Practical Guide to the EU Bank Recovery and Resolution Directive

1. Introduction

1.1 The **Directive 2014/59/EU of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms** ("**BRRD**") paves the way for the establishment of a Banking Union within the EU, via a legislative framework whose practical objective is to restore confidence in banks (and the euro currency). It establishes a three-stage mechanism for the management of insolvency situations: preparation/prevention, early intervention and resolution.

1.2 Its aim is the maintenance of financial stability across the European Economic Area, especially in relation to systemic institutions, i.e. credit institutions and investment firms whose failure might trigger a financial crisis ("**Systemic Financial Institutions**" or "**SFI**"). The epitome of the BRRD framework is the adoption of a comprehensive bail-in tool that ensures that shareholders and creditors bare the cost of bank failure, thus minimizing the burden of taxpayers.

1.3 The BRRD also caters for measures to address the Eurozone-specific risks perceived as imminent via the establishment of cross-jurisdictional coordination and cooperation framework in those cases where the failure of an SFI would have adverse effects on a cross-border or Union-wide level.

1.4 The BRRD entered into force on 2 July 2014 (20 days after its publication in the Official Journal of the EU, on 12 June 2014). Member States must now transpose the BRRD to national law by 31 December 2014 and apply its provisions as of 1 January 2015, save for the bail-in tool, which shall apply as of 1 January 2016.

> ***Note:*** *Unless explicitly specified otherwise, all references to legislation in this paper shall mean Articles of the BRRD.*

2. Key Concepts

Framework:

2.1 The BRRD establishes a framework that provides for crisis management and recovery tools in cases where it is possible to prevent an SFI's resolution, as well as resolution tools and

powers where the systemic nature of an institution would make its partial or total resolution inevitable. Thus, the framework created via the BRRD provides authorities with more comprehensive and effective arrangements to deal with failing SFIs at national level, as well as cooperation arrangements to tackle cross-border SFI failures. In summary, the BRRD provides for the following:

- Preparatory/preventative powers and obligations for minimizing the risk of a potential banking/financial crisis stemming from an SFI;
- Early intervention powers for the prevention of an imminent banking/financial crisis;
- Resolution powers for the reorganization of an SFI, when its winding down becomes inevitable;
- The creation of a European system of financing arrangements (including resolution funds via industry contributions) to be utilised in the event of resolution; and
- Provisions in relation to cross-border co-operation for recovery and resolution (both within the EU and with third countries).

"Resolution":

2.2 Under Article 2 the term "resolution" means the "**Resolution Actions**" taken for the restructuring of an SFI by a Resolution Authority, via the application of one or more of the "**Resolution Tools**" (Article 37(3) and 37(9)), in order to achieve one or more of the "**Resolution Objectives**" (Article 31(2)) of equal significance, namely:

- to ensure the continuity of an SFI's critical functions;
- avoid adverse effects on the financial system and to preserve financial stability;
- to protect public funds by minimizing reliance on public financial support;
- to protect insured depositors and investors; and
- to protect client funds and client assets.

2.3 Resolution is triggered only when the "**Resolution Conditions**" (Article 32(1)) are met, meaning that the relevant authorities conclude that:

- an SFI is failing or likely to fail;
- viability of the SFI cannot be restored (within a reasonably short timeframe) via any private sector intervention; and
- a resolution action is necessary in the public interest.

2.4 In essence resolution under the BRRD aims to restore the viability of (the whole or part of) the SFI. Accordingly, those parts of an SFI that cannot be managed / restructured under the resolution procedure undergo normal insolvency proceedings.

