

**THIRD-COUNTRY RELATIONS  
IN THE DIRECTIVE ESTABLISHING  
A FRAMEWORK FOR THE RECOVERY  
AND RESOLUTION OF CREDIT  
INSTITUTIONS**

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# **THIRD-COUNTRY RELATIONS IN THE DIRECTIVE ESTABLISHING A FRAMEWORK FOR THE RECOVERY AND RESOLUTION OF CREDIT INSTITUTIONS**

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## **Abstract**

This article presents a critical analysis of the principles behind the scope and forms of cooperation between EU Member States and third-country resolution authorities in the context of the 2014 Bank Recovery and Resolution Directive. The article also explores the future responsibilities of the prospective Single Resolution Authority regarding relations between the euro area and third-country resolution authorities.

**Keywords:** European Union, banks, international economics, bankruptcy.

**JEL classification:** F39, G18, G33, G38, K33, L51.

## **Resumen**

Este artículo realiza un análisis crítico de los principios que inspiran el alcance y las formas de cooperación entre las autoridades responsables de la restructuración y resolución de entidades de crédito de los Estados miembros de la Unión Europea con sus homólogos de terceros países, en el marco de la Directiva de Reestructuración y Resolución de Entidades de Crédito de 2014. Además, este artículo explora las competencias de la futura Autoridad Europea de Resolución en el ámbito de la cooperación con terceros países.

**Palabras clave:** Unión Europea, bancos, gestión de crisis, liquidación, economía internacional.

**Códigos JEL:** F39, G18, G33, G38, K33, L51.

## 1- Introduction

The introduction of the Directive for the recovery and resolution of credit institutions (RRD)<sup>2</sup> explicitly recognizes that effective resolution of internationally active institutions requires cooperation between the Union, Member States and third country resolution authorities.<sup>3</sup> This is a welcome consideration given the degree of internationalization and the geographical diversification of the major European cross-border banking groups as well as the important presence of non-EU international banks in the EU.

Whether expansion takes place via branches or subsidiaries (EU international banking groups favor subsidiaries over branches -around two thirds of their activity- in their foreign expansion), arrangements between national authorities responsible for managing the resolution of crisis of international banks should ensure effective planning, decision making and coordination of action. (e.g. granting and withdrawing licenses). The Directive (RRD) aims to provide national authorities within EU jurisdictions with a broad range of powers and tools to effectively resolve a bank that is no longer viable and has no reasonable prospect of becoming so (see Annex for a description of bank resolution general

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<sup>2</sup> European Parliament legislative resolution of 15 April 2014 on the proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (COM (2013)0520 – C7-0223/2013 – 2013/0253(COD)).

<sup>3</sup> The RRD does not define “cooperation” but it establishes that cooperation should aim at: (a) a group resolution scheme and (b) prevent fragmented national responses. It is an all encompassing concept that includes information sharing and joint decision making. The terms “cooperation” and “coordination” are often used interchangeably.

principles and tools as envisaged in the RRD). The Directive is based on the common principles and best governance practices enshrined in the Key Attributes of Effective resolution regimes.<sup>4</sup> The RRD establishes that the objectives of resolution authorities are to ensure the continuity of critical functions; to avoid significant adverse effects on financial stability, including to prevent contagion and to protect insured depositors and client relations, while minimizing the public and private costs of resolution (Article 26). Cooperation with third countries resolution authorities will be facilitated if their resolution regimes are also consistent with those principles; hence, the importance of international coordination.

The rest of this paper is organized in four sections in addition to this introduction. The second section describes some stylized facts of cross border banking in the EU. The third part presents the inspiring principles and their exceptions as well as the scope of cooperation with the third party resolution authorities. It also makes some reflections about the single point of entry (SPE) and multiple point of entry (MPE) resolution strategies in the context of the Directive. Section four presents a reflection of third party relations in the context of the prospective Single Resolution Authority. The last section concludes.

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<sup>4</sup> Financial Stability Board Key Attributes of Effective Resolution Regimes are new international standard for the reform of national resolution regimes that sets out the responsibilities, instruments and powers that all national resolution regimes should have to enable authorities to resolve failing financial firms in an orderly manner and without exposing the taxpayer to the risk of loss (see [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf) accessed 28 January, 2014)



## **2- Cross border international banking: From and to the EU**

From the point of view of the international banks, the choice of expansion between subsidiaries or branches is not only influenced by differences in regulation and corporate tax rates across home and host countries, or differential treatment of overseas profits from branches and subsidiaries (e.g., the United Kingdom), but also by organizational considerations. Fiechter et alii. (2011) argue that the funding costs for the wholesale group are likely to be lower under the branch structure, given the flexibility to move funds to where they are most needed. International banks with important investment banking activities such as Goldman Sachs, J P Morgan Chase and Deutsche Bank, which are structured centrally for a more efficient use of group capital and liquidity heavily rely on branches. In turn, a subsidiary structure puts constraints on the banking group's ability to transfer funds across borders and could be less suitable for wholesale activities. For a global retail bank, however, a more decentralized subsidiary model may work better because of its focus on serving local retail clients and its reliance on local deposits and local deposit guarantees. This is the case of lenders as HSBC, BBVA and Santander, which are organized geographically.

In practice, even if international banks choose one legal form over the other (i.e. subsidiaries vs branches) to enter a particular country, most cross-border banking groups have rather complex organizational structures. They run operations through a mixed structure that includes both branches and subsidiaries in different jurisdictions.

In Europe (i.e. in EU and non-EU countries), international banking groups' preference for subsidiaries is pronounced. However, differences among countries are significant. For example, entry into the UK, Austria and Luxemburg banking systems takes place most often via branches; while, in Switzerland, Portugal, Belgium and, to a lesser extent France, it takes place via subsidiaries. In the US, the foreign banking groups use subsidiaries as well. In Latin-American, the share of foreign activities carried out through subsidiaries is even larger. In Asia most activities are carried out via branches, particularly in Japan and, to a lesser extent in China. However, there is a need to distinguish between retail and wholesale banking because several jurisdictions require foreign banks to set up subsidiaries to take deposits from the public.

