



EUROPEAN COMMISSION

## MEMO

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# EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions

## I. CONTEXT

### What is bank resolution?

Resolution occurs at the point when the authorities determine that a bank is failing or likely to fail, that there is no other private sector intervention that can restore the institution back to viability within a short timeframe and that normal insolvency proceedings would cause financial instability.

'Resolution' means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings.

The EU Bank Recovery and Resolution Directive provides authorities with more comprehensive and effective arrangements to deal with failing banks at national level, as well as cooperation arrangements to tackle cross-border banking failures.

Effective resolution should also address moral hazard, as one of its key functions is to enhance discipline within the markets. Resolution is thus a vital complement to other work streams designed to make the financial system sounder, e.g. making banks stronger through requiring greater levels of better quality capital, greater protection of depositors, safer and more transparent market structures and practices, and better supervision.

### Why is a EU framework for bank recovery and resolution needed?

During the recent financial crisis, a number of banks were bailed out with public funds because they were considered "too big to fail". The level of state support was unprecedented<sup>1</sup>. While this may have been necessary to prevent widespread disruption to the financial markets and real economy, it is clearly undesirable for taxpayers' money to be used in this way at the expense of other public objectives. In the future, the financial system must be more stable and banks must be permitted to fail in an orderly manner, so that government bail-outs are not needed.

The high profile national and cross-border bank failures in the last few years (including Fortis, Lehman Brothers, Icelandic banks, Anglo Irish Bank and Dexia) revealed serious shortcomings in the existing tools available to authorities for preventing or tackling failures of systemic banks, those that are intrinsically linked to the wider economy and play a central role in the financial markets. The ability of governments to support banks which are too big to fail with squeezed public finances is becoming increasingly unsustainable.

Therefore, a clear and comprehensive bank recovery and resolution regime – that covers both national and cross-border bank failures - is crucial for ensuring long term financial and economic stability, and for reducing the potential public cost of possible future financial crises.

### **Why are normal insolvency proceedings unsuitable for banks?**

Banks perform functions which are critical for economic activity to take place. They collect funds (deposits and other forms of debt) from private persons and businesses, provide loans for households and businesses, allow savings to be allocated for investment and manage payment systems that are crucial for various sectors of the economy and society.

Banks operate on the basis of public trust. If confidence in them is lost, depositors and other creditors may quickly withdraw their funds, which may lead to their failure. As well as depriving their customers of access to the socially valuable banking functions mentioned above, the failure of a large bank may undermine confidence in other banks, affect their finances and create instability across the financial system as a whole. Thus, through this contagion effect, the value and viability of other banks can be rapidly eroded and the entire financial system could be destabilised.

In normal insolvency procedures, the primary objective is to maximise the value of assets of the failed firm in the interest of creditors. However, these may take many years, in particular for complex institutions leading to uncertainty with a knock on effect on confidence. In contrast, the primary objective of bank resolution is to respond in a rapid and decisive manner to a bank in financial distress to maintain financial stability and minimise losses for society, in particular in relation to taxpayers, while ensuring similar results to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors.

Resolution thus aims to protect certain critical stakeholders and functions of the failing bank (such as depositors and payment systems). Other parts, which are not considered key to financial stability, may be allowed to fail in the normal way. Resolution also ensures that moral hazard is addressed, through minimising the use of taxpayers' money to support failing banks. Instead, shareholders and debt holders will bear an appropriate share of the losses in the event of a failure and will increase discipline on banks by attributing a suitable price to this risk during normal conditions.

### **Why didn't the EU have this framework in place before the crisis?**

Until the crisis, many felt that bank failures could be dealt with at a national level through normal insolvency proceedings. However, the crisis proved that these proceedings would lead to the disorderly failure of some banks with potentially disastrous wider consequences. Therefore, in response to bank failing, a number of Member States adopted measures to ensure the stability of their financial markets. These measures varied greatly between Member States.

