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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE EUROPEAN CENTRAL BANK

Bank Resolution Funds

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1. CONTEXT

Over the course of the ongoing crisis, governments throughout the European Union and internationally have provided massive amounts of public money to support their financial sectors[1]. This support was necessary to ensure financial stability and to protect depositors, and was accompanied by measures to support the real economy. However the overall effect has been to impose a heavy economic burden to be borne by today's taxpayers and future generations[2].

A clear political message that emerged from the G-20 meeting in Pittsburgh in September 2009, strongly backed by the EU,[3] is that taxpayers' money should not be used again to cover bank losses. The European Commission is working to achieve this in at least two complementary ways: i) by reducing the probability of banking failure through stronger macro and micro-economic supervision, better corporate governance and tighter regulatory standards and; ii) by ensuring that, if in spite of these measures failure does occur, appropriate tools including sufficient resources are available for orderly and timely resolution. The establishment of resolution funds constituted from private sector sources are an important part of this response.

The Commission **supports the establishment of *ex ante* resolution funds**, funded by a levy on banks,[4] to facilitate the resolution of failing banks in ways which avoid contagion, allow the bank to be wound down in an orderly manner and in a timeframe which avoids the "fire sale" of assets ("*principe de prevoyance*"). The Commission believes that resolution funds are a necessary part of the toolbox of several different measures that will be included in the new EU crisis management framework seeking to mitigate the burden on taxpayers and minimize – or better still eliminate - future reliance on taxpayer funds to bail out banks.

It is a matter of critical importance, in an era of increasingly integrated and global financial markets that solutions are found to effectively handle banking crises. Recent extreme volatility of financial markets is a clear example and reminder of the extent to which financial markets are integrated. Robust and credible funding arrangements are more than ever needed.

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1 According to the IMF, the net direct fiscal cost of the crisis has averaged 2.7% of GDP for advanced G20 countries although amounts pledged, including guarantees and other contingent liabilities averaged 25% of GDP.

2 Government debt in advanced G20 economies is projected to rise by almost 40 percentage points during 2008-15 (cf IMF).

3 ECOFIN Council Conclusions of 18 May 2010.

4 In accordance with the scope of application of the EU banking legislation, i.e. the Capital Requirements Directive 2006/48/EC, the reference to "bank" shall in this Communication be understood to include banks and investment firms.

In its Communication of October 2009[5], the Commission strongly supported the establishment of a new crisis management framework at the EU level designed to facilitate orderly bank failures and to minimize costs to taxpayers. In an April 2010 Staff Working Document[6], the Commission services identified a bank levy as one possible option for making the financial sector contribute to the costs of the crisis and preventing the occurrence of future crises. On the 9th of May 2010, the ECOFIN concluded that work on crisis management and resolution has to be accelerated.

Political support is growing for applying the so-called **"polluter pays" principle**, known from environmental policy, also in the financial sector so that those responsible for causing it will pay for the costs of any possible future financial crisis. A number of countries have already introduced, or are in the process of introducing levies on banks, although these differ across jurisdictions.

The G20 will hold a first discussion about such levies at its Ministerial meeting in June. .This Communication will provide substantial input to these meetings. The EU should lead G20 efforts to find a global approach and model with a view of maintaining a world-wide level playing field..

This Communication sets out the Commission's thinking on how the financial sector could contribute to the cost of financing the resolution of failing banks. It also explains where bank resolution funds fit within the overall set of tools which should be made available in the area of crisis prevention and management of banks. This Communication also sets out the Commission's broad ideas on a number of important issues, such as the purpose of funds, their potential size, as well as the conditions under which they might be used.

However, it does not deal with any levies or taxes whose purpose is to recoup the public funds committed during the current crisis to stabilise the banking system or to tackle excessive risk-taking or speculation. The examination of such measures should continue in parallel as a useful complement to the preventive funds that are considered in this Communication.