Scope of application

2.5 The BRRD is applicable to:

(i) institutions established in the Union (i.e. credit institutions and large Investment Firms that are required to hold initial capital of at least EURO 730,000[1]);

(ii) financial institutions which are subsidiaries of EU credit institutions or investment firms, or of companies referred to in (iii) or (iv) below (where the said subsidiaries are covered by the supervision of their parent undertaking on a consolidated basis [2]);

(iii) certain types of financial holding companies established in the Union (see Article 1(c));

(iv) certain types of parent financial holding companies in Member States and certain types of Union parent financial holding companies (see Article 1(d)); and

(v) certain branches of institutions established outside the Union (see Article 1(e)).

2.6 It is noted that the definitions attributed to financial institutions, investment firms and the various types of financial holding companies in the BRRD, are those set out in Regulation (EU) No. 575/2013 on Prudential Requirements of Credit Institutions and Investment Firms ("**CRR**"), and Directive 2013/36/EU on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and investment Firms ("**CRD IV**").

Relevant Authorities:

2.7 The BRRD provides for three decision-making authorities with different powers and obligations; the Resolution Authority ("**RA**"), the Competent Authority ("**CA**") and the European Banking Authority ("**EBA**"). Certain powers are to be exercised on the initiative of either the RA or the CA, while others (mostly in relation to cross-border resolution planning) require joint decision-making between the RA and EBA.

2.8 Member States, shall designate the RA (and exceptionally, more than one RA on a discretionary basis), provided that such RA is a "public administrative authority entrusted with public administrative powers".

2.9 A CA shall be, as per the definition in the CRD, an "officially recognised public authority which is empowered by national law to supervise institutions, as part of a Member State's supervisory system"[3].

2.10 The EBA is granted a significant role under the BRRD, in supervising the BRRD framework as well as in assessing and assisting with the drawing up of cross-border (group) recovery and

[1] Article 28(2) of CRD IV

[2] See Articles 6 to 17, CRD IV

[3] Article 3(40) of CRD IV

resolution plans. In addition to its decision-making powers the EBA is afforded the power to issue technical standards in relation to both prevention and intervention of financial crises situations.

2.11 A single ministry must also be designated by the Member State, to exercise the functions of the competent ministry under the BRRD. It is noted that where the RA is not the competent ministry, and unless laid down in national law, the competent ministry must approve all decisions of the RA prior to their implementation.

2.12 For the purposes of the BRRD, the Republic of Cyprus shall designate the Central Bank of Cyprus as its RA, while both the Central Bank of Cyprus and the Cyprus Securities and Exchange Commission will act as CAs, for those entities supervised by each of them, namely credit institutions and investment firms. The competent ministry shall be the Ministry of Finance.

3. Preparatory/Preventative measures

3.1 Preparatory measures for recovery can be taken by any SFI independently; such measures consist of private law arrangements and do not involve any public or official intervention. Such preparatory measures include planning on behalf of the institution for the sale of assets or business lines, the discontinuation of activities, reorganization and downsizing.

*Recovery Plans – **SFI's Obligations***

3.2 Under the BRRD, CAs shall require SFIs to draw up and maintain detailed Recovery Plans which set out the actions to be taken by the SFI to restore its financial position following a significant deterioration of its financial situation (Article 5). Recovery Plans must include a wide range of recovery options to cater for a range of scenarios of severe macroeconomic and financial stress that could be relevant to the SFI's specific conditions (including system-wide events and stress specific to the individual SFI as well as its wider group, if applicable). Detailed information on the contents and requirements of the Recovery Plan are set out in Section A of the BRRD Annex.

3.3 CAs shall require SFIs to update their Recovery plans at least annually, or following any changes in the legal/organizational/business structure of the institution which would have a material effect on the SFI's existing Recovery Plan.

3.4 The Recovery Plan shall be approved by the SFI's management body prior to being submitted to the CA for review and assessment.

3.5 While the CA shall assess and review the Recovery Plan to detect any deficiencies and impediments in its implementation (within 6 months of its submission), the RA may examine the recovery plan in order to assess whether the proposed recovery actions may adversely impact the resolvability of the SFI (and may make recommendations to the CA to that end). Any material deficiencies or impediments shall be notified to the SFI by the CA, giving the SFI two months to submit a revised plan.