The crisis also highlighted the lack of arrangements to deal effectively with failing banks that operated in more than one Member State. It was thus agreed that greater EU financial integration and interconnections between institutions needed to be matched by a common framework of intervention powers and rules. The alternative would be fragmentation and inefficiency in EU banking and financial services, something which would harm the single market and would impair its advantages for consumers, investors and businesses.

What is the relationship between the BRRD and the Single Resolution Mechanism (SRM) in the context of the banking union?

The two pieces of legislation are complementary. The BRRD is a necessary step to improve efficiency and cohesion in ensuring that failing banks in the EU single market can be resolved in a way which preserves financial stability and minimises costs for taxpayers across the EU28. It largely completes the roadmap of financial sector reforms launched since 2009, in line with G20 agreements.

The Single Resolution Mechanism (SRM) is an essential complement to the European Central Bank-led Single Supervisory Mechanism for more integrated bank oversight and crisis management in the banking union. The BRRD provides uniform rules for the whole EU single market and the SRM sets out the institutional and funding architecture for applying those rules in Member States participating in the banking union.

## **II. INTERNATIONAL LEVEL PLAYING FIELD**

### **How does the BRRD relate to work undertaken at international level?**

It conforms to international commitments in this area:

- In November 2008, G20 leaders called for a "review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border institutions".<sup>2</sup>
- At the Pittsburgh summit<sup>3</sup> (September 2009), the G20 committed to act together to "...create more powerful tools to hold large global firms to account for the risks they take" and, more specifically, to "develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future."
- In Seoul (November 2010), the G20 endorsed the Financial Stability Board (FSB) Report on "Reducing the moral hazard posed by systemically important financial institutions"<sup>4</sup> which recommended that "all jurisdictions should undertake the necessary legal reforms to ensure that they have in place a resolution regime which would make feasible the resolution of any financial institution without taxpayer exposure to loss from solvency support while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order of seniority".
- In Cannes (November 2011), the G20 endorsed<sup>5</sup> the Financial Stability Board FSB's core recommendations for effective resolution ("Key Attributes of Effective Resolution Regimes for Financial Institutions"<sup>6</sup>) which jurisdictions should implement to achieve the G20 commitments.

The BRRD is fully in line with the Financial Stability Board (FSB) recommendations. It delivers a comprehensive bail-in tool that ensures that shareholders and creditors bare the cost of bank failure, minimising the burden on taxpayers. It also includes a number of elements where the specificities and divergences in Europe's markets and regulatory structures require particular solutions (e.g. resolution colleges, role of the European Banking Authority).

### **What are the main differences between the EU regime and the US approach?**

In 2010, the US established a resolution framework for systemic financial institutions under the Dodd-Frank Act<sup>8</sup>. The powers provided under this Act complement those that were already in existence to resolve failing banks, whereby the Federal Deposit Insurance

Corporation (FDIC) takes any failing bank into receivership, after which their business is transferred to a new entity or wound down with losses and costs allocated to shareholders and creditors to the necessary degree.

Similarly, the BRRD will also allow authorities to put banks into an orderly resolution in which their critical functions would be preserved by, for example, a sale to a third party or the creation of a bridge bank, while the non-critical parts of the failed institution would be wound down. In cases where it would be in the public interest to restore an institution back to financial viability, the BRRD also allows authorities to write down and convert some of the bank's liabilities (bail-in), and, through this process and subsequent restructuring, enables the bank to continue in business, albeit as a deeply restructured institution. Such a restructuring process would include dilution of shareholders, changes to management, haircutting of creditors and other structural changes so as to ensure that the surviving entity was viable. All resolution operations would also need to adhere to EU state aid rules.

### **III. STRUCTURE OF BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)**

#### **What are the key elements of the BRRD?**

The BRRD lays out a comprehensive set of measures which ensures that:

- banks and authorities make adequate preparation for crises;
- national authorities are equipped with the necessary tools to intervene in a troubled institution at a sufficiently early stage to address developing problems;
- national authorities have harmonised resolution tools and powers to take rapid and effective action when bank failure cannot be avoided;
- authorities cooperate effectively when dealing with the failure of a cross-border bank; and
- banks contribute to resolution financing arrangements to support the costs of restructuring.

