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Financial Industry Alert

THE LEGACY OF LEHMAN SERIES: ARTICLE 1

The EU Bank Recovery and Resolution Directive – Bringing Stability Back to the European Banking Sector

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1. Introduction

The collapse of Lehman Brothers was a pivotal moment which had catastrophic effects on the European financial sector which are still reverberating. Inadequacies in banking regulation were highlighted as most jurisdictions had few (if any) specific laws which covered the peculiarities of the banking sector. Documentation and legislation was tested and often found wanting by the courts. The stresses have acted as a catalyst for change in practices, regulation and documentation.

In order to fill the lacuna in statutory tools available to European governments and central banks to deal with failing financial institutions, many European jurisdictions have enacted new legislation. The legislation adopted differs between various jurisdictions within Europe and in some cases the tools at the disposal of the appropriate governing bodies of such jurisdictions are relatively limited.

Six years on after the collapse of Lehman Brothers, the European banking sector is back in the spotlight after a certain amount of turmoil over the first half of 2014. We have seen the dividing of Banco Espirito Santo in Portugal, the Austrian government introducing legislation to write off certain subordinated debt issued by Hypo Alpe Adria and the nationalisation of Corpbank in Bulgaria. The European banking sector still has its vulnerabilities. The introduction of a comprehensive set of tools which enable relevant authorities to take early and decisive action in relation to failing financial institutions is therefore imperative.

This common framework across the European Union will be provided by the European Bank Recovery and Resolution Directive[1] ("**BRRD**") which was adopted by the European Parliament on 15 April 2014. This client alert in the Legacy of Lehman series considers the key terms of the BRRD and the impact it may have in relation to the financial industry. In particular, it considers:

[1] 2014/59/EU

(a) the rationale for the adoption of the BRRD;

(b) the early intervention measures introduced by the BRRD;

(c) the key resolution measures introduced by the BRRD; and

(d) the impact of the BRRD on Europe's economy.

2. Rationale for the BRRD – Regaining Confidence

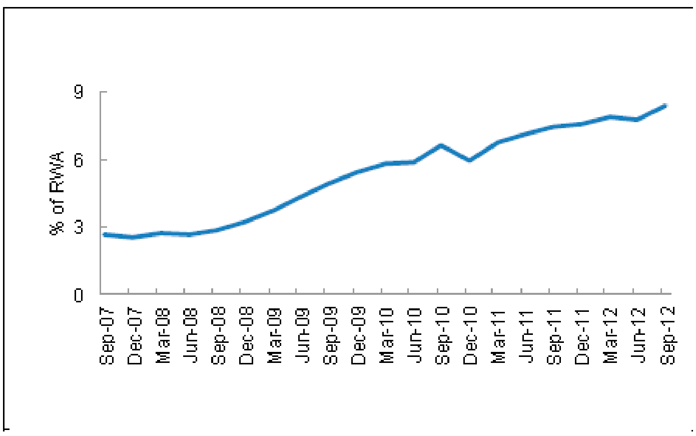
The banking crisis in Europe had caused catastrophic implications for public finances and damage to sector confidence. According to the International Monetary Fund (the "**IMF**"), losses related to the financial crisis incurred between 2007 and 2010 reached €1 trillion, which equated to 8% of EU GDP. In addition, approved state aid measures through recapitalisations and asset relief measures between October 2008 and December 2012 amounted to €591.9 billion, or 4.6% of EU 2012 GDP, according to the European Commission. This figure rises to €1.6 trillion of EU 2012 GDP if state guarantees are added. These figures alone provide significant motivation to establish tools that enable appropriate authorities to ensure that the loss suffered by failing banks in the future rests with investors and not the taxpayer.

Continued uncertainty surrounding the stability of the banking sector has also made it difficult to attract the fresh capital required by many of Europe's banks. The BRRD, together with the Capital Requirements Regulation/Directive IV ("**CRD**"), seeks to address issues of stability. Whilst the CRD seeks to reduce the likelihood of financial institutions facing financial distress by ensuring strengthened balance sheets of Europe's banks, the BRRD seeks to provide certainty with respect to how financial institutions will be restructured without the need for institutions to be bailed out at the expense of the taxpayer or causing systemic disruption in the banking system.

The IMF report on the *Progress with Bank Restructuring and Resolution in Europe Technical Note March 2013* identifies four hurdles that impair restructuring and resolution in Europe, in relation to which the IMF called for urgent progress. The four key hurdles identified were:

(a) The need to strengthen EU bank resolution tools. A swift introduction of bank resolution tools was stated to be imperative.

