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International Environment: Recovery and Resolution Regimes as the Pillar of the Banking Union

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Abstract

The purpose of the article is to present the possible regimes of bank resolution in the euro system and to highlight open questions concerning additional capital buffers and the valuation of assets according to the Bank Recovery and Resolution Directive (BRRD). The bail-in tool is used to write down or to convert certain liabilities with the purpose of restoring the capital adequacy. The valuation exercise would determine the amount of loss absorption to restore viability of the institution and capital adequacy. The bridge bank tool offers deeper restructuring powers to the competent resolution authority. Sale of the business tool is actually a variation of the bridge bank tool, enabling the resolution authority to transfer assets and liabilities to investors. The asset separation tool always is combined with another tool. The write-down is not a resolution tool, as it affects equity, while a bail-in tool goes further to other subordinated debt and senior debt. It is possible to establish additional resolution tools in the national legislation, as long as these tools are compatible with the principles of directive and national legislation in order to support cross-border group resolution. The issue of bank overregulation and the ability to meet the requirements without negative effects on the economy is emphasized.

Keywords: recovery and resolution regimes, bridge bank, sale of business, asset separation tool, bail-in, regulation.

Introduction

In January 2014, a proposal for a regulation on structural measures increasing resilience of the banking sector in Europe resulted as a reaction to the Liikanen report.¹ Bank resolution and restructuring are important issues for the future regarding the Banking Union. The role of banking supervisors is to assess recovery plans and implement measures needed for those plans. EBA was proactive with recommendations from 2013 on (see EBA, 2013). The goal of resolution schemes is that ordinary costumers do not notice any difference in day-to-day banking business even if their bank becomes distressed. The resolution scheme gives an alternative to compulsory liquidation, in which proceedings take many years and during which creditors do not have access to their funds. Therefore, it is not desirable to wind up at a bank via compulsory liquidation.

¹ It aims at a structural reform relating to systemic risks deriving from “too-big-to-save,” “too-big-to-fail,” and “to-complex-to-resolve” [COM/2014/043 final-2014/0020 (COD)].

The reduced market discipline and incentive to take excessive risk caused by the safety net has long been recognized, which is one of the major reasons for the prudential supervision of banks. The problem with this change in structure is not that banks are larger, but that the scope of the safety net and its subsidy—and therefore their sizes—has expanded beyond traditional bank activities that provide external social benefits (see Morris & Hoenig, 2011). The consequence of the last crisis involves limitations for doing business in banks under a resolution process.

The restructuring and resolution of an international bank with subsidiaries, branches, and representative offices in different countries does differentiate from a bank organized nationally. Resolution authority is allowed to decide, together with the competent authorities, about the separation of high-risk trading activities in the context of a resolution planning review.² The question of bank insolvency³ and bank restructuring⁴ has to differentiate in this context.

Recovery and Resolution

Together, with higher capital and liquidity requirements, the enhancement of resolution regimes was a central element of the international regulatory response to increase banks' resilience. The Financial Stability Board's key attributes of effective resolution regimes for financial institutions provide the new harmonized international standard for resolution regimes for financial institutions. Within the European Union (EU), more than 40 legislative and non-legislative measures were adopted in the wake of the financial crisis. A new framework for dealing with failing banks, the Bank Recovery and Resolution Directive (BRRD), was agreed upon in 2014 (EUR-Lex, 2014, 2017). It builds on other EU legislation, such as the capital adequacy requirements for banks (CRR/CRD), the European Market Infrastructure Regulation (EMIR), the Deposit Guarantee Scheme Directive (DGSD), and EU state aid (Festić 2012), as a cornerstone in creating a more stable banking system that serves the economy at large (ZRPPB 21017).

² Separation is imposed only under certain conditions and following an in-depth review of the impact of those activities on the risk profile and behaviour of the core credit institution (see COM/2014/043).

³ Moreover, measures to harmonize insolvency laws could have a positive impact on the banking union; particularly, those harmonizing the hierarchies of claims could strengthen the functioning of the resolution mechanism (see Valiante, 2016).

⁴ Regulatory arbitrage has been one of the major factors contributing to the severity of the crisis. Given the ever more complex set of future regulatory constraints, it may keep generating costly negative spillover effects on the whole economy (see Petitjean, 2013).