The BRRD takes into account the cross-border nature of some banks. It provides for strong coordination between national authorities under the leadership of the group resolution authority to ensure that resolution tools are applied to a cross-border group in a coherent manner across different jurisdictions. Where subsidiaries are particularly significant in one or other Member State, the BRRD provides the possibility for the local authority to undertake specific distinct plans and steps to protect local financial stability.

#### **Key elements**

- **Preparation and prevention:** banks and resolution authorities are required to draw up recovery and resolution plans on how to deal with situations which might lead to financial stress or the failure of a bank. If authorities identify obstacles to resolvability during the course of this planning process, they can require a bank to take appropriate measures, including changes to corporate and legal structures, to ensure that it can be resolved with the available tools in a way that does not threaten financial stability and does not involve costs to taxpayers.
- **Early intervention:** Bank supervisors are accorded an expanded set of powers to enable them to intervene if an institution faces financial distress (e.g. when a bank is in breach of, or is about to breach, regulatory capital requirements), but before

the problems become critical and its financial situation deteriorates irreparably. These powers will include the ability to dismiss the management and appoint a temporary administrator, as well as convening a meeting of shareholders to adopt urgent reforms and requiring the bank to draw up a plan for the restructuring of debt with its creditors.

- **Resolution:** The objective of resolution is to minimise the extent to which the cost of a bank failure is borne by the State and its taxpayers. To this end, should the bank in distress continue to fail, the BRRD provides resolution authorities with a credible set of resolution tools. These include the power to sell or merge the business with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones and to convert to shares or write down the debt of failing banks (bail-in). These tools will ensure that any critical functions are preserved without the need to bail out the bank, and that shareholders and creditors of the bank under resolution bear an appropriate part of the losses. They should also prevent the precipitous loss of value in a failing bank associated with bankruptcy, for example by quickly recapitalizing it and allowing it to be restructured.
- **Cooperation and coordination:** The BRRD also provides a framework to improve cooperation between national authorities so that, should a cross-border banking group fail, national authorities will be able to coordinate resolution measures to protect financial stability in all affected Member States and achieve the most effective outcome for the group as a whole.

### **Can other tools be used?**

Other tools can be used to the extent that they conform to the principles and objectives of resolution set out under the BRRD. In circumstances of very extraordinary systemic stress, authorities may also provide public support instead of imposing losses in full on private creditors. The measures would nonetheless only become available after the bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities and would be subject to the applicable rules on State aid.

### **What are the objectives of resolution and the conditions to trigger it?**

The main aims of a bank resolution are to: 1) safeguard the continuity of essential banking operations, 2) protect depositors, client assets and public funds, 3) minimise risks to financial stability, and 4) avoid the unnecessary destruction of value.

The authorities may determine that a bank needs to be resolved if:

- it has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe,
- all other private sector or supervisory intervention measures have been proved insufficient to restore the bank to viability, and
- winding up the institution under normal insolvency proceedings would risk prolonged uncertainty or financial instability and therefore resolving the bank would be better from a public interest perspective.

Entry into resolution will thus always occur at a point close to or at insolvency. Authorities nonetheless will retain a degree of discretion to ensure that they can intervene before it is too late for resolution to meet its objectives.

## **What resolution tools will be needed?**

With a view to the aforementioned objectives, resolution authorities would be able to exercise clear-cut measures to resolve the situation of the bank when it meets the conditions for resolution. The choice of tools will depend on the specific circumstances of each case and build on options laid out in the resolution plan prepared for the bank. They consist of powers to:

- (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders);
- (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits;
- (iii) separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities; and/or
- (iv) bail in creditors (mechanism to cancel or reduce the liabilities of a failing bank, or to convert debt to equity, as a means of restoring the institution's capital position).

