.

4. RESOLUTION STRATEGY

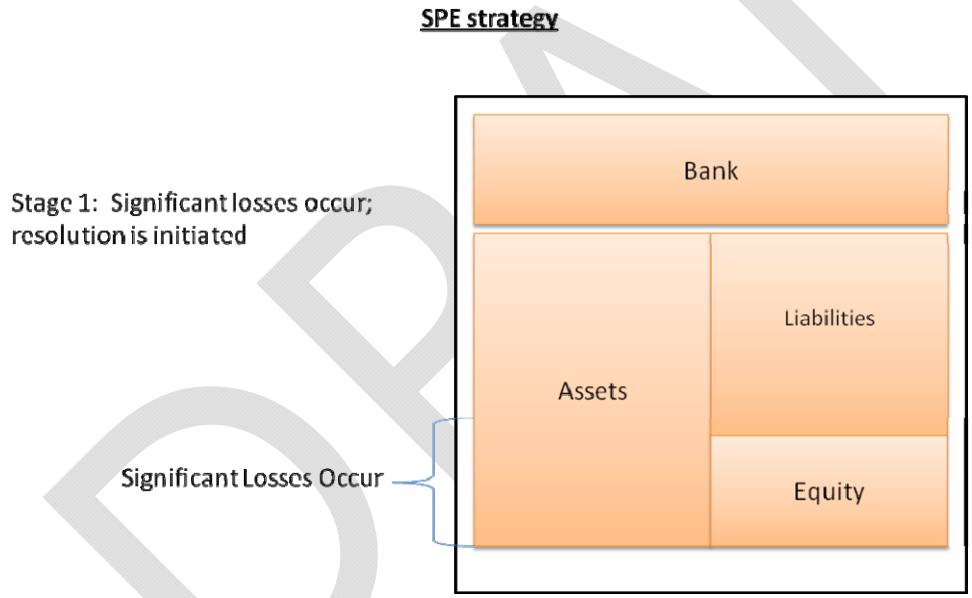
When thinking about a resolution strategy, it is useful to consider two different strategies. On the one hand we could have a Single Point of Entry resolution strategy (SPE) and on the other hand a Multiple Point of Entry resolution strategy (MPE).[23]

We broadly distinguish two phases in every resolution. The first phase is the stabilisation phase which is initiated quickly. The second phase is the restructuring phase which can take months if not years. The fundamental difference between both resolution strategies is the first phase.

4.1. Single Point of Entry Resolution Strategy (SPE)

Figure 2 shows the different stages of the stabilisation phase. Under a SPE resolution strategy, the resolution focuses on the entire SIFI.[24] After losses have occurred, the resolution is initiated. The assets are then valued and the resolution authority executes a resolution plan. In our set-up, an intervention such as a bail-in or mandatory debt-to-equity swap happens on the group level only. Losses in subsidiaries can be covered but only through the holding company (by means of a downstream of new capital).

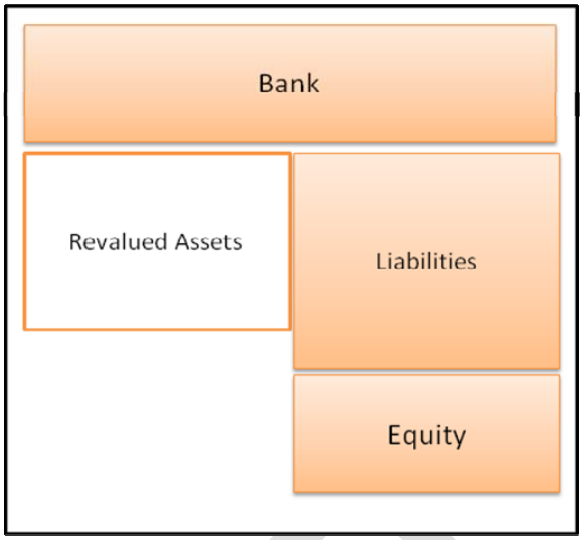
Figure 2: Single Point of Entry Resolution