3.6 Should the SFI fail to make such changes and take such measures to adequately address the deficiencies/impediments identified by the CA, the BRRD empowers the CA to take 'any measures it considers necessary and proportionate' to mitigate the deficiencies. In particular, the CA may even direct the SFI to enable timely recapitalization measures or make changes to its governance structure (Article 6(6)).

Intra-group financial support

3.7 Via the use of intra-group financial support agreements, some SFIs belonging to a group are enabled to take an extra preventative measure, to address developing financial problems within their group, prior to the SFI reaching a state of irreparable financial distress (and requiring recovery or resolution).

3.8 Members of the same group of companies may enter, on a voluntary basis, into agreements to provide financial support (e.g. loans, guarantees or the provision of assets for use as collateral in transactions) to other entities within the group that experience financial difficulties. These agreements cater for those cases where one member of the group is in need of financial support, without this being a trigger for the initiation of recovery and/or resolution proceedings.

3.9 The management body of the SFI providing financial support is the one with the ultimate decision-making power with regard to the provision of such support, subject to the approval of the involved SFIs shareholders. Prior to providing financial support, the SFI shall notify, among others, the CA (which informs the RA) as well as the EBA of its intention.

4. Early Intervention measures

4.1 Where an SFI faces financial distress and infringes or is likely to infringe the regulatory capital requirements of CRD, but prior to the SFI's financial situation deteriorating irreparably, the CA is empowered to intervene and require of the SFI, among other measures (Article 27(1)), to implement the arrangements set out in its recovery plan, to request that the management body of the SFI identifies and implements measures to overcome identified problems, to remove and replace the board of directors in case these

persons are found unfit to perform their duties, to change the institutions business strategy and generally to make changes to the legal and operational structure of the SFI

4.2 In cases where there is a significant deterioration in the financial situation of an SFI and the measures taken are not sufficient to reverse that deterioration, or where there are serious infringements of law or serious administrative irregularities, and the replacement of the management body has not mitigated the situation, a CA may request that a "temporary administrator" is appointed to replace the existing management of the SFI. Although such temporary administrator may have all the powers given to shareholders, senior management and management body, the exercise of such powers is subject to the control of the CA. Temporary administrators may be required by the CA to draw up reports, at intervals set by the CA and at the end of their term, on the financial position of the SFI, and on the acts they are performing in the course of their appointment.

4.3 The appointment of a temporary administrator shall last for one year (a period that may be exceptionally renewed if the CA considers that the conditions for appointing the temporary administrator continue to be met, and justifies its decision to the shareholders).

5. Resolution measures

Resolution Plans

5.1 In those extreme cases where prevention and early intervention measures are not able to ensure that an SFI regains sufficient capital adequacy and cannot regain its resilience through recovery proceedings, the BRRD empowers the RA to intervene via the application of Resolution Tools and the exercise of Resolution Powers, which as mentioned above, may be utilized by the RA only to achieve the Resolution Objectives as these are set out in Article 31.

5.2 The Resolution Plan, unlike the Recovery Plan, is drawn up by the RA, in cooperation with the SFI which is obliged to provide the RA with all requisite information (as a minimum, see the contents of Part B of the BRRD Annex) to assess and plan for the unlikely event of an SFI's resolution.

5.3 In order for the RA to be able to draw up the appropriate Resolution Plan for each SFI, the BRRD requires that RAs assess an SFI's resolvability in order to detect any impediments that could hinder its resolvability, which the RA can require the SFI to remove at the stage of the resolvability assessment. The RA takes into account the factors set out in Part C of the BRRD Annex in order to plan for the appropriate tools and powers to be used for the SFI's resolution.

5.4 The Resolution Plan requires close cooperation between the CA and RA, and RAs must inform CAs of the contents of each Resolution Plan, and any changes thereto.