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## **What financial institutions would be covered by the EU regime?**

The BRRD covers deposit-taking banks and large investment firms (e.g. those institutions like Lehman Brothers), because this is where action is needed most urgently. Past crises have demonstrated that banks and investment firms represent the kinds of business models most prone to experience a destabilising loss of confidence in their ability honour their obligations and to give rise to systemic concerns at the point of failure. These institutions are also those subject to harmonised prudential requirements under the Capital Requirements Regulation and Directive.

However, the Commission will continue to work on prevention, management and resolution of financial institutions other than banks, such as market infrastructures, the failure of which are capable of having a systemic effect too.

## **What is the role of the European Banking Authority (EBA)?**

The EBA will play a strong coordination role both during the prevention and early intervention stages (in particular in resolution planning), with a view to facilitating the taking of joint decisions. The BRRD provides the EBA with clear and decisive powers in areas where harmonisation and consistency in rules and practices is key, while avoiding any duplication in the tasks of national authorities responsible for day-to-day oversight and resolution.

## **How does the EU regime apply to the failure of a cross-border group?**

The BRRD will equip national authorities with a set of harmonised tools and to establish a robust framework for information sharing, consultation and cooperation between them. Resolution colleges built around existing supervisory colleges will be at the centre of this.

In order to better deal with large and more complex cross-border groups, the consolidating supervisor would play a leading role in overseeing the development of a recovery plan and the group resolution authority (the authority in the Member State in which the consolidating supervisor under EU banking rules is situated) will be responsible for designing a resolution plan for the whole banking group. The resolution plans could allow for intervention both at the level of the parent or holding or of the subsidiaries, depending on the nature of the group. Coordination would be ensured through resolution colleges and binding technical standards by the EBA. EBA could also carry out binding mediation in case of disagreements. The plans would not dictate how the group operates internally (separated subsidiaries, integrated liquidity and risk management, etc.) but would ensure that the legal structure does not constitute an obstacle to resolvability. The EBA would also help coordinate any joint decisions by national authorities at the stage of early intervention.

Groups may also enter into arrangements, approved by regulators and shareholders, of financial support between constituent entities for restoring the group's financial health efficiently (see below).

The exercise of any resolution powers in relation to various entities of the group will thus be prepared in advance and take place as far as possible in a coordinated and consistent manner.

## **How would financial support within groups work?**

As part of the planning and early intervention phase, the BRRD enables entities in a group to enter into agreements to provide help to other parts of the group (parent company or subsidiary) in case of difficulties. This provision works both ways so a parent company can help the subsidiary and the subsidiary can help the parent company.

Such help is subject to approval by the supervisor of each subsidiary/parent company which is asked to help and by the shareholders of each entity. It must aim to restore or ensure the viability of the group as a whole, must not damage the solvency of any entity providing support, and must not cause a breach of regulatory capital requirements.

It might be in the interest of a subsidiary to help the group because the overall group will be stronger and continue for example to be able to provide services to the subsidiary. But this cannot be done against the subsidiary's will.

## **IV. BAIL-IN**

### **What is bail-in?**

The main aim of bail-in is to stabilise a failing bank so that its essential services can continue, without the need for bail-out by public funds. The tool enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity so that the bank can continue as a going concern. This would avoid disruption to the financial system that would likely be caused by stopping or interrupting the bank's critical services, and give the authorities time to reorganise the bank or wind down parts

of its business in an orderly manner – an 'open bank resolution'. In the process, shareholders should be severely diluted or wiped out, and management be replaced.

In a 'closed bank resolution' the bank would be split in two, a good bank or bridge bank and a bad bank. The good bank-bridge bank is a newly created legal entity which continues to operate, while the old bad bank is liquidated. Bank creditors that are not systemic can either be left with the old bank and undergo losses as part of the liquidation or be transferred to the new bank either reducing their claims or converting them into equity.

