

IN-DEPTH ANALYSIS

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# Valuation reports in the context of banking resolution: What are the challenges?

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Banking Union Scrutiny



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PE 624.418 - June 2018

EN

# Valuation reports in the context of banking resolution: What are the challenges?

## Abstract

The preparation of accurate valuation reports is among the most challenging elements of the resolution mechanism. That challenge is underlined by the following observation: during the crises in the past decade, for almost half of the bailed-out banks the estimates for losses and capital needs were initially too low, resulting in several rounds of public capital injections. The single resolution mechanism has introduced a formal procedure with three valuations, respectively, to determine whether a bank is failing or likely to fail (valuation 1), to inform about the use of the resolution tools including bail-in (valuation 2), and to ensure that the 'no creditor worse off' condition is respected (valuation 3). This paper gives an initial assessment of the preparation of valuation reports in resolution. It finds that there are still substantial uncertainties regarding the outcome of these valuations due to organisational, legal and economic challenges. In order to reduce the uncertainties, several measures are suggested, such as improving the IT systems, increasing the use of historical data, shortening the procedure to assign the valuator, introducing a moratorium, and harmonising the insolvency laws for banks in a way that integrates the insolvency and resolution regimes.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.



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Original: EN

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Manuscript completed in June 2018

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## EXECUTIVE SUMMARY

Accurate valuation reports are essential for the overall success of a bank resolution. If valuation reports are inaccurate they can drag out the financial distress or prompt shareholders and creditors to file suit and ask for compensation. This holds even more so now than in the past, when systemically important banks in need were supported by their national governments. Those valuations performed on an ad hoc basis were often inaccurate: For almost half of the banks that received public recapitalisation the initial estimated losses and capital requirements were too low, resulting in multiple rounds of public capital injections.

The introduction of the Single Resolution Mechanism with the bail-in of creditors has increased the importance of valuations, leaving less margin for error. If the valuation is too high, it might require additional capital injections including bail-ins later on. If the valuation is too low, it might require the Single Resolution Fund to compensate creditors in order to respect the 'no creditor worse off' principle and cause higher losses (hard bail-ins), which potentially might lead to more significant negative spillover effects on the economy, especially during systemic crises.

At the same time the valuation has been formalised in the single resolution mechanism, which includes three types of valuations, respectively, to determine whether a bank is failing or likely to fail (valuation 1), to inform the use of the resolution tools including bail-in (valuation 2), and to ensure that the no creditor worse off principle is respected (valuation 3). This analysis focuses on the second and third valuations, which are performed by independent valuers.

There are still major challenges to providing more robust results. For example, the provisional valuation report for Banco Popular (valuation 2) – the only bank resolution at the time of writing – explicitly indicated that the valuation results were "highly uncertain". Based on the initial valuation reports and experiences with the valuations of failed banks in the aftermath of the 2007–09 global financial crisis and the 2010–12 eurozone economic crisis, this paper identifies seven main challenges in the preparation of the valuations.

The main challenges include the time and information available to prepare the valuation, but there are also legal and economic challenges. The legal challenges, on the one hand, make it more difficult to come up with robust valuations (non-harmonised national insolvency regimes and misselling), while on the other hand they affect the credibility of the valuation (disclosure). The economic challenges primarily involve predicting the impact of deteriorating conditions just before the resolution and credible estimations of the economic developments afterwards.

Although there will always be some degree of uncertainty in valuations, there are definitely measures imaginable that could improve the accuracy of the valuations, in particular,

- improving the IT systems of the banks;
- increasing the use of historical data on previous bank failures;
- shortening the procedures to select the valuator;
- introducing a moratorium to allow a short suspension of payments if necessary; and
- harmonising the insolvency regime for eurozone banks in a way that integrates both resolution and insolvency.

The proposed measures address most of the challenges except for misselling, which could be addressed with consumer protection regulation and supervision to limit malpractice.

## 1 INTRODUCTION

Valuing a bank in resolution is one of the most challenging elements in a resolution procedure. On the one hand, the valuations need to be accurate to avoid negative spillovers for the real economy and consecutive bail-ins. On the other hand, the valuations will have to be performed at short notice, which increases the likelihood of inaccuracies (PWC, 2016).

In resolution, the valuation of bank assets and liabilities is likely to diverge substantially from the accounting values. The international accounting standards used by most banks require in principle reporting the fair value of assets, which should be equal to the market value. However, for a large share of the banking assets there is no liquid market available to determine the fair value. It is especially that part of assets in the bank balances that is valued based on amortised costs and models that might cause losses in case of resolution, which often takes place during economic and financial crises and is accompanied by time pressure suppressing the asset prices. Moreover, the losses in resolution also depend on the resolution tool applied, whether the activities are wound up, sold immediately, or continued aiming to maintain the franchise value.

The challenge that valuation poses to bank resolution was also shown in the 2007–09 financial crisis and the 2010–12 eurozone economic crisis, in which many banks received several rounds of public recapitalisation. In total 72 eurozone banking groups received public capital support in the period between 2007 and 2014, of which 33 banking groups (46%) were recapitalised more than once (De Groen and Gros, 2015). This means that the initial capital injection was insufficient to cover the future losses and capital requirements, which could be due not only to mistakes in the valuation, but also to deteriorating economic and financial conditions or to initial recapitalisations that were too conservative.