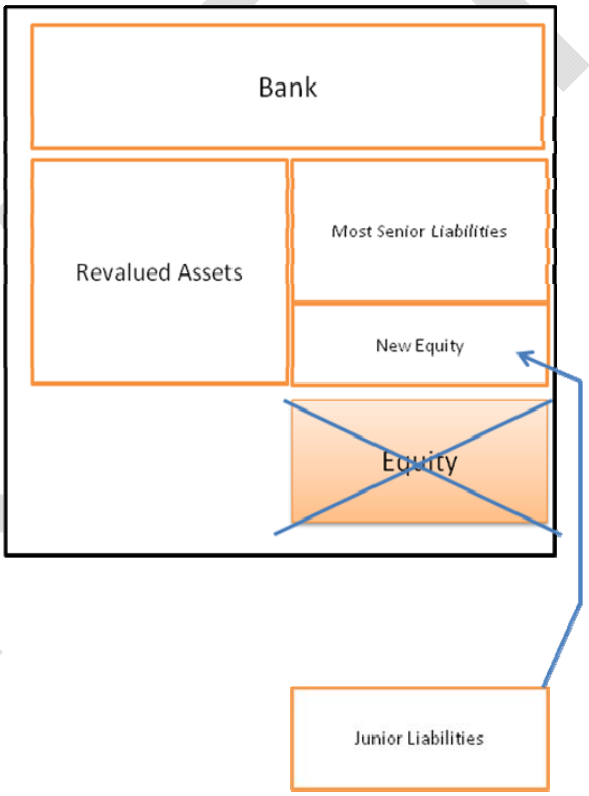
[23] The description of these corner strategies is based on an internal paper on resolution strategies developed by De Nederlandsche Bank.

[24] See for comparison FSB, Recovery and Resolution Planning: Making the Key Attributes Requirements Operational, Consultative Document, November 2012: "*This proposed guidance sets out the key elements that may be included in resolution strategies and plans. It draws on two stylised approaches to resolution: a 'single point of entry' approach by which group resolution takes place primarily through action by the home authority mainly at the level of the parent or holding company; and a 'multiple point of entry' approach whereby resolution actions are taken by multiple authorities along national, regional or functional lines. The guidance is not intended to be prescriptive as to one approach or the other. Resolution authorities will need to adapt the strategies and plans to fit individual G-SIFIs and, in practice, some combination of approaches is likely.*"

Stage 2: Assets are revalued.



Stage 3: Old equity is written off, apply a bail-in until sufficient recapitalization (most junior first). Bailed-in creditors become the new owners of the bank.



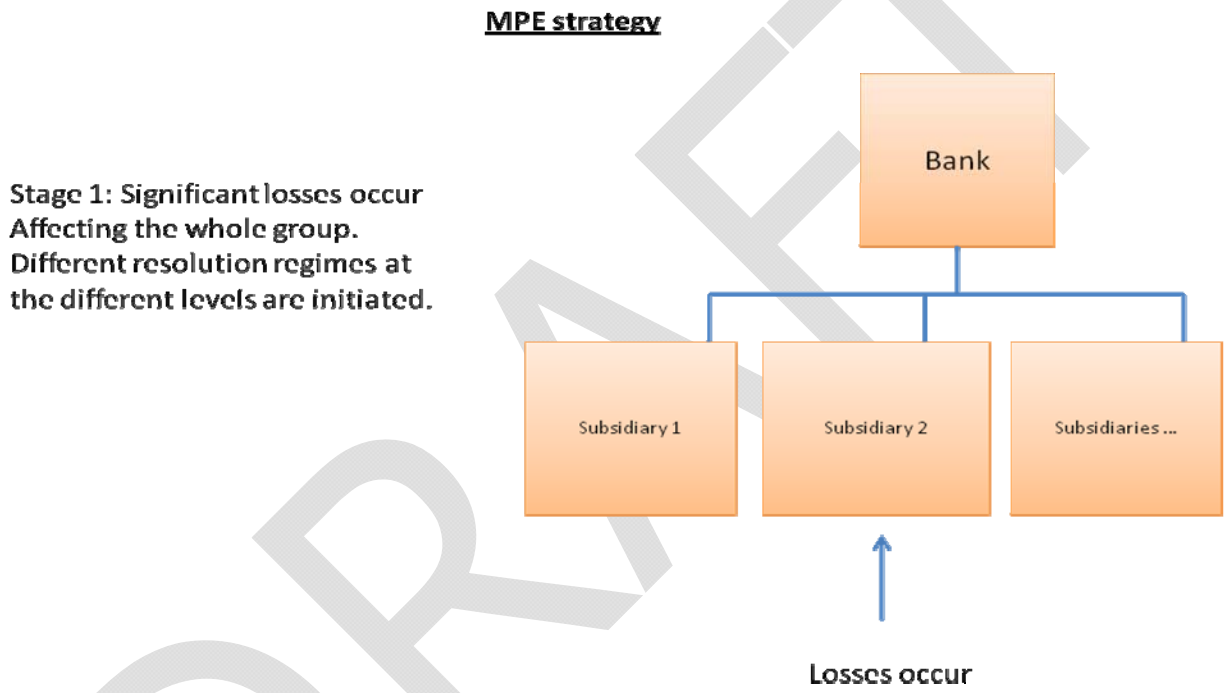
Source: De Nederlandsche Bank (2013), Internal document. (reproduced and adapted with DNB permission).