International banks' motives for the choice of model of establishment in non-EU countries are broadly the same as for the case of the EU: acquisition of local banks allows a faster establishment in markets, particularly in retail banking that heavily relies on the value of the local franchise. The UK and US remain the far most important host countries in terms of bank assets held by foreign entities.

Fiechter et alii. (2011) conclude that from the supervisors' (or resolution authorities') perspective, the trade-off between their objectives and those of the international bank vary depending on a country's status as home or host to international banking groups. Home authorities might prefer the subsidiary model when their banks expand into countries with weak economies and a risky business environment (i.e. not fully convertible currencies; capital controls). Host authorities might also prefer that model, because it allows them to shield the affiliate from the problems of its parent (i.e. requiring higher

capital/provisions). Nonetheless, the key to ensuring financial stability lies in whatever the model (subsidiary or branch) in the design of effective mechanisms to supervise and resolve cross-border banking groups. These include effective home/host prudential supervision and information-sharing arrangements; satisfactory cross-border resolution regimes as well as burden sharing agreements of financial crisis costs.

Within the EU, effective cooperation is the inspiring principle of the Capital Requirement Directive IV and Capital Requirement Regulation<sup>5</sup> (CRD IV and CRR IV) in the realm of supervision and of the RRD establishing a framework for the recovery and resolution of credit institutions. From the view point of financial stability, the regulatory distinction between significant branches and subsidiaries of international banks has been significantly blurred by the similar treatment of systemic branches and subsidiaries for the purpose of coordination among competent authorities including information sharing. Cooperation between EU prudential supervisors / resolution authorities and third country authorities is also the inspiring principle of the relation as described in detail in the next section.

### **3- Third country relations in the recovery and resolution Directive**

Title VI of the RRD deals with different aspects of cooperation with third countries' resolution authorities, namely the inspiring principles and their exceptions; the legal framework for cooperation agreements; their scope and obligation of confidentiality.

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<sup>5</sup> Directive 2013/36/EU of 26 June 2013 of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176, 27.6.2013.

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013.

References to cooperation with third country national resolution authorities in the context of resolution colleges are included in previous articles of the RRD (Articles 80 and 81).

### *3.1 Inspiring principles and exceptions*

The principle that inspires relations with third countries is that of recognition and enforcement of their resolution proceedings, which is consistent with Key Attributes of Effective resolution regimes. Member States shall ensure, ideally at the time of licensing or launching the supervisory and resolution colleges that resolution authorities are empowered to do the following (Article 85):

- exercise the resolution powers in relation to the following:
  - (i) assets of a third country institution that are located in their Member State or governed by the law of their Member State;
  - (ii) rights or liabilities of a third country institution that are booked by the domestic branch in their Member State or governed by the law of their Member State, or where claims in relation to such rights and liabilities are enforceable in their Member State;
- perfect, including to require another person to take action to perfect, a transfer of shares or instruments of ownership in a domestic subsidiary institution established in the designating Member State;
- exercise the powers to (a) suspend certain obligations pursuant any contract to which any institution under resolution is a party except eligible deposits, payment and delivery obligations owed to payment systems, central counterparties and central banks (Article 61); (b) restrict the enforcement of secured creditors from enforcing security interest in relation to any asset of the institution under resolution (Article,

62) or (c) suspend termination rights of any party to a contract with a subsidiary of an institution under resolution from publication of the notice until midnight (Article 63);

- Render unenforceable any contractual right to:
  - i) terminate, liquidate or accelerate contracts of, or
  - ii) to affect the contractual rights of the subsidiary and / or domestic branches of third country banks established in the EU that are regarded as significant by two or more Member States, where such right arises from resolution action taken in respect of the third country institution or parent undertaking of such entities, whether by the third country resolution authority itself or otherwise pursuant to legal or regulatory requirements as to resolution arrangements in that country, provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed.

The RRD implies that cooperation with third countries will be based on common principles, powers, tools and approaches; which, in turn, are in line with best international practices as developed by the Financial Stability Board in the Key Attributes. Otherwise, the RRD also envisages that Member States have the right to refuse recognition in the case of branches of institutions having their head office in third countries because host countries do not enjoy the legal protection of the Union Law as is the case with subsidiaries of third country international banking groups. Under what circumstances a Member State has the right to refuse to recognize or enforce a third country resolution proceeding? The RRD (Article 86) envisages the following circumstances:

- the third country resolution proceeding would have an adverse impact on financial stability in the Member State (or another Member State);

- independent resolution action in relation to a domestic branch is necessary to achieve one or more of the resolution objectives established in the RRD (Article 26);
- domestic creditors (depositors) would not receive equal treatment in the third country. For example, the FSA (UK) proposed that firms from non-EEA countries that operate national depositor preference regimes (e.g. United States) be required to accept deposits in the UK using a UK-incorporated subsidiary or they must implement an alternative arrangement that ensures UK depositors are no worse off than the depositors in the home country if the firm fails. In 2012, the FSA proposed ban of non-EEA bank branches taking deposits unless they have protection;<sup>6</sup>
- the enforcement of third country resolution proceedings would have material negative fiscal implications for the Member State;
- effects of recognition or enforcement would be contrary to public policy.

Hence, the RRD ensures that Member States have the powers necessary to act in relation to a domestic branch that is either not subject to any third country resolution proceeding or that being subject to it, would have an undesirable impact on its economy or would be contrary to its laws and regulations. The underlying assumption seems to be that the third country resolution framework is not consistent with the Key Attributes of Effective Resolution Regimes.

What are the conditions for national resolution authorities of any Member State to resolve a branch of a third country bank? The principles should always be consistent with those stated in the RRD (Article 26) and at least one of the following conditions should be met (Article 86):

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<sup>6</sup>. See <http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf>.