Simple mistakes can lead to large differences in valuation. For example, during the financial crisis Fortis Bank was bailed out and separated into Dutch and Belgium/Luxembourg parts, which were recapitalised separately by the respective national governments. Yet the recapitalisation of the Dutch part did not properly anticipate the consequences of the consolidation of the Dutch activities of Fortis Bank Nederland and ABN Amro into a single bank, as was decided at the time when the Dutch government acquired the activities. The bank required €6.9 bn of additional capital to address the capital shortfall and the costs of the restructuring necessary for the consolidation (European Commission, 2010).<sup>1</sup>

The post-crisis reforms have made bank crisis management more orderly than during the crises. In particular, the introduction of the resolution mechanism with resolution authorities and resolution funds, as well as procedures such as the resolution plan and tools to resolve failing banks, should ensure that the authorities are better prepared and have more time if a bank fails. This should have made it easier for authorities to determine the value of the failing bank. However, the shift from public bail-outs during the crises to private bail-ins to cover the losses in resolution has increased the importance of the valuation exercise. Indeed, during the crises the burden sharing was only applicable to equity and in some cases subordinated debt holders. Capital injections by national governments covered the remainder of the losses as well as the recapitalisation. When the amount of capital required was initially underestimated, as in the case of Fortis Bank Nederland, the government injected additional capital into the bank. Under the old situation of public bail-outs, the initial undercapitalisation in most instances had limited impact and the loss would have been covered by the government anyway; with the implicit government guarantee, there was limited effect on the funding costs and they could sustain lending to the real economy.

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<sup>1</sup> The main reason for the additional capital was the different treatment of intangible assets for prudential requirements before and after the consolidation.



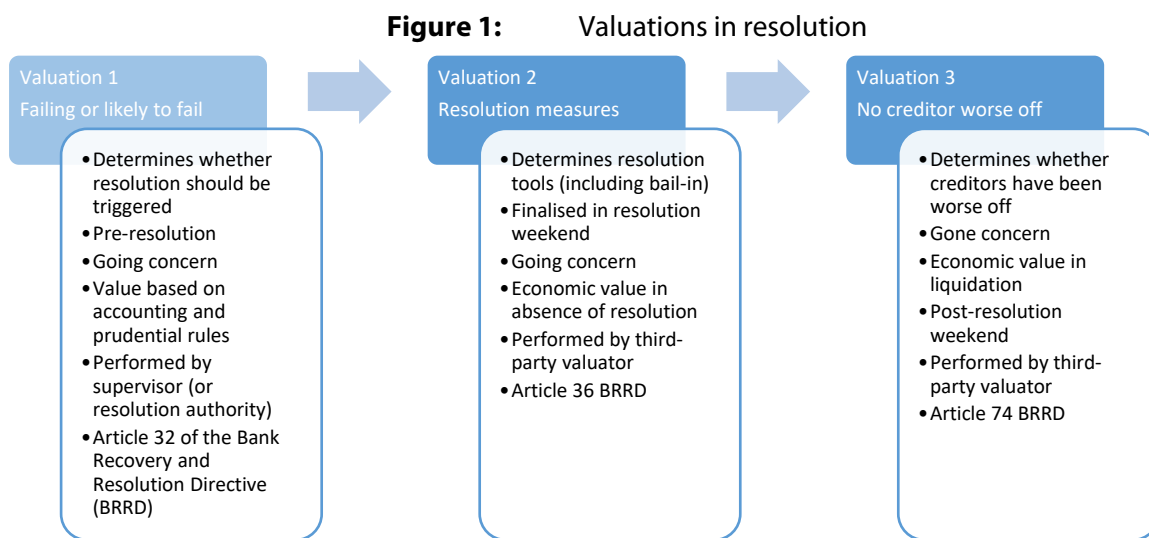
Under the resolution mechanism the valuation will largely determine who will be subject to a hard or a soft bail-in. The valuation determines not only the total loss, but also which creditors should absorb the loss (hard bail-in) or conversion to capital (soft bail-in) according to the creditor hierarchy (Gros and De Groen, 2016). The Single Resolution Fund could potentially contribute up to 5% of total liabilities and own funds to the resolution, but in practice the losses of systemically relevant banks in most cases are likely to be lower than the 8% minimum bail-in that is required before the fund can be used (De Groen and Gros, 2015). Moreover, if the fund has to contribute to the resolution this is likely to be in the form of capital for the resolved bank, reducing the soft bail-in but not the hard bail-in, which would require absorbing losses.

Both under- and overestimations of the value of the resolved bank can be problematic. If the total losses in the valuation are underestimated (Type I error), this might impact the lending of the bank to the real economy and exacerbate the total losses due to deteriorating funding conditions as well as recurring resolutions. If the losses are overestimated (Type II error), some creditors might face higher losses than necessary, which may cause negative spillover effects on other banks and the wider economy as well as a higher chance that compensation needs to be paid for violation of the no creditor worse off principle. Especially in times of systemic crises the spillover effects might become problematic. Overall, an underestimation (Type I error) seems to be most problematic, with recurring losses aggravating the total losses.

