Resolution

Background

Prior to the recent regulatory innovations arising from the transposition in Italy of the BRRD, bank recovery and resolution measures consisted of extraordinary administration (Amministrazione straordinaria) and compulsory liquidation (liquidazione coatta amministrativa).

The aim of the first was to restructure the bank, while the second was geared towards winding up the bank's activities and settling creditors' claims through the distribution of the proceeds of the bank's assets liquidated during compulsory liquidation (or through the assumption of the bank's liabilities by another bank with proven solvency).

The aforesaid two procedures **have been maintained**, although with some changes (in particular, with regards to the requirements to be met in order for compulsory administration to be ordered), however provisions governing bank crisis management have also been supplemented by the introduction of brand-new bank crisis management procedures, which include an actual insolvency procedure, known as "bank resolution", which offers an alternative to extraordinary administration.

1. Extraordinary administration of the bank.

Article 70 Tub stipulates that the bank may be subject to extraordinary administration by the Bank of Italy, through the termination of the governing and supervisory bodies (and consequent replacement thereof, respectively, with one or more extraordinary court-appointed administrators and with a monitoring committee; the functions of the meeting bodies, meanwhile, are merely suspended), when

(i) there are "*serious breaches of laws, regulations, or bylaws*"; and
(ii) "*serious loss of assets are expected*".

In principle, provisions for the extraordinary administration of banks do not include the production of particular effects in relation to third parties, i.e. with regards to legal relationships with third parties (customers, suppliers, employees, savers, borrowing businesses, etc.) In principle, no changes are caused by the bank's subjection to the procedure.

Administration and business proceed as normal, both as regards the establishment of new legal relationships and the performance of pending legal relationships, except that both are now entrusted to the committee and not to the ordinary governing body, as it has been terminated.

Furthermore, it is envisaged that in exceptional circumstances and if the need arises to protect creditors' interests, a suspension of payments (of debts outstanding at the time the procedure is started) may be ordered, pursuant to Article 74 Tub. However, the suspension may be ordered for one month only (extendable for a maximum of two more).

In the past, the purpose of the extraordinary administration was to:

a) remove the governing and supervisory bodies;

b) subject the bank's operations to state control; – through the appointment of new governing and supervisory bodies designated by the Bank of Italy -;

c) ensure continuation of current banking operations (ruling out, therefore, the standard effects of in-court debt-restructuring proceedings", such as payments being frozen, a hold being placed on all new transactions (including new loans); enforcement or interim action against the failing company etc.);

d) assess whether the performance, equity, and financial conditions exist for the bank to return to ordinary management, subject to the appointment of new directors and new supervisory bodies (a situation which does not occur often);

e) identification of another bank willing to acquire the bank subject to the extraordinary administration (the most common solution).

This procedure produced good results as long as other banks were interested in acquiring the banks in difficulty. Since the global economic crisis marked by the bank crisis that occurred first in the United States and subsequently in the major European countries, banks have no longer been interested in increasing their number of branches (which were already too numerous) or employees (who were already being laid off due to the increased computerisation of banking services), extraordinary administration procedures have no longer been able to find buyers for failing banks. The measure has become less useful and its future use would appear to be much less significant.

One reason for this stands out in particular and that is the difficulty in remaining on the market in the absence of a full operational management (and specific skills). A bank under the control of a court-appointed administrator for a few months, pending the takeover of a new, stronger and more competitive bank, can maintain a certain value and a reason for existing; a bank placed in the hands of a 'conservative' manager (as a court-ordered administrator inevitably is) for a lengthy period (sometimes lasting up to two years or more) is destined to lose its best customers and market shares to the rival banks, with the result being that the temporary period of difficulty it was experiencing when the procedure was started has turned into an irreversible crisis.

2. Compulsory liquidation

Article 80, section 1, Tub regulates the revocability of the bank's licence to trade and the compulsory subjection of the bank to liquidation.

