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NOTE

from:	General Secretariat of the Council
to:	Council
Subject :	Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 - *State of play*

1. The above mentioned Commission proposal (hereinafter "BRRD Proposal") was transmitted to the Council on 6 June 2012[1].

2. The BRRD Proposal aims to introduce an effective recovery and resolution framework for credit institutions and investment firms at national level and to ensure minimum harmonisation at EU level. The proposed Directive provides for three stages of crisis prevention and management: a preventative stage, an early intervention stage, and a resolution stage. It also provides for national resolution financing arrangements and arrangements for co-operation with third country authorities. A key objective is to remove the "too big to fail" concept and thus minimise recourse to public funds in relation to institutions which are failing or likely to fail.

[1] Doc. 11066/12 EF 136 ECOFIN 552 DRS 91 CODEC 1600.

Enabling national authorities to resolve institutions, before insolvency proceedings become inevitable, is also expected to minimise overall losses considerably. The BRRD Proposal seeks to establish a hierarchy of bail-inable claims that applies in a resolution context and member states will wish to note that this hierarchy of claims in a resolution context may vary from that under normal insolvency proceedings.

3. The European Economic and Social Committee issued its opinion on the BRRD Proposal on 12 December 2012.[2] The European Central Bank delivered its opinion on the BRRD Proposal on 29 November 2012.[3]

4. The European Parliament Committee on Economic and Monetary Affairs (ECON) is expected to adopt its report on the BRRD Proposal in the near future and the EP would then be ready to begin trilogues with a view to an agreement in first reading. Since June 2012, the Council's working party on financial services has held 21 meetings and the Presidency believes that considerable progress has been achieved towards reaching a general approach at ECOFIN and an agreed basis for pursuing negotiations with the European Parliament. However, a number of key political issues remain outstanding.

STATE OF PLAY

5. Discussions in the working party and in COREPER have led the Presidency to identify the **design of the bail-in tool** as a central issue: the tool would enable resolution authorities to write down or convert into equity the claims of the shareholders and creditors of institutions which are failing or likely to fail. Recent developments have highlighted the political importance of finding a common understanding on the scope and functioning of this tool and, in particular how uninsured deposits over €100,000[4] should be dealt with in bail-in. With a view to paving the way for final agreement on the Proposal, the topic will therefore require an examination by Ministers at the 14 May ECOFIN.

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2 OJ C 44, 15.2.2013, p. 68.

3 Doc. 17849/12 EF 322 ECOFIN 1087 DRS 141.

4 For the purposes of this note, uninsured deposits means eligible deposits, as referred to in the DGS Directive, which are over €100,000.

<u>Consideration of the three main approaches for the design of the Bail-in Tool</u>:

6. Discussions in the working party and in COREPER have allowed the Presidency to identify three main approaches to the design of bail-in. The three approaches – the Harmonised approach; the Discretionary approach; and the Mixed approach – are described below and set out in the Annex.

6.1 The first approach is the "**<u>Harmonised approach</u>"**, comprised of a limited set of defined exclusions from bail-in, with almost no discretionary exclusions (limited to derivatives) and insured depositor preference. This approach would provide a high degree of ex ante predictability and legal certainty to markets regarding the treatment of creditors in a bail in scenario. As only a single class of creditors, derivatives, may be excluded on a discretionary basis, this model achieves a high degree of harmonisation across Member States

A variation of the model described above, which reflects the original Commission Proposal, involves **bailing in the DGS on the same basis as all other senior unsecured creditors (*pari passu*).** The **main difference** between *pari passu* and insured depositor preference is that **insured depositor preference in most cases means that the DGS is unlikely to be bailed in**, as other creditors will have to absorb the losses first**.** A number of Member States have suggested that giving insured depositors' preference will mean increased costs for banks for non preferred depositors and other classes of creditors, but the US, Australia and a number of other developed countries already have depositor preference with no appreciable cost difference to banking systems without preference. In any case, the low size of DGS funds compared to insured depositors balances means that the funds would not be able to cover the losses in the event of a bail-in of a large bank if a *pari passu* approach was adopted, thus potentially making the bail-in tool in the model unusable.

Many Member States consider that the major drawback to the harmonised approach is the inability to deal with unforeseen events and that the absence of flexibility may result in the resolution authority avoiding or being unable to use the bail-in tool. This situation could arise, for example, where there are financial stability concerns or practical impediments to bailing in a given class of creditors for financial stability reasons. Where there is no flexibility to exclude such a creditor or class of creditors from the bail-in, the Resolution Authority may not be able to use the bail-in tool and instead may resort to using the resolution fund or bailing out at the tax payers' expense.