### **What instruments will bail-in apply to and in what order?**

Bail-in will potentially apply to any liabilities of the institution not backed by assets or collateral. It will not apply to deposits protected by a deposit guarantee scheme, short-term inter-bank lending or claims of clearing houses and payment and settlement systems (that have a remaining maturity of seven days), client assets, or liabilities such as salaries, pensions, or taxes. In exceptional circumstances, authorities can choose to exclude other liabilities on a case-by-case basis, if strictly necessary to ensure the continuity of critical services or to prevent widespread and disruptive contagion to other parts of the financial system, or if they cannot be bailed in in a reasonable timeframe.

The write down will follow the ordinary allocation of losses and ranking in insolvency. Equity has to absorb losses in full before any debt claim is subject to write-down. After shares and other similar instruments, it will first, if necessary, impose losses evenly on holders of subordinated debt and then evenly on senior debt-holders.

Deposits from SMEs and natural persons, including in excess of EUR 100,000, will be preferred over senior creditors. The Deposit Guarantee Scheme to which the institution is affiliated (and the deposits it covers) will in turn rank above these. It will also be liable to assume losses for the amount that it would have had to bear if the bank had been wound up under normal insolvency proceedings.

### **Are institutions required to maintain a minimum level of liabilities subject to bail-in?**

For bail-in tool to be a credible resolution tool, it is necessary to ensure that there are sufficient 'in-scope' liabilities at the point when a resolution authority determines that an institution meets the conditions for resolution and that writing down or converting the debt of an institution would be in line with the objectives of resolution.

By definition, this will depend on the systemic footprint of different institutions. Depending on their risk profile, complexity, size, interconnectedness etc., all banks should maintain (subject to on-going verification by authorities), a percentage of their liabilities in the form of shares, contingent capital and other unsecured liabilities not explicitly excluded from bail-in. The Commission, upon a review by EBA, could specify further criteria to ensure similar banks are subject to the same standards.

### **Will the bail-in tool apply immediately to all outstanding debt or only after a transitional period?**

The BRRD states that the tool will apply as of 1 January 2016 at the latest to all outstanding and newly issued debt. Member States can choose to apply the tool before 2016.

## **What does the BRRD provide for in terms of thresholds of loss absorption and recapitalisation?**

The exact degree of burden-sharing would depend on the bank in question, the amount of losses that would need to be covered, and the wider economic situation.

Bail-in would a priori apply to any liability which is not excluded. In exceptional circumstances and where strictly necessary for financial stability, bail in could be discontinued upon reaching 8% of total liabilities including capital (or alternatively 20% of risk weighted assets in specific situations). After this, resolution funds could assume 5% of the losses. Public funds could either be provided to give limited backup support to the resolution fund at this point or, in extraordinary circumstances, directly to cover losses after the 5% contribution from the resolution fund and if bail-in has reached eligible deposits. Only in the scenario of severe systemic stress could public funds replace the resolution fund immediately, but only after bail-in up to 8% of total liabilities.

## **V. FINANCING OF RESOLUTION**

### **How will the cost of bank resolution be financed?**

In order to be effective the resolution tools require a certain amount of funding. For example, if the authorities create a bridge bank, it will need capital or short term loans to be able to operate. These costs should be borne by the banking sector rather than taxpayers.

This is why every Member State will have to set up financing arrangements funded with contributions from banks and investment firms in proportion to their liabilities and risk profile. Banks will contribute in relation to their share of specific liabilities of the total size of the national financial sector so that those who contribute most could potentially benefit most in case they enter resolution.

The national financing arrangements would be financed ex-ante. To that end contributions will be raised from banks annually in order to reach a target funding level of at least 1% of covered deposits over a 10 year period<sup>9</sup>.

Each national fund will finance the resolution of the entities established in its own territory. For cross-border groups, the relevant national arrangements will be required to contribute to a financing plan pre-agreed between the competent resolution authorities. If the ex-ante funds are insufficient to deal with the resolution of an institution, further contributions will be raised (ex post).

In case of need, national financing schemes will also be able to borrow from one another. Other schemes can provide support unless they consider that such lending would for instance leave them without sufficient funds to deal with an imminent resolution action in their own national market.

