

# European Union Bank Resolution Framework: can the objective of financial stability ensure consistency in resolution authorities' decisions?

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**Abstract** The Bank Recovery and Resolution Directive (BRRD), agreed in 2014 and transposed into national law by now, equipped EU resolution authorities with a number of tools and powers to deal with EU failing institutions. To use these tools and powers, and to act swiftly prior to institutions reaching the state of insolvency, resolution authorities must undertake appropriate planning (resolution planning) in accordance with a number of rules and processes under the Directive.

Resolution planning should enable authorities to “handle situations involving both systemic crises and failures of individual institutions”. The resolution plan must take into consideration the resolution scenarios “including that the event of failure may be idiosyncratic or may occur at a time of broader financial instability or system wide events”. The protection of financial stability has a central place in the BRRD, albeit in some instances it should also be balanced against other considerations, for example the other ‘resolution objectives’. The term ‘financial stability’ is not defined in the Directive; it is further qualified, however, in the context of a number of assessments that the resolution authorities must undertake.

The paper discusses the notion of ‘financial stability’ through the lenses of a number of tasks that EU resolution authorities must perform. It argues that although the financial stability objective should be necessarily broad to provide discretion to resolution authorities, it is hard to ensure consistency in resolution decisions and actions.

**Keywords** Bank resolution · Financial stability · BRRD · SRM

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The views expressed in this paper are those of the author, and any errors and omissions are the sole responsibility of the author.

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## 1 Introduction

The Bank Recovery and Resolution Directive (BRRD),<sup>1</sup> agreed in 2014 and transposed into national law by now,<sup>2</sup> equipped EU resolution authorities with a number of tools and powers to deal with EU failing institutions.<sup>3</sup> To use these tools and powers, and to act swiftly prior to institutions reaching the state of insolvency,<sup>4</sup> resolution authorities must undertake appropriate planning (resolution planning) in accordance with a number of rules and processes under the Directive. In conducting resolution planning, resolution authorities may require institutions to assist them by for example drawing up a draft resolution plan or preparing a draft update of the existing resolution plan.<sup>5</sup> In either case, the ultimate responsibility rests with the resolution authorities who own the planning process and should ensure its smooth functioning.

Resolution planning should enable authorities to “handle situations involving both systemic crises and failures of individual institutions”.<sup>6</sup> The resolution plan must take into consideration the resolution scenarios “including that the event of failure may be idiosyncratic or may occur at a time of broader financial instability or system wide events”.<sup>7</sup> The protection of financial stability has a central place in the BRRD, albeit in some instances it should also be balanced against other considerations, for example the other ‘resolution objectives’.<sup>8</sup> The resolution objectives are to:

- (a) ensure the continuity of critical functions;
- (b) avoid a significant adverse effect on the financial system;
- (c) protect public funds by minimising reliance on extraordinary public financial support;
- (d) protect depositors covered by Directive 2014/49/EU (DGSD)<sup>9</sup> and investors covered by Directive 97/9/EC;<sup>10</sup> and
- (e) protect client funds and client assets.

The resolution objectives underpin all decisions in resolution-from preparation to application. Resolution authorities should have regard to these objectives when:

<sup>1</sup>Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L 173/190.

<sup>2</sup>The transposition deadline was 31 December 2014 (Article 130 (1) of the BRRD).

<sup>3</sup>For the purposes of this paper, ‘institutions’ means all of the individual entities as well as groups captured by the BRRD as defined in Art. 1 (1).

<sup>4</sup>Resolution authorities will trigger resolution when the institution is “failing or is likely to fail” (Art. 32 (1) (a) of the BRRD) with a view to preserving the institution’s value and minimising the cost of resolution.

<sup>5</sup>Art. 10 (5) of the BRRD.

<sup>6</sup>Recital 6 to the BRRD.

<sup>7</sup>Art. 10 (3) of the BRRD.

<sup>8</sup>Art. 31 of the BRRD.

<sup>9</sup>Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes [2014] OJ L 173/149.

<sup>10</sup>Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes [1997] OJ L 84/22.

shaping their resources and operational capacity;<sup>11</sup> deciding on whether to legislate for additional resolution tools and powers;<sup>12</sup> assessing the resolvability of an institution;<sup>13</sup> triggering resolution;<sup>14</sup> managing the institution under resolution;<sup>15</sup> deciding whether to exercise control over the institution under resolution when taking resolution actions;<sup>16</sup> considering whether to take resolution actions that have not been contemplated in the resolution plan;<sup>17</sup> applying the resolution tools and powers;<sup>18</sup> marketing the assets, rights, liabilities, shares or other instruments of ownership of the institution under resolution;<sup>19</sup> authorising the bridge institution;<sup>20</sup> exempting mortgage credit institutions from the application of the minimum requirement for own funds and eligible liabilities (MREL);<sup>21</sup> setting the MREL;<sup>22</sup> writing down or converting Additional Tier 1 and Tier 2 instruments;<sup>23</sup> considering whether to extend the deadline for the preparation of the business reorganisation plan;<sup>24</sup> exercising ancillary powers;<sup>25</sup> using the financing arrangements;<sup>26</sup> refusing to recognise and enforce third-country resolution proceedings;<sup>27</sup> and taking independent action in relation to a Union branch.<sup>28</sup>

The term ‘financial stability’ is not defined in the Directive; it is further qualified, however, in the context of a number of assessments that the resolution authorities must undertake. For example, as one of the resolution objectives that resolution authorities should have regard to when choosing and applying the resolution tools, and exercising the resolution powers, ‘financial stability’ is achieved “in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline”.<sup>29</sup> Equally, the scope of ‘financial stability’ is further specified in that resolution authorities must take into account “the potential impact of the decision in all the Member States where the institution or the group operates and minimise the negative effects on financial stability and negative economic and social effects in those

<sup>11</sup> Art. 3 (8) of the BRRD.