- branch of a third country bank that no longer meets or is likely not to meet the conditions imposed by law for its authorization and operation, and there is no prospect of any private sector solution (e.g. acquisition by a sound bank);
- no third country resolution proceeding have been or will be initiated in a reasonable timeframe and the branch is/likely unable /unwilling to pay its domestic creditors;
- third country has initiated /notified the Member State resolution authority and the Member State refuses to recognize the third country resolution regime on the grounds that the exceptions meet any of the circumstances described in Article 86 (see above).

These RRD inspiring principles and exceptions are broadly consistent with the Financial Stability Board recommendations regarding resolution of cross border banks.

The RRD is neutral regarding resolution strategies whether single point of entry or multiple point of entry is preferable to the extent that the general objectives of resolution as stated in the RRD are met. Also, the RRD removes obstacles to sharing information among resolution authorities.

### *3.2 What bank financial structures are covered by the recovery and resolution Directive?*

Cooperation is envisaged to take place both with regard to subsidiaries of third country internationally active financial institutions and groups (including parent financial or mixed financial holdings) and with regard to branches of third country internationally active financial institutions and groups.

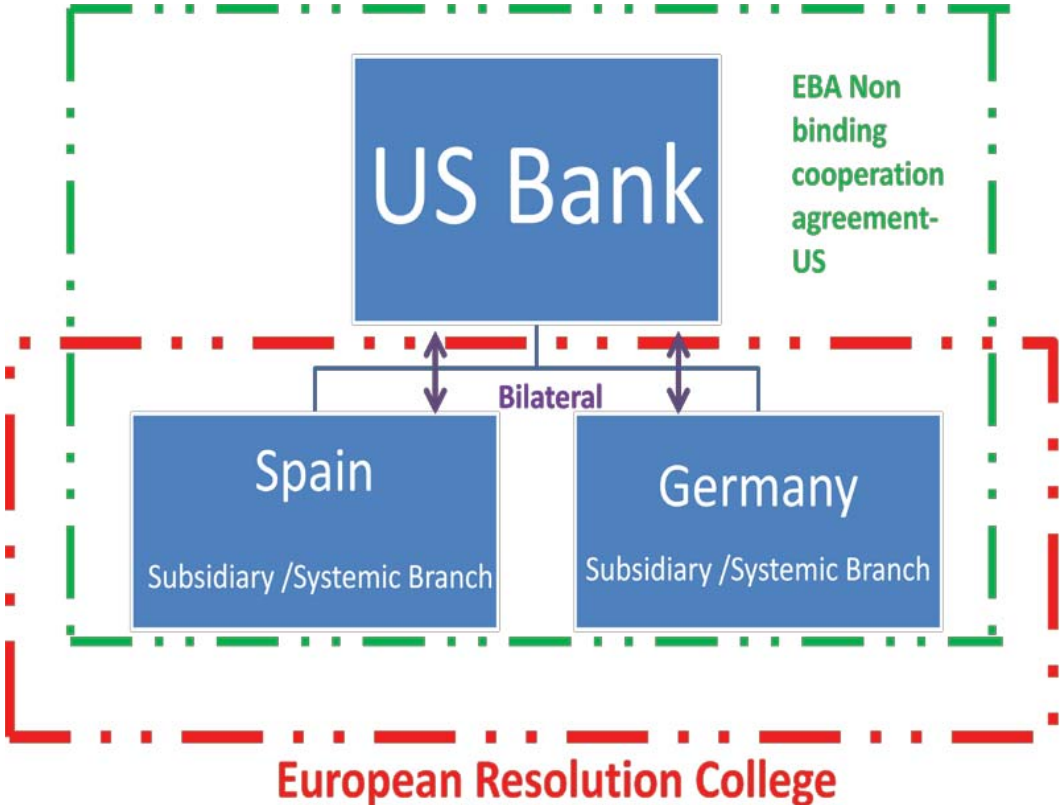
A subsidiary of a third country international banking group is a separate legal entity, which is legally incorporated in the EU and supervised by Member States' prudential supervisors,

with the parent bank having no legal obligation to support it if it falls into distress, although reputational risks are always a consideration. These subsidiaries are fully subject to Union law including the RRD. In contrast, a branch of a third country international banking institution is legally inseparable from that institution, which is ultimately responsible for its financial commitments and it is subject to prudential supervision and crisis management proceedings in the third country. Despite a clear legal distinction between branches and subsidiaries, however, both may in practice sometimes be operated and managed in a similar fashion. In some countries, branches work effectively as independent banks (i.e. Argentina, Bolivia, Brazil, Chile, Ecuador, India, and Korea, branches face local capital and liquidity charges identical to those applied to subsidiaries – Fiechter *et alli*, 2011); while, subsidiaries may function similarly to branches when they are dependent on their parents for funding. In the EU, the distinction between systemic branches and subsidiaries is somewhat blurred by requiring their national competent authorities to be both members of the supervisory and resolution colleges. Also, host Member States retain responsibility in cooperation with the competent authorities of the home Member State for the supervision of liquidity of the branches of credit institutions (Article 156, CRD IV).

Figures 1 to 3 show the different bank structures envisaged in the RRD regarding agreements on cooperation between EU resolution authorities and third country resolution authorities. The figures represent examples of group structures -not necessarily real- as envisaged in the RRD and included in the heading of each figure. In practice, EU banks use some of these group structures or very similar in their international activity (i.e. Citibank, Santander, BBVA).