(b) Restructuring of non-performing loans ("**NPLs**"). The IMF identified limitations with the ability of banks to easily and efficiently enforce collateral in certain European jurisdictions as a significant barrier to the restructuring of NPLs. Certain banks have taken considerable steps to reduce their exposure to NPLs. However, other jurisdictions have been somewhat slower (for example, Italy). However, it seems that many third parties (particularly alternative investment providers) are looking to acquire NPL portfolios from Italian banks. This diagram (to the right) shows the significant increase of



Source: Bloomberg.

NPLs to total loans of European banks between 2007 to 2009.

(c) Further evolution of the General Directorate for Competition's practices will be needed in systematic cases to ensure consistency with the country's macro-financial framework and support viability of weak banks, recovery of market access and credit provision.

(d) Disclosure should be enhanced and harmonized to restore market confidence. In particular, interpretable metrics regarding the quality of banks' assets in terms of NPLs, collateral, probability of default and loan recovery rates are key to assessing the strength of banks and restoring confidence.

Steps have been taken by the EU and at national levels to address some of the issues highlighted. European banks are dealing with their NPLs, but some have been slower than others. Countries on the periphery of Europe are still holding on to too many NPLs, which will need to be dealt with sooner rather than later. Many jurisdictions are also yet to address the issue of the ease in which security is enforced.

The BRRD will also provide a set of tools that are "fit for purpose" in order to enable intervention by relevant authorities without significant costs being left with the tax payer. However, it is questionable whether the European legislative bodies and national authorities have acted swiftly enough in enacting the BRRD. The BRRD must be transposed into national law by member states by 1 January 2015 however, provisions relating to the "bail in" of subordinated creditors by conversion of debt to equity and write down do not become mandatory until 1 January 2016. Given the lethargic recovery of European "super powers" such as France and Germany and the slide back into recession of Italy, there may be a need for a more rapid adoption of the BRRD.

In terms of issues relating to transparency regarding the quality of financial institutions' assets, the ECB's asset quality reviews and stress tests will be complete and published by November 2014 before the ECB takes over supervision under the Single Supervisory Mechanism. The asset quality reviews and stress tests are part of the comprehensive assessment being carried out by the ECB in order to ensure greater transparency into banks' balance sheets and consistency of supervisory practices across Europe. The comprehensive assessment is being carried out in relation to 131 banks across 19 countries (including Lithuania when it joins the European area).

Together, the continued actions taken in relation to Europe's financial institutions will increase certainty in the market and will enhance confidence.

3. Prevention is better than cure

In our view, the key to whether the BRRD will be a success lies with the requirement of preparation for distressed scenarios and the early intervention tools introduced, and whether such early intervention tools can be used appropriately and decisively by relevant authorities. However, if early intervention is not enough, the bail in measures will protect the taxpayer.

3.1 Preparation and Prevention

The implications of the global recession were exacerbated by Europe's banks and limited preparation with respect to how individual institutions would be restructured in the event of their distress. This led to a scenario where banks that provided critical banking functions were "too big to fail" and had to be bailed out by appropriate authorities. The BRRD seeks to address this through preparation and prevention.

The BRRD requires that each institution to which the BRRD applies[2] to prepare a recovery plan setting out different situations that might occur that could cause risk to continuation of the institution and detailing different steps it will take in such scenarios. The key focus of the recovery plan is to ensure that the critical functions of the of the institution in question can be protected to allow such functions to continue in a scenario where the institution faces collapse.

In the event that authorities identify obstacles to resolvability during the course of this planning process the authority can require the institution to change its corporate or legal structures to ensure that it can be resolved with the available tools in a way which does not threaten financial stability and does not involve costs to the tax payer.

This planning and preparation stage will be critical to providing certainty and stability back into the financial sector. This combined with a comprehensive assessment carried out by the ECB will give the market more transparency with regard to the strength of a financial institution's balance sheet and will allow early action to be taken to prevent continued deterioration of struggling institutions.

3.2 Early Intervention

The BRRD has sought to providing authorities with a wide range of powers that enable them to intervene with the management of the institution to obviate the need for a bail out by the state. The early intervention measures include the ability to dismiss the management of the institution and appoint a temporary administrator, as well as convening a meeting of shareholders to adopt urgent reforms and requiring the institution to draw up a plan for the restructuring of its debt with creditors.

Any administrator appointed would have all the powers given to management under the institution's constitutional documents and by the laws of the relevant European member state. Such powers may include recapitalising the institution through a capital raising, a reorganisation of the group or a take-over of the institution by a third party institution.