Until the recent implementation of the BRRD, the conditions for subjecting banks to compulsory liquidation (CL) are the same as those envisaged for the extraordinary administration measure (mismanagement, breaches, losses) of "***exceptional gravity***".

The transposition of the BRRD into Italian law has also led to important innovations in the objective prerequisites for a bank's subjection to compulsory administration.

Today, the choice of measure with which to tackle a bank crisis no longer depends on the assessment of the level of gravity thereof when the crisis arises, but on the assessment of the ability **to remedy the crisis situation**, starting from the least invasive measure and then moving on to measures with increasing impact.

In particular, the compulsory liquidation of a bank is only available if the conditions do not exist to begin the new procedure known as bank resolution: and more precisely, it is chosen if the bank resolution procedure "*makes it possible to remedy the [bank's] distress situation or risk of distress*".

CL means the immediate exit from the market of the failed bank: its license is withdrawn, payments of all its liabilities are suspended and its assets are wound down. While covered depositors are reimbursed, other creditors must line up and file their claims in the insolvency proceedings to receive their share of the proceeds resulting from the liquidation of the assets according to the priority set by the insolvency law.

This entails **several negative consequences**:

1. the going concern's business value is destroyed; this translates into large losses for all the bank's creditors (senior ones included) other than insured depositors;

2. due to the immediate interruption of lending, borrowers are exposed to liquidity constraints which, especially for SMEs that cannot easily find alternative source of financing, can rapidly evolve into solvency problems. All relationships are lost and depositors abruptly lose access to their funds. While insured depositors only suffer a freeze until the DGS pay-out, other depositors and liabilities holders are subject to considerable uncertainty as to the timing and magnitude of the recovery of their funds;

3. managing the liquidation procedure entails high administrative costs at the expense of what creditors, including the DGS, can recover. In addition, this activity implies trade-offs and complex decisions regarding the asset sale process. If the liquidator sells assets quickly it may obtain low prices even for high-quality assets, especially in a downturn. On the other hand, quick sales avoid operational complexity and costs associated with the management of the assets.

4. the DGS immediately faces potentially large pay-outs to reimburse covered depositors and risks recovering only part of the amount paid due to low recovery rates in the liquidation procedure and the time lag between the payout and the distribution of the proceeds;

5. risks for financial stability can be material, for at least two reasons. First, disorderly liquidation may have a negative impact on the confidence of other banks' depositors. Depositor protection arrangements might not suffice to avoid a crisis of confidence on the part of non-insured liability holders. The likelihood of such an event may also depend on the business cycle (contagion effects would be more likely in a negative phase, when the number of weaker banks is larger) and on other factors related to market structure. Second, in the case of a crisis of a relatively large bank, pay-outs may exceed the financial capacity of both the DGS (in light of the existing limits on banks' contributions) and the participating banks. This could potentially trigger a domino effect.

In sum, **a disorderly piecemeal liquidation is a painful process that may have disruptive effects** for depositors, banks' creditors and other stakeholders, and in general for the real economy: for these reasons it is de facto largely untested, at least for banks of a non-negligible size.

Disorderly liquidation contradicts the main goal of any crisis management procedure, i.e. to **minimize the unnecessary destruction of the going concern's value**.

The resolution procedure aims, inter alia, to maintain the going concern's value.

Resolution: objectives

The EU legislator first specifies the objectives of "resolution". In reality it seems that the identification of the objectives goes beyond resolution alone and constitutes a general justification of the whole Directive; this impression is reinforced by a reading of the initial recitals of the Directive.

In any case, the objectives are listed in **art. 31 BRRD**, as follows:

a) to ensure the continuity of critical functions;

b) to avoid significant adverse effects on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline;

(c) to protect public funds by minimising reliance on extraordinary public financial support;

(d) to protect depositors covered by Directive 94/19/EU and investors covered by Directive 97/9/EC;

(e) to protect client funds and client assets.

The EU legislator does not explicitly state whether these objectives **are all to be considered on the same level or whether, instead, they are listed according to a precise order of priority**. The second hypothesis seems more plausible.