The recovery and resolution are both ex ante crisis management measures, and their common characteristic is preparation for prevention. The recovery plan objective is to lessen the probability of a bank's resolution, while the resolution plan objective is to lessen the impact on society at a large scale. The institution itself is responsible for the recovery plan, while the resolution authority, together with the competent national authority, is responsible for the resolution plan. The central bank, supervisor, and head of government are responsible for resolution plan implementation. The role of the resolution plan is to defend the financial system, and the role of recovery plan is a sound risk management of an institution. Basic pillars for a recovery plan are capital and liquidity planning, while the basic pillars for resolution planning enable the authorities sufficient information for an effective decision-making process. The EBA proposes an identification process based on a combination of standard qualitative and quantitative criteria and internal criteria developed by the institutions (EBA, 2013; Directive EPC, 2011).

The purpose of the recovery plan is to ensure business continuity. EBA requires that the recovery plan includes scenarios for a systemic-wide events, idiosyncratic events, and a combination of systemic wide and idiosyncratic events:

- taking into account systemic wide events, an analysis has to include the shortfall from public bonds impact on capital and liquidity, the business model impact on profitability, and its effect on payment systems, etc.;
- taking into account idiosyncratic events could be a severe write-off in a certain asset class, the leveraged buyout market effect.

The most important part of the recovery plan is to describe the potential crisis situation and scenarios and the actual actions against the simulated crisis scenarios. The reliability of a recovery plan is determined by negotiations with relevant stakeholders and truthfulness of the potential crisis scenarios; further, it is focused on the specific balance sheet items. The competent authority takes into account capital and funding structure, organizational structure, and risk profile of the institution, etc., in order to require the institution to submit a revised plan and demonstrate effects of deficiencies that need to be addressed (against a set of predefined criteria) and measures needed to address obstacles for recovery plan implementation. The competent authority has the right to refer a matter of disagreement to the EBA in order to reach a joint decision regarding the entities in their jurisdiction.⁵

⁵ More in directives of the European Parliament and the council (2011), EBA (2013), EUR-Lex 2014, 2017), BRRD (2014), BIS (2019).

There are relevant indicators signaling early distress related to a situation in which the institution is likely to fail. Early intervention, as a preventive measure, tries to avoid resolution. The competent authority orders such measures in the context of ECB single supervisory mechanism (SSM), while the single resolution board (SRB)⁶ is responsible for resolution measures (the requirement of business strategy changing, the introduction of legal and institutional measures, calling of a shareholders assembly, the update of recovery plan, etc).

The purpose of the resolution plan is to ensure systemic protection on the basis of sufficient information for the decision-making process. The focus of this article is to present resolution in more detail.

Resolution Regimes

The BRRD (2014) and the SRM (2016) regulations have gone a long way toward harmonizing EU insolvency law for banks by entrusting administrative authorities.

In addition to lacking a focus on systemic risks, there is a need to enhance crisis management, including resolution and transparent burden sharing; furthermore, many reform areas have lagged: a lack of a specific enough analytical framework and appropriate data with which to evaluate the possible costs and benefits of various regulations and their interactions and a lack of practical methods of implementation or enforcement of conceivable reforms (see Claessens & Kodres, 2014).

Resolution means that a bank is liquidated or it continues its business via contributions from shareholders and creditors; further, its creditors register their claims and assets are sold. Shareholders and creditors do not get full repayment and share the burden of restructuring.⁷ An institution could prolong its business partially with support of creditors and their contributions. The new bank resolution system addresses the regulatory gap of ordinary insolvency regimes, which do not offer the processes and tools that are specific enough to fit the complexity of banking institutions due to the high associated social costs of the bank in operation until now. It is also possible that resolution proceedings might involve bank insolvency in the future. Resolution can into four tools (Schelo 2015, 81–95):

- sale of business (which allows for the total or partial disposal of the entity in a financial transaction, the approach compares to some extent to the bridge bank; due to combination of continuation and insolvency);
- bridge bank (all or part of the business is transferred to a temporary entity partially or totally publicly owned; the new bridge bank is up for continuation; certain liabilities are left behind at the remaining institution; remaining bank entity could be put, after a certain period of time, into ordinary insolvency proceedings). Operating a bridge bank is a labor-intensive process and may require ongoing liquidity support from the government. If the calculation of the franchise value of the troubled bank is incorrect, and a subsequent sale is not made or cannot be made at an acceptable price, the cost of operating the bridge bank may exceed the cost of liquidation (see McGuire, 2012). In some jurisdictions, the bridge bank option is reserved for systemically important banks;
- bail-in (where debt or equity could be written down or converted, burdens are placed on shareholders and creditors of the bank rather than on the public; bail-in does not lead to an insolvency process of any part of the bank; it is applied if the bank can be rescued by an injections of equity; creditors are converted into shareholders; this conversion force the creditors to participate in the restructuring process and to clean up the bank balance sheet). For economies in recession with high unemployment, the bail-in tool provides the most efficient crisis resolution mechanism. Under no circumstances do taxpayer-funded bail-out schemes outperform bail-in with private sector placement (see De Grauwe, 2013).⁸
- asset separation tool (whose liquidations could cause market disruption and assets could be transferred to an asset management company, partially or totally owned by the public; the approach compares to some extent with the bridge bank due to a combination of continuation and insolvency).