There is always a certain degree of uncertainty about the value of bank assets, particularly in times of crisis. This paper focuses on how the degree of uncertainty can be reduced as much as possible. It discusses the specific challenges for the valuations in resolution performed by independent valuers. Moreover, it assesses the different possibilities to improve the valuation process as well as mitigate the potential consequences of inaccurate valuations. The remainder of this paper discusses the different valuations in resolution in section 2. This is followed by a discussion of the challenges related to the valuations provided by independent valuers in section 3. In section 4, several potential measures to improve the valuation process and mitigate the consequences of inaccurate valuations are assessed. In section 5, conclusions are drawn, followed by policy recommendations.

## 2 VALUATION IN RESOLUTION

There are three valuations in resolution (see Figure 1). Valuation 1 is to determine whether a bank is failing or likely to fail. Valuation 2 is to inform the selection of resolution tools, including the bail-in of creditors. Valuation 3 determines whether creditors have been worse off than under the normal insolvency regime.



Source: Own elaboration based on EBA (2017).

### 2.1 Valuation 1: Failing or likely to fail

Valuation 1 determines whether a bank is deemed failing or likely to fail. Together with ascertaining whether there are reasonable private alternatives and or public interests involved, these aspects form the main criteria for putting the bank in resolution. When a bank is failing or likely to fail, and there are no reasonable private alternatives or public interests at stake, it is supposed to be liquidated under the applicable national insolvency regime. This valuation is based on the standard financial reporting obligations and regulatory capital requirements on a going concern basis, which are required for continuing authorisation. The supervisory authority or resolution authority has to determine whether a bank is failing or likely to fail (KPMG, 2017).

### 2.2 Valuation 2: Resolution measures

The aim of valuation 2 is to determine the resolution tools and the extent that liabilities and equity need to be written down (hard bail-in) and converted into capital (soft bail-in). Indeed, especially the sale of business, bridge institution and asset separation tools are expected to affect the loss as well as the capital required (see section 3.3.2).

The value of the assets and liabilities is based on the present value of the expected future cash flows, i.e. economic value. This valuation is like valuation 1 on a going concern basis. This value might differ from the first valuation based on the reporting standards and capital requirements, because of the resolution tools and different perspective on future losses. Based on the adjustment in present value and creditor hierarchy, the losses, capital requirement and bail-in can be determined.

This valuation is conducted by an independent valuator in the run-up to the resolution and finalised as closely as possible to the resolution action. When, due to urgency, it is not possible to fulfil all the requirements on time, the initial valuation can take the form of a provisional valuation. This valuation

can be prepared by the resolution authority itself. This valuation includes a buffer to account for uncertainty in the estimations and ensure that the bail-in will cover the losses. The provisional valuation 2 needs to be finalised as soon as practically possible and can be integrated into valuation 3.

### **2.3 Valuation 3: No creditor worse off**

Valuation 3 is to determine potential compensation for creditors that were disadvantaged by a bail-in. This valuation will estimate the difference between the compensation that creditors received in resolution (valuation 2) and liquidation. The necessary counterfactual to determine the value in liquidation will be based on the discounted cash flows that reasonably could have been expected under the national insolvency regimes without taking into account potential government support.

This valuation, unlike valuations 1 and 2, is based on a gone concern. The losses in liquidation (as a gone concern) are likely to be higher than under valuation 2 (a going concern), because of the loss giving default (litigation costs, collection procedures, loss of franchise value, etc.) that can be assumed in the event of liquidation. Valuation 3 is conducted based on the information available before the resolution action by the same independent valuator that is responsible for valuation 2 and is completed as soon as reasonably possible after the resolution action.

The remainder of this analysis focuses on the valuations performed by independent valuers (valuations 2 and 3).

### 3 CHALLENGES IN PREPARING VALUATION REPORTS

There are various challenges in the preparation of the valuation reports. The most pressing are of an organisational nature, but there are also some legal and economic challenges. The challenges discussed in this section have primarily been identified based on the resolution of the Spanish Banco Popular in June 2017 and other banks that have failed (or been bailed out or liquidated) in the past couple of years. At the time of writing, Banco Popular is the only bank for which the Single Resolution Board (SRB) has disclosed part of the (provisional) valuation report (valuation 2).

In the valuation report of Banco Popular there are concerns about the quality of the valuation performed. The independent valuator Deloitte even described it as “highly uncertain”. Moreover, the report provided a broad range for the value of the bank, between €1.3 bn and €-8.2 bn, with a best estimate of €-2.0 bn. Taking into account the conversion of subordinated debt, the best estimate is equal to the price paid by Banco Santander for the bank in resolution.

#### 3.1 Organisational

The main challenges for the preparation of the valuation reports is to obtain and process all the required information on time, which is necessary to come up with a robust valuation when the resolution action is performed.

