CEPS COMMENTARY

CEPS

Thinking ahead for Europe

Closing financial institutions on both sides of the Atlantic:

Are there differences in approach?

Michael Krimminger and María J. Nieto

25 February 2015

In the aftermath of the Great Financial Crisis both the EU and the US have implemented resolution procedures for their largest and most systemic financial institutions. Prepared for discussion at the 2nd CEPS Ideas Lab, this Commentary examines the main differences between the two frameworks. The EU framework allows, inter alia, action to prevent the failure of a credit institution, while the US regulatory framework requires that all systemic banks subject to resolution must be closed and resolved. The greater flexibility under the EU resolution framework allows action to be taken to preserve a credit institution without putting it through an insolvency process, which makes limiting moral hazard less obvious. Moreover, the scope of the EU framework is still narrow, since it does not allow the recovery of non-bank financial institutions, whereas the US framework does.

Introduction

Following the generous government support to banks in the immediate aftermath of the collapse of Lehman Brothers, policy-makers on both sides of the Atlantic have adopted legislation that strengthens market discipline and facilitates orderly resolution of complex banks. A principal goal of these reforms has been to limit, if not prohibit, the possibility of government bail-outs for systemically important financial institutions (SIFIs). This commentary discusses the main differences between the two schemes.

In the US, resolution of deposit-taking institutions is subject to the Federal Deposit Insurance Act (FDIA). Included within the many issues addressed by the Dodd-Frank Act (DFA) is a new resolution framework for SIFIs called the Orderly Liquidation Authority (OLA). OLA is designed exclusively to address the failure of SIFIs when resolution under the normal insolvency statutes would potentially impair financial stability. In Europe, there are two systems based on geographical coverage. The Bank Recovery and Resolution Directive (BRRD), which applies to all member states in the EU, and the Single Resolution Mechanism (SRM) Regulation (collectively the EU Framework), which applies only to the euro-area countries, are limited to credit institutions, financial (and mixed financial) holdings and

Michael Krimminger is a partner based in the Washington, D.C. office of Cleary Gottlieb. María J. Nieto, Associate to the Director General of Banking Regulation and Financial Stability, Banco de España, Madrid.

The views expressed in this column are the authors and do not necessarily represent those of the Bank of Spain, Eurosystem or Cleary Gottlieb. Any errors are our own.

investment firms. For the euro-area countries a Single Resolution Mechanism cum Single Resolution Fund (SRF) is centrally managed by the Single Resolution Board (SRB). Hence, the scope of OLA, which encompasses securities brokers and dealers, and other non-bank financial companies, is broader than the EU framework. Moreover, OLA cannot apply to insured banks, which are exclusively resolved under the Federal Deposit Insurance Act (FDIA) by the Federal Deposit Insurance Corporation (FDIC).

Table 1. Main differences between EU and US SIFI resolution frameworks

	European Union	**United States**
Legal framework	Bank Recovery and Resolution Directive (BRRD), supplemented by Single Resolution Mechanism (SRM) for euro area countries	Orderly Liquidation Authority (OLA) provision of the Dodd-Frank. Wall Street Reform and Consumer Protection Act
Scope	All credit institutions, (mixed) financial holdings, and investment firms	Systemically important non-credit financial institutions
Objectives	Limiting the direct costs for the tax payers although minimising moral hazard is not an explicit objective	OLA explicitly bars any losses to tax payers
Governance	Cumbersome and incentive structure not fully aligned	Quick decision-making
Bail-in approach	Possible both before and after receivership	Only After Receivership – no pre-failure bail-in limiting the loss given default

Source: Authors.

The OLA and EU framework have also similarities and differences regarding objectives, tools and approaches, which will be discussed hereafter.

Objectives

The general objectives of both frameworks are to ensure the continuity of critical functions; to avoid significant adverse effects on financial stability, including to prevent contagion and to protect insured depositors and client relations, while minimizing the public and private costs of resolution.

An important distinction between the EU and US frameworks is that minimizing moral hazard is not an explicit objective in the EU. In the EU, the resolution objectives include minimizing reliance on extraordinary public funds subject to State Aid rules.[1] In contrast, OLA specifically bars any losses to taxpayers and requires that all losses be borne by the failed company's creditors or, if necessary, through contributions by other SIFIs. While debate over whether OLA provides a 'bail-out' to some creditors continues, there is no question about that taxpayers cannot bear the losses. The same is true in bank resolutions under the FDIA.