The setting up of resolution funds raises a number of challenges – in particular with respect to **moral hazard concerns**, which have been fuelled by actions taken during the crisis. The Commission recognises that this is a major concern which needs to be addressed by making it clear and unambiguous that shareholders (up to the value of their investment) and creditors (excluding depositors which are guaranteed by deposit guarantee schemes) must be the first to face the consequences of a bank failure and that **resolution funds must not be used as an insurance against failure or to bail out failing banks**, but rather to facilitate an orderly failure. In short, bank resolution funds should, as the IMF suggests, be tied strongly to the future resolution regime.

The establishment of bank resolution funds will form a part of the new crisis management framework. It is acknowledged that this will entail costs for banks at a time when they are in the process of implementing additional measures in response to the crisis. The Commission recognises that it is essential to develop a clear understanding and careful assessment of the cumulative impacts of the broad set of reforms dealing with levies, deposit guarantee schemes and bank capital, and adjust the individual elements of the reform package accordingly. It is necessary to ensure that the costs are calibrated in such a way as to avoid stifling the

5 COM(2009) 561.
6 Innovative Financing at a Global Level - SEC(2010) 409, 1.4.2010.

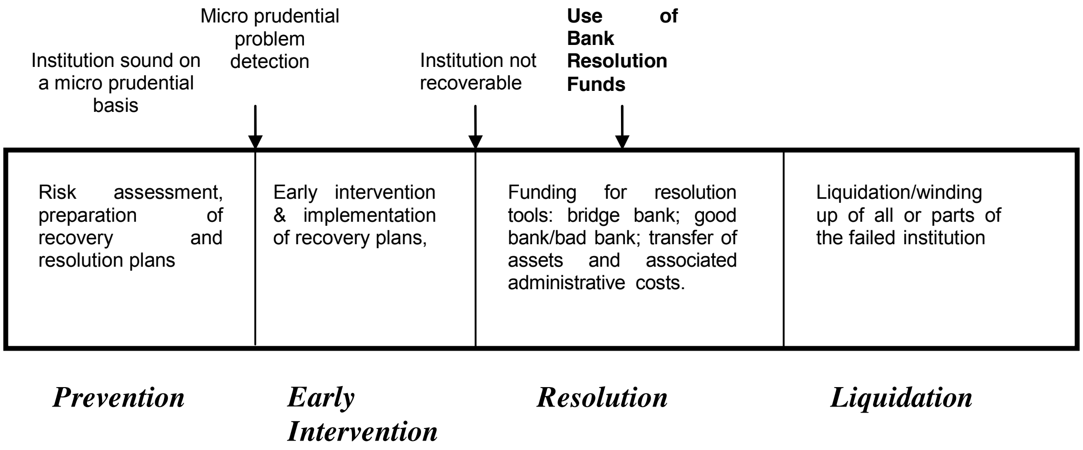
economic recovery and increasing the cost of credit to the real economy. It should also be avoided that increased costs are passed on to bank customers in the form of higher charges. The Commission will ensure that all these elements are properly taken into account in the accompanying impact assessment work.

2. Bank resolution funds should be part of a Financial Stability framework

Establishing bank resolution funds should not be considered in isolation and should be understood as part of the range of broader initiatives aimed at strengthening the financial system in the wake of the current crisis. Fundamental reform of the regulation and supervision of financial markets is currently underway to address the failings exposed by the banking crisis. The Commission has proposed measures to strengthen capital requirements, reform the EU supervisory architecture and will in July come forward with a proposal to strengthen existing Deposit Guarantee Schemes (DGS). Furthermore, the Commission will soon launch a wide-ranging consultation with a view to strengthen corporate governance of financial institutions, in particular banks.

Understanding the broader context is an essential part of deciding what funds should do, how they would to work and how large they might need to be. Broader reforms to the financial framework focussed on *prevention* can be expected to diminish the probability and severity of bank failure, and more efficient procedures leading to earlier intervention and effective resolution measures should reduce the cost of any measures taken and mitigate the implicit guarantees associated with institutions deemed 'too big to fail'.

Diagram 1: When would a resolution fund be used?



The Commission will adopt in October 2010 a roadmap setting out the timetable, concrete measures, tools and plans for a complete EU framework for crisis management. The intention is to present the relevant legislative proposals regarding both crisis management measures and tools and resolution funds by early 2011.