##### 3.1.1 Information on the bank in resolution

Valuations 2 and 3 require granular information on the assets and liabilities of the bank in resolution. The information about the assets should primarily allow the valuator to assess the extent to which the resolution, including potential resolution tools, might affect the value as well as to assess the quality of the assets. This is important notably for assets for which there is no liquid market available. For liabilities, it is most important to have the creditor hierarchy in both resolution and national liquidation, along with the collateral that has been provided to creditors of the bank.

In the case of Banco Popular, the information on both the assets and liabilities was considered incomplete and insufficiently granular.

*“It has been based on public information and information uploaded through the SRB sharepoint and a virtual data room available through Intralinks; we have not had access to certain critical information”,* stressed the valuator Deloitte (2017) in the provisional valuation report on Banco Popular.

More specifically, there appeared to be a lack of information on line-by-line or portfolio-by-portfolio yield. Additionally,

*“The information available to us [Deloitte] has not been sufficient to construct a detailed and reliable estimate of the creditor hierarchy. This is due principally to the limited availability of information on a legal entity level and on intragroup assets and liabilities, and to the fact that the deteriorating liquidity position of the entity is likely to result in significant changes to the liability structure between the date of the most recent information available to us and the resolution date.”*

The lack of complete, correct and sufficiently granular information makes it more challenging not only for the independent valuator to prepare the valuations, but also for parties that would potentially like to acquire the bank in resolution. A lack of information is likely to lower the final sales price and thus the loss for creditors, as potential candidate purchasers are likely to apply a higher discount when there is greater uncertainty about the inherent value of the assets.

### 3.1.2 Time available for preparation

The (provisional) valuations (valuation 2) need to be ready at the time of the resolution action, which is only likely to be only known shortly before the action is taken. This gives the valuator limited time to verify the information, perform the valuation and validate the results.

The time available for the valuation depends on the time that the independent valuator is assigned and the resolution action is taken. The time available is likely to vary to a large extent, depending on the circumstances and the promptness of the authorities. The more predictable the failure of the bank, the earlier the resolution authority can assign the independent valuator and the more time the valuator has for preparing the report. When the financial situation of a failing bank is likely to worsen rapidly and close to resolution as described below, the resolution in turn is likely to be triggered more rapidly, which reduces the time for preparing the valuation report.

For example, the provisional valuation report on Banco Popular had to be prepared in just a couple of days, which did not allow the valuator to verify information and validate the valuation results. As indicated by Deloitte (2017), which prepared the valuation report,

*"In light of the challenging liquidity position of Hippocrates [code name for Banco Popular], we have been required to draft this Report in an extremely short period of time. The principal work has been limited to twelve days since the date on which we had access to the relevant documentation, whereas we would normally expect a project of this nature to take at least six weeks (as initially agreed between the SRB and us on 23 May 2017)."*

The limited time available forced the valuator to focus on the main assets and liabilities of which the value was uncertain. These are in particular assets for which there are no liquid markets available (loans, real estate, etc.).

## 3.2 Legal

The legal challenges for the preparation of the valuation reports are broadly twofold. On the one hand, there are differences in the national insolvency regimes and potential misselling claims that affect the valuation. On the other hand, there are the disclosure practices of the valuator, which might make the valuation contestable in court. The bail-in of Banco Popular shareholders and creditors shows that investors that lose money are likely to try EU and national judicial remedies to recover their losses through claims on the various involved parties, including the European Commission, SRB, Spanish resolution authority (FROB), acquirer Santander and others.

### 3.2.1 National insolvency regimes

The insolvency regimes vary between countries, which is a specific challenge for valuation 3 (ensuring that no creditor is worse off). Although most of the national insolvency regimes aim to recover as much as possible of the claims of the creditors, there are differences in the preferred strategies to reach the maximum recovery value, such as sales of businesses and unwinding. The regimes also have varying incentives for the liquidator. Especially the remuneration level, maximum time spent and involvement of the court in decision-making can influence the preferred strategy for unwinding the bank. Indeed, when the liquidator has more time, receives higher remuneration per hour and/or the court is not having to approve every decision, the liquidator is incentivised to take more time to unwind the bank and vice versa. For example, in Spain there is a preference for selling the business in the insolvency regime and the liquidator only receives remuneration for 18 months, which incentivises the liquidator to keep the unwinding of the entity within that period (Deloitte, 2017). The differences in procedures, preferences and judicial systems leads to wide variety in the recovery values, cost of procedures and average time required to finish the insolvency proceedings (Valiante, 2016).

Additionally, there are differences between the national insolvency regimes and the resolution mechanism, such as the treatment of the bank at the consolidated and individual entity level.<sup>2, 3</sup> That being stated, the latter also relates to whether the resolution follows a single or multiple point-of-entry approach. The single point of entry refers in general to the consolidated level and the multiple point of entry can refer to consolidation at intermediate levels as well as the individual entity level. Indeed, valuation 2 follows the legal structure under the resolution strategy mostly at the consolidated level, whereas valuation 3 needs to consider the treatment under the national insolvency regimes at the individual entity level.

Finally, banks that are failing or likely to fail are not automatically considered bankrupt under the insolvency regimes (Nouy, 2018). This complicates the calibration of the counterfactual for the purpose of no creditor being worse off, because the counterfactual might have to be based on a going concern instead of a gone concern.