[1] Article 31 of BRRD and 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") (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013XC0730(01)&from=EN).

Governance

The resolution of a SIFI requires quick and decisive action because uncertainty will lead to a rapid unwinding of its operations and dissipation of its value. While a decision can be made quickly, experience shows that speed requires a streamlined decision-making process. OLA requires recommendations from super-majorities of the Board of Governors and the FDIC[2] and a decision by the Treasury Secretary in consultation with the President, experience in 2008 shows that such decisions can be made over a weekend in a crisis.

In the SRM, the decision-making process also involves the political power. However, the decision-making process on whether to finance a cross-border bank resolution via the SRF and, if not sufficient, the mutualised national bank resolution funds (NRFs) is cumbersome and common fiscal backstops have not been developed as yet. Such complexity derives from the desire of the creditor countries to protect their right of objection to contribute to the funding of cross-border bank resolution.[3]

Once the decision to resolve a SIFI is made, the question then turns to how to fund a resolution and whether the tools available to the resolution authority provide powers to stem the potential systemic risks.

Funding

On both sides of the Atlantic, funding for bank resolutions comes primarily from banks. In the US, the FDIC's Deposit Insurance Fund is funded principally through assessments from member banks and protects insured depositors and provides financing for bank resolutions. Similarly, in the EU the NRFs[4] and Deposit Guarantee Schemes (DGSs)[5] are funded from member banks. DGSs serve to compensate insured depositors and NRFs finance bank resolution tools and compensate bailed-in creditors left worse off than in liquidation.[6]

Funding for SIFIs resolutions is somewhat different – as reflects the potential systemic consequences. Both the EU and the US resolution frameworks recognise that public funding

[2] The SEC in case of brokers and dealers or the Director of the Federal Insurance Office in the case of insurance companies.

[3] Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund. ECOFIN, 14 May 2014 (Intergovernmental Agreement –IA-). Recourse to all contracting parties (contributors to cross border bank resolution funding) is very protected by the IA that requires, first, financial recourse to the national compartments of the SRF. If such funding is not sufficient, the IA envisages recourse to all contracting parties (mutualised part of the SRF - full mutualisation will take place only after 8 years starting 2016), if not sufficient to finance resolution tools, recourse will be made to the remaining financial means of national compartments. If not sufficient, the IA envisages extraordinary "ex post" contributions from banks of the member states where the cross border bank is incorporated. If not immediately accessible, the Single Resolution Authority (Board) will decide on temporary transfers between compartments not yet mutualised of the SRF up to maximum of 50% (Board will decide on terms and conditions). Board decision should exclude financing of objecting contracting parties based on a number of reasons contemplated in the IA (i.e. the objecting member state considers that will need those financial resources in the near future or the objecting member state considers that the borrower does not have the financial capacity to pay back are among the reasons envisaged in the IA).

[4] Single Resolution Fund funded by deposit institutions in the participating members in the SRM.

[5] BRRD, Article 109: Use of deposit guarantee schemes in the context of resolution.

[6] BRRD, Article 101 Use of the resolution financing arrangements.

may be necessary.[7] The EU Framework provides for public funds ("only to the extent necessary") to facilitate resolution transactions, including guarantees for a bridge institution.[8] Temporary access to public funds corresponds to EU countries´ fiscal sovereignty requiring burden-sharing coordination and authorisation by the Commission in the context of its State Aid policy. In the US, the Orderly Liquidation Fund (OLF) from the Treasury may be used for similar functions. Funds from the OLF are repaid first from the proceeds of the resolution, and if this priority is insufficient, the industry can be assessed to recoup the balance. By law, no taxpayer losses from the liquidation process are allowed. Such legal prohibition does not exist in the EU Framework although the wording of the BRRD reflects the purpose of reducing public exposure to the extent possible and making it conditional to a minimum burden-sharing with private investors.[9]

Tools

Both approaches provide similar tools to facilitate continuity and avoid a destabilising collapse of operations.

Under OLA as well as the EU frameworks, resolution authorities have the powers to suspend certain obligations, transfer assets and liabilities to new purchasers or to bridge financial institutions, and temporarily suspend the rights of counterparties to enforce their rights to collateral and terminate contracts with the failed company. Both the EU framework and OLA include special provisions that stay the exercise of cross-default clauses if any guaranty is transferred to a solvent third party or adequate assurances are otherwise provided. Under both frameworks, the resolution authorities are given tools to continue key operations, services and transactions that will maximise the value of the firm's assets and operations and avoid a disorderly collapse in the marketplace. The authority to transfer operations to a bridge company is designed to preserve systemic activities that, if interrupted, could create a spiral of contagion.

A key distinction

Perhaps one of the most significant difference between OLA and EU frameworks is that the latter allows action to prevent the failure of a credit institution. OLA requires that all SIFIs subject to resolution must be closed and resolved.[10] This difference is significant because it

---

[7] In the US, FDIC may borrow from the Treasury among other things, to make loans to, or guarantee obligations of, a covered financial company or a bridge financial company to provide liquidity for the operations of the receivership and the bridge financial company. In the EU, public funding of bank resolution is envisaged in order to preserve financial stability. When the use of the resolution tools involves the granting of State aid, interventions should have to be assessed in accordance with the State aid provisions.

[8] BRRD, Article 101.

[9] BRRD, Articles 43 and 44. Only when bailing in of private investors and funding from resolution funds are not sufficient, could be recourse to either the member state's own taxpayer resources (provided such recourse received state aid approval from the Commission) or, in the case of banks headquartered in the Euro area to the European Stability Mechanism's direct bank recapitalization facility. Any such taxpayer support would be subject to the Commission's State Aid rules and to the systemic exception.

[10] While OLA technically requires the SIFI to be 'liquidated' this term is defined by the statutory powers in OLA, which give the FDIC authority to resolve the SIFI to preserve value and limit systemic risks. Arguments that 'liquidation' in OLA requires a value-destroying fire-sale are not supported by the statutory framework.

reveals a divergence in approach and probable outcomes of US and EU frameworks. This divergence is best illustrated in the bail-in tool.

An important distinction – which is often confused – is between closed bank bail-in and open bank bail-in. Closed bank bail-in simply describes the FDIC's long-standing process for failed banks in which all creditors are 'bailed-in' by having their claims impaired in proportion to the bank's losses and the creditors' seniority under the statutory claims hierarchy. Insured depositors are protected under FDIA, but uninsured depositors may lose money. OLA, like the FDIA, does not include an explicit bail-in tool because all liabilities are subject to impairment and bail-in to cover losses after closure. The OLA exit strategy of capitalising a new holding company by bailing-in pre-existing creditors is designed to have a completely new company, with a restructured balance sheet, emerge from insolvency.

In turn the EU Framework explicitly authorises open bank bail-in.[11] The EU approach, in contrast with OLA, is a recapitalisation of the existing credit institution and would not involve a formal insolvency (receivership) proceeding. It requires the restructuring and recapitalisation of the existing open institution and bails-in certain creditors to achieve a new, strengthened balance sheet.

Combined with the ability under the EU Framework to utilise funding from the resolution funds, despite the conditional minimum creditor bail-in and maximum NRF/SRF contribution, this could allow a credit institution in Europe to remain open and operating with potentially greater protection for creditors than the closed institution approach in the US.

There has been much debate about which approach to bail-in is likely to achieve greater continuity and systemic stability and encourage more market discipline. Given the greater flexibility under the EU resolution framework to take action to preserve a credit institution without putting it through an insolvency process, it remains an open question to what degree the new EU resolution framework will significantly limit moral hazard. Irrespective of the merits of the competing approaches, it is important to recognise that bail-in and resolution continue to reflect significant differences between the US and the EU. These differences mirror different institutional frameworks and histories, different expectations around resolution, and likely different future strategies in spite of the similar objectives. These differences should be discussed openly by all stakeholders to ensure that the trajectory of a future crisis does not itself create inconsistencies and an uneven playing field.

[11] See BRRD Articles 43-58. For a discussion of the advantages of the open SIFI approach, see Bank of England (2014).

References

Bank of England (October, 2014), "The Bank of England's Approach to Resolution", October (www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf).

Krimminger, Michael (2006), "Controlling Moral Hazard in Bank Resolutions: Comparative Policies & Considerations in System Design", July (available at SSRN: http://ssrn.com/abstract=1123224 or http://dx.doi.org/10.2139/ssrn.1123224).

Nieto, María J. and Thomas Huertas (2013), "A game changer: The EU banking recovery and resolution directive", Vox.EU 19 September (www.voxeu.org/article/banking-recovery-and-resolution-directive).