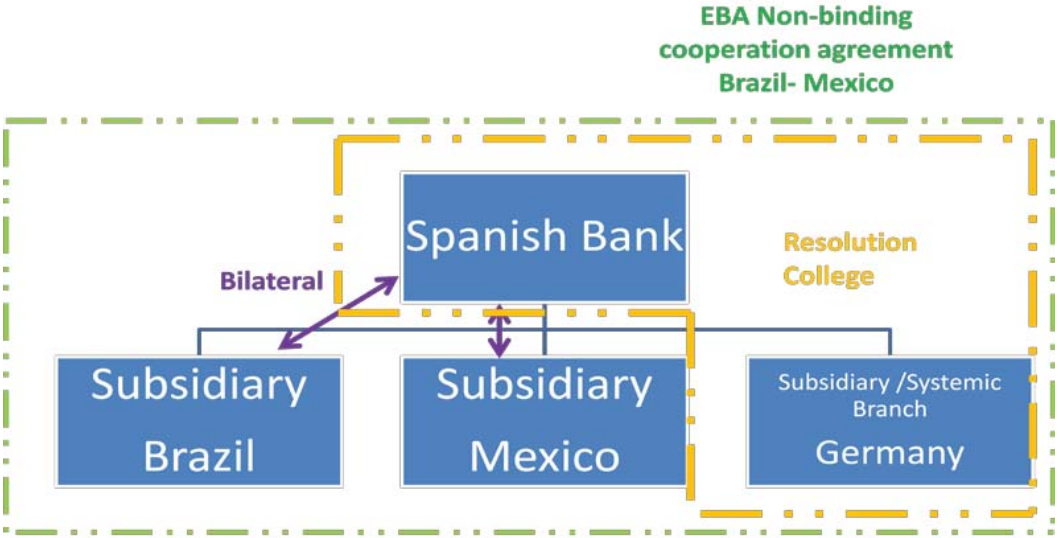


**Figure 1: A third country parent institution has subsidiary institutions or significant branches in two or more Member States**

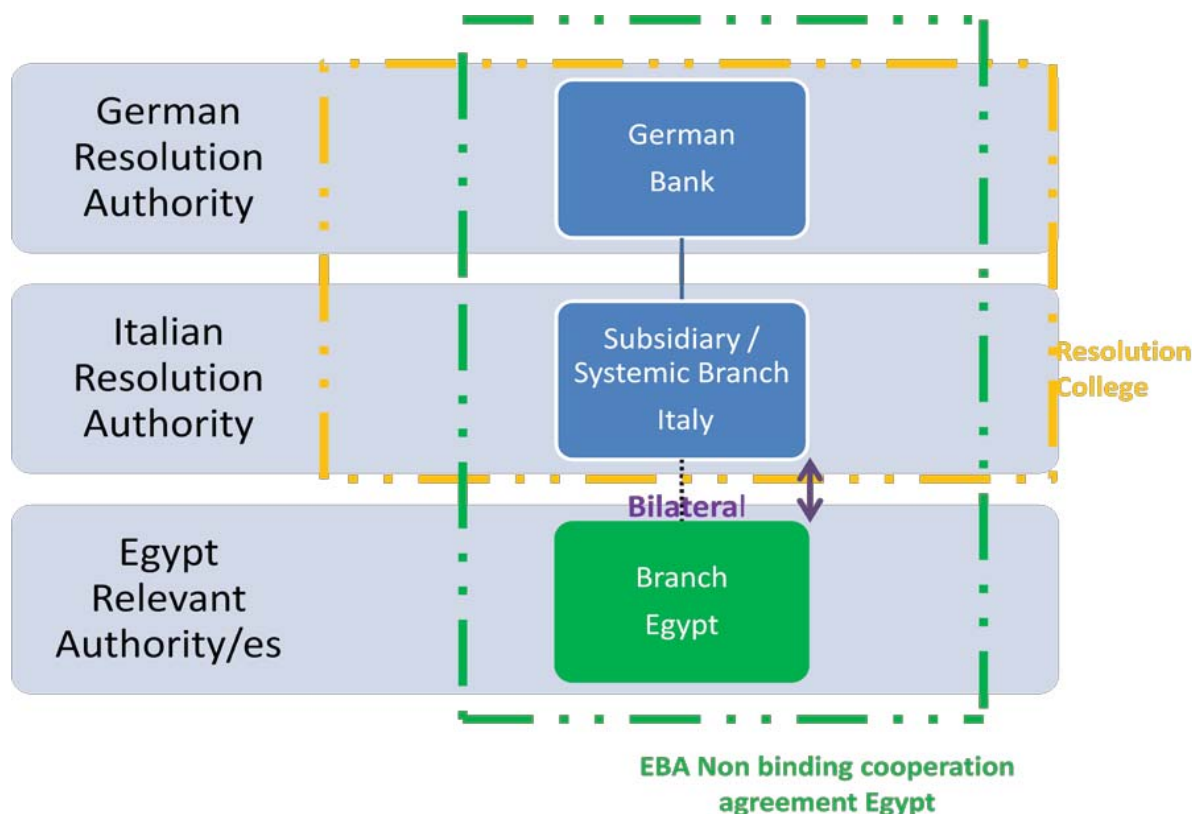


RRD also envisages the case of third country institutions that have rights or liabilities located in or governed by the law of that Member State.

**Figure 2: A parent undertaking established in a Member State and which has a subsidiary or a significant branch in at least one other Member State has one or more third country subsidiary institutions**



**Figure 3: An institution established in a Member State and which has a parent undertaking, a subsidiary or a significant branch in at least one other Member State has one or more branches in a third country**



### 3.3 Cooperation framework with third country resolution authorities

In accordance with the Treaty (Article 218 TFEU), the Commission may submit to the Council proposals for negotiation of agreements with one or more third countries regarding the means of cooperation between the resolution authorities and the relevant third country authorities, inter alia, for the purpose of information sharing in connection with recovery and resolution planning in relation to institutions, financial institutions, parent undertakings and third country institutions (Article 84 of the RRD). Such agreements will be among national competent authorities and will not be institution specific cooperation agreements for

planning and crisis resolution (COAGs in the FSB Key Attributes).<sup>7</sup> In this regard, the RRD is rather broad in its definition of institution that encompasses individual institutions, financial institutions, parent undertakings or third country institutions.