The objective of the new framework will be to ensure Member State authorities have common tools that can be used in a coordinated manner to allow prompt and legally robust action in the event of major banking failures, protecting the broader financial system, avoiding costs for taxpayers and ensuring a level playing field. In particular, the aim will be to ensure that orderly failure is a credible option for any bank, irrespective of size or complexity.

Applying resolution tools with accompanying private sector financing, to very large and complex financial institutions may pose particular challenges. For these reasons other alternative tools, that would not include public funding, need to be available. They could be used in specific circumstances to stabilize situations and avoid a forced and rushed liquidation that may be detrimental to financial stability in the short term.

Significant work is underway at international level to reduce the probability and impact of the failure of such institutions (Box 1).

BOX 1: Addressing large and very complex financial institutions in distress

There needs to be sufficient certainty that distressed entities could be handled without jeopardising financial stability or triggering a systemic event. The tools outlined below could complement ex ante resolution funds and provide authorities with a set of sufficiently robust measures to deal with distressed large and very complex financial institutions.

Recovery and Resolution Plans

Work is ongoing both at EU (CEBS) and at international level (Financial Stability Board) on the design and testing of **recovery and resolution** plans (the G20 has called for these plans to be drawn up by the end of 2010), which will be an essential element of a future EU crisis prevention framework. Relevant authorities should be equipped to actively use existing or, if necessary, new preventative powers to ensure, in advance of a crisis, that banks can be wound down in an orderly manner. An efficient legal framework for resolution will be essential.

Creditor haircuts and debt to equity conversion

Institution-specific options include **debt to equity conversion** (either administrative or contractual[7]) or imposing '**haircuts**' on holders of subordinated debt and unsecured creditors (excluding deposits) in order to provide significant funding to a distressed firm and maintain it as a going concern.

There is an active international debate about the possible introduction of such measures. This could include modifying prudential rules to require or encourage the use of convertible debt instruments (so institutions can 'self insure'), or conferring an administrative power for authorities to apply haircuts to non convertible debt or to convert debt into equity. Pre-insolvent recapitalisation through such mechanisms could serve to stabilize an institution. Measures of this kind would clearly have an impact on the cost of funding for banks, on capital structure and on market practices, but they would also help to reinforce market discipline by ensuring that unsecured creditors fully bear the costs of the risks to which they are exposed. To be workable in practice, considerable legal and practical obstacles would need to be overcome and further work is underway.

3. AN EU APPROACH TO BANK RESOLUTION FUNDS IS REQUIRED

The extent of integration of global financial markets requires common approaches to be adopted both at EU level and globally with respect to the introduction of bank resolution funds. The experience of handling cross-border failures during the current crisis has provided clear illustrations of why new crisis management arrangements are necessary. The EU's immediate response to the financial crisis has been to propose legislation strengthening macro-economic supervision and cross-border supervisory arrangements by setting up new authorities in recognition of the need for closer cooperation. Under the new arrangements, day to day supervision will remain national, consistent with Member States' fiscal competence. However this choice to remain with a supervisory system which is essentially decentralised, relies on a high level of trust among authorities and cooperation in the new European Supervisory Authorities and will only deliver its full potential if underpinned by a solid cross-border crisis management framework backed by robust financing arrangements.

In principle, pooling resources into a single pan EU resolution fund would deliver clear benefits by: increasing risk diversification; delivering economies of scale; reducing the amount that would be subject to burden sharing; providing the right incentives for cooperation; speeding up decision-making; and guaranteeing a level playing field. It would also better reflect the pan EU nature of banking markets, in particular for cross border banking groups.

However, the Commission recognises that it would be very difficult to begin with the creation of an EU Resolution Fund in the absence of an integrated EU supervisory and crisis management framework. The European approach to the establishment of bank resolution funds should mirror the broader approach to supervisory arrangements.

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7 For example through the issuance of contingent capital with either debt to equity conversion or write-down features. A number of banks such as Lloyd's and Rabobank have already issued such instruments.

For that reason, an appropriate first step could be a system based around the establishment of a harmonized network of national funds linked to a set of coordinated national crisis management arrangements.[8] These arrangements are a first step and would be reviewed by 2014[9] with the aim of creating EU integrated crisis management and supervisory arrangements, as well as an EU Resolution Fund in the longer term.