4. Resolution Measures

In the event that the institution cannot be rescued via early intervention measures, the BRRD provides various tools which can be used to preserve critical functions of the institution, namely, the powers to:

(a) effect a private sector acquisition of all or part of the assets and liabilities of the bank without the consent of the shareholders;

(b) transfer the business to a temporary structure (such as a bridge bank) to preserve essential functions of the institution;

(c) separate the assets of the institution into a good bank and bad bank through a partial transfer of assets; and

[2] The BRRD applies to financial institutions and large investment firms which are subject to the Capital Requirements Directive as well as to EU-based parent and intermediate financial holding companies and mixed financial holding companies (within the scope of the Financial Conglomerates Directive) and subsidiary financial institutions of the EU credit institutions or an investment firm.

(d) bail in creditors to reduce the liabilities of a failing institution by conversion of its debt into equity or by writing down its debt.

In addition to the tools prescribed by the BRRD, other tools could be adopted by member states provided they are consistent with the principles and objectives of the BRRD.

The resolution measures are not particularly ground breaking as they include measures that certain European jurisdictions have already adopted and have already been used. For instance, the UK and Germany adopted banking related legislation following the banking crisis. We have also seen resolutions being used in various jurisdictions over the last few years, such as the splitting of good and bad banks in Cyprus (in relation to Cyprus Popular Bank) and more recently in Portugal (in relation to Banco Espirito Santo). However, the methods used in each case differ and issues regarding recognition and cooperation between member states where banks have a cross-border presence is a reoccurring issue. However, the introduction of a standard framework will give more certainty with respect to the likely outcome in cases of distress.

In order to ensure that the resolution measures have maximum impact and limit the possibility of challenge, the BRRD requires that certain instruments issued under laws of a country other than an EU country include contractual provisions pursuant to which investors agree to be bound by measures taken under the BRRD.

5. Shareholders and subordinated creditors must suffer loss before state aid

Whilst the BRRD seeks to prevent the tax payer suffering as a result of the failure of a financial institution, it is recognised that in some circumstances it may be necessary for public funds to be made available to a failing financial institution. However, the shareholders and subordinated creditors of the relevant institution should suffer an appropriate amount of loss where public funds are being used to recapitalise an institution. Therefore, such measures will only become available where the shareholders and subordinated creditors bear losses equivalent of 8% of the institution's liabilities and will be subject to the application of rules on state aid. This particular provision did cause a certain amount of controversy prior to being approved by the European Parliament when the UK sought amendments to allow specific government guarantees without the need to first "haircut" bondholders. Such a loophole to the requirement that losses be suffered by private investors as opposed to the taxpayers seems to be contrary to the original rationale of the BRRD. However, it was recognised that certain national central banks do not have big balance sheets and need extra guarantees from the state when lending to struggling lenders.

6. Extraordinary Public Financial Support

The settled position in the BRRD that where extraordinary financial support is required in order to remedy a serious disturbance in the economy of a member state and preserve financial stability, such support may take the form of the following without the need to take resolution measures:

(a) a state guarantee to back liquidity facilities provided by central banks according to the central banks' conditions;

(b) a state guarantee of newly issued liabilities; or

(c) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution where:

(i) the institution has not and is not objectively determined to have infringed its continued authorisation;

(ii) its assets are greater than its liabilities;

(iii) it is able to pay its debts as they fall due; and

(iv) the requirement to write down or concert capital instruments has not been triggered under the terms of the BRRD.

7. Cooperation and Coordination

In order for any resolutions to be effective, particularly in relation to institutions with a cross-border presence throughout the European Union, it will be necessary for member states to cooperate in relation to the resolution of a financial institution. Therefore, the BRRD permits authorities in different member states to cooperate with one another to coordinate resolution measures to achieve the most effective outcome for the group as a whole.

8. Use of Resolution Measures

The resolution measures under the BRRD must be used to achieve the following objectives:

(a) to protect the continuity of critical functions;

(b) to avoid a significant adverse effect 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 depositor guarantee schemes; and

(e) to protect client funds and client assets.

A relevant authority may determine that the financial institution should be resolved only where all the following conditions are met:

(a) a determination is made that the institution is failing or is likely to fail;

(b) there is no reasonable prospect that any alternative private sector measures, including measures by an IPS, or supervision action, including early intervention measures or the write down or conversion of relevant capital instruments would prevent the failure of the institution within a reasonable timeframe; and

(c) a resolution action is necessary in the public interest.

With respect to the first of these conditions, "failure or is likely to fail" has a specific meaning, namely:

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

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

(c) the institution is unable to pay its debts as they fall due or there are objective elements to support a determination that it will be unable to do so in the near future; and

(d) extraordinary public financial support is required, except for certain excluded public guarantees and capital injections.