### 3.2.2 Misselling claims

Most banks that failed in the past couple of years had sold bail-inable debt instruments (including their own MREL-eligible securities<sup>4</sup>) to their clients. The banks did not always comply with the consumer and investor protection rules, which could give some of their clients the right to ask for compensation. These claims for the misselling of bail-inable instruments are likely to be filed only when the clients face an actual loss, for example due to a bail-in as part of a resolution. These potential claims on the bank in resolution can lead to additional losses post-resolution and thus the value of the bank in resolution. It is for the independent valuator, however difficult or nearly impossible, to accurately determine these losses at the time of the resolution (valuation 2).<sup>5</sup>

### 3.2.3 Disclosure

Disclosure of the valuation report can contribute to the credibility of the valuations, discourage creditors from taking legal action and if they nevertheless file a court case it could support the SRB. In turn, when the motivation for the valuation is insufficiently established, the disclosed information can also give grounds for court cases and provide evidence that can be held against the SRB. The SRB was initially hesitant to publish any information on the valuation. After the decision of the SRB Appeal Panel on Banco Popular, the SRB published some parts of the valuation reports (valuations 1 and 2). Still, substantial parts of the documentation have remained confidential. The SRB indicated three different motivations for this: i) protection of public interests; ii) the risk of undermining commercial interests; and iii) potential effects on the ongoing valuation of no creditor being worse off (SRB, 2018). This means that the valuation reports will have to be formulated in such a way that it is clear that the valuations are fair, prudent and realistic even without the parts that are likely to remain confidential.

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<sup>2</sup> For example, on 9 March 2018 the commercial court in Luxembourg denied the request of the national resolution authority to put the subsidiary of Latvian ABLV (which had failed at the end of February) into liquidation (Deslandes and Magnus, 2018).

<sup>3</sup> In the case of Banco Popular, the valuation was based on the consolidated level, whereas this not possible under Spanish insolvency law (Deloitte, 2017).

<sup>4</sup> Minimum Requirement for own funds and Eligible Liabilities (MREL) is the minimum required loss absorption capacity of EU banks.

<sup>5</sup> The potential claims from retail clients might be mitigated when the SRB decides to exclude some of the bail-inable instruments from the bail-in for financial stability reasons.

### 3.3 Economic

The valuation depends on many different factors and is likely to change over time. Valuations 2 and 3 require the independent valuator to predict the changes to the bank shortly before the resolution as well as the impact of macroeconomic developments after the resolution action.

#### 3.3.1 Before resolution

There is in most cases a gap between the date when the information on the assets and liabilities is available for the valuation and the date when the resolution action is undertaken. In the case of Banco Popular the majority of the information was as of 31 March 2017, which was about two months before the resolution date (Deloitte, 2017). In normal times, with stable exposures, funding and market conditions, this time gap would have a limited impact on the valuation. Yet especially around the time of a resolution the funding and market conditions for the bank are likely to deteriorate, affecting the value of the assets and composition of the liabilities. For example, bank runs – which are likely to occur around the time that a bank is failing or likely to fail – may lead to a reduction of the unsecured creditors that are susceptible to bail-ins.

#### 3.3.2 Economic developments

Market and economic conditions are likely to change over time. Banks are most likely to fail at times of market and economic distress. At those times financial markets are likely to undervalue assets. This has a different impact on the various resolution tools. There is a distinction between tools that affect the loss and required recapitalisation of the bank in resolution (such as the sale of business, bridge institution and asset separation tools) on the one hand, and the bail-in tool on the other hand, which determines how the losses and recapitalisation are distributed across creditors.

Looking at the resolution tools that impact the loss and recapitalisation (see Table 1), the values of the bridge institution tool and asset separation tool depend on future economic developments, whereas the sale of business value depends on the market value at the time that the sales price is agreed, usually around the resolution action. This means that the actual losses of the bridge institution and asset separation can increase or decrease after the valuation and resolution action, depending on economic developments. This could potentially trigger recurring bail-ins at the point when economic conditions deteriorate and the capital buffers prove too conservative.<sup>6</sup>

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<sup>6</sup> The economic value of the assets for bridge institutions and asset management companies may not necessarily be the same as the accounting value of the assets of the resolved bank, which might mean that some liabilities that have been written down still have book value. Indeed, not all accounting standards anticipate all the expected losses. This forms an additional motivation for the resolution authority to use the sale of business tool.

**Table 1:** Valuation across selected resolution tools

Resolution tool	Sale of business (partial)	Sale of business (all)	Bridge institution	Asset separation
<b>Description</b>	Part of bank assets are sold to other banks or investors	All bank assets are sold to other banks or investors	Selected assets and liabilities are transferred to a new bank	Legacy assets are transferred to an asset management company (AMC)
<b>Type of institution</b>	Bank	Bank	Bank (bridge-institution) Non-bank (remaining-part)	Non-bank (AMC)/bank (other)
<b>Capital required</b>	No (sold part) Yes (remaining bank)	No	Yes (bridge bank) No (institution unwinding remaining part)	No (AMC) Yes (remaining bank)
<b>Type of valuation</b>	Market (sold part) Economic (remaining bank)	Market	Economic	Economic
<b>Asset value</b>	Yes	Yes	Yes	Yes
<b>Franchise value</b>	Yes	Yes	Yes	No
<b>Hard bail-in</b>	Yes	Yes	Yes	Yes
<b>Soft bail-in</b>	Yes	No	Yes	Yes
<b>Chance for multiple bail-ins</b>	Yes	No	Yes	Yes

Note: Bail-in, which officially is also a resolution tool, has not been included in this table since it is the outcome of the valuation and does not affect the valuation.