### **Can the resolution financing arrangement be used to recapitalise an institution?**

Shareholders and creditors of the bank under resolution should bear the cost of the bank failure in the first instance. Recapitalisation should be financed primarily by these stakeholders. However, the BRRD agreement provides that after these stakeholders have borne sufficient losses (i.e. 8% of the liabilities of the bank under resolution) through write-down or conversion, in exceptional circumstances the resolution financing arrangement may bear remaining losses but only up to 5% of the bank's liabilities.

This restrictive approach is important to combat the moral hazard that might arise with the creation of a large fund. Consequently, the main use of the resolution funds will be limited to, for example, providing loans to a bridge institution, purchasing specific assets of an institution under resolution, guarantee certain assets or liabilities of the institution under resolution, or in exceptional circumstances – as mentioned above – contributing to loss absorption by replacing creditors who would have been bailed in..

## **VI OTHER ISSUES**

What is the purpose of appointing a temporary administrator and wouldn't this appointment lead to loss of confidence in and consequent runs on the firm in question?

As part of the early intervention measures, a temporary administrator could be appointed by the authorities to replace or assist the management of a troubled institution. Under the close oversight of the banking supervisor, his/her primary function would be to restore the financial situation and the sound management of the bank. To this end, the temporary administrator would have all the powers of the managers of the company, and could take decisions to, for example, implement a part of the recovery plan, or take steps to reorganise its ownership or business structure.

This tool already exists in some Member States, and has been used successfully in the past. It has been proven to create confidence (e.g. there have been no depositor runs in Italy on the appointment of such a special manager). Consequently, its inclusion in the EU framework will enhance the tools available to supervisors to prevent failure.

### **Resolution measures may interfere with the rights of shareholders and creditors. How is this dealt with?**

The EU recovery and resolution framework incorporates adequate safeguards to protect the interests of stakeholders affected by resolution measures. Notably, this includes the principle that no creditor should be worse off under resolution than it would have been had the bank been wound up under applicable insolvency law proceedings.

Rights of shareholders and debt holders are also recognised by appropriate mechanisms for judicial redress and compensation. However, a balance has been provided between protecting the legitimate interests of shareholders and enabling resolution authorities to intervene quickly and decisively to restructure a failing institution or group to minimise contagion and ensure the stability of the banking system in the affected Member States. Therefore, remedies for wrongful decisions are limited to compensation for damages suffered and do not affect any administrative acts and/or transactions concluded as part of the resolution.

### **How does the EU bank recovery and resolution framework square with the resolution regime adopted in some Member States?**

Many Member States already have in place or have recently introduced mechanisms at national level to resolve failing banks (e.g. the UK, Germany, Denmark, Ireland, Greece, Portugal, the Netherlands, France and Italy). These regimes pursue the same objectives and are generally compatible with the framework set out under the BRRD.

The Directive sets out a minimum harmonised set of tools and powers, so that Member States would be able to introduce additional tools at national level to deal with crises, as long as they are compatible with the resolution objectives and principles set out in the BRRD, as well as State aid rules provided for at EU level. For Member States participating

in the Banking Union, the Single Resolution Mechanism fully harmonises the range of available tools.

### **How does the EU Framework square with the EU State Aid rules?**

Although the EU BRRD aims to minimise losses for society, in particular to avoid as far as possible the use of taxpayers' money during a bank failure, the framework does not prohibit the use of public funds to finance bank resolution notably in systemic crises. The granting of any rescue aid by a State in systemic crises is governed by the EU framework for State Aid.<sup>11</sup> The framework on bank recovery and resolution does not prejudice these rules. They will continue to apply in the context of a bank resolution, if a form of financing that is supplied qualifies as State aid according to the applicable rules.

On 10 July 2013 the Commission adopted a Communication on State aid rules to support measures in favour of banks in the context of the financial crisis (the so-called Banking Communication) which is applicable since 1 August 2013. Its burden-sharing requirements apply to all state aid granted to banks, not only resolution scenarios. They apply before bail-in enters into force as per the Bank Recovery and Resolution Directive.