Note, in fact, that the objectives a) and b) complement each other and represent the ultimate reason for the legislation: preserving the functioning and stability of the credit/financial system is crucial. This confirms a constant and traditional aim of credit and financial systems in developed countries.

The innovation lies, instead, in the fact that the EU legislator has decided that a limit to public spending for this type of intervention must be set.

Lastly, the protection of covered deposits is guaranteed within the limit of the DGSs' capacity to intervene and, in any case, will not weigh on public finances but on the schemes themselves.

The protection of "client funds and client assets" will be guaranteed only if they are separate funds from those of the institution under resolution, while transferred funds, with the obligation of repayment, run the risk (as we shall clarify later) of being decimated.

Principles

In fulfilling its resolution-related tasks, the authority must comply with a series of principles laid down under **art. 34 BRRD**, i.e.:

(a) the **shareholders** of the institution under resolution **bear first losses**;

(b) **creditors** of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings…;

(c) management body and senior management of the institution under resolution are replaced, except in those cases when the retention of the management body and senior management, in whole or in part, as appropriate to the circumstances, is considered to be necessary for the achievement of the resolution objectives;

(d) management body and senior management of the institution under resolution shall provide all necessary assistance for the achievement of the resolution objectives;

(e) natural and legal persons are made liable, subject to Member State law, under civil or criminal law for their responsibility for the failure of the institution;

(f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;

(g) no creditor shall incur greater losses than would have been incurred if the institution or entity …. had been wound up under normal insolvency proceedings in accordance with the safeguards…;

(h) covered deposits are fully protected;

The principles listed above under letters a), b), f), g) and h) express the idea, underlying the whole Directive, **that losses must be internalized**, or in other words borne by the institution under resolution. At the same time, they constitute the other aspect of the key objective, as mentioned above, according to which **public funds are to be safeguarded**.

However, from the point of view of recovery, penalization of the institution through its shareholders and holders of "quasi capital" alone may clearly not be sufficient: it may also be necessary to penalize the institution's creditors, financers, providers and employees.

In relation to these figures it is no longer correct to speak of internalization. On the other hand, even if penalized, these categories, with the exception of depositors protected for up to a hundred thousand euros per deposit, will not suffer losses greater "*than would have been incurred if the institution […] had been wound up under normal insolvency proceedings*" (**no creditor worse off principle – NCWO**). In other words, in view of avoiding disproportionate interference with his/her property rights, no creditor may incur greater losses than would have been incurred if a designated entity had been wound up under normal insolvency proceedings at the time that the resolution decision is taken.

The rule seems to be clear and provide a sufficient level of protection, but remains **difficult** to apply in practice, given the evident difference between real liquidation and the preventive simulation of liquidation. This difference will certainly lead to numerous disputes, which will impact the financial statement of the bridge institution and of any end purchaser of the assets and liabilities of the institution under resolution. The result will be diminished legal and bookkeeping clarity and inefficiency in the use of this tool.

Letters c), d) and e), in turn, penalize the administrators and managers. This choice is correct and appropriate, but will require the adaptation of domestic systems to ensure the existence of relevant practical consequences in terms of deterrents to bad behaviour or a too-great propensity for risk on the part of administrators and other managers.

The resolution procedure

Conditions

A resolution scheme must be adopted by the SRB or a NRA, in principle depending on the significance of the relevant entity or group covered by the SRM.

If a resolution action requires use of the Fund, the **SRB must always adopt the resolution scheme**, irrespective of the significance of the relevant entity or group covered by the SRM (rt. 7(3), second paragraph, SRMR).

A resolution scheme must be adopted if the following three conditions are met (**art. 32 BRRD, Art. 18(1) SRMR**).

Condition 1: Failing or Likely to Fail

First, the entity is failing or likely to fail: this is deemed to be the case in one or more of the following circumstances:

(1) the entity infringes, or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorization in a way that would justify the withdrawal of the authorization by the ECB, including but not limited to the fact that the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds;

(2) the assets of the entity are, or there are objective elements to support a determination that the assets of the entity will, in the near future, be less than its liabilities;

(3) the entity is or there are objective elements to support a determination that the entity will, in the near future, be unable to pay its debts or other liabilities as they fall due;

(4) extraordinary public financial support is required.

The conditions reveal first that the concept of failure includes, but does not coincide, with the state of insolvency, and second, for the same reason, that failure as an objective condition for resolution has some aspects in common with the conditions for the compulsory administrative liquidation of banks.

An assessment of the condition that an entity is failing or likely to fail, **is made by the ECB**, **after consulting the SRB**, or, as the case may be, a national resolution authority, to be communicated without delay to the Commission and the SRB, or as the case may be, a national resolution authority.

Condition n. 2: no reasonable prospect

Having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, including measures by an institutional protection scheme (IPS), or supervisory action, including early intervention measures or the write-down or conversion of capital instruments, would prevent its failure within a reasonable timeframe.

An assessment of the condition that there are no reasonable alternatives, is made by the **SRB in its executive session** or, where applicable, by the NRA, each time in close cooperation with the ECB. The ECB may also inform the SRB or the national resolution authorities concerned that it considers that this condition is met. If the members of the executive session of the SRB are not able to reach a joint agreement by consensus within a deadline set by the Chair, a decision must be taken by simple majority of the Chair and the four further full-time members.

Condition 3: Resolution Action Necessary in the Public Interest

A resolution action is treated as in the public interest if (**Art. 18(1)(c) SRM Regulation**):

(1) it is necessary for the achievement of, and is proportionate to one or more of the resolution objectives and

(2) winding up of the entity under normal insolvency proceedings would not meet those resolution objectives to the same extent.

Although this is not expressly stipulated in the SRM Regulation, it seems that the **determination** of the condition that a resolution action is necessary in the public interest, **is made by the SRB,** by consensus or (if that is not possible within a deadline set by the Chair) by simple majority in its executive session or, where applicable, by the NRAs. If the members of the executive session of the SRB are not able to reach a joint agreement by consensus within a deadline set by the Chair, a decision must be taken by simple majority of the Chair and the four further full-time members.

The exemptions – art. 32 (4) BRRD

If the extraordinary public financial support required takes any of the following three forms, in order to remedy a "serious disruption" in the national economy and preserve financial stability, the resolution regime is not activated.

The first form is support granted by means of a State guarantee to back liquidity facilities provided by the central bank on conditions set by it; the second is support granted by means of a State guarantee of newly issued liabilities. With regard to both these cases, recital (57) (seventh sentence) SRMR considers that in order to preserve financial stability, in particular in the case of a systemic liquidity shortage, State guarantees on liquidity facilities provided by central banks or State guarantees of newly issued liabilities to remedy a serious disturbance in the economy of a Member State should not trigger the resolution framework provided that a number of conditions are met (see the recital's eight sentence).

Even though in principle Member States' guarantees for equity claims are prohibited, a third form of State intervention is the precautionary recapitalisation (see Mps).

In each of these above-mentioned cases, the guarantee or equivalent measures must meet the following five criteria:

1) firstly, be confined to *solvent institutions*;
2) secondly, be *conditional on final approval by the Commission under the EU State aid rules*;
3) thirdly, be of a *precautionary and temporary nature*;
4) fourthly, be *proportionate to remedy the consequences of the serious disruption*;
5) finally, not be used to offset losses that the credit institution has incurred or is likely to incur in the near future. In addition, recital (57) (tenth sentence) SRMR considers that when providing a guarantee for newly issued liabilities other than equity (i.e. in the first two cases), a Member State should ensure that the guarantee is sufficiently remunerated by the credit institution.

Involvement Commission and Council

In the case of adoption of a resolution scheme by the SRB, immediately after the adoption of the resolution scheme, the **SRB must transmit it to the Commission** (**Art. 18(7) SRMR**).