Establishing greater clarity and mutual understanding between authorities through more robust financing arrangements will also be key to aligning incentives between authorities to cooperate fully in the event of a cross-border banking failure. This would in turn represent an important underpinning for effective cross-border crisis management arrangements.

Failure to adopt an EU approach with respect to bank resolution funds could result in the unilateral imposition of resolution levies domestically and thus risk competitive distortions between national banking markets. It could also lead to the overlapping of levies in the case of cross-border banks. Moreover, different approaches to private sector financing mechanisms may create obstacles to efficient handling of crises or use of resolution tools, if private sector funds are available in some Member States but not in others and may render agreement on the sharing of costs more complex, if not impossible.

For these reasons, **an EU approach is the appropriate way forward** with respect to the principles of subsidiarity and proportionality as set out in Article 5 of the Treaty on the European Union. Only EU action would ensure that banking groups operating in more than one Member State were subject to similar requirements concerning resolution funds, and thus a broadly level playing field, avoid unwarranted compliance costs for cross-border activities and promote further integration within the Internal Market. Furthermore, such an approach should ensure consistency, where appropriate, with existing EU legislation. Such EU level action would also reinforce financial stability within the EU.

4. FINANCING, SCOPE OF EXPENDITURE AND GOVERNANCE OF A BANK RESOLUTION FUND

This chapter explores three main pillars of such a resolution fund: financing (4.1); scope and size (4.2) and governance (4.3).

4.1. Financing Bank Resolution Funds

Designing financing arrangements for a fund should aim to achieve two objectives: i) to raise the necessary amounts of money reflecting the nature of its usage (i.e. the likelihood and cost of resolution); ii) to do so in a way which incentivises appropriate behaviour, mitigating the risk of resolution. Essentially there are three main parameters: the contribution could be based on the institution's liabilities, its assets, or its profits.

- **Banks' assets** are good indicators of their risk. They could also accurately reflect the potential likelihood of a bank failure and therefore the need to resolve the bank[10]. Indirectly assets could represent an indicator of the amount which might need to be spent

[8] This approach takes into account that resolution funds already exist in some Member States.

[9] 2014 is the date foreseen in the proposed EBA Regulation for reviewing the new supervisory .

[10] In banking regulation terms, this would mean building on the existing monitoring capacity of assets' riskiness to assess both the Probability of Default (PD) and the Loss Given Default (LGD) in order to estimate the relative size of the levies.

in handling the bank's resolution. However, banks' assets are already subject to risk weighted prudential capital requirements in the form of capital charges. Imposing a levy based on assets could therefore amount to an additional capital requirement and would have to be considered carefully in the context of the wider reforms to capital standards currently underway.

- **Banks' liabilities**[11] would appear to be the most appropriate indicators of the amounts that might be needed when facing the need to resolve a bank. Costs of bank resolution are most likely to arise from the need to support certain liabilities (excluding equity and insured liabilities - e.g. deposits). However, banks' liabilities could be a less effective proxy for the degree of risk.

- In addition to balance sheet related levies, levies could be related to **profits and bonuses** as an indicator of a bank's size and more reflective of the 'polluter pays' principle.[12] However profits and bonuses may not be closely correlated to the amount of resolution financing a bank might require or the probability of its failure.

The Commission is carefully assessing which of the different basis mentioned would be the most appropriate for the financing of a bank resolution fund. In any case, regardless of the basis finally chosen, the Commission considers that it should at least comply with the following principles: a) avoid any possible arbitrage, b) reflect the appropriate risks; c) take into account the systemic nature of certain financial entities, d) be based on the possible amounts that could be spent if resolution becomes necessary and e) avoid competition distortions.

There is also an important consideration as to whether funds need to be raised on an ex post or an ex ante basis. **The Commission takes the view that resolution funds should be built up on the basis of contributions from banks *ex ante***. Fully ex post funded schemes may imply upfront taxpayer funding and therefore increase the risk that banking failures would be accompanied by broader negative economic impacts. Such an approach may prove pro-cyclical, placing strains on the public budget during a financial crisis when the State is least well equipped to provide additional financing[13].