9. Financing the Resolution

The BRRD will only achieve its purpose if the costs associated with creating the new resolution regime do not fall upon the taxpayer. The BRRD therefore requires that member states set up financing arrangements funding contributions from banks and investment firms in proportion to their liabilities and risk profile, proportionate to the size of the national financial sector. Such contributions are expected to raise a target funding level of at least 1% of covered deposits over a 10 year period.

As each member state is responsible for financing the resolution of the financial institutions within that member state, in a cross border scenario relevant authorities within the appropriate member states will be required to pre-agree the proportions of their contribution to any financing plan. In addition, it is recognised that a member state may not be capable of raising sufficient funds to finance the resolution of an institution or institutions within its own jurisdiction in which case relevant authorities will be able to borrow funds from the authorities of another member state.

The main use of the resolution funds will be limited, for example, to providing loans to a bridge institution, purchasing specific assets of an institution under resolution, guaranteeing certain assets or liabilities of the institution under resolution, or in exceptional circumstances contributing to loss absorption by replacing creditors who would have been bailed in.

The European Commission has calculated that whilst the increased costs to financial institutions may have a negative impact on GDP, the improved financial stability of the sector and reduced likelihood of system crises and risks for taxpayers' money to recapitalise failing banks would have a much larger positive impact on GDP. The table below shows the European Commission's view of the accumulative benefit of the BRRD when taken together with the new capital requirements under Basel III (reducing the probability of bank failures) and the positive net benefits of the funding of the deposit guarantee scheme.

	Basel III	DGS/RF	Bail-in	Sum
Cost (% of EU GDP annually)	0.16	0.04	0.14 – 0.42	0.34 – 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 – 0.62	0.76 – 1.04

10. Rights of Shareholders and Creditors

Notably, the BRRD includes the principle that no creditor should be worse off as a result of a resolution than it would have been had the bank been wound up under applicable insolvency law proceedings. This is a welcome addition on the basis that many resolution measures taken in haste over recent history have failed to clearly address the issue of recourse in a scenario where subordinated creditors or shareholders would have been better off in an insolvency scenario. Imposing losses on shareholders and subordinated creditors may be considered a form of expropriation where a new bank emerges from the ashes of a failure and is sold for a profit. In a number of bank failures and restructurings, affected equity holders and creditors have argued that their rights have been expropriated.

To this end, relevant authorities are expected, where possible in the circumstances, to carry out an independent valuation of the institution before resolution measures are taken. If the early intervention procedures work correctly, it should be possible to carry out an independent valuation prior to resolution measures are taken. To the extent that this is not possible, a provisional valuation may be carried out. The valuation is significant in that it is will be used for the purposes of determining whether the conditions are present to require the use of resolution measures.

Whilst the BRRD provides a right of appeal, it is not possible to appeal only the valuation and any appeal shall relate to the decision to use a resolution measure in relation to which the valuation may be relevant.

Notwithstanding the existence of a right of appeal, 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, which is intended to strike a balance between the rights of subordinated creditors and shareholders, with the ability of relevant authorities to decisive action to prevent contagion in the banking system (without the possibility of such action being overturned and thus creating more uncertainty). The same rationale applies to the requirement that insolvency legislation relating to the unwinding antecedent transactions shall be disapplied with respect to measures taken under the BRRD. This makes sense given that the ability to unwind actions taken under the BRRD would create significant uncertainty and would impede the ability of the resolved bank to raise finance in the future.

11. Conclusion

The BRRD is a welcome introduction which, together with Basel III, the ECB's asset quality reviews and stress tests will provide a system whereby potentially unstable banks can be identified early and steps can be taken to restructure and to shore up the bank's balance sheet before it passes the point of no return.

The BRRD itself is not particularly ground breaking as certain European jurisdictions had already adopted banking legislation following the financial crisis in 2008. The UK Banking Act 2009, for instance, provides many of the tools which will become mandatory to all European Member States by January 2015. However, the greater benefit is to those jurisdictions that have not already taken steps to introduce such legislation.

Mediobanca has reported that a number of large European banks are likely to fail, or "quasi fail" the ECB's asset quality reviews and stress tests, the outcome of which will be known in late October. However, it is not expected that this will cause an immediate need to utilise tools under the BRRD. We expect that as the comprehensive assessment draws to a close, behind the scenes the ECB will be negotiating with certain banks to force a range of measures including additional capital raises and asset sales. We are in for some interesting times: expect a fair number of interesting transactional developments in the next few months. The ECB will be walking the tightrope between being seen to be tough and ensuring the banking sector remains stable. In the long term, however, a functioning bank resolution tool can only be welcomed by the tax payer and market participants alike. Of all the legislative stories that have emerged from the 2008 crisis it is arguable that the BRRD may become to be seen as the most important measure to provide financial stability.

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