Until the entry into force of such agreements, the RRD envisages that EU national competent authorities may enter into bilateral non-binding cooperation agreements with resolution authorities ultimately responsible for subsidiaries or branches located outside the EU (see Section 3.2 above that shows the different international bank group structures).<sup>8</sup> As envisaged in the RRD, the European Banking Authority (EBA) may also conclude non-binding framework cooperation arrangements with third country resolution authorities. Such arrangements are not legally binding upon Member States and they are not mutually exclusive with the bilateral agreements. That is, Member States' resolution authorities may enter into bilateral agreements with third country resolution authorities at the same time that EBA has a non binding cooperation agreement with the same third country responsible authority. Nonetheless, Member States are obliged to notify EBA of any such cooperation agreement that they subscribe in order to avoid the scope for overlaps, under laps, and inconsistencies. Here the RRD seems to put EBA and the national competent authorities on an equal foot regarding cooperation on bank resolution with

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<sup>7</sup> As envisaged in the FSB Key Attributes of Effective Resolution Regimes, institution specific cooperation agreements (COAGs) establish the objectives and processes for cooperation between home and host authorities for individual banks through Crisis Management Groups (KA 9).

<sup>8</sup> At present, national prudential supervisors can enter into institution specific MoU with third country competent authorities concerning only one credit institution. Such MoU envisages more specific and intensive information exchange; it enhances consolidated supervision, and facilitates joint work and decision making. Usually it contains provisions regarding the organization of colleges and crisis management.

third country resolution authorities. Enhanced coordination within the EU and with third country resolution authorities allows for better internalization of the potential negative spill overs resulting from the decisions of resolution authorities of non EU countries.

In this vein, third country resolution authorities could participate as observers in Resolution Colleges (Article 80). Designed for authorities of Member States, Resolution Colleges should take a coordinated position on whether third country resolution proceedings should be recognized. Also, resolution authorities of third countries, where a parent bank (or holding company) established in the EU has a subsidiary or significant branch, could participate as observers in the Resolution Colleges (see Figures 2 and 3 above), provided that the third country resolution authority is subject to confidentiality requirements comparable to those in the EU.

Where a third country bank or third country parent undertaking has subsidiary institutions established in, or two or more branches that are regarded as significant by two or more Member States (see Figure 1 above), the resolution authorities of Member States where those subsidiary institutions in the Union are legally incorporated shall establish a European resolution college (Article 81). Such European resolution colleges are meant to perform the same functions of the resolution colleges designed for authorities of Member States as envisaged in Article 80 with respect to the subsidiary or the significant branch. European resolution colleges are to be chaired by the resolution authority of the consolidating supervisor, if no consolidating supervisor exists, the resolution authorities of the Member States will decide on the chair of the resolution college. The RRD also envisages the possibility of waiving the requirement of European resolution colleges if

other groups or colleges, including a resolution college established under Article 80, perform the same functions and carry out the same tasks of European resolution colleges and comply with all the conditions and procedures, including those covering membership and participation.

Bilateral and EBA agreements with third country resolution authorities outside the EU aim at establishing processes for sharing information for carrying out tasks and exercising powers that are consistent with the governance of effective resolution regimes as enshrined in the RRD and consistent with the FSB Key Attributes. Such processes should be established at the time of entering into those agreements and definitely before the bank enters into resolution.

Promising areas of cooperation in the context of EBA and bilateral cooperation agreements are those related to the transfer of funds or capital from the parent bank to the subsidiary as an alternative to bail-in; the location of gone concern loss absorbing capacity within the international banking group; treatment of intragroup liabilities in resolution as well as international legal enforceability and mutual recognition of the home and host laws under which debt considered loss absorbing are issued (i.e. requiring liabilities issued under non EU law debt to contain contractual features recognizing that they are subject to the EU resolution authority's powers to absorb losses of a bank as gone concern).

The RRD cannot be prescriptive about particular arrangements with third country authorities such as resolution strategies (i.e multiple point of entry vs single point of

entry) and it recommends matters of cooperation (Article 88.3): Development of resolution plans; assessment of the resolvability and the application of powers to address or remove impediments to resolvability; application of early intervention measures (or consultation of parties to the cooperation arrangement before taking action) and resolution tools as well as the exercise of resolution powers; coordination of public communication and establishment and operation of crisis management groups.

Because cooperation arrangements led either by EBA or EU national authorities with third country resolution authorities heavily rely on the exchange of information, they are subject to confidentiality rules (Article 89). Third country authorities should be subject to similar standards of professional secrecy; information being exchanged should be considered necessary for the performance by the third country authorities of their resolution functions and not used for other purposes. Moreover, confidential information provided from one Member State to another cannot be disclosed to third country authorities unless the former agrees to that disclosure and only for the sole authorized purpose. Against this background, nothing seems to preclude, provided authorities have the legal capacity to enter into such agreements, the possibility of bilateral legally binding agreements with third party competent authorities regarding certain aspects of bank crisis resolution, such as a common resolution strategy and the implementation of common resolution tools. However, legally binding agreements seem unlikely because national authorities are expected to keep intentionally vague on the possibility of temporary access to public funds since any obligation on signatories of such bilateral agreement to grant access to public funds could interfere with countries' fiscal sovereignty.

Non binding bilateral agreements are particularly suited for countries with highly integrated banking systems and very similar resolution regimes in terms of objectives and tools, such as the UK and the US.<sup>9</sup> The top seven large cross-border US banks have approximately 66 percent of the total reported foreign activity located in the UK (Azevedo, 2012). Against this background, the US (FDIC) and the UK (Bank of England) have agreed a common resolution strategy that takes control of the failed banking group at the top of the group by home authorities, imposing losses on shareholders and unsecured creditors (single receivership at parent holding company).<sup>10</sup> The bilateral agreement does not preclude other resolution strategies for US and UK banks, based on multiple point of entry or mixed single receivership at parent holding company and multiple point of entry.

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<sup>9</sup> In the US, the long-standing special resolution regime for insured US banks is based on FDI Act 1950 and subsequent enhancements in 1987 (bridge banks), 1991 (least cost resolution) and 1993 (depositor preference). The resolution tools for insured banks include P&A, bridge banks; open bank assistance and liquidation procedures. The Dodd-Frank Act 2010 extends resolution powers to other financial institutions whose failure could be systemic, including bank and financial holding companies; it introduces recovery and resolution planning requirements for US G-SIBG-SIBs and outlaws open bank assistance. In the UK, the Banking Act 2009 introduced a special resolution regime for UK banks and building societies with similar resolution tools. The Financial Services Act 2012 introduces resolution powers for UK investment firms, financial holding and affiliated companies of banks and investment firms, and central counterparties (CCPs). The Banking Reform Bill 2012 introduces explicit bail in power as an additional resolution tool; mandate primary loss-absorbing capacity at ring-fenced banks and G SIFIS and introduce insured depositor preference.