Resolution Actions

5.5 In cases when the Resolution Conditions (Article 32) are met, a RA may take Resolution Actions via the use of the resolution tools set out in the BRRD, namely:

- the Sale of Business Tool
- the Bridge Institution Tool
- the Asset Separation Tool
- the Bail-In Tool

5.6 The above may be used individually or combined, save for the Asset Separation Tool which may only be used in conjunction with another tool

5.7 It is noted that, as per Article 56, in extremely extraordinary cases, where the Resolution Conditions are met, and all other resolution tools have been assessed and utilized to their maximum extent without achieving financial stability (See Article 56(4)), government financial stabilization tools may also be used (in the form of government bail-outs).

The Sale of Business Tool

5.8 The BRRD empowers RAs to sell an SFI under resolution without the consent of the shareholders, creditors or debtors whose claims and liabilities are transferred, or any other procedural requirements**.** RAs may use this mechanism for effecting the transfer of the whole or part of the SFI's business (any of its shares or other instruments of ownership, all or any of its assets, rights and liabilities) to another institution or recipient. Via the use of this tool, the RA ensures the continuation of the SFI's critical functions by the institution to which such business is transferred. It is noted that the sale must be conducted on "commercial terms", which conform to the valuation conducted under Article 36.

5.9 Where this does not jeopardise the Resolution Objectives, the RA is under an obligation to market the assets in full transparency, free from any conflict of interest, without discrimination between potential purchasers and without conferring any unfair advantage on a potential purchaser.

5.10 It is possible for RAs to exercise this tool more than once in the course of resolution.

The Bridge Institution Tool

5.11 The Bridge Institution Tool is an alternative to seeking a purchaser in the market that is willing to acquire the SFI's business, or, a mechanism to be used in cases where a purchaser cannot be found. The RA has the option of establishing a bridge institution (a publicly

owned legal entity), whose aim is to preserve the SFI's critical functions. The RA must ensure that such bridge institution is wholly owned or controlled by one or more public authorities (and may include the RA).

5.12 This tool gives RAs the power to:

(i) transfer the SFI's business to a bridge institution (more than once in the course of the resolution process) without shareholder's consent; and

(ii) in certain circumstances, to transfer the business from the bridge institution back to the SFI (or from the bridge institution to a third party).

5.13 The goal of this tool is to sell the SFI's business (shares, assets, rights and liabilities) based on open and transparent marketing and on commercial terms, within a short period. As such, a bridge institution may only operate for a period of two years (although the holding period may be extended – Article 41(5) and (6)). After this period expires, the operation of the bridge institution is terminated by liquidation.

The Asset Separation Tool

5.14 The Asset Separation Tool bears similarities to the Bridge Institution Tool, since it involves the transfer of assets, rights and liabilities of an SFI to a recipient controlled by the RA (an entity owned by public authorities that may also include the RA). However, in this case, the recipient is used as an "asset management vehicle", thus instead of maintaining the SFI's critical functions, the purpose of this tool is to eventually sell the assets or proceed to their winding down.

5.15 The RA makes use of this tool when it determines that certain activities are deemed "bad assets", which are not worthy to maintain, and are therefore transferred to the asset management vehicle (the 'bad bank'), to be sold at an equitable price. The distressed, problematic assets of the institution are separated and managed in such a way as to maximise their value.

5.16 As mentioned above, this tool can only be used together with one of the other resolution tools.

Write-Down or Conversion of Capital Instruments ('WD/C')

5.17 Under Article 60, the possibility to write down or convert capital instruments is provided to RAs prior to the use of the Bail-In Tool. This option is not a resolution tool, but allows for the write down or conversion of only certain types of liabilities (in contrast to the Bail-In Tool which applies to all of the SFI's liabilities). This option is available where an SFI meets the Resolution Conditions and the RA decides to apply one of the resolution tools; in such cases,

the RA must first exercise its power of WD/C prior to exercising any of its Resolution Powers and applying any of the Resolution Tools.

5.18 This option may be exercised when the RA or CA determines that the conditions of Article 59(3) are satisfied.

5.19 The option for WD/C may be used in combination with other resolution tools or independently of any other Resolution Action.

The Bail-In Tool

5.20 The Bail-In tool enables RA to require that the SFI's creditors will be written down or converted into equity where the SFI falls under resolution, thus the creditrs contribute to the recapitalization of the SFI themselves, instead of taxpayers. The bail-in tool may only be applied to meet the Resolution Objectives in order to:

- Recapitalise an SFI to the extent sufficient to restore its ability to comply with the conditions of authorization, and to continue its operations, while sustaining sufficient market confidence in the SFI; or
- To convert to equity or reduce the principal amount of claims or debt instruments that have been transferred to a bridge institution or via the sale of business or asset separation tools.

5.21 The write-down takes immediate effect and is binding on the institution, affected creditors and shareholder.

Minimum Required Eligible Liabilities ('MREL')

5.22 In order to assure sufficient funding for the bail-in procedure, the RA shall require that SFIs hold bail-inable capital (own funds and eligible liabilities) that is at least equal to the prescribed percentage of total liabilities of the institution (the 'MREL'). Derivative liabilities are included in the calculation of the MREL on a net basis.

5.23 The MREL shall be determined by the RA after consultation with the CA for each institution on an individual assessment. The MREL of each institution shall also be communicated to the EBA.

Resolution Powers

5.24 Further to the powers discussed herein, the RA has various other Resolution Powers, which the RA can exercise without being subject to any requirement to obtain any

approval or consent from any person (including shareholders and creditors), or any procedural requirements of notification prior to exercising any such Resolution Powers.

5.25 Under Article 63, the RA may:

- Require any person to provide the RA with any information in relation to its assessments and decisions on taking any Resolution Actions (including information gathered through on-site inspections)
- Take control of an FSI and exercise all rights conferred on the shareholders or owners and the management body of the FSI
- Remove or replace senior management
- Transfer instruments of ownership or debt instruments issued by the FSI
- Amend or alter the maturity of debt instruments or amend the amount of interest payable, altering term or temporarily suspending interest payments
- Require an FSI to issue new shares
- Close out and terminate financial contracts or derivative contracts
- Require the CA to assess any potential buyer of qualified holding outside the time limits laid down in the CRD

6. Financing Arrangements (Resolution Funds)

6.1 Although the guiding principle of the BRRD is that shareholders and creditors will bear the losses of a failing SFI, the BRRD also takes into consideration those cases where other sources of funding may be necessary in the event of resolution. As a way of safeguarding taxpayers from bearing the cost of rescuing failing SFIs, and in order to ensure the effective application of the Resolution Tools and Resolution Powers, the BRRD requires that member states establish one or more Financing Arrangements ("**FAs**"). These FAs will generally take the form of resolution funds, whose use may be triggered by the RA. However, a minimum level of losses equivalent to 8% of total liabilities (including own funds) must be imposed upon the SFI prior to granting access to a FA/resolution fund. If the FA is to be used, it may only contribute up to a maximum of 5% of total liabilities to cover losses not absorbed by eligible liabilities.

Scope:

6.2 Under Article 103 institutions authorised in the territory of a Member State (i.e. those credit institutions and Investment Firms in the Scope of BRRD as per paragraph 2.5 above) are required to contribute, at least annually, to the FA. The entities to contribute include Union branches (i.e. branches of third country institutions located in the Member State).

Purpose:

6.3 The FAs may be used by the RA only to the extent necessary to ensure the effective application of Resolution Tools and powers, and only for the following purposes or combination thereof:

- To guarantee the assets and liabilities of an SFI (including its subsidiaries) a bridge institution or an asset management vehicle.
- To make loans to the SFI (including its subsidiaries) a bridge institution or an asset management vehicle.
- To purchase the SFI's assets.
- To make contributions to a bridge institution and an asset management vehicle.
- To pay compensation to shareholders or creditors.
- In those cases where the bail-in tool has been applied and the RA decided to exclude certain creditors from the scope of bail-in (see Article 44), the FA may be used to make a contribution to the SFI, instead of the contribution which would have been achieved by the write down those excluded liabilities.
- To lend, on a voluntary basis, to other FAs.

Target level of Funds:

6.4 Under the BRRD, the funds available to FAs must reach a target level at least 1% of the amount of covered deposits in all authorised institutions[4] of the each member state by 31 December 2024, although each Member State has the discretion to set a target level in excess of this amount. After the target level has been reached, in the cases where the aggregate amount is reduced to less than two thirds of the target level, there is a six-year period within which the target level must be reached.

Contributions: Ex-ante, Ex-post, alternative funding means and inter-fund borrowing

6.5 The annual contribution of each institution shall be raised through ex ante contributions, and shall be calculated pro rata, as the amount of a contributing party's liabilities (excluding own funds) less the contributing party's Covered Deposits, divided by the Aggregate liabilities of all contributing parties (excluding own funds) less Covered Deposits of all contributing parties. The final amount shall be adjusted in accordance to the risk profile of each contributing party. Such contributions can include up to 30% "irrevocable payment contributions fully backed up by collateral of low risk assets" (Article 103).

6.6 Where the funds raised through the available (ex ante) contributions is not sufficient to cover the losses, costs and other expenses incurred by the use of the FA, extraordinary ex post contributions can be raised from the institutions authorised in the Member State,

[4] The issue as to whether investment firms will be called to make contributions, or the levels of such contributions is currently under discussion on a pan-European level; more information on this subject shall be provided to investment firms at a later stage.

with an upper limit of three times the annual amount of ex ante contributions. Extraordinary ex-post contributions may be discretionary deferred, where the Member State assesses that such contribution could endanger the solvency or liquidity of the institution.

6.7 Where the funds raised through the above means are still insufficient, the BRRD permits the use of alternative funding means (such as borrowings and other forms of support). Such support could come from institutions, financial institutions or "other third parties" (Article 105). Where such loans are taken out, they are to be repaid via future contributions to the fund.

6.8 Where the funds raised through the above means are still insufficient, (or not immediately available or refused due to not being offered on reasonable terms), the FA may make a request to borrow from another fund within the Union, taking the conditions of Article 106 into account.

7. Cross-Border Cooperation

7.1 The BRRD provides for enhanced cooperation between national authorities in those cases where SFIs are part of groups with cross-border entities. A group-centered approach is envisaged, whereby the national RA of the SFI is responsible for the application of the Resolution Tools and Powers, while decisions are to be taken in coordination with authorities from other members of the group, and with the input of the EBA in certain cases.

7.2 In those cases where joint decisions need to be taken, Group-level RAs are to implement a framework of cooperation via the establishment of Resolution Colleges, calling for the participation of all relevant Resolution Authorities and the EBA, which may assist in reaching a joint decision.

7.3 The EBA takes an active role in relation to the decision making process, and authorities are granted the ability to refer matters pertaining to the group Resolution Plan to the EBA for input.

7.4 A similar procedure calling for cross-border cooperation is applicable in the case of drawing up the group Recovery Plan, whereby a framework for joint assessment for the group Recovery Plan is set out, providing for similar procedures as with the above in cases where no joint decisions can be reached.

7.5 Additionally, co-operation between RAs becomes crucial in cases where a cross-border group is to be resolved, calling for joint decisions on the group Resolution Actions to be taken for individual group members. Where no joint decision can be taken as to the actions and costs to be borne, each RA may take independent Resolution Actions for all SFIs within its jurisdiction.

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