First, no contribution will be required from senior debt holders, in particular from insured deposits, uninsured deposits, bonds and all other senior debts.

Banks intending to resort to State aid should undertake all measures to minimise the public intervention. To that end, a bank with a capital shortfall should first carry out all possible capital raising measures by private means before it can resort to any public support. The Member State and the bank have to set up a capital raising plan which is to be endorsed by the competent supervisory authority. Capital raising measures can, for example, include rights issues, a voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive, liability management exercises which should in principle be 100 % capital generating, sales of capital-generating assets and portfolios, securitisation of portfolios in order to generate capital from non-core activities, or an earnings retention.

Only if those measures are not sufficient to fill the capital shortfall, then shareholders and subordinated creditors will be required to contribute:

In cases where the capital ratio of the bank remains above the EU regulatory minimum, the bank should normally be able to restore the capital position on its own, in particular through the capital raising measures mentioned above. If there are no other possibilities, including any other supervisory action such as early intervention measures or other remedial actions to overcome the shortfall defined by the supervisory authority, then subordinated debt must be converted into equity before State aid is granted.

In cases where the bank no longer meets the minimum regulatory capital requirements, subordinated debt must be converted or written down before State aid is granted.

Under the Banking Communication, the Commission can make an exception to the burden sharing requirements only when the implementation of writing down or conversion of subordinated creditors would lead to disproportionate results or would endanger financial stability. This could cover cases where the aid amount to be received is small in comparison to a bank's risk weighted assets and the original capital shortfall has been significantly reduced through capital raising measures. The Commission will decide about the application of the exception on a case by case basis.

## **How does the Bank Recovery and Resolution Directive relate to the Capital Requirements Regulation/Directive IV (CRR/CRD IV) already in force?**

These legislative texts complement each other. CRR/CRD IV ([MEMO/13/690](#)) strengthens the prudential requirements and supervision related to banks and investment firms. The bank recovery and resolution framework contains measures on how to address a banking crisis at an early stage and, if the crisis develops further, how to resolve a failing bank in an orderly manner without damaging the financial system and by extension, the real economy. While CRR/CRD IV reduces the probability of banks failing, the BRRD framework manages a failure and reduces the societal impact of such failures.

## **ANNEX**

### **Key Numbers**

#### **Process and public consultations:**

Two online public consultations were run between 2009 and 2011. In addition an informal discussion document was published in March 2012. Together, over 250 responses were received to the two online consultations and to the discussion document. 14 A public hearing was organised on 19 March 2010.

#### **Crisis costs:**

Crisis-related losses incurred by European banks between 2007 and 2010: almost €1 trillion or 8% of EU GDP (IMF). EU GDP contraction in 2009 due to the economic recession induced by the financial crisis: 6% (Eurostat). The approved state aid measures in the form of recapitalisation and asset relief measures between October 2008 and December 2012 amount to €591.9 billion or 4.6% of EU 2012 GDP (Commission). If we include guarantees, this figure would amount to €1.6 trillion or 13% of EU GDP (Commission) for the period 2008-2010 only. See [IP/13/1301](#).

**Economic impact of the BRRD** (notably the bail-in tool and funding of the resolution framework):

The European Commission analysed the costs and benefits, before presenting this text in the impact assessment accompanying its proposal.

The costs of the framework are taken to derive notably from the potential increase in the funding cost of banks due to the removal of the implicit state support and from the costs of setting up resolution funds. Such increases in banks' costs might have negative effects for GDP. On the other hand, the improved stability of the financial sector, and reduced likelihood of systemic crises and risks for taxpayers' money to recapitalise failing banks, would have a much larger positive effect on GDP.

The framework seeks to design an approach which is both efficient and effective. In other words, new costs for banks should be minimal while the framework should work in a variety of crises of different magnitude (losses by EU banks during the recent crisis from 2008 to 2012 are taken as a key reference point).