The main resolution tools with private placement before the public sector enters into resolution are: i) the bail-in tool, which ensures that losses are absorbed by shareholders and creditors; ii) the sale of business tools, which allows the resolution authority to sell all or part of the failing bank to a private acquirer.

⁶ See SRB (2016), Financial Stability Board (2011), SSM (2016).

⁷ The cascade of the liabilities in order of loss bearing: common equity Tier 1, additional Tier 1 and Tier 2 instruments, claims from senior executives, other subordinated creditors, unsecured nonpreferred claims (see ZRPPB 2017, articles 50, 78, 80-83, Directive EPC, 2011).

⁸ Avgouleas and Goodhart (2015) provide an explanation why bail-in regimes will not eradicate the need for injection of public funds, where there is a threat of systemic collapse because a number of banks have simultaneously entered into difficulties. On the other hand, principle “too big to fail“ distorts competition, creates moral hazard, and threatens the public finances, which are the introduction of special resolution regimes for banks. For resolving large, complex cross-border banks, without equity support from taxpayers, bail-in offers the promise of such a solution (see Huertas, 2011).

The EU resolution framework aims at protecting creditors, which must not be “worse off” than under liquidation, in that context of assessing whether shareholders and creditors would have received better treatment under insolvency proceedings than in resolution. Where the operations of a bridge institution are terminated, the bridge institution shall be wound up under national insolvency law. Part of the assets, rights, or liabilities of the original bank that have not been transferred to a bridge bank may be transferred to an asset management vehicle. Asset management vehicles receiving assets, rights, or liabilities under the asset separation tools shall maximize their value through eventual sale or orderly wind-down under national insolvency law (see Deslandes & Magnus, 2018).

Resolution has the impact on shareholders losing equity and creditors losing the value of their claims. Creditors get paid before the shareholders receive their equity back. Directive BRRD (2014) refers to loss bearing instead of setting up a distribution order. The traditional distribution applies to proceeds generated when assets are liquidated. Holders of subordinated debt notes participate in annual losses so that the issuing capital can be restored. Contractual loss sharing can be triggered before the institution is likely to fail. The capital could be provided by decreasing the institution’s liabilities by converting debt into equity or by partial transfer in a bridge bank, which could also have a liquidity effect. If the liability is converted into equity of left behind in the failing institution, the institution is free from paying this liability, and less funds are needed from the resolution fund(s).

No creditor is worse off, as it would be in normal insolvency proceedings. Similar rules are also found under existing national bank insolvency laws. The principle of assessment of the position under normal insolvency proceedings, as compared with the position after bail-in, is a subject of a detailed valuation.

We have different valuations regarding the phase of the cycle, market conditions, and health of the bank; according to Hellwig (2018), the principle “no-investor-worse-off” as applying *ex post*, after everything has been settled, or *ex ante*, at the time of the resolution decision. The allowance for a buffer in a provisional *ex ante* suggests a final accounting *ex post*, when the realizations of risks are known, so that, if the buffer was not needed, further distribution can be made to investors/creditors. The concept of “economic value,” as distinct from market value, could be problematic if there is no feasible strategy attached to it. If markets are depressed, one may consider prices to be abnormally low, so that holding or managing them is preferred to a sale. We should distinguish between asset impairments coming from considerations of prospective returns and asset impairments

coming from frictions in the markets and between threats to bank solvency and threats to bank funding/liquidity. If these threats concern bank funding and asset liquidations at depressed prices, public funds may eventually not be needed. If threats to bank solvency come from nonperforming loans, taxpayer support may be essential. The notion of “real economic value” as the price at which assets should be transferred is problematic and leaves ample room for hidden subsidies. Additional risks may come from the burden on the government’s fiscal stance (see Hellwig, 2017).