4.2. Scope and Size of Fund Expenditure

The task of bank resolution funds will be to contribute to financing the orderly resolution of distressed financial entities. They should be available for resolution of banks irrespective of their size and interconnectedness, but their use to bail out institutions should be clearly excluded. At this stage, it does not seem appropriate to extend resolution funds to other financial institutions such as investment funds or insurance institutions. Although they are also active participants in financial markets, they have a number of specificities that would complicate the application to them of a similar resolution regime as the one envisaged for banks. Although resolution funds will not be used to recapitalise banks, they will need to be

[11] Using liabilities as the basis for the calculation of the amount of the levy is the IMF's preferred approach.

[12] Some Member States have recently decided to introduce taxes on bonuses. This is different from the bank levy discussed in this Communication.

[13] In the event that ex ante funds proved insufficient to cover the costs of a resolution, resolution funds would however need to be backed by sufficiently credible alternative financing

sufficiently resourced to cope with different resolution costs, and the approach taken will need to be tailored to entities of different sizes and nature.

The size of the fund will depend on which type of financial institutions fall under the scope of a crisis resolution framework and will also need to be designed in the context of the planned broader reforms to the financial sector.

BOX 2: Which measures would a Bank Resolution Fund be expected to cover?

Actions taken by resolution authorities to carry out an orderly resolution of a bank may involve a variety of different costs. In principle, a well designed resolution framework should oblige a resolution authority to resolve ailing entities at the lowest economic and social cost, in compliance with the relevant Treaty provisions including state aid rules. The following are examples of different measures that resolution funds might be expected to cover:

- **Financing a bridge bank** (with the resolution authority taking over the bank) to allow for the continuation of operations of an insolvent institution. This could imply, for example, providing bridge financing and/or guarantees.

- **Financing a total or partial transfer of assets and/or liabilities** from the ailing entity to a third party. Costs could involve a guarantee on the assets (for example loss sharing with a potential acquirer of bad assets) and/or financing or guaranteeing the transfer of liabilities for a period of time in order to maintain market confidence and avert the risk of a run by creditors.

- **Financing a good bank/bad bank split.** Costs to the fund might entail the temporary purchase and management of bad assets and the provision of bridge financing for the good bank.

- **Covering administrative costs, legal and advisory fees,** as well as the need to preserve certain vital functions of the banks – such as payments systems.

During the ongoing crisis, government pledges in support of the banking sector reached a significant percentage of EU GDP. Resolution funds as described in this Communication do not have the prospect of achieving a size of that dimension because the very purpose of a resolution fund is to make sure that interventions by governments to bail out banks will be pre-empted. Importantly, the Commission considers that a crisis management framework must ensure that any losses in the context of a bank failure are first and foremost borne by shareholders, holders of subordinated debt and unsecured creditors, before resolution funds can be available. The Commission will take a position on the appropriate target limit for funds following further detailed quantitative analysis and comprehensive impact assessment. The examples provided in Box 3 are included for illustrative purposes and represent a spectrum of possible target sizes based on recent initiatives.

BOX 3: Cost implications of recent initiatives to create funds

Some countries have already taken the decision to impose levies on banks for the express purpose of establishing dedicated funds. However the precise purpose of these funds, as well as the financial implications, differs:

- In Germany, proposals are under preparation for a systemic levy on banks to be paid into a stability fund to finance measures under a special resolution regime. The details about the design of the levy, the size of the fund and the way funds should be invested and used are still to be developed, however indications are that the levy could be expected to raise around €1 billion per year.

- Sweden has recently established a bank "stability fund", the purpose of which is to finance measures to counteract the risk of serious disturbance to the financial system in Sweden[14]. In 15 years the fund is targeted to reach 2.5 per cent of GDP. It will be built up on the basis of a stability fee paid by banks and other credit institutions, amounting to 0.036 percent per year levied on certain parts of the institution's liabilities (excluding equity capital and some junior debt securities).

- The IMF has indicated[15] that on the basis of past experiences of crises, approximately 2-4 percent of GDP should suffice for the provisioning of resolution funds (this corresponds to the direct costs of ongoing banking crisis), depending on the relative importance of the financial sector.