<sup>12</sup> Art. 37 (9) of the BRRD.

<sup>13</sup> S. C (21) and (24) of the Annex to the BRRD.

<sup>14</sup> Art. 32 (5) of the BRRD.

<sup>15</sup> Art. 34 (1) (c) and 35 (3) of the BRRD.

<sup>16</sup> Art. 72 (3) of the BRRD.

<sup>17</sup> Arts. 87 (j), 91 (6) (a) and 92 (2) (a) of the BRRD.

<sup>18</sup> Arts. 31 (1) and 91 (6) (b) of the BRRD.

<sup>19</sup> Art. 39 (3) of the BRRD.

<sup>20</sup> Art. 41 (1) of the BRRD.

<sup>21</sup> Art. 45 (3) (b) of the BRRD.

<sup>22</sup> Art. 45 (6) (a) of the BRRD.

<sup>23</sup> Arts. 60 (1) (b) and 60 (1) (c) of the BRRD.

<sup>24</sup> Art. 52 (3) of the BRRD.

<sup>25</sup> Art. 64 (2) of the BRRD.

<sup>26</sup> Art. 100 (1) of the BRRD.

<sup>27</sup> Art. 95 (b) of the BRRD.

<sup>28</sup> Art. 96 (3) of the BRRD.

<sup>29</sup> Art. 31 (2) (b) of the BRRD.

Member States”.<sup>30</sup> Therefore, in addition to domestic financial stability, resolution authorities should consider financial stability in all other Member States; in case of a conflict, domestic financial stability would presumably take precedent although the BRRD is silent on this issue. The wording of the relevant provision (i.e. “minimise the negative effects”) could imply that a limited degree of negative impact on other Member States’ financial stability could be acceptable.

In relation to third countries, the BRRD is clear that domestic financial stability and financial stability in other Member States take precedent. In other words, resolution authorities have the right to refuse to recognise or enforce third-country resolution proceedings if they consider that the third-country resolution proceedings would have adverse effects on domestic financial stability or financial stability in another Member State.<sup>31</sup> The UK legislation is an interesting example where the legislator has gone beyond the BRRD to require the resolution authority, the Bank of England, to have regard to the potential effect of the exercise of the stabilisation powers<sup>32</sup> on the financial stability of third countries (particularly those third countries in which any member of the banking group is operating).<sup>33</sup>

The paper discusses the notion of financial stability through the lenses of a number of tasks that EU resolution authorities must undertake under the BRRD. It argues that although the financial stability objective should be necessarily broad to provide discretion to resolution authorities, it is hard to ensure consistency in resolution decisions and actions.

## 2 ‘Financial Stability’ in the context of resolution planning and resolution execution

### 2.1 Division of authorities’ responsibilities and use of public funds

The BRRD introduces a number of obligations (and powers) falling upon, in most cases, the resolution authorities and, in some aspects, the supervisory authorities, the latter primarily being the case in the context of recovery planning and early intervention measures.<sup>34</sup> Within Member States, the resolution and supervisory responsibilities must be structurally separated, that is there should be two separate bodies performing these roles, to ensure operational independence and avoid conflicts of interest.<sup>35</sup> The Directive does not go as far as to rule out the possibility of having both functions within the same entity; so long as the staff involved in carrying out the resolution and supervisory functions are structurally separated and subject to separate reporting lines, Member States are free to decide on the remainder of the organisational arrangements. At the same time, resolution and supervisory authorities are

<sup>30</sup>Art. 3 (7) of the BRRD.

<sup>31</sup>Art. 95 (a) of the BRRD.

<sup>32</sup>Under the UK Special Resolution Regime the resolution tools are called ‘stabilisation options’.

<sup>33</sup>S. 7A (2) (c) of the Banking Act 2009.

<sup>34</sup>The BRRD also introduces a number of obligations falling upon institutions within scope.

<sup>35</sup>Art. 3 (3) of the BRRD.

subject to exchange of information and cooperation obligations in the preparation, planning and application of recovery, early intervention and resolution decisions.<sup>36</sup> This structural separation is a fundamental concept in the BRRD, which aims at preventing regulatory forbearance while promoting accountability as it acts as a system of ‘checks and balances’ for both functions.