6.2 The second approach to bail-in, is the "**Discretionary approach**", with **framed flexibility,** which provides resolution authorities some degree of discretion on how the bail-in tool is used, depending on the circumstances. This flexibility could be framed in an EU context and set strict preconditions for the exercise of discretion by the resolution authority. The rationale is that, in order for the bail-in tool to be practicable and credible, the resolution authority must be able, where it thinks it necessary, to exclude liabilities (e.g. for financial stability, or continuity of critical functions reasons) that would otherwise inhibit the bail-in tool being used.

A number of alternative models can be considered which provide a range of discretionary exclusions from limited to wide ranging with appropriate safeguards. These include:

- A small number **of discretionary exclusions**, e.g. uninsured deposits and/or short term debt (refined appropriately, e.g. confined to natural persons and SMEs and with the option of limiting to specific maturities), liabilities related to the participation in payment, or clearing and settlement, systems, possibly subject to a strict maturity cap, OTC derivatives. The liabilities in the list of potential discretionary exclusions are limited to those which have the greatest propensity to generate concerns for financial stability or the continuation of critical functions);

- Provide as a general rule that **uninsured deposits of a natural person and SMEs** are excluded from bail-in, but provide the discretion to bail them in under strict preconditions and specific circumstances, i.e. subject to their bail-in being necessary to absorb losses and not raising financial stability risks. Under the strictly framed flexibility, this option could be complemented with a limited number of discretionary exclusions which would be subject to approval of an EU body within 48 hours of notification. Alternatively, these discretions could be framed in EU legislation, by way of a Commission Implementing Act, which would set strict preconditions for the exercise of these discretions by the resolution authority.

- An alternative approach would be to **provide the resolution authority with the discretion** to exclude any liability from bail-in on a case by case basis. This is a much broader approach which would require particularly strict criteria (e.g. the resolution authority must be able to justify that a given liability was not bail-inable in practice).

The argument in favour of this approach is that from a practical perspective a Resolution Authority should be able to exclude any liability which prevents a successful bail-in, because the alternative would be less palatable, i.e. use of Resolution Fund or a bail-out. This approach guarantees that the tool would always be available for use. A further safeguard to this approach might be to limit the actual exclusion to a percentage of the total pool of bail-inable liabilities.

It is argued by some Member States that the drawback of this flexibility is a lowering of harmonisation and a significant degree of legal uncertainty and unpredictability for investors and other unsecured creditors which would lead to an increase in the cost of funding greater than would arise simply from the removal of the implicit government guarantee, and would necessitate an institution holding a higher minimum amount of own funds and bail-inable liabilities in order to ensure it maintained sufficient and appropriate loss-absorbency capacity.

6.3 The third approach, the **"Mixed approach**" sets out a number of defined exclusions and contains a small number of discretionary exclusions. Crucially, it also provides depositor preference for uninsured deposits. It seeks to accommodate those looking for predictability and legal certainty on the one hand, while at the same time taking account of the need to have some degree of flexibility. It aims to provide a workable alternative solution to how uninsured deposits are treated by providing for depositor preference of these uninsured deposits. Some Member States insist that these deposits be included in the scope of bail in, while others consider that this class, particularly natural persons and SMEs, cannot be exposed to the same level of risk as senior bond holders and indeed are unlikely to be bailed-in in practice.

The compromise set out in the Discretionary approach (see paragraph 6.2) above, whereby uninsured deposits can be excluded on a discretionary basis, seeks to reconcile these two views, but leads to a lack of harmonisation.

The Mixed approach provides a solution to the harmonisation issue while reconciling the two views by giving uninsured deposits preference. This reduces the likelihood that the uninsured depositors will be bailed in, but still leaves the loss absorbency available if required. The approach makes the bail-in tool more credible, as it removes the risk that Resolution Authorities will not bail-in due to concerns about the impact on public confidence. It is possible that uninsured deposits could be limited to a smaller subset of uninsured deposits (e.g. natural persons and SMEs).

Common issues to all three approaches

7. It should be noted that all of the approaches share a common starting point which seems to be universally agreed, i.e. they provide for a broad scope of bail-in, with a limited list of defined exclusions (such as insured deposits, secured liabilities, wages and tax liabilities, secured borrowing etc.).

8. Most Member States agree that where discretion is applied, even in a very limited way (e.g. derivatives only), the loss absorbing capacity of an institution should be set at a level to reflect the potential of a reduced pool of loss absorbing creditors. In other words there is no cost-free way of excluding a liability, as the contribution that it would otherwise have made to the overall losses will have to be found elsewhere, either from a higher minimum loss absorbing requirement, burden shifting to other creditors, or the Resolution Fund.