<sup>10</sup> In the US, the Orderly Liquidation Authority in Title II of the Dodd-Frank Act empowers the FDIC under extraordinary circumstances where failure of a financial institution would clearly present systemic risks: (a) to impose losses on shareholders and creditors and (b) to enable resolution in an orderly manner.

**Box: An economic analysis of the Single Point of Entry resolution strategy**

The single receivership at parent holding company resolution strategy is meant to be used only in those extraordinary circumstances where a financial institution's failure and resolution under UK and US laws that would otherwise apply would cause severe adverse effects on financial stability. This is expected to allow continuity of all critical services because the subsidiaries (foreign and domestic) would remain open for business and operating with access to sufficient liquidity (FDIC and Bank of England, December 2012). Melaschenko and Reynolds (2013) argue that allocating losses to debt issued by a pre-existing holding company that owns the bank is likely to entail an unnecessary cost arising from "structural subordination," because debt issued by the holding company is de facto junior in the credit hierarchy to any debt issued by the operating bank subsidiary – and is therefore more expensive.<sup>11</sup> Huertas (2013) makes a similar criticism and he goes even further highlighting that the implementation of single receivership at parent holding company is easy only if the parent holds 100% of bail-inable debt in a location where it is accessible to the parent country authorities. Also in practice, losses occur at the bank subsidiary level so that bail-in at the parent does not itself recapitalize the bank subsidiary. In turn, if the bank subsidiaries issue bail-inable debt, the geographic location

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<sup>11</sup> Standard & Poors is changing the criteria for assigning issue credit ratings to certain hybrid capital instruments subject to bail-in. While noting the geographic expansion of bail-in powers, Standard & Poors considers that the predictability of risks to senior unsecured debt holders remains relatively high. Such changes will by themselves increase the cost of this type of debt. (see, "Increasing Bail-In Risks For Bank Hybrid Capital Instruments Are Behind Our Proposed Criteria Change"

[https://www.globalcreditportal.com/ratingsdirect/RatingsDirect\\_Commentary\\_1255846\\_02\\_10\\_2014\\_08\\_14\\_17.articlePDF?rand=ebDflp1AdZ&id=1255846&sourceId=&type=&outputType=&from=Alert&prvReq=&pager.offset=&SIMPLE\\_SEARCH\\_TYPE=&CONID=&entl=&requestFrom=getPDF&articleType=Commentary](https://www.globalcreditportal.com/ratingsdirect/RatingsDirect_Commentary_1255846_02_10_2014_08_14_17.articlePDF?rand=ebDflp1AdZ&id=1255846&sourceId=&type=&outputType=&from=Alert&prvReq=&pager.offset=&SIMPLE_SEARCH_TYPE=&CONID=&entl=&requestFrom=getPDF&articleType=Commentary), 6 February, 2014).



and the legal enforceability of its loss absorbing capacity may be a major problem (unless the law under which a liability is issued recognizes the power of the home country resolution authority).<sup>12</sup>

Last but not least, a successful single receivership at parent holding company strategy demands a certainty that the home authority would allow resources generated by recapitalization at holding company level to be down-streamed within the group.

In practice, the large continental European banks and in particular G-SIB's have issued less senior debt at the parent company and more at the subsidiary level than their US counterparts.

International banking groups that operate in the EU will have also to abide by the FSB's specifications and requirements as regards the G-SIBs and the respective Crisis Management Groups (CMG) as well as institution specific cooperation agreements (COAGs) for planning and crisis resolution.<sup>13</sup> The interaction of the FSB CMG and COAGs with the EU cross border resolution structures envisaged in Title V of the RRD as well as the Single Resolution Authority crisis management framework demand urgent clarification and development.<sup>14</sup> Also, consistent with the FSB Key Attributes, EU countries resolution

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<sup>12</sup> Many banks deliberately hold their debt in non-accessible jurisdictions eg Jersey

<sup>13</sup> In November 2013, the FSB published the list of G-SIBs: HSBC, JP Morgan Chase, Barclays, BNP Paribas, Citigroup, Deutsche Bank, Bank of America, Credit Suisse, Goldman Sachs, Group Crédit Agricole, Mitsubishi UFJ FG, Morgan Stanley, Royal Bank of Scotland, UBS, Bank of China, Bank of New York Mellon, BBVA, Groupe BPCE, Industrial and Commercial Bank of China Limited, ING Bank, Mizuho FG, Nordea, Santander, Société Générale, Standard Chartered, State Street, Sumitomo Mitsui FG, Unicredit Group and Wells Fargo (see [https://www.financialstabilityboard.org/publications/r\\_131111.pdf](https://www.financialstabilityboard.org/publications/r_131111.pdf) accessed 29 January, 2014).

<sup>14</sup> The SSM will be responsible of ensuring that institutions prepare and regularly update recovery plans and the SSM will have the power to arrest a deterioration of bank's financial condition.

authorities, including the Single Resolution Authority, should take into consideration the impact of their decisions on third countries financial stability although such assessment is not envisaged in the RRD.

#### **4- Third party relations with resolution authorities in the European Banking Union**

A single resolution regime is one of the cornerstones of the European Banking Union. The RRD is just a first step that relies in the principle of regulatory harmonization at the highest level as well as on a network of national authorities to resolve banks. At the time of writing, policy makers have agreed the institutional design of the Single Resolution Mechanism (SRM) around a Single Resolution Authority (SRA) which will be responsible for resolving crisis banks in the euro area (and in the future other participating countries) ensuring a uniform approach.<sup>15</sup> The Single Resolution Mechanism only extends to banks established in Member States participating in the Single Supervisory Mechanism (SSM)<sup>16</sup> and subject to the supervision of the ECB and the national competent authorities within the framework of the SSM.<sup>17</sup>

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<sup>15</sup> The new SRM is expected to be in operation at the beginning of 2015 (see the European Council Agreement of 18<sup>th</sup> December, 2013 at [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/140193.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/140193.pdf) accessed 24 January, 2014).