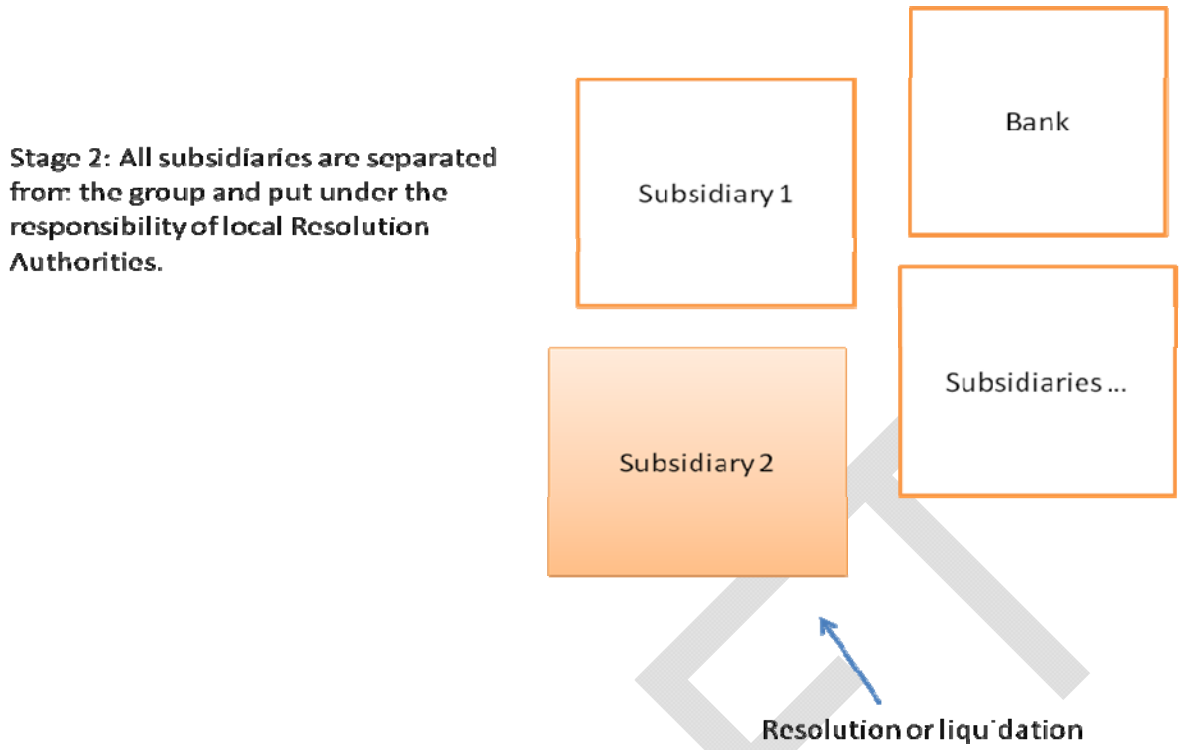
4.2. Multiple Point of Entry Resolution Strategy (MPE)

Compare the SPE resolution approach with a MPE strategy where a cross-border bank is resolved on multiple levels: the holding company and the subsidiaries. The resolution effectively ends the existence of the 'cross-border' bank and multiple national resolution authorities take resolution actions. Within the MPE framework, resolution authorities typically act along national, regional or functional lines.