9. The treatment of uninsured depositors remains a key issue particularly after recent events. The harmonised approach above would require that such deposits be automatically bailed in, while the discretionary approach would allow the option to exclude them from bail-in depending on the extent of discretion provided. The third approach (the application of depositor preference for uninsured deposits) removes the discretionary exclusion from bail-in for uninsured depositors, but would mean that in many instances uninsured deposits would not be bailed in, as there is a reasonable possibility that other creditors would fully absorb the losses first. However it does allow for them to be bailed in where losses exceed the capacity of other creditors to absorb.

Other issues:

10. In addition to bail-in, the other major political issue to be settled in ECOFIN is the **financing arrangements**. An aspect of this is directly linked with the bail-in tool i.e. the use of the resolution fund. The draft Directive requires the bail-in tool to be used first as a general rule (i.e. shareholders, capital and senior creditors to be bailed in) before the Resolution Fund can be used. However, there are a small number of Member States that would like a greater flexibility in the use of the Resolution Fund to allow it to be used for direct solvency support, possibly to complement a partial bail-in or the bail-in of junior creditors in well defined circumstances. The Presidency is of the view that there is not wide support for this approach.

11. The Presidency's view is that if the scope of the bail-in tool can be agreed and the link with loss-absorption capacity more clearly set out, this should in turn enable agreement to be reached on the **necessary minimum target level for the resolution fund**.

12. In relation to the option of moving forward the **date of application of bail-in** from 2018 to 2015, the Presidency notes that most delegations support keeping the commencement date for bail-in as of 2018 as well as the view that this could not be changed without considering the necessary counterbalancing measures to ensure that it could operate effectively and on a level playing field in its early years. This matter needs to be further explored if the option of bringing forward the date of application is to be pursued.

13. Finally, a third block of critical issues which needs to be agreed relates to **home-host arrangements** (which span over more than 20 Articles in the Proposal). The Presidency notes that major progress has been made with a view to finding a broad agreement on these provisions, but considers that more work is needed at technical level before a draft agreement can be presented to COREPER.

CONCLUSION

14. The following questions are put to Ministers:

1. Can Ministers agree to the common elements set out above, and in particular in paragraphs 7 and 8?

2. Which treatment set out in paragraph 9 should be given to uninsured deposits over €100,000?

3. Which one of the 3 approaches – the Harmonised approach; the Discretionary approach; or the Mixed approach – or a combination thereof achieves the optimum balance between the predictability inherent in a harmonised framework and the need for flexibility given the unpredictability of crisis situations?

Annex

Harmonised Approach - *Along the lines of the Commission Proposal*

Main elements	*Variant: Commission original proposal:*
• DGS substitutes for covered (i.e. insured) deposits • Insured depositor preference (i.e. DGS gets depositor preference) • Limited pre-defined mandatory exclusions from bail-in: e.g. wages, some tax debts, short term debt (to be defined), secured borrowings • Only discretionary (optional) exclusion: derivatives • **Uninsured depositors always bailed in**	• No Insured depositors preference (= DGS gets bailed in)

Discretionary Approach

Main elements	*Variants*
• DGS substitutes for covered (i.e. insured) deposits • Insured depositor preference (i.e. DGS gets depositor preference) • Limited pre-defined mandatory exclusions from bail-in i.e. : wages, some tax debts, secured borrowings • **Discretionary (optional) exclusions – possible candidates:** - All uninsured deposits - Uninsured deposits with a maturity of less than one month - Liabilities arising from payment, clearing and settlement - All/some derivatives, - Short term debt (subject to different maturity from ST debt under mandatory exclusion) Discretions subject to criteria defined in the Directive • **Bail-in of uninsured depositors essentially a question to be decided on a case- by-case (IF they are on the list of discretionary exclusions).**	• All liabilities may in principle be excluded, BUT subject to strict overall condition (Resolution Authority must be able to fully justify that a given liability was not bail-inable in practice and on financial stability grounds) • A second variant could be to provide as a general rule that uninsured deposits of natural persons and SMEs are excluded from bail-in, but provide the discretion to bail them in in specific circumstances where it is necessary to absorb losses and where it does not raise financial stability risks

Mixed Approach

Main elements	*Variant :*
• DGS substitutes for covered (i.e. insured) deposits • Insured depositors preference (i.e. DGS gets depositor preference) • **Uninsured depositor preference** • Broad pre-defined mandatory exclusions from bail in: e.g. wages, some tax debts, secured borrowing and possibly debt resulting from payment, clearing and settlement systems. • Small number of discretionary (optional) exclusions: e.g. all/some derivatives	• Could **limit uninsured depositors to a smaller sub-set