Creditors of the same class are treated equally. In Germany, under a former regime, the authorities had free discretion to apply different haircuts within the same class of creditor group (stronger creditors would be disadvantaged and weaker creditors would be incentivised regardless of the reason for their particular weakness or strength). The criterion for a decision of some creditors staying behind in the failing institution showed creditors of the same class that are transferred to the ongoing concerned bridge bank, which was of systemic relevance.

The BRRD is intended to treat creditors of the same class in an equitable manner. The discretion right of a resolution authority is to partially exclude certain liabilities from writing down (Schelo, 2015, 86) the bail-in toll to those liabilities that would cause destruction in value and higher losses of other creditors; further, the exclusion is necessary to avoid giving strength to widespread contagion in the cases when exclusion enables continuity of critical functions and core business lines and the ability of the institution under resolution to continue basic services and transactions.

The resolution authority must be able to exclude partial/total liabilities where there is a necessity to avoid widespread contagion and systemic financial instability. This concern is the driver for total loss absorbing capital (TLAC), gone concern loss absorbing capital (GLAC), and minimum required equity liabilities (MREL). It is also possible to offer more equity to creditors with a deeper haircut and vice versa. Global systemically important banks are required to meet a minimum total loss-absorbing capacity (TLAC) requirement (more in BIS, 2016). Investments in the capital or other TLAC liabilities of banking, financial, and insurance entities are typically outside the scope of regulatory consolidation.

TLAC and MREL pursue the same objective of ensuring that union institutions have sufficient loss-absorbing and recapitalisation capacity.⁹ The commission proposed that the harmonized minimum level of the TLAC standard systemic important institutions and the eligibility criteria for liabilities

⁹ For clarification of the buffers framework, see also BIS (2019).

used to comply with that standard, which should be introduced in union law through amendments to Regulation (EU) No 575/2013 of the European Parliament and of the council, while the institution-specific add-on for institution-specific requirement for nonsystemic important institutions are to be addressed through targeted amendments to Directive 2014/59/EU and to Regulation (EU) No 806/2014 of the European Parliament and of the council. Directive 2013/36/EU of the European Parliament and of the council concerns the ranking of unsecured debt instruments in insolvency hierarchy (see EUR-Lex, 2017).

Covered deposits [defined in Art. 2 (1), point 5 of Directive 2014/49/EU] are protected by a statutory deposit guarantee scheme up to the coverage ratio of 100.000 EUR, and the covered deposits are excluded from the bail-in tool. Part of eligible deposits from natural persons and micro-, small-, and medium-sized enterprises that exceed the coverage ratio and those not made through branches, located outside the union of institutions established within the union, have the higher-priority ranking provided for the claims of ordinary unsecured creditors. In principle, these deposits are not of the quality of covered deposits. Their subjection to a bail-in is restricted due to the “no creditor worse-off” principle. The hypothetical quota in an insolvency process will be higher if these deposits are granted priority in insolvency. These deposits might get the sum of 100% in an insolvency procedure.

Problems arise from the incompatibility of the laws governing cross-border bank insolvencies, when incorporating burden-sharing arrangements between countries (Avgouleas et al., 2013). National authorities are free to put into place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions. The principle is not designed to cover all the needs and circumstances of every deposit insurance system (see BIS, 2010). In order to enhance the resolvability of institutions, the EU directive (EUR-Lex, 2017) requires member states to create a new class of nonpreferred senior debt that should rank in insolvency above own funds instruments and subordinated liabilities that do not qualify as own funds instruments but below other senior liabilities.

Failure or Likely to Fail

The key components of an effective regulatory regime include Basel-type rules (see BIS, 2016, 2010) robust to off-balance sheet arbitrage, and little forbearance in monitoring and supervision by regulatory agencies, with a focus on systemic risk control, automatic and quick intervention as well as resolution mechanisms. While all components

are necessary, none is sufficient; further, without strong international coordination, none will be effective (see Petitjean, 2013).¹⁰

Regulators should use restrictions on equity payouts and mandate equity issuance to help banks and to assure that they maintain adequate and high equity capitalization (Admati et al., 2010).¹¹ The proposal to allow for a moratorium on payouts would not solve the problem; it might, however, have disastrous side effects. Time might be gained if the valuation process was initiated sooner, with appropriate safeguards against indiscretions that might themselves trigger a run (see Gstädtner, 2014; Hellwig, 2018). Moratorium is not a suitable decision in the bottom of a depression because usually there are not enough funds for keeping bad banking claims (NPLs) in balance. Instead of keeping them in the balance of the bank, it is better to write them off and use a bail-in tool. The problem of scarce funding is derived from the fact that investors tend to leave their financial position (see Schelo, 2008).