<sup>16</sup> At present, 128 significant banks that include subsidiaries of non euro area, including non EU, banks (HSBC, JP Morgan Chase, Barclays, Citigroup, Credit Suisse, Mitsubishi UFJ FG, UBS, Bank of China, Bank of New York Mellon). The SSM also encompasses also another 3,175 less significant banks.

<sup>17</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, L 287/63.

The Regulation establishes uniform rules and procedures for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism.<sup>18</sup> According to this Regulation, a Board replaces national resolution authorities of the participating Member States in their resolution decisions. Such Board should ideally be a European Union agency with a specific structure corresponding to its tasks and with legal personality. The Resolution Board will consist of a chair person, four full-time appointed members and the resolution authorities of all participating member states.<sup>19</sup> The Board will decide on a particular resolution scheme and instruct national resolution authorities. While the decision for actual resolution of a credit institution including the decision on the choice of resolution tools and its financing remains with the Resolution Board, the Council, acting on a proposal by the EU Commission may overturn the Board's decision on the grounds that it is not necessary for the public interest or the Council may approve or object to material modification of funding by the Single Resolution Fund.<sup>20</sup> The Resolution Board is responsible for decisions on financing

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<sup>18</sup> Proposed Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council.

<sup>19</sup> The Board upon notification of the ECB that the bank is failing or likely to fail, or on its own initiative after having previously informed the ECB will place an institution under resolution and will decide on the application of the resolution tools and the use of the single resolution fund.

<sup>20</sup> Single Resolution Mechanism. Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (approval of the final compromise text). Council of the European Union. Brussels, 27 March, 2014.

arrangements in the event of the resolution group with institutions in both SRM-participating and non-participating EU and non EU countries.

Against this background, the Resolution Board should also replace national resolution authorities for the purposes of the cooperation with non-participating Member States as far as the resolution functions are concerned. Also, the Resolution Board will take the responsibilities of euro area national resolution authorities regarding recognition and enforcement of third country resolution proceedings as well as their right to refuse recognition of third country resolution proceedings. Moreover, it is expected that the Resolution Board will also take over from participating resolution authorities in the non binding bilateral agreements with third country resolution authorities. This mandate opens the possibility of bundling euro area countries existing bilateral agreements with third country resolution authorities. For example, all the existing bilateral agreements of the euro area countries with the respective agencies in the United States of America could be merged into one common agreement.

Since the Resolution Board replaces national resolution authorities of the participating Member States in their resolution decisions, the Board should also replace those authorities for the purposes of the cooperation with non-participating Member States as far as the resolution functions are concerned including the responsibilities of the Resolution Colleges of euro area competent authorities in which third country resolution authorities can participate as observers.

The proposed Regulation establishes that the Regulation establishing the European Banking Authority <sup>21</sup> should be amended in order to include the Board in the concept of competent authorities established by that Regulation. Such assimilation between the Board and national competent authorities is consistent with the functions attributed to EBA pursuant to Article 25 of Regulation No 1093/2010 to contribute and participate actively in the development and coordination of recovery and resolution plans and to aim at the facilitation of the resolution of failing institutions and, in particular, cross border groups. Regarding cross border groups, it includes EBA non-binding agreements with third country resolution authorities in those instances in which euro area countries and, in the future all members of the SSM, are hosts of subsidiaries and branches of international banks legally incorporated in a third country or home of subsidiaries and branches of international banks.

The Resolution Board should ensure that the decision making structures of resolution are legally sound and effective in times of crisis. The Board is empowered to assess third country resolution procedures for its recognition and enforcement or alternatively for the exercise of the right to refuse such recognition as explained in Section 3.1 above. The latter would imply that the Board could recommend that resolution of domestic branches of third country institutions is necessary in the public interest. In such case, the Board, is expected to: (i) assess the systemic threat of the foreign branch and

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<sup>21</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, L331/12

conclude that there is no prospect of any private sector solutions involving a solvent acquirer bank and no third country resolution proceeding has been or will be initiated in a reasonable time frame; (ii) propose the necessary resolution tools and their funding and (iii) ensure their implementation by relevant national resolution authorities in the euro area countries. Furthermore, the Board is expected to centralize cooperation with the FSB regarding Global SIFIs that operate in the participating countries.

The preferable resolution strategy depends on the organizational structure of international banks: whether they operate as globally integrated firms or as banks with multiple regional subsidiaries and neither of them is a priori superior. Notwithstanding, the centralization of the decision to resolve a bank and of the preparation of resolution actions in the Resolution Board will simplify the multiple point of entry of globally integrated banks that are headquartered in the euro area (and any other country participating in the SSM) as well as for those headquartered in third countries with subsidiaries in the euro area. Moreover, it would facilitate single-point-of-entry resolution strategy for those international banks that, operating in the SSM, use the single-point-of-entry resolution strategy (in practice international banks operating in the euro area also operate internationally limiting the benefits of such simplification). The Resolution Board would decide on the use of the bail in resolution tool at the home and/or host country level within the SSM, which is key to the success of the single-point-of-entry resolution strategy.

## 5- Final reflections

In line with the internationally accepted best practices, the RRD enshrines the principle of recognition and enforcement of third country resolution proceedings. This general principle has two implications: first, the RRD defines the different forms of cooperation with third country resolution authorities, which are either home of non EU international parent banks that have subsidiaries or branches established in any Member State or host of subsidiaries or branches whose parent banks are legally incorporated in the EU and; second, in the case of foreign branches of non-EU banks, the RRD establishes the circumstances under which a Member State has the right to refuse recognition of third country resolution laws and regulations.