The stabilisation phase emphasises a stabilisation of the bank and the continuity of its critical activities. In the restructuring phase the financial institution is restructured, a reorganisation may take place and management replaced. This strategy is presented in figure 3.

Figure 3: Multiple Point of Entry Resolution





Source: De Nederlandsche Bank (2013), Internal document. (reproduced and adapted with DNB permission).

4.3. Assessment of the two strategies

Both strategies are at the opposite ends of the spectrum and many resolution interventions may lie in between. In the context of the SRM we recommend that any resolution intervention should be close to a SPE resolution strategy and resolution plans should take this *ex ante* into account. The use of a MPE resolution strategy while having a supranational Resolution Authority seems hardly beneficial. In practice a MPE resolution strategy leads to a split along national lines or at least to segments which are more relevant for some countries. This may tempt national governments to put pressure on the national resolution authority to favour their part. Also, when a country (government, voters or media) have the impression that the resolution strategy is more harmful domestically than to other countries, the risk rises that the country will push for a national solution. Similarly a country may have the impression that it could have done better on its own. As an example, the resolution of the Fortis/ABN AMRO group proved to be difficult for these reasons.

This concern is related to the financial trilemma mentioned earlier. In times of distress it is harder for an individual country to internalise the broader impact on global financial stability. A SRM which is meant to deal with complex cross-border banks should be protected from national agendas. A strategy which avoids increased national intrusion is to be preferred.

If the resolution plans by the SRM are all conceived from a SPE resolution perspective then the incentive for national governments to push for particular outcome is weakened. After all, after the resolution there are no pieces to be picked up or national champions to be preserved. The cross-border bank, albeit in a new form, may remain intact.[25] We therefore have a strong preference for a SPE resolution strategy.

[25] Claessens,S., R. Herring and D. Schoenmaker (2010), A safer world financial system: Improving the resolution of Systemic Institutions, 12th Geneva Report on the World Economy, London: CEPR.

5. CONCLUSION

In this note we discussed issues related to the implementation of the SRM. Specifically the questions of form, legal nature and relation between SRM and national resolution mechanisms. Finally, we focused on the broader strategy a supranational Resolution Authority should take.

The discussion leads to five recommendations:

i) **Single Independent Entity:** First, it is recommended that a new separate, independent European entity for the SRM should be created, the European Resolution Authority. This separate entity has one clear task, the resolution of cross-border banks/SIFIs.

ii) **Common rules for all countries:** Second, we argued that to have any probability of success, the SRM should include common insolvency rules. Common insolvency rules could preclude regulatory arbitrage and avoid hazardous legislative asymmetries between countries.

iii) **Resolution Plans for SIFIs**: In the same section we emphasised that resolution plans should be drafted for the totality of the SIFI and not for the separate parts.

iv) **Priority over national authorities:** Then we argued that the European Resolution Authority should have priority over national supervisors and resolution authorities. If this is not the case then this leaves the door open for conflicts of interest. Moreover, a clear delineation of tasks is necessary for properly drafted living wills and resolution plans.

v) **Single Point of Entry resolution:** Finally, we concluded that a Single Point of Entry resolution mechanism is more suitable than a Multiple Point of Entry resolution strategy for a supranational Resolution Authority.

The rationale behind these five recommendations is the same. The problem with national resolution approaches for complex SIFIs is that national governments tend to take a national perspective and do not take the international (European) dimension into account. To be effective in solving this problem, the SRM needs to deal with national interests and avoid national interference. A single independent entity (i), accompanied by common rules applicable in all countries (ii), with resolution plans drafted for SIFIs in their entirety (iii), with priority over national authorities, and (iv) with a Single Point of Entry resolution , is the best set-up to ensure that the SRM can be successful.

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