Randell (2015) explains why the principle “too big to fail” could expose the questions of why a special insolvency law for banks should be introduced, along with the reasons for and instruments of bank insolvency proceedings, i.e., the competent authority has the power to undertake a systematic review of certain other activities, e.g., market-making conditions, investment in/sponsoring of securitization, and trading of certain derivatives.

If an institution is likely to incur losses, the competent authority justifies the withdrawal of the authorization in the sense of the regulatory requirement of holding the banking licence (about the liquidation of the banks in EU, see Merler, 2018; on critical functions, see World Bank, 2017). If the assets are less than its liabilities, we talk about over-indebtedness or balance-sheet insolvency. The important question is whether the assets of institution are valued with “going concern” value or with a “liquidation” value. The liquidation value is measured upon the

¹⁰ Further clarification by the Commission may be needed on how the various criteria will be applied during the ongoing transition to a banking union, perhaps through new communication completing the state aid framework for banks in view of the adoption of the resolution rules (see Micossi et al., 2014). For the content of prudential norms, institutional setup, and its envisaged reforms, we propose a qualification of these norms and an assessment of their interaction with other types of norms, e.g., corporate, auditing and accounting, consumer protection, competition rules, see Dragomir (2010).

¹¹ In contrast with commonly used capital regulation, leverage regulation has stronger effects on risk taking and calls for higher interest rates. Combining interest rate policy with state-contingent macroprudential regulations—either capital or leverage regulation and a tax on profits—achieves efficiency (see Simona et al., 2018).

assumption that all the assets would be sold. The determination of “liquidation” versus “going concern” value depends on the feasibility of “going concern.” Because regulatory capital requirements operate on risk-weighted assets and estimation of over-indebtedness takes into account all liabilities and assets of the institution, over-indebtedness serves as a trigger point according to BRRD (see Randell, 2015; BRRD, 2014; Hellwig, 2018).¹²

The “bail-in” is always accompanied with a business reorganization plan implemented to make the institution viable. “Write-off” can be used as an ancillary tool prior to the actual resolution tool. Converting regulatory equity (core equity composed of common equity Tier 1; additional Tier 1 and Tier 2) into equity means converting Additional Tier 1 and Tier 2 instruments into statutory equity. This is legally possible because those instruments are debt positions. The “write-down” and conversion tool can make the institution ready for a step-in by an investor. Bearing losses means writing down or diluting equity to allow for new equity, cancel debt, or convert into equity (see Schelo, 2015, 134–144). Write-down begins with the common equity Tier 1. It is possible only to reduce debt by reducing equity. A write-down of debt must always go along with a partial conversion of debt into equity. These two instruments are linked together.

A bail-in tool should be applied only if there is a reasonable solution that the application of that tool, together with the measures of business reorganisation plan, will restore the institution in order to achieve financial soundness and long-run viability (Article 43 of BRRD, 2014). Secured liabilities and covered bonds are “bail-in safe” insofar the value of the security covers its liability.¹³ Above the value of the pool covering of bonds and above the value of the securities, the bail-in is possible (more in Merler, 2018; Huertas, 2011). It is possible that senior ranking liabilities

to another bank are excluded because of the fact that this institution also would then fail in a potential cascade effect (according to the Article 44 of BRRD, 2014) and outstanding losses could not be absorbed by the bailed-in creditors.

If shareholders and other creditors have contributed to loss absorption and recapitalisation at the amount of not less than 20% of the risk-weighted assets, financing arrangement can be applied (see BRRD, 2014). The approach depends on the structure of the risk-weighted assets (the financing can be drawn from *ex ante* contributions made to national resolution funds).¹⁴ All unsecured, nonpreferred liabilities (other than eligible deposits) must have been fully written down or converted into equity (ZRPPB, 2017).