Exceptionally, the BRRD reserves some obligations (and powers) for the competent ministry (in most cases this will be the ministry of finance) or the government. In particular:

- (1) Where extraordinary public financial support is provided through the application of the public equity support tool or the temporary public ownership tool (the so called ‘government financial stabilisation tools’), the ministry of finance or the government will take the lead in consultation with the resolution authority.<sup>37</sup> These tools can only be used in the very extraordinary situation of a systemic crisis as a last resort “after having assessed and exploited the other resolution tools to the maximum extent practicable whilst maintaining financial stability” and are subject to specific conditions set out in Article 56 (4) and Article 37 (10) of the Directive.

It is notable that the conditions for use of the government financial stabilisation tools explicitly refer to one of the resolution objectives, that is the preservation of financial stability. Financial stability therefore takes precedence over the other resolution objectives in the determination of whether the conditions for use of public funds have been met.

- (2) Separately, the resolution authority must inform the ministry of finance of all the decisions pursuant to the Directive and, unless otherwise laid down in national law, seek its approval before implementing decisions that have “a direct fiscal impact or systemic implications”.<sup>38</sup> For the cases where the resolution authority is the same entity as the ministry of finance (this is possible given that the resolution authority can be any public administrative authority or authority entrusted with public administrative powers),<sup>39</sup> as above, there must be a structural separation between the resolution functions and the other functions of the ministry of finance. In this case, it will arguably be more challenging for the approval requirement to be fulfilled by a separate function, especially where there is internally a common ultimate decision-making body for both functions.

Another important element of this provision is that there is flexibility to amend the approval requirement under national law (i.e. “unless otherwise laid down in national law”). In other words, Member States may choose not to require the resolution authority to seek approval by the ministry of finance or may introduce a different process to the same or different effect.

In the above two cases, the government or ministry of finance intervention is triggered by the necessity to use public funds. In the first case this necessity leads to

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<sup>36</sup>Art. 3 (4) of the BRRD.

<sup>37</sup>Art. 56 of the BRRD.

<sup>38</sup>Art. 3 (6) of the BRRD.

<sup>39</sup>Art. 3 (2) of the BRRD.

the application of the government financial stabilisation tools, while in the second it presumably leads to the use of the resolution fund or the deposit guarantee scheme fund, hence having a “direct fiscal impact or systemic implications”. The fiscal impact and systemic implications will potentially be caused by the need to use public funds in the form of the resolution and deposit guarantee funds, and even as a backstop for those funds. A funding backstop will be necessary where the resolution or deposit guarantee fund has not reached the required target level under the BRRD<sup>40</sup> and DGSD,<sup>41</sup> respectively, or has reached the target level but is still insufficient to address the extent of losses.

It is unclear in the BRRD and DGSD whether the use of resolution or deposit guarantee funds is regarded as use of public funds, notwithstanding both funds are privately funded by the institutions that fall within scope of the Directives on the basis of *ex ante* risk-based contributions. For example, Article 10 (3) (a) of the BRRD refers to “any extraordinary public financial support besides the use of the financing arrangements established in accordance with Article 100” (the so called ‘resolution fund’), hence potentially implying that the use of the resolution fund would normally amount to public financial support. In contrast, recital 55 to the BRRD distinguishes between “the use of extraordinary public financial support, resolution funds or deposit guarantee schemes”, but provides that in all these cases such use should be compliant with the EU State aid framework, hence pointing to the conclusion that the use of resolution or deposit guarantee fund receives the same treatment as public funds. This is also the case in the European Commission Banking Communication<sup>42</sup> where it is contemplated that the use of deposit guarantee funds or similar funds to assist in the restructuring of credit institutions may constitute State aid: “Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds’ application is imputable to the State. The Commission will assess the compatibility of State aid in the form of such interventions under this Communication. State aid in the form of interventions by a resolution fund will be assessed under this Communication in order to assess its compatibility with the internal market”.<sup>43</sup>

Systemic implications may also emerge from the resolution of a systemically important institution or the resolutions of more than one (systemic or not) institution, irrespective of whether the funding available is sufficient to cover losses or there is a need to resort to public funds. The BRRD does not elaborate further on how severe the systemic implications should be but potentially they do not have to be as severe as a systemic crisis. Were they to be as severe as a systemic crisis, the legislator would have presumably spelled it out, not least because ‘systemic crisis’ is a defined term in the BRRD. In particular, Article 2 (1) (30) of the BRRD defines ‘systemic crisis’ as “a disruption in the financial system with the potential to have serious negative

<sup>40</sup>Art. 102 of the BRRD.

<sup>41</sup>Art. 10 of the DGSD.

<sup>42</sup>Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (‘Banking Communication’) [2013] OJ C 216/1.

<sup>43</sup>Paras. 63 and 64 of the Banking Communication.

consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.” In light of the broad definition of a ‘systemic crisis’, one may well conclude that any resolution with even a limited degree of impact on any part of the financial system, including the institution under resolution which is a financial intermediary in itself, could have systemic implications (which will not necessarily amount to a systemic crisis if there are no “serious negative consequences”), hence triggering the requirement for approval of the resolution authority’s decisions by the ministry of finance.