Source: Own elaboration based on De Groen (2018).

The undervaluation of assets in systemic crises is likely to lead to a valuation of the bank in resolution below the intrinsic value. Indeed, the counterfactual to determine whether creditors are worse off than in liquidation is likely to be estimated lower than the actual value if the assets were unwound over a longer period, which would allow the value of the assets to recover. This would decrease the losses for the creditors in the medium to long term.



## 4 SOLUTIONS TO IMPROVE VALUATION IN RESOLUTION

There are many different options to mitigate at least some of the organisational, legal and economic challenges outlined in the previous section. In this section several concrete options that do not necessarily require legal intervention to improve the robustness of the valuation in resolution are assessed. The measures include improved IT systems, enhanced use of historical data, a shorter tender procedure, a moratorium and a separate insolvency regime for banks.

### 4.1 IT systems

The IT systems of the banks that might be subject to resolution and the SRB need to be able to provide the independent valuator the information it needs to provide a robust valuation at the time of the resolution action. Statements in the valuation report on Banco Popular as well as the audit of the SRB by the European Court of Auditors have raised some doubts about the banks' ability to provide the required information in time.

In its 2017 report on the SRB brief, the European Court of Auditors is clear about the readiness of the SRB for valuations in resolution:

*"The Single Rulebook requires a description of the information that is necessary to implement the resolution strategy. An important part of this is the provision of information on the valuation of the bank for resolution purposes, which is a very complex and time-consuming procedure. We found no statements in this regard in any of the sampled chapters. It follows that the SRB was unable, as required, to assess the feasibility of delivering such information."*

Moreover, the IT systems of some banks have problems in delivering the data required for the bail-in on time (ECA, 2017).

The SRB would thus have to list the information required for the valuation in resolution in the resolution plans and communicate the information requirements to the banks under its remit. The valuator in particular requires information on the exposures, valuation techniques, creditworthiness of borrowers, collateral and creditor hierarchy. Moreover, the SRB has to ensure that the banks have the IT systems and processes in place to deliver the information in a standardised format to them in time. The standardisation as well as quality assurance processes are important to reduce the time required to prepare the data for the valuation exercise by the independent valuator. The time available for the valuation is in most cases likely to be insufficient to verify the quality of the information or improve the processes to generate the information. This means that the SRB needs to address this in the resolution planning process. When it finds deficits in the IT systems or information collection these should be addressed in the impediments to resolution processes. Additionally, the SRB should also ensure that the independent valuator has not only the expertise but also the systems and procedures in place to analyse the data in a very short period of time. The SRB can formulate this as one of the criteria in the tender specifications that the independent valutors need to meet, but also by requiring regular audits or test runs of the IT systems and processes.

The information is potentially changing rapidly around the time of the resolution. This requires that the bank in resolution must be able to generate balance sheets ideally on a daily basis. Most banks have up-to-date information available on their trading business (mostly valued at fair value), but not for their retail and commercial businesses (mostly valued at amortised costs) (RBS, 2015). These currently have longer timescales in place to prepare their balance sheets. Especially the value adjustments of assets for which no market values are available are traditionally only performed at intervals. This can be addressed by allowing the banks to perform the major valuation adjustments on, for instance, a monthly or quarterly basis. This would imply no or only a limited change compared to the current practise of systemic banks.

It is important that the SRB and valuator can access the data without the bank noticing, to ensure that the valuation process does not distort any recovery process underway and trigger a resolution.

## 4.2 Historical data

The current regulation and technical standards leave room for flexibility in the methodologies and assumptions for the valuations. In order to enhance the consistency between the different valuations and make them more evidence-based, historical data from previous bank failures could be used to formulate and verify the assumptions. This would require that the SRB actively collects information on failing banks (resolution and liquidation) and shares this information with the independent valuator, ideally in a manner such that it can be easily integrated into the valuation models used by the independent valuers.

At present, the public information on failing is rather scarce and often not presented in a structured manner (De Groen and Gros, 2015; De Groen, 2018). Banks in liquidation are usually no longer required to provide annual reports and the information in the reports of the liquidator tends to give insufficient detail. For example, for the valuation in resolution it is particularly important to have information on the liquidity outflows around the time of resolution, which requires more frequent reporting. In order to obtain this kind of information the SRB might have to strengthen its collaboration with the supervisory authorities, national resolution authorities, European Commission (DG for Competition) and local authorities. In some instances, laws might have to be amended to allow access by the resolution authorities to this confidential data and to use it for the valuation of other banks.