In accordance with the Treaty, the RRD envisages cooperation with third country resolution authorities in the context of agreements with one or more third countries that should make provision for all the banks located in the that / those countr(ies) and they will not be institution specific arrangements. Until such agreements are in place, competent authorities of Member States and EBA are put on an equal foot to enter into non binding bilateral agreements with third country resolution authorities with the only obligation of information about non binding unilateral agreements on the part of the Member State to EBA . Such simultaneity may result in duplications and over and under laps of coverage. Promising areas of cooperation in the context of EBA and bilateral cooperation agreements are those related to the transfer of funds or capital from the parent bank to the subsidiary as an alternative to bail-in; the location of gone concern loss absorbing capacity within the international banking group; treatment of intragroup liabilities in

resolution as well as international legal enforceability and mutual recognition of the home and host laws under which debt considered loss absorbing are issued.

Third country resolution authorities may participate as observers in resolution colleges if the EU participating resolution authorities so decide. Ideally, all forms of cooperation should be established at the time of the authorization of the foreign subsidiary/branch or the establishment of the supervisory / resolution colleges and, in any event, before the bank enters into resolution.

These cooperation structures as well as confidentiality requirements will have to interact with the FSB's institution-specific cross border group resolution structures (CMG and CoAGs) in the case of the SSM participating (at present euro area) banks that are home or host of G-SIBs.<sup>22</sup>

Member States have the right to refuse recognition or enforcement of third country resolution proceedings in the case of foreign branches legally established in the EU. Such exceptions are based on financial stability concerns and / or legal grounds, including the existence of no reciprocity. In sum, it should be based on the defense of the public interest.

In the context of the banking union, the regulation only envisages that the Resolution Board will take the responsibilities of euro area national resolution authorities regarding their rights (i.e. to recognize or refuse recognition or enforcement of third country resolution proceedings) and obligations (i.e. non binding bilateral agreements with third country resolution authorities. While the decision for actual resolution of a credit

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<sup>22</sup> HSBC, JP Morgan Chase, Barclays, BNP Paribas, Citigroup, Deutsche Bank, Credit Suisse, Group Crédit Agricole, Mitsubishi UFJ FG, UBS, Bank of China, Bank of New York Mellon, BBVA, Groupe BPCE, ING Bank, Santander, Société Générale and Unicredit Group.



institution including the decision on the choice of resolution tools and as well as on the use of the Single Resolution Fund remains with the Resolution Board, the Council based on a proposal by the EU Commission may object to the Board's decision to the bank resolution scheme or may approve or object to material modification of the funding of resolution via the Single Resolution Fund.

In the case of G-SIBs that operate in the euro area (and any future member of the SSM), the Single Resolution Authority will have also to abide by the FSB's specifications and requirements and the respective Crisis Management Groups (CMG) as well as institution specific cooperation agreements (COAGs) for planning and crisis resolution.

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## ANNEX:

Bank resolution general principles and tools as envisaged in the Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms.

The Directive enshrines general principles governing resolution:

- shareholders take first losses;
- creditors bear losses after shareholders in accordance with priority;
- senior management is replaced;
- creditors of the same class are treated in an equitable manner;
- no creditor incurs greater losses that they would have incurred under liquidation.

The Directive harmonizes:

- early intervention measures by bank supervisors to the highest standards.  
In particular, prudential supervisors now can:
  - require shareholders to support the institution with cash;
  - replace managers;
  - implement recovery plan;
  - divestment of activities;
  - appoint special management.
- bank resolution tools when authorities use an administrative resolution procedure:
  - sale of business;
  - bridge bank;
  - asset separation;
  - debt write down.

- Sale of business:
  - sale of business to a purchaser (not Bridge Bank) without obtaining the consent of the shareholders:
    - shares / other instruments of ownership;
    - all or specified assets, rights or liabilities;
    - combination of the two above;
  - proceeds of sale to shareholders or benefit institution under resolution.
- Bridge bank:
  - legal entity that is wholly or partially owned by one or more public authorities created for the purpose of carrying out some or all the functions of an institution under resolution and for holding some or all of the assets and liabilities of an institution under resolution;
  - positive net worth;
  - temporary because it aims at privatization.
- Asset separation tool:
  - resolution authorities have the power to transfer assets, rights or liabilities of an institution under resolution to an Asset Management Vehicle -legal entity that is wholly owned by one or more public authorities-
  - if the situation of the particular market for the transferred assets is of such nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on the financial markets.

- Bail-in tool:
  - conservation mechanism to absorb losses of institutions failing or likely to fail (“trigger”) in order to save the firm from failure;
  - purposes:
    - recapitalization above the regulatory minimum - quantitative requirement for bail-in is not a target but a minimum of 8% of banks’ total liabilities including own funds-
    - equity conversion;
    - reduction principal amount of claims / debt in order to facilitate (1) bridge bank and/or (2) sale of business/Asset separation tool;
    - it goes hand in hand with recovery and reorganization measures reflected in the Business Reorganization Plan aimed at restoring long term viability.
  - Authorities can interfere on creditors rights without having exhausted shareholders’ rights:
    - “carve-out” approach to bail-in (vs “waterfall”). National discretion for exclusions from bail-in is limited;
    - “no creditor worse off” when “necessary exclusions from bail-in” would need to be compensated with other financing arrangements such as Bank Resolution Funds (BRFs) or “other.” The participation of BRFs is topped to a maximum of 5% of failed banks’ total liabilities;
    - European Commission’s immediate approval needed;

- State Aid rules for crisis banks to make sure that shareholders and subordinated debt-holders' contribute to recapitalizations or asset protection measures before resorting to public money.
- Scope of bail-inable debt: applies to all liabilities except:
  - insured depositors;
  - interbank liabilities < 7 days;
  - secured liabilities;
  - fiduciary assets protected by the insolvency law;
  - liabilities to employees, a commercial or trade creditor, tax and social security authorities.
- Conditions to qualify:
  - contractual provisions governing any eligible liability that inform investors about the priority of claims in case of resolution and liquidation;
  - authorities' assessment of their legal enforceability;
  - bail in is still enforceable even if institution fails to include the contractual provision.

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