Within 24 hours after the transmission of the resolution scheme by the SRB, the Commission acting by simple majority, must either endorse the scheme, or object to it on the ground that (1) the condition that the relevant entity is failing or likely to fail is not fulfilled and/or (2) the condition that there is no reasonable prospect for the relevant entity is not fulfilled.

Within 12 hours from the transmission of the resolution scheme, the Commission acting by simple majority, may propose to the Council (1) to object to the resolution scheme because the criterion that the resolution action is necessary in the public interest is not fulfilled; (2) to approve or object a material modification of the amount of the Fund provided for in the resolution scheme of the SRB.

The Council acts by simple majority of the Member States. So, if the Commission believes that the Fund should make a greater or lesser contribution to the cost of winding up a failing bank, the Council will be able to issue an objection and ask the SRB to change the resolution scheme.

The Council or the Commission, as the case may be, must provide reasons for the exercise of their power of objection.

The timing for the Commission and Council to exercise their power of endorsement / approval and objection is rather sharp, but particularly the Commission will in practice participate as an observer in meetings of the SRB in an early stage, thus enabling an efficient decision-making process. See also recital 26 SRM Regulation:

'*As an observer to the meetings of the [SRB], the Commission should, on an ongoing basis, check that the resolution scheme adopted by the [SRB] complies fully with this Regulation, balances appropriately the different objectives and interests at stake, respects the public interest and that the integrity of the internal market is preserved. Considering that the resolution action requires a very speedy decision-making process, the Council and the Commission should cooperate closely and the Council should not duplicate the preparatory work already under- taken by the Commission*.'

The power of endorsement / approval and objection by the Commission and the Council is explained by the Meroni-doctrine, which limits the delegation of discretionary powers to EU agencies, including the SRB. Of course, particularly the involvement of the Council is also explained by the considerable impact of the resolution decisions on the financial stability of Member States and on the Union as such, as well as on the fiscal sovereignty of Member States.

In any event, where the Council objects by simple majority of the Member States, to the placing of an institution under resolution on the ground that the public interest criterion is not fulfilled, the relevant entity must be wound up in accordance with the applicable national law (Art. 18(8) SRMR).

The resolution scheme may enter into force only if no objection has been expressed by the Council or the Commission within a period of 24 hours after its transmission by the SRB.

All in all, the procedure should take place within 24 hours, or, at most, 32 hours (8 hours being the period for the SRB to modify the scheme in response to Commission sion or Council objections). This timing makes it possible to adopt a resolution scheme over the weekend, between the closure of the markets in the United States on Friday night and the opening of the markets in Asia the following Monday morning. Hopefully this timeframe will be workable in practice.

Role Commission in Case of State Aid or Aid from the Fund (art. 107(1) TFEU/art. 19(3) SRMR)

Where resolution action involves the granting of State aid or aid from the Fund, the adoption of the resolution scheme does not take place until such time as the Commission acting by simple majority, has adopted a positive or conditional decision concerning the compatibility of the use of such aid with the internal market.

The SRM Regulation unfortunately does not provide a time limit for the Commission's decision. In any event, on application by a member State, the Council may, acting unanimously, decide that the use of the Fund is considered to be compatible with the internal market, if such decision is justified by exceptional circumstances. If, however, the Council has not made its attitude known within seven days of the application being made, the Commission must give its decision on the case.

Valuation for the purposes of resolution

1. The ex-ante valuation(s)

(1) Various valuations must be carried out for the purposes of resolution, the objective of which is the protection of shareholders' and creditors' rights.

The valuation framework is governed by Article 20 SRMR, the structure of which is very close to that of Articles 36 and 74 BRRD.

Before deciding on a resolution action or the exercise of the power to write down or convert relevant capital instruments, the Board must ensure that a fair, prudent and realistic valuation of the assets and liabilities of a designated entity is carried out by a person independent from any public authority, including the Board and the NRA.