## 2.2 Simplified obligations, public interest and resolvability assessment

Resolution authorities, in consultation with supervisory authorities, must draw up individual resolution plans for all institutions within their jurisdiction that are in scope of the BRRD.<sup>44</sup> Banking and investment firm groups are subject to group resolution plans which are drawn up by all relevant resolution authorities, in consultation with the relevant supervisory authorities, under the leadership of the resolution authority that is responsible for the EU parent undertaking.<sup>45</sup>

Prior to embarking on resolution planning, resolution authorities should decide whether there is a need for a full or a ‘simplified’ plan. For a simplified plan to be applicable, resolution authorities must assess whether the institution is eligible for such simplification on the basis of the impact of its failure. If the failure of the institution and its subsequent winding up under normal insolvency proceedings “would be likely to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy”, resolution authorities must conclude that the institution is ineligible for a simplified plan. To assess the impact of the institution, resolution authorities must have regard to a number of criteria set out in Article 4 (1) of the BRRD (e.g. size, interconnectedness, complexity of activities, risk profile etc). It follows that the more significant the impact of the institution’s failure, the more detailed the resolution plan should be. Most importantly, the more significant the impact of the institution’s failure, the more likely resolution, as opposed to normal insolvency, to be appropriate for dealing with the institution’s failure.

The contents of a full resolution plan are set out in Article 10 (7) of the BRRD: for example, a demonstration of how critical functions and core business lines could be legally and economically separated from other functions to ensure continuity, an explanation of how the resolution options could be financed, and a detailed description of the different resolution strategies that could be applied according to the different possible scenarios. Resolution authorities do not have discretion on whether to reduce those contents. However, taking account of the characteristics of the institution and the resolution scenarios envisaged,<sup>46</sup> resolution authorities may specify in the resolution plan more or less detail (and accordingly adjust their information requests to the institutions<sup>47</sup>). For instance, one may expect a more extensive plan for an institution

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<sup>44</sup>Art. 10 (1) of the BRRD.

<sup>45</sup>Art. 12 of the BRRD.

<sup>46</sup>Art. 10(3) of the BRRD.

<sup>47</sup>Art. 11 of the BRRD.

where it is envisaged that the bail-in tool may be applied than for an institution which would be resolved by the application of the transfer powers to a narrow part of its business. The BRRD leaves room for such flexibility because it prescribes only contents requirements for resolution plans but the details to be presented are not further specified (e.g. compared to the reporting framework under the Capital Requirements Regulation<sup>48</sup>/Capital Requirements Directive<sup>49</sup> where, in order to provide for a more proportionate approach, legislative changes would be necessary in view of the degree of specification in legislative instruments). For those institutions that are subject to a simplified plan, both the contents and details of resolution plans can be reduced, and information requests to the institutions can be calibrated accordingly. The BRRD does not specify the scope of simplifications and resolution authorities are therefore free to define it; a simplified or proportionate plan cannot, however, extend so far as to waive the requirement for resolution planning imposed upon resolution authorities.

In the context of the simplified obligations eligibility assessment, resolution authorities must assess whether the impact of the institution's failure would be likely to have a significant negative effect on financial markets, other institutions, funding conditions and the wider economy. A question that arises is whether the assessment of the institution's impact on financial markets, other institutions and funding conditions is different from the assessment of the impact of the institution's failure on the 'financial system'. The latter consideration is integral to the assessment of the resolution objectives: one of the resolution objectives is to avoid a significant adverse effect on the financial system. If the conclusion is that the two assessments are not dissimilar, then they should inform and be consistent with each other. Whilst the simplified obligations assessment addresses the question of whether an institution is eligible for a simplified plan or not, the resolution objectives have a broader impact on a number of decisions and actions under the BRRD, as explained above. First and foremost, the resolution objectives shape the strategy that the resolution authorities will follow to resolve the failing institution ('resolution strategy'). In particular, during the planning phase and upon entry into resolution, the resolution objectives will guide resolution authorities through determining whether resolution, compared to normal insolvency, would be in the public interest.<sup>50</sup> If resolution authorities conclude that resolution would be in the public interest, they should decide on their subsequent actions having regard to the resolution objectives; for example, how the resolution tools will be applied to the institution's business, including what parts of the business will be left behind in a partial transfer, to what extent creditors will be affected by the bail-in etc.

The outcome of the public interest test may change between planning and execution depending on the circumstances at the time of the institution's failure, although the BRRD provides that, as a general principle pertaining to cross-border group res-

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<sup>48</sup>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 [2013] OJ L 176/1.

<sup>49</sup>Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 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 [2013] OJ L 176/338.

<sup>50</sup>Art. 32 (5) of the BRRD.



olutions, resolution authorities should take into account and follow the group resolution plans, unless they consider that a different course of action would be appropriate.<sup>51</sup> It is noteworthy that the same principle has not been reiterated in the context of the individual plans applicable to individual institutions. The explanation may be that in the case of individual institutions, resolution authorities have more flexibility to depart from the resolution plan given that the plan is not subject to a joint decision taken by all the relevant authorities that are members of the resolution college. Equally, there is no requirement for the resolution authorities to prepare a resolution scheme when it comes to the resolution of an institution that is not member of a group operating across borders. However, in view of the resolution authorities' obligation to disclose a summary of the key elements of the resolution plan to the institution concerned,<sup>52</sup> any departure from the original plan and the legitimate expectations created thereunder should be treated with caution and be duly justified taking into account the resolution objectives. Most importantly, on the basis of the original plan, resolution authorities will have identified any material impediments to the institution's resolvability and, where necessary and proportionate, taken relevant actions to address those impediments.<sup>53</sup>

The decision of whether resolution would be in the public interest, or in other words whether resolution or insolvency would be the preferred resolution strategy, is informed by the resolvability assessment, which resolution authorities must undertake for each institution as part of the resolution planning process.<sup>54</sup> The Commission Delegated Regulation 2016/1075<sup>55</sup> sets out four consecutive stages for the resolvability assessment:

- (a) assessment of the feasibility and credibility of the liquidation of the institution under normal insolvency proceedings;
- (b) selection of a preferred resolution strategy;
- (c) assessment of the feasibility of the selected resolution strategy; and
- (d) assessment of the credibility of the selected resolution strategy.

Resolution authorities will only complete stage one and not move on to the remainder of the stages, if they conclude that liquidation under normal insolvency proceedings would be feasible and credible. To assess the credibility of liquidation, resolution authorities must consider the likely impact of the liquidation on the financial systems of any Member State and the EU. To do that, resolution authorities must assess whether liquidation would be likely to have a material adverse impact

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<sup>51</sup> Art. 87 (j) of the BRRD.

<sup>52</sup> Art. 10 (1) of the BRRD.

<sup>53</sup> Art. 10 (2) of the BRRD.

<sup>54</sup> Art. 15 of the BRRD.

<sup>55</sup> Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, the minimum criteria that the competent authority is to assess as regards recovery plans and group recovery plans, the conditions for group financial support, the requirements for independent valuers, the contractual recognition of write-down and conversion powers, the procedures and contents of notification requirements and of notice of suspension and the operational functioning of the resolution colleges [2016] OJ L 184/1.

on financial market functioning and market confidence; on FMIs; on other financial institutions; and on the real economy and in particular the availability of critical financial services.<sup>56</sup> To assess the feasibility of liquidation, resolution authorities must assess whether it would be feasible for the DGS to timely reimburse covered depositors taking account of the institution's systems' capabilities (e.g. ability to provide necessary information and distinguish between covered and non-covered balances on deposit accounts).<sup>57</sup>

Where a resolution authority concludes that it may not be feasible or credible to wind up the institution under normal insolvency proceedings, or that resolution action may otherwise be necessary in the public interest because winding up under normal insolvency proceedings would not meet the resolution objectives to the same extent, it must identify a preferred resolution strategy which is appropriate for the institution. To the extent necessary, it must also identify variant strategies to address circumstances in which the strategy would not be feasible or credible.<sup>58</sup> To assess the feasibility of the selected resolution strategy, resolution authorities must consider whether there are potential impediments to resolution related to at least the following categories: structure and operations, financial resources, information, cross-border issues, and legal issues.<sup>59</sup> Resolution authorities must then assess the credibility of the selected resolution strategy taking into consideration the likely impact of resolution on the financial systems and real economies of any Member State or of the EU, with a view to ensuring the continuity of critical functions carried out by the institution.<sup>60</sup> For this purpose, resolution authorities must assess whether implementation of the resolution strategy would be likely to have a material adverse impact on financial market functioning and in particular market confidence; on FMIs; on other institutions; and on the real economy and in particular on the availability of financial services.<sup>61</sup>

'Critical functions' is a term widely used in the BRRD, not least because it is one of the resolution objectives (i.e. "to ensure the continuity of critical functions"<sup>62</sup>). 'Critical functions' is defined as the "activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations". These functions may involve activities such as deposit-taking, payments, clearing, settlement and custody; the BRRD does not set out a list of critical functions and it is within the resolution authorities' discretion to identify those functions on a case by case basis as part of the resolution planning. It is noteworthy that resolution authorities should identify the institution's

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<sup>56</sup> Art. 24 (2) of the Delegated Regulation.

<sup>57</sup> Art. 24 (3) of the Delegated Regulation.

<sup>58</sup> Art. 23 (3) of the Delegated Regulation.

<sup>59</sup> Art. 26 of the Delegated Regulation.

<sup>60</sup> Art. 32 (1) of the Delegated Regulation.

<sup>61</sup> Art. 32 (2) of the Delegated Regulation.

<sup>62</sup> Art. 31 (2) (a) of the BRRD.

critical functions taking account of the potential disruption to the real economy and financial stability, which in effect creates a link between the resolution objective of financial stability and that of continuity of critical functions.

From the above analysis it follows that resolution authorities are required to conduct parallel assessments in all of the three contexts: simplified obligations eligibility assessment, public interest test and resolvability assessment. A resolution authority may well reach the following conclusions in relation to an institution: (1) simplified obligations are not appropriate because the impact of the institution's failure would be likely to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy; (2) it would not be feasible to liquidate the institution under normal insolvency proceedings because liquidation would be likely to have a material adverse impact on financial market functioning and market confidence, FMIs, other financial institutions or the real economy; and (3) resolution action would be necessary in the public interest to meet the resolution objectives, which include avoiding a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline.

However, given that the BRRD does not elaborate further on how these three assessments interact with each other, there is nothing preventing resolution authorities from reaching the following conclusions in relation to an institution: (1) simplified obligations are appropriate because the impact of the institution's failure would not be likely to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy; (2) it would not be feasible to liquidate the institution under normal insolvency proceedings because liquidation would be likely to have a material adverse impact on financial market functioning and market confidence, FMIs, other financial institutions or the real economy; and (3) resolution action would be necessary in the public interest to meet the resolution objectives, which include avoiding a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline. The risk from the above conclusions would amount to having a simplified plan for an institution that would enter resolution upon its failure. A simplified plan may fail to ensure that resolution planning is conducted in a proper manner, in a manner that would not undermine the resolution authority's capacity to take resolution actions under different possible resolution scenarios.

### 2.3 'Financial stability' in recent resolution cases

Delving into some of the recent resolution cases, the foregoing potential inconsistency in interpreting the impact of an institution's failure on financial stability receives no guidance:

- (A) HETA Asset Resolution AG (HETA) was an asset management vehicle falling within the scope of the Austrian law transposing the BRRD (Federal Act on the Recovery and Resolution of Banks (BaSAG)),<sup>63</sup> which was resolved in March

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<sup>63</sup>The Federal Act on the Recovery and Resolution of Banks goes beyond the scope of the BRRD in that it captures other types of financial institutions in addition to those captured by the BRRD. Those captured

2015 through the application of the bail-in tool. HETA had been established in 2014 as a ‘wind-down entity’ to ensure that the remainder of Hypo Alpe-Adria-Bank International AG (HBInt)- the parent company of Hypo Group Alpe Adria (HGAA)-would be liquidated in an orderly manner over a reasonable period of time via the sale of its viable assets and wind-down of the residual part. In view of its wind-down objective, HETA performed limited banking and leasing activities, for example providing staff, IT, and access to its Continuous Linked Settlement system, and acting as counterparty to other entities of the group in derivative transactions.

Notwithstanding that limited activity, the Austrian resolution authority concluded that HETA’s resolution was in the public interest on the basis of the essential services provided by HETA to the other entities of the group, and the likely negative effects of its liquidation on domestic financial stability as well as on financial stability in Croatia and Slovenia. Additionally, given that some of HETA’s liabilities were guaranteed by the State of Carinthia, the resolution objective of protecting public funds would be better achieved through resolution compared to risking the State of Carinthia also becoming insolvent. In terms of size, as of 1 March 2015, HETA’s assets were valued at EUR 9.6 billion and its liabilities at EUR 17.6 billion.<sup>64</sup>

(B) Andelskassen J.A.K Slagelse (Andelskassen) was a Danish cooperative bank, which provided retail and private banking products and services as well as pensions, insurance and investment funds products to its members. It was the 69th largest bank in Denmark by total assets and as of 2015, its total assets amounted to 306,41 mln DKK, rendering the bank with a market share of 0.00%. Among the cooperative banks, it was the 6th largest, out of 9, with a market share of 1.93%. Notwithstanding the bank’s small relative size, the Finansiell Stabilitet, as the Danish resolution authority, determined that the resolution of Andelskassen was in the public interest to allow its critical functions to continue, and protect depositors and client funds.

Andelskassen was the first resolution case under the BRRD in Denmark and was conducted through the application of the bail-in tool in conjunction with the bridge bank tool. A notable aspect of the resolution was that it, among others, affected uninsured-by the Deposit Guarantee Scheme-depositors. The bridge bank that was set up as part of the resolution process was wholly owned by the Danish financing arrangements (‘resolution fund’), which contributed to the capitalisation of the bridge bank. In the absence of a private purchaser for the sale of the bridge bank, the bridge bank was eventually wound up.<sup>65</sup>

(C) In November 2015, four Italian banks, which were already under special administration, were resolved under the legal framework transposing the BRRD into national law. After absorbing part of the losses with equity and subordinated

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by the BRRD are credit institutions and the investment firms that are subject to initial minimum capital requirements.

<sup>64</sup>Lincoln/Lintner [4].

<sup>65</sup>Andersen/Lintner/Schroeder [1].

debt, the four banks were split into a 'good' bridge bank each and one single 'bad' bank (asset management vehicle) where all of the bad quality assets and liabilities (especially the non-performing loans) were transferred. It is noteworthy that the resolution of the four banks brought into the fore the issue of exposing retail debt holders to losses, which are unsophisticated investors with limited diversification in their portfolios and in some cases, they are even unaware of their status as investors and the subsequent risks. The percentage of bank bonds held by households has historically been high in Italy, partly because of the preferential tax treatment of interest income on such bonds. Although the protection of retail debt holders is not a resolution objective, unless regarded as a critical function, a potential exposure of such holders to losses may have contagion effects (for example, resulting in a bank run) or be politically sensitive (for example, affecting their pensions). The measures taken in the context of the four resolutions were designed with a view to protecting senior retail bond holders. This required higher contributions by the resolution fund, which, given that it had not met the target level required under the BRRD by that time, borrowed the funds needed from the three biggest Italian banks (Unicredit, Intesa and UBI).<sup>66,67</sup>

The four banks were very small, accounting for only 1% of total deposits in Italy. In more detail:

Banca delle Marche was active in the Marche region and in other areas of Central Italy: Umbria, Emilia Romagna, Lazio, Abruzzo and Molise via a network of 308 branches. The bank's business model was focused on lending to small and medium-sized enterprises (SMEs) and retail clients. According to the latest published figures at the end of 2012, Banca Marche had total assets of €22.7 billion, net customer loans of €17.3 billion and deposits of €7.2 billion. The bank had been placed under special administration on 15 October 2013.

Banca Popolare dell'Etruria e del Lazio was listed on the Italian stock exchange and operated mainly in Tuscany and Central Italy. It had a network of 175 branches and conducted a business focused on lending to SMEs and retail clients. According to the latest published figures of 30 September 2014, the group had total assets of €12.3 billion, net customer loans of €6.1 billion and deposits of €6.4 billion. The bank had been placed under special administration on 10 February 2015.

Cassa di Risparmio di Ferrara was a regional bank the business of which was focused on lending to SMEs and private clients with funding mainly from retail customers. It operated with 106 branches in the geographical area around Ferrara. According to latest published figures at the end of 2012, the group had total assets of €6.9 billion, net customer loans of €4.6 billion and deposits of €3.4 billion. The bank had been placed under special administration on 27 May 2013.

Cassa di Risparmio della Provincia di Chieti was a medium-sized regional bank with a focus on the Italian region of Abruzzo with a traditional business focused on lending to SMEs and retail clients. According to the latest published figures at the end

<sup>66</sup>Under the BRRD, a contribution by the resolution fund is only possible if 8% of the institution's liabilities have first been exposed to losses. The BRRD gave Member States the flexibility to apply this provision from 2016, hence at the time of the resolution of the four banks the 8% rule was not applicable in Italy.

<sup>67</sup>Merler [5].

of 2013, the bank had total assets of €4.7 billion, €2.1 billion of net customer loans and deposits of €2.5 billion. The bank had been placed under special administration on 5 September 2014.<sup>68</sup>

(D) Banko Espirito Santo (BES), the third largest bank in Portugal, was resolved in August 2014, prior to the transposition deadline of the BRRD of end of December 2014. The Portuguese legislation in force at the time was, however, to a large extent consistent with the international standards on resolution, including the main resolution objectives and principles as were subsequently articulated in the BRRD. BES had a market share of around 11.5% of total deposits and belonged to an international financial group (Grupo Espirito Santo-GES), which had operations in 25 countries and was active in both the financial and non-financial sectors. The bank was, thus, significant for domestic financial stability and financial stability of other relevant countries, and a possible disruption in its critical functions could have had systemic implications.

The resolution process involved the transfer of the majority of the bank's activity to a bridge bank, Novo Banco, the capital of which was formed through contributions by the resolution fund. Due to the resolution fund having insufficient financial means, it borrowed the required amount from the Portuguese State and a consortium of banks that were members of the resolution fund. The residual part of BES was placed into liquidation in July 2016.<sup>69</sup>

Save for the last case of the resolution of the third largest bank in Portugal, it is questionable whether the EU legislator was targeting the other cases, when articulating the regulatory assessments that are focusing on the likely impact of failure on financial stability. The resolution of a 'wind-down' asset management vehicle or a small cooperative bank being in the public interest, having regard to the resolution objectives, merits the question of whether the public interest test is in fact fit for purpose. A potential solution may well be having no such 'threshold' or 'safeguard', and relying on resolution being the default option at all times. This solution would not be dissimilar from the US case, where there is no equivalent assessment to the public interest test and the resolution authority for federally insured deposit-taking institutions, the Federal Deposit Insurance Corporation (FDIC), seeks to resolve failing institutions in all cases. The most common resolution tool is the purchase and assumption transaction (P&A); if the FDIC does not receive a P&A bid by private sector purchasers that meets the objective of the 'least cost resolution',<sup>70</sup> it reimburses all of the insured depositors of the failed institution and places the institution into receivership.

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<sup>68</sup>European Commission [2].

<sup>69</sup>Garcia [3].

<sup>70</sup>With the passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, the FDIC amended its resolution procedures in an effort to decrease the costs to the Deposit Insurance Fund (DIF). These new procedures require the FDIC to choose the bid that is the least costly resolution to the DIF when resolving a failing institution. Prior to the passage of the FDICIA, the FDIC was not required to use the least costly bid and could pursue any resolution alternative as long as it was less costly than liquidation.

## 2.4 ‘Financial stability’ in the Single Resolution Mechanism Regulation

Regulation 806/2014 (SRMR)<sup>71</sup> established the Single Resolution Board (SRB) and the Single Resolution Fund (SRF), the second pillar of the European Banking Union, comprising centralised supervision, a centralised resolution regime including a centralised resolution fund and, potentially in future, a centralised deposit protection scheme. The SRMR centralizes resolution decision-making within the Eurozone under the aegis of the SRB, but relies on national resolution authorities to help prepare and execute those decisions. The SRB is also in control of the SRF, which mutualises contributions by national banking sectors and ensures the availability of medium-term funding support, if required, after shareholders and creditors have been exposed to losses to a minimum level.

The SRMR is consistent with the BRRD; it however adapts the rules and principles of the BRRD to the specificities of the SRM and ensures that appropriate funding is available to the latter.<sup>72</sup> To achieve a centralised application of the resolution rules by a single authority and avoid divergent interpretations among Member States, the SRM has been established in the form of an EU Regulation, directly applicable in the participating Member States. As a result, the wording of some of the BRRD provisions has been amended to meet those needs.

As to financial stability, the SRMR clarifies from the outset that, as a general principle, when the SRB, Council, Commission or a national resolution authority is making decisions or taking action which may have an impact in more than one Member State, and in particular when taking decisions concerning groups established in two or more Member States, due consideration must be given to “the interests of the Member States where a group operates and in particular the impact of any decision or action or inaction on the financial stability, fiscal resources, the economy, the financing arrangements, the deposit guarantee scheme or the investor compensation scheme of any of those Member States and on the Fund”.<sup>73</sup> Accordingly, the group resolution plan drawn up by the SRB must take into account the impact on financial stability in all Member States concerned.<sup>74</sup>

In the SRMR, the resolution objectives remain unchanged with the exception of that pertaining to financial stability, where the wording has been slightly modified: under the BRRD resolution authorities must have regard to the need “to avoid a significant adverse effect on the financial system”,<sup>75</sup> whereas in the SRMR the objective is “to avoid significant adverse effects on financial stability”.<sup>76</sup> It is likely that the spirit of the two provisions is identical; any differences in the wording are however suboptimal as they could create ambiguity.

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<sup>71</sup>Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 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 Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L 225/1.

<sup>72</sup>Recital 18 to the SRMR

<sup>73</sup>Art. 6 (3) of the SRMR.

<sup>74</sup>Art. 8 (11) of the SRMR.

<sup>75</sup>Art. 31 (2) (b) of the BRRD.

<sup>76</sup>Art. 14 (2) (b) of the SRMR.

When assessing an institution's eligibility for simplified obligations, "the Board shall conduct an assessment of the institution or group concerned and shall apply simplified obligations, if the failure of the institution or group is not likely to have significant adverse consequences for the financial system or be a threat to financial stability".<sup>77</sup>

In the context of the resolvability assessment, the SRMR provides that "significant adverse consequences for the financial system or threat to financial stability refers to a situation where the financial system is actually or potentially exposed to a disruption that may give rise to financial distress liable to jeopardise the orderly functioning, efficiency and integrity of the internal market or the economy or the financial system of one or more Member States. In determining the significant adverse consequences the Board shall take into account the relevant warnings and recommendations of the ESRB and the relevant criteria developed by EBA in considering the identification and measurement of systemic risk".<sup>78</sup> Equally, in identifying measures to address impediments to an institution's resolvability, "the Board shall take into account the threat to financial stability of those impediments to resolvability and the effect of the measures on the business of the institution, its stability and its ability to contribute to the economy, on the internal market for financial services and on the financial stability in other Member States and the Union as a whole".<sup>79</sup>

As can be seen from the foregoing, certain definitions or concepts entailed in key regulatory assessments have been articulated in a different manner in the SRMR compared to the BRRD. Although this inconsistency can be justified to a certain extent in light of the different legal instruments (i.e. one being a Regulation with direct effect and the other a minimum harmonising Directive applicable only once transposed into national law), it may lead to ambiguity. Such ambiguity will be particularly challenging in cases where the SRB will be applying binding technical standards developed by the European Banking Authority (and adopted by the European Commission) on the basis of the BRRD and not the SRMR.<sup>80</sup>

### 3 Conclusion

All of the decisions of the resolution authorities, from resolution planning to resolution execution, are necessarily based on broad notions with a central one being that of protection of financial stability. In particular, resolution authorities in fulfilling some of their key obligations under the BRRD and SRMR must assess the likely impact of the institution's failure on domestic financial stability as well as on financial stability of other Member States in the case of groups operating across borders. It is necessary for the resolution authorities to have sufficient flexibility to be in a position to effect an orderly resolution as quickly as is necessary. At the same time, it is also important for this flexibility to be constrained so as to provide certainty to the institutions'

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<sup>77</sup>Art. 11 (3) of the SRMR.

<sup>78</sup>Art. 10 (5) of the SRMR.

<sup>79</sup>Art. 10 (10) of the SRMR.

<sup>80</sup>Art. 5 (2) of the SRMR.



stakeholders (e.g. bondholder, depositors, FMI's etc) on the parameters around which the resolution authorities' decisions will be made.

One example of such limitation is the five resolution objectives that should guide the resolution authorities' actions and should serve as a justification to any interference in property rights where creditors or shareholders are affected by the exercise of the resolution powers. The resolution objectives are, however, too broad to ensure convergence of practices in the EU. As a result, it is unclear whether a bank with a small balance sheet size or limited interconnectedness could have a significant adverse effect on domestic financial stability if it failed or it is only bigger banks in size or more interconnected banks that could have an adverse effect on financial stability. The answer will also depend on the wider macro-economic or institution-specific circumstances at the time of failure or may be defined by reference to normal insolvency proceedings: if the insolvency process is lengthy and complex, it may have a significant adverse effect on domestic financial system, hence justifying intervention by resolution authorities in most cases.

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