The use of historical data will also enhance the SRB and valuers' understanding of the financial situation before, during and after the resolution action. Indeed, it will facilitate not only assessment of the deterioration and recovery of the financial situation, but also identification of the factors that contribute to this.

## 4.3 Tender procedure

The time available for valuation could be increased by appointing the independent valuator earlier in the process. This might mean that the SRB decides earlier to call for the valuation, but also the shortening of the actual tender procedure. The latter requires that immediately after the decision to conduct a valuation, the SRB is able to issue the term sheet for the valuation to the parties in the framework, which requires that this term sheet is standardised and allows for sufficient flexibility to address the uncertainties regarding the required valuations in the process. Moreover, the preparation of the term sheet as part of the procedure could potentially, at least partially, be performed before the actual call for proposals is launched (for example, the identification of potential conflicts of interests), instead of once the invitation for tender has been launched as is currently the case. The same is true for the response time and short standard response format, which would ease the assessment of the bids. All this could reduce the time required for the selection of the independent valuator to within a couple of days from the almost a week that was required in the case of Banco Popular.

## 4.4 Moratorium

A potential alternative to provide some more time to prepare the resolution action could be a moratorium. The European Commission has already proposed two forms of moratoria,<sup>7</sup> which enable a suspension of bank payments for a short period during the early intervention and resolution

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<sup>7</sup> See the Proposal for a directive of the European parliament and of the council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC, COM(2016) 852 final, European Commission, Brussels (2016).

respectively. The duration of the moratorium in the European Commission proposal is limited to up to five working days, which extends the time available for the resolution action from one night or weekend to almost a week. For the valuation it would thus slightly increase the available time to complete the (provisional) valuation report.

Although a moratorium can provide the necessary time to complete the valuation, prepare the resolution tools and bail-in, it is also likely to make the resolution more disruptive and more similar to liquidation. The moratorium increases the negative impact on the broader economy and potentially reduces the franchise value of the bank. In particular, retail clients and SMEs often depend on a single bank for their payment transactions and might face problems in making payments when their bank fails, implying negative spill-over effects for the wider economy. For this reason and to maintain depositor confidence, the pay-out period of the current deposit insurance is put at a maximum of seven working days.<sup>8</sup> The moratorium should therefore only be used in exceptional cases and kept as short as possible.

#### 4.5 Harmonised insolvency regimes

The single resolution mechanism is built on top of national insolvency laws, and requires that there is a provision that no creditor is worse off in resolution than under the national insolvency regimes. This poses some additional operational challenges to the SRB, which needs to be acquainted with 19 different legal systems in the eurozone. In practise, most of the banks under the remit of the SRB are active with entities in several countries, which means that expertise on several national regimes may be required in a single resolution case.

The harmonisation of the insolvency regimes for banks at the EU or eurozone level would especially ease the resolution of cross-border banks, including the preparation of the valuation reports. Indeed, a harmonised insolvency regime imply a common ranking of creditors, priorities, approach and procedures. In particular the harmonisation of the creditor hierarchy across countries and regimes is important for the preparation of the valuation reports (Valiante, 2016), as it would require the SRB only have to be acquainted with a single rule book for the EU or eurozone.

Ideally the resolution mechanism would be integrated in the insolvency regime. This would provide the SRB especially more flexibility to weigh the various interests at stake and reduce the legal uncertainty. The current insolvency laws are often prioritising the recovery of the funds for (individual) creditors, whereas in the case of bank failures there are also other interests such as preserving financial stability, which not necessarily go hand in hand. The SRB might for instance decide that for financial stability reasons it is important that certain liabilities are excluded from bail-in or more expensive resolution actions are taken. Under the current regime it has than a higher risk that it will receive claims from creditors under a no creditor worse off provision. This provision is necessary in the current resolution regime to ensure that the property rights of the creditors are respected.

However, the existence of the no creditor worse off provision increases the legal uncertainty. It is not unlikely that the SRB has to compensate bailed-in creditors under the current regime, especially when a resolution does not necessarily imply that a bank is considered default in the absence of resolution. This is especially an issue when the failing or likely to fail call (valuation 1) is made based on future

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<sup>8</sup> See Article 8, OJ L 173 of 12.6.2014  
(<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0049&from=EN>).

illiquidity. Indeed, most insolvency regimes require actual and present illiquidity to activate bankruptcy (Nouy, 2018). This proved already a problem for the Latvian ABLV which was considered failing or likely to fail, but could not immediately be liquidated. In these cases, the SRB cannot assume that the losses given default, which provide the main financial space to use the resolution tools in the absence of resolution.

A harmonised insolvency regime for banks that integrates the resolution mechanism could take various forms. One option would be to create a special chapter of the insolvency law for bank insolvencies. Such approach to resolution of systemically important financial institutions is currently considered in the US, where the US Treasury proposed to create a New Chapter 14 Bankruptcy regime to replace the Orderly Liquidation Authority (US Treasury, 2018). Translated to the European context the US Treasury basically proposes to transfer the assets and the part of the liabilities that are not bailed-in to a bridge bank. Whether liabilities are transferred to the bridge bank depends on a procedure similar to the current valuation 2, including an initial provisional valuation with buffer and final valuation. These valuations are still necessary to determine the allocation of losses among the holders of bail-inable liabilities. The liability holders at risk to be bailed-in, in first instance remain a claim on the bank in resolution, which is at the finalisation of the valuation either written down or converted to shares in the bridge bank. This way the property rights of the creditors is respected without the need for a no creditor worse off provision and corresponding valuation 3. The bailed-in creditors would also under such a harmonised regime have the right to contest the resolution in court.