The maximum and minimum thresholds must be taken into account before the financing arrangements can be triggered in order to reduce the external funds needed: i) shareholders and other creditors are subject to “bail-in,” which must contribute to loss absorption and recapitalisation, in the sense of being converted or written down in the amount of 8% of the total liabilities including own funds. If the contribution is not enough for a sufficient restore of viability of the failing institution, and once the 8% threshold has been met, financing arrangements may be included in the resolution. The resolution funds might only contribute with an amount not higher than 5% of the total liabilities (the 5% quota is measured at the time of resolution planning).¹⁵

A regulator sets risk-sensitive capital requirements in order to maximize a social welfare function that incorporates the social cost of bank failure (see Merler, 2018). The result provides a rationale for the cyclical adjustment of risk-sensitive capital requirements (see Repullo & Saurina, 2012). MREL/TLAC are assessed on a case-by-case basis.

In order to minimize the amount of “bail-in-able” liabilities and reduce the exposure of investors, the minimum requirements for own funds and eligible liabilities

¹² Assets that can be liquidated only within a longer period of time cannot be accounted for setting liabilities that are immediately due. We have to mention the concept of impending illiquidity [refer to Article 32 (4) of BRRD, 2014], where a bank is likely to become unable to pay its debts when they fall due. To cover liquidity gaps, the central banks may provide emergency liquidity lines usually if the availability of bankable securities is sufficient.

¹³ Liabilities that are not subject to bail-in according to the Article 44 of the Directive BRRD (2014) are deposits up to 100,000 eur, secured liabilities and covered bonds, liabilities held by the institution as a trustee, liabilities to other banks and investment firms with original maturity, liabilities to system operators with remaining maturity of less than seven days, liabilities to employee, liabilities related to client money and client assets, liabilities to trade creditors if they relate to activities that are essential for daily functioning of the business, tax and social security liabilities and liabilities to deposit guarantee schemes. These items may be transferred in the case of bridge bank scenario and not undergo an insolvency procedure.

¹⁴ The contributions have two components, fixed rate and variable rate (mirroring risk exposure, strategy and size of the institution). National Funds are responsible for collecting *ex ante* (regular) and *ex post* (extraordinary) contributions from the banking sector. Total target is going to be fulfilled by 2024 in the amount of 1% of all covered deposits. Contributions are raised by national funds and transferred to the single resolution fund (SRF). *Ex post* contribution are limited to an amount of three times the annual contribution. And *ex ante* contributions can be drawn by national financial arrangements (see BRRD, 2014; Schelo, 2015, 149-152).

¹⁵ For systemic stability effect and external funds see, Micossi (2014).

(MREL) was introduced. The liabilities with the remaining maturity of at least one year can only be counted for MREL.¹⁶ There are conditions for including eligible liabilities in the MREL quota (see SRB, 2016; Merler, 2018): i) with the remaining maturity of least than one year; ii) the liability that does not arrive from derivative; iii) the liability that does not arise from a deposit, which benefits from the preference in the national insolvency hierarchy; iv) the instrument that is fully paid up; v) the liability that is not guaranteed by the institution itself; vi) the purchase of the instrument that was not funded by the institution (see Schello, 2015; BIS, 2016).¹⁷

Total loss absorption capacity (TLAC), which should be subordinated to senior debt is supposed to play a similar role as MREL, i.e., to oblige institutions to create buffers for “bail-in.”¹⁸ This purpose could be reached contractually or by setting the holding structure (BIS, 2016; Huertas, 2011). The conditions for contractual “bail-in” instruments have to be fulfilled: i) binding subordinated agreement, which could not be repaid until other eligible liabilities outstanding have been settled; ii) the instrument must be written down or converted on the contractual basis to the needed extent required before other eligible liabilities are written down or converted by decision of resolution authority (see Repullo & Saurina, 2012).

Resolution authority has the power to transfer to a bridge bank: i) shares and other instruments of ownership issued by institutions under resolution; ii) any assets or liabilities of one or more institutions under resolution. The shares of the institution failing or likely to fail consist of little value to a bridge bank. The losses are bearable by shareholders first and followed by the further ranking of regulatory capital down to subordinated and senior liabilities. The actual business is transferred, while the toxic assets and certain amount of liabilities are excluded. The amount of liabilities left behind usually corresponds to the amount needed for a “bail-in” (see Micossi et al., 2014). The institution left behind will undergo liquidation process usually through bankruptcy (see Merler, 2018). The new entity is usually interesting for a new start and potential investors. The creditors and shareholders, which stay behind in the failing institution, should not receive less than they would have receive in the case of ordinary insolvency of the

institution, which complies with the “no creditor worse-off” principle (see McGuire, 2012; Müller, 2015).

Regarding the transfer to the bad bank, we have to reveal that bad bank is not established in the late phase of recession because it's too late to ensure higher transfer prices for bad banking assets over the liquidation price (see Tanzer et al., 2012). Further, the principle of the state aid rules demand that transfer price is higher than liquidation price. In this way, the bank receives more and the difference between transfer price and liquidation price is the state aid (see Festić, 2012).¹⁹ The aims at providing a “middle way” between liquidation and “bail-out,” which achieves the continuity of essential banking functions, is essential by recapitalizing the entity or by capitalizing on a newly established entity or bridge institution to which its functions have been transferred while not relying on public solvency support and not creating an expectation that such support will be available (see Müller, 2015).²⁰

The idea of sale of a business tool is that an old institution is reshaped by partial transfer for making it attractive to investors. It is possible to transfer certain assets and liabilities of systemic relevance and in the public interest to be transferred to an investor (see Merler, 2017; Micossi, 2014). There are specific requirements regarding on the sale of business tools: i) distinction to a bridge bank is that the acquirer is an external investor; ii) the acquirer entity may need to get permission by the competent authority to take over the bank business; iii) the purchase price may be paid in shares in fewer circumstances in distinction to the bridge bank tool.

An asset separation tool is used always in conjunction with other tools (see Morris & Hoening, 2011; Petitjean, 2013). The intention is to sell the assets that have suffered losses in value in order to minimize the losses (any value lower than book value triggers a loss). Large institutions might have a certain portfolio of nonperforming loans (NPLs), and their value is steadily decreasing, but these loans might have some recovery potential (there are options in resolution scenarios for management to sell or to “write-off”). Toxic assets continue to exist, either in the bailed-in institution or bridge bank or institution under insolvency.²¹

¹⁹ The condition for approving the state aid from August 1, 2013, in to include bail-in toll (see EC, 2013, 2013/C, 216/01; see Festić, 2012).

²⁰ The BRRD (2014) requires that: i) any security attached to a transferred liability is transferred together; ii) netting rights may not be changed when liabilities are tied to netting agreement; iii) there is a protection for structured finance arrangements; iv) certain trading clearing and settlement systems shall be protected (see Schelo, 2015, 143–148).

²¹ Potentially, equity cushions have to be increased in order to enable a bank's ongoing operations (COM/2014/043).

¹⁶ MREL is expressed as a percentage based on the sum of own funds plus total liabilities divided by the sum of the total liabilities plus own funds (see BIS, 2016).

¹⁷ Developing a common methodology for MREL represents a considerable challenge given the wide diversity of banking groups. Informative MREL targets were defined at consolidated level only (SRB, 2016).

¹⁸ See BIS, 2016; Schelo, 2015.

Some conditions have to be fulfilled for the asset separation tool (Schelo, 2015, 151-153): i) the liquidation of toxic assets under normal insolvency proceedings might have an adverse effect on more financial markets; ii) a transfer is necessary to ensure the proper functioning of the institution under resolution; iii) a transfer is necessary in order to maximize liquidation proceeds; iv) it is possible to obtain an attractive price for these assets in the market if haircuts are applied.

To benefit from a capital markets union, insolvency frameworks would also need to remove sources of cost unpredictability in cross-border insolvency procedures, which are often hidden in national insolvency laws. The diffusion of best practices in credit recovery procedures could help to improve the management of nonperforming loans (NPLs) by fostering liquidity in secondary markets (see Valiante, 2016).

According to McGuire (2012, p. 3–12) resolution mechanisms can be defined differently depending on the jurisdiction and legal framework in place: i) when an institution is liquidated, its license is withdrawn, and its assets are sold over time to pay its liabilities to depositors or other creditors²²; ii) depending on the legal framework in place, bank owners can be removed from bank ownership, or their rights can be temporarily constrained in order to improve its financial health or prepare it for a sale or merger with another institution; iii) a resolution tool that allows purchase and assumption for the transfer of a troubled bank's operations to another, healthy bank, the assumption of the troubled bank's deposits and good assets, and the takeover of the bank's problem assets by the resolution authority; iv) a bridge bank as a form of a purchase and assumption, where the government forms a bank into which all or parts of a failing bank can be transferred, with the goal of effecting a sale to a private party at some future date; v) nationalization, which occurs when the government assumes ownership of an institution.²³

The difference between what banks would and would not be allowed to do is based on the principle that beyond their core services; they should not conduct activities that create intransparency. The benefits of prohibiting banks

from conducting high-risk activities outside of their core business, however, would be limited if those activities continue to threaten stability by migrating to the “shadow” banking system. The associated incentive to take greater risks have grown substantially over the past 30 years because the activities the safety net support have expanded beyond the core banking activities considered necessary to protect (see Morris & Hoenig, 2011).

Challenges for the Future

As we have seen, the BRRD regulates the different stages and elements of a problem bank's recovery and resolution process, including advanced planning and restructuring. It rests upon the following key elements: i) recovery and resolution planning, including the removal of obstacles to resolvability; ii) an enhanced set of early intervention measures to foster forward looking supervision and crisis prevention; iii) a harmonized set of resolution tools and powers to manage bank failure, aiming to ensure that losses are absorbed by shareholders and creditors, while allowing the continuity of critical functions.

As we have mentioned, an effective resolution regime should (in general, see, Financial Stability Board, 2011; World Bank, 2017): (i) ensure continuity of systemically important financial services, along with payment, clearing, and settlement functions; (ii) protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policyholders and investors as are covered by such schemes and arrangements; (iii) allocate losses to shareholders, unsecured and uninsured creditors in a manner that respects the hierarchy of claims; (iv) not rely on public solvency support and not create an expectation that such support will be available; (v) avoid unnecessary destruction of value and therefore seek to minimize the overall costs of resolution in home and host jurisdictions; (vi) provide transparency and predictability as possible through legal and procedural clarity of orderly resolution; (vii) provide a mandate in law for cooperation, coordination domestically and with relevant foreign-resolution authorities before and during a resolution; (viii) ensure that nonviable firms can exit the market in an orderly way; and (ix) be credible and thereby enhance market discipline and provide incentives for market-based solutions.

For a banking union to function effectively, the framework should be harmonized to provide the same level of certainty in liquidation, as expected in resolution. We examine the recent liquidation of two Italian banks to show how resolution and liquidation differ substantially when it comes

²² In countries with deposit insurance schemes, the deposit insurer may pay depositor claims up to an agreed amount, and those payments may be substituted for those claims in the recovery process.

²³ In the case of assisted merge, the government must carefully monitor the bank operations and properly design the transaction to ensure the acquirer is managing the acquired operations effectively and that the incentives of the acquirer in dealing with the assets acquired are aligned with the government's interests in making an investment in the merged institution (see McGuire, 2012; Petitjean, 2013).

to the scope of legislation applicable to the use of public funds. More clarity would be needed as to the role that the concepts of critical functions and public interest play

to grant liquidation aid in the two-tier system, in which resolution is done at the EU level but insolvency remains at the national level (see Merler, 2017; Merler, 2018).

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Mednarodno okolje: režimi reševanja in okrevanja bank kot tretji steber bančne unije

Izvleček

Namen članka je predstaviti možne oblike reševanja bank v evro sistemu in izpostaviti odprta vprašanja glede dodatnih kapitalskih blažilnikov ter vrednotenja aktive po Direktivi okrevanja in reševanja bank (BRRD). Orodje za reševanje bank s sredstvi upnikov je orodje za odpis ali pretvorbo podrejenih obveznosti z namenom ponovne vzpostavitve kapitalske ustreznosti. Pri vrednotenju aktive se določi znesek absorpcije izgub za ponovno vzpostavitev sposobnosti preživetja institucije in kapitalske ustreznosti. Orodje premostitvene banke ponuja pristojnemu organu za reševanje večje pristojnosti za prestrukturiranje. Prodaja aktive je dejansko oblika orodja premostitvene banke, ki omogoča organu za reševanje, da prenese sredstva in obveznosti investitorjem. Orodje za ločevanje sredstev se uporablja vedno v kombinacija z drugim orodjem. Instrument za odpis ni orodje za reševanje in vpliva na lastniški kapital, medtem ko se orodje konverzije nanaša na sredstva upnikov in obsega podrejene in hibridne instrumente. V nacionalni zakonodaji je mogoče vzpostaviti dodatna orodja za reševanje, če so ta orodja združljiva z načeli direktive reševanja bank in nacionalne zakonodaje pri podpiranju čezmejnega reševanja skupine. Izpostavlja se vprašanje prereguliranosti bank in sposobnosti izpolnjevanja teh zahtev brez negativnih učinkov na gospodarstvo.

Ključne besede: režimi okrevanja in reševanja bank, premostitvena banka, prodaja aktive, razdelitev aktive, konverzija podrejenih instrumentov v kapital, regulacija.