In a number of Member States, Deposit Guarantee Schemes (DGS) are already tasked with funding the transfer of deposits from the failing entity[16]. The Commission believes that the use of deposit guarantee funds for resolution purposes should be limited to the amount that would have been necessary to pay out covered deposits. Costs beyond this limit should be borne by resolution funds. Care will also need to be taken when designing systems to avoid any duplication.

4.3. The Governance of Bank Resolution Funds

Given that the size of a bank resolution fund is likely to be significant in most economies, the governance rules for such a fund are of paramount importance. Contributions from banks to cover the costs of future resolution could be either allocated to the general budget or to a fund. Some Member States could find it attractive to use these contributions to reduce their public deficit. However in the longer term, failure to establish dedicated resolution funds may result in increasing the dependence of the financial sector on public funds should new crises occur, and further reinforce the moral hazard problem associated with 'too big to fail' institutions. Furthermore, the risk will always remain that levies paid into the general budget over time might be diverted for other uses.

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14 The mandate is to be understood more broadly than the "bank resolution funds" described by the Commission.

15 A Fair and Substantial Contribution by the Financial Sector, Interim report for the G-20, April 2010.

16 There have been a number of examples of orderly bank failures using the Deposit Guarantee Scheme during the recent financial crisis. These which serve to illustrate the potential costs associated with small and medium bank failures (e.g. Dunfermline Building Society £ 1.5 billion, Bradford & Bingley £ 14 billion,.

The Commission therefore takes the view that bank resolution funds should remain separate from the national budget and dedicated only to resolution costs.

For practical purposes, management of bank resolution funds should be entrusted to authorities that would be in charge of resolving financial entities and which would act as independent executive bodies. Clear lines of accountability will be needed where new powers for the allocation of funds are granted. Functional independence from government would ensure that the funds were strictly reserved to pay for resolution measures. The details of the governance arrangements will have to be further developed. In this context, three questions are particularly relevant for the management of a fund:

i) How should the money collected be held, ii) Under which conditions should the funds be used to resolve banks and iii) How to decide the allocation of costs payable by funds in case of a cross-border resolution*:*

(i) Investment of funds would need to be in a geographically well diversified portfolio in highly liquid non-bank assets with low credit and market risk and in a way that supports the real economy.

(ii) With regard to the use of funds, the Commission intends to put in place a harmonised resolution framework which should aim to avoid any differences resulting from the way national authorities apply resolution powers and tools, thus limiting competitive distortions. This will determine when and how resolution funds can be used.

(iii) With regard to arrangements in case of a cross-border resolution, the Commission intends to come forward with proposals to establish clear rules on how coordination will be expected to take place. At the core of these arrangements could be colleges involving authorities in charge of resolution with a view to taking joint decision on the preparation for the resolution of a cross-border banking group under the oversight of an entity such as the future European Banking Authority as proposed by the Commission. Such resolution plans, based on clear principles to be established by law, would include discussion about how burdens might be fairly shared and the sharing of costs between privately financed resolution funds.

Finally, the use of bank resolution funds will need to **respect the EU state aid rules**. The definition of the operational aspects of resolution funds will need to take proper account of potential state aid implications. Interventions using resolution funds will thus need to embed features that make easier their compatibility assessment, particularly in relation to the type of support given, appropriate burden sharing and avoidance of undue distortions of competition.

5. NEXT STEPS

This Communication contributes to the discussions on levies and resolution funds that will take place in the context of the upcoming G20 meetings. It is important to find broad agreement – within the EU and globally - on general principles and orientations on these matters as rapidly as possible to avoid the development of divergent national approaches.

The Commission invites the European Council of 17 June 2010 to endorse the principles and suggested way forward in this Communication and to invite the EU's representatives in the G20 to advocate it in forthcoming meetings.

As a next step in the creation of a comprehensive crisis prevention and management framework, the Commission will present in October 2010 a Communication setting out a roadmap and its broader and detailed plans for the development of a new crisis management framework, including further assessment of the viability of tools to ensure creditors contribute at an early stage to a resolution (e.g. through the use of creditor haircuts). **The Commission plans to adopt legislative proposals for crisis management and resolution funds in early 2011**.