## 5 CONCLUSIONS

The enhanced burden sharing in the resolution mechanism has increased the importance of the valuation exercises, compared with the ad hoc government capital support during the financial and economic crises. The valuation exercises not only determine when a bank is considered failing or likely to fail (valuation 1), but also which creditors will be bailed in (valuation 2) and need to be compensated (valuation 3).

The fact that the creditors are now supposed to cover all the losses has made the valuation exercise more challenging than in the aftermath of the crisis. In this analysis, seven key challenges of an organisational, legal and economic nature have been identified and discussed. Based on the valuation report for Banco Popular, in particular organisational challenges (such as the time and information available for the valuation) make it difficult to determine robust results.

The potential solutions primarily aim to increase the time available for valuation 2 and improve the information available for both valuations 2 and 3. At the same time, the potential solutions – such as improvement of the IT systems, enhanced collection and use of historical data, a shorter selection procedure to appoint the independent evaluator, moratoria and a harmonised insolvency regime for banks – also address at least to some extent the legal and economic challenges (see Table 2). Misselling claims are the only challenge for which no real solution is proposed. Given the limited time available for preparing the valuation, it is unlikely that justified misselling claims can be accurately estimated. The measures in this area should primarily aim to avoid that there is a ground to establish these claims, which requires restrictions on the sale of bail-inable liabilities to own clients and/or enhanced supervision.

**Table 2:** Challenges and potential solutions for valuation in resolution

Challenges	Potential solutions				
	IT systems	Historical data	Tender procedure	Moratorium	Harmonised insolvency regimes
<b>Organisational</b>					
• Information on the bank in resolution	√				√
• Time available for preparation of the report			√	√	
<b>Legal</b>					
• National insolvency regimes	√				√
• Misselling claims					
• Disclosure	√	√			
<b>Economic</b>					
• Before resolution		√		√	
• Economic developments		√			

Source: Own elaboration.

The SRB could implement most of these solutions without legal intervention. It already has the possibility to obtain information from the banks under its remit, it can change the tender procedure as long as it remains within the European procurement rules and the technical standards foresee the use of historical data. However, legislative changes might be needed in order for the SRB to obtain the sometimes confidential data and share it with the independent valuers. The European Commission has already included this possibility in the EU banking reform package that is currently being discussed

by the co-legislators. It is only the harmonisation of the national insolvency regimes for banks that would require legislative intervention, but this might be the most complicated to implement. The current national insolvency laws in most Member States are closely related to other areas of law and policies (European Commission, 2009).

Finally, the valuation reports still seem a work in progress. The public information on the valuation reports at the time of writing remains rather limited. This means that there might be challenges for the preparation of the valuation reports that are not currently perceived as such. Some of these might, for instance, originate from the lawsuits that are underway. The valuation practices might therefore have to be reviewed after the rulings in the various ongoing court cases. Moreover, at present the valuation exercise primarily seems to facilitate the execution of the preferred resolution strategy. But this might change in the future. At that point, the valuation reports (valuation 2) could potentially be extended to make them more informative, by including the estimated values of the banks in resolution under alternative resolution strategies as well.

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## **ANNEX: SUGGESTED QUESTIONS FOR THE HEARING**

Dr Elke König, Chair of the Single Resolution Board (SRB), will come to the European Parliament for a public hearing of the ECON committee in June 2018. In the context of this paper on valuation reports, the author suggests asking the following questions during the Q&A part of the hearing:

- Anticipating the surge in cashless and instant payments as well as the substantial share of retail clients and SMEs with a single bank account for their transactions, should not the use of a moratorium be avoided as much as possible?
- Could 'actual' valuation data on banks (in the eurozone) that have entered resolution and national insolvency regimes in the past be of any use to making the valuations during resolution more accurate? If so, could the SRB collect this information and provide it to the valuator when performing the valuation?



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This document was provided by the Economic Governance Support Unit at the request of the ECON Committee. It discusses the challenges concerning bank valuation reports in resolution. The resolution mechanism has three types of valuation reports, respectively to determine whether a bank is failing or likely to fail (valuation 1), to inform the use of the resolution tools including bail-in (valuation 2), and to ensure that the no creditor worse off condition is respected (valuation 3). The first experience with the preparation of valuation reports shows that even with the more formal procedures there are still substantial uncertainties regarding the outcome of these valuations due to organisational, legal and economic challenges. Additional mitigating measures should be considered to reduce the uncertainty.

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PE 624.418

Print ISBN 978-92-846-3221-3 | doi:10.2861/611874 | QA-09-18-008-EN-C

PDF ISBN 978-92-846-3211-4 | doi:10.2861/156449 | QA-09-18-008-EN-N