The objectives of this valuation are the followings:

- *firstly,* to inform the determination of whether the conditions for resolution or the conditions for the write-down or conversion of capital instruments are met;
- *secondly*, if the conditions for resolution are met, to inform the decision on the appropriate resolution action to be taken in respect of the designated entity concerned;

- *thirdly*, when the power to write down or convert relevant capital instruments is applied, to inform the decision on the extent of both the write-down or conversion of such instruments and the cancellation or dilution of instruments of ownership;
- *fourthly*, if the bail-in tool is applied, to inform the decision on the extent of the write-down or conversion of eligible liabilities;
- in addition, when the bridge institution or the asset separation tool is applied, to inform the decision on the instruments of ownership, assets, rights and/or liabilities to be transferred and the decision on the value of any consideration to be paid to the institution under resolution or to the owners of the instruments of ownership,
- *sixthly,* if the sale of business tool is applied, to inform both the decision on the instruments of ownership, assets, rights, and/or liabilities to be transferred and the Board's understanding of what constitutes 'commercial terms' for the purposes of Article 24(2), point (b);
- and finally, in all cases, to ensure that any losses on the designated entity's assets are fully recognised at the moment when the resolution tools are applied or the power to write down or convert relevant capital instruments is exercised.

Very Important -> art. 20, par. 9 SRMR: *The valuation shall indicate the subdivision of the creditors in classes in accordance with the priority of claims referred to in Article 17 and an estimate of the treatment that each class of shareholders and creditors would have been expected to receive, if an entity referred to in Article 2 were wound up under normal insolvency proceedings. That estimate shall not affect the application of the 'no creditor worse off' principle referred to in Article 15(1)(g).*

2. *The provisional valuation*

If an independent valuation is not possible, the Board may decide to carry out a 'provisional' valuation pursuant to Article 20(10) SRMR.

This valuation is considered to be provisional, until an independent person has carried out a fully compliant valuation.

3. *The ex-post valuation in accordance with Article 20(16)-(18)*

By application of the NCWO principle, for the purposes of assessing whether shareholders and creditors would have received better treatment if an institution under resolution had entered into normal insolvency proceedings, the Board must ensure that a valuation is carried out by an independent person as soon as possible after the resolution action or actions have been effected.

This valuation has to determine:

1) the treatment that shareholders and creditors, or the relevant DGSs, would have received if the institution under resolution with respect to which the resolution action or actions have been effected, had entered normal insolvency proceedings at the time when the decision on the resolution action was taken;
2) the actual treatment that shareholders and creditors have received in the resolution of the institution under resolution; and
3) thirdly (and consequently), whether there is any difference between the two.

It must be based on two assumptions: the institution under resolution with respect to which the resolution action or actions have been effected would have entered into normal insolvency proceedings at the time when the decision on the resolution action was taken, and the resolution action or actions had not been effected.

Finally, it must disregard any provision of extraordinary public financial support to the institution under resolution.

Execution Resolution Scheme

The SRB must ensure that the necessary resolution action is taken to carry out the resolution scheme by the relevant national resolution authorities. The resolution scheme must be addressed to the relevant national resolution authorities and must instruct those authorities. The national resolution authorities must take all necessary measures to implement the scheme by exercising resolution powers. Where State aid or Fund aid is present, the SRB must act in conformity with a decision on that aid taken by the Commission.

If all the conditions for resolution are met, resolutions tool will apply: “sale of business tool” (art. 38 BRRD); the “bridge institution tool” (art. 40 BRRD); the “asset separation tool” (art. 42 BRRD); the “bail-in tool” (arts. 43 et seq. BRRD).

In order to implement the resolution action, the resolution authorities, under art. 35, BRRD, have the power to appoint a ***special manager.***

The special manager replaces the management body of the institution under resolution and has all the powers of the shareholders and the management body of the institution. The Special manager may only exercise such powers under the control of the resolution authority.