The efficiency and effectiveness of the proposed framework is to be seen in the context of a joint calibration of Basel III rules, funding available under Deposit Guarantee Schemes (DGS) and the bail-in tool. The new capital requirements under the Basel III accord (which reduces the probability of bank failures) are expected to generate net benefits equal to 0.14 % of the EU's GDP annually. The necessary funding of DGS or specific resolution funds are expected to bring positive net benefits equal to 0.2-0.3 % of the EU's GDP annually. The bail-in tool could produce economic net benefits equal to 0.3-0.6 % of the

EU's GDP annually. Overall, these measures are expected to generate a cumulative net benefit equal to 0.7-1.0 % of the EU's GDP annually.

**Table 1. Cumulative impact of Basel III, RF/DGS and Debt Write Down tool (bail-in) (costs and benefits as % of annual GDP.)**

|                                     | Basel III | DGS/RF | Bail-in        | Sum            |
|-------------------------------------|-----------|--------|----------------|----------------|
| Costs (% of EU GDP annually)        | 0.16%     | 0.04%  | 0.14%<br>0.42% | 0.34%<br>0.62% |
| Benefits (% of EU GDP annually)     | 0.30%     | 0.32%  | 0.76%          | 1.38%          |
| Net Benefits (% of EU GDP annually) | 0.14%     | 0.28%  | 0.34%<br>0.62% | 0.76%<br>1.04% |

The costs (in terms GDP, investment, volume of loans, etc.) are estimated through a simple methodology also used by the Bank of England, and validated by the estimations of a dynamic general equilibrium macroeconomic model (QUEST III) that has been extended to incorporate financial intermediation by the banking sector.

The benefits are estimated using the SYMBOL model, developed by the European Commission. This model allows estimating the aggregated losses deriving from bank defaults, explicitly linking Basel capital requirements to the other key tools of the banking safety net (i.e. DGS). Macroeconomic benefits are calculated by multiplying the reduction in the probability of a systemic banking crisis (due to improved regulation) times its total (avoided) costs.

These findings have on the whole been supported by subsequent studies by researchers and international organisations.

<sup>1</sup> : According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP. Between October 2008 and December 2012, the Commission approved €591.9 billion or 4.6% of EU 2012 GDP in state aid measures in the form of recapitalisation and asset relief measures.

<sup>2</sup> : <http://www.g20.org/images/stories/docs/eng/washington.pdf>

<sup>3</sup> : <http://www.g20.org/images/stories/docs/eng/pittsburgh.pdf>

<sup>4</sup> : [http://www.financialstabilityboard.org/publications/r\\_101111a.pdf](http://www.financialstabilityboard.org/publications/r_101111a.pdf)

<sup>5</sup> : <http://www.g20.org/images/stories/docs/eng/cannes.pdf>

<sup>6</sup> : [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

<sup>7</sup> : [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

<sup>8</sup> : <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>

<sup>9</sup> : 1% represents around €80 billion for the Union and €65 billion for the Euro area (as of March 2012, based on data from the European Commission, the European Central Bank and Bankscope).

<sup>10</sup> : [COM\(2010\)579](#)

<sup>11</sup> : The State aid rules established in response to the financial crisis are available at [http://ec.europa.eu/competition/state\\_aid/legislation/temporary.html](http://ec.europa.eu/competition/state_aid/legislation/temporary.html)

<sup>12</sup> : Communication "A roadmap for stability and growth" : [http://ec.europa.eu/commission\\_2010-2014/president/news/speeches-statements/pdf/20111012communication\\_roadmap\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/speeches-statements/pdf/20111012communication_roadmap_en.pdf)

<sup>13</sup> : [http://ec.europa.eu/commission\\_2010-2014/barnier/headlines/news/2012/01/20120116\\_en.htm](http://ec.europa.eu/commission_2010-2014/barnier/headlines/news/2012/01/20120116_en.htm)

<sup>14</sup> : All documents (apart from submissions to the informal discussion document) are available at [http://ec.europa.eu/internal\\_market/bank/crisis\\_management/index\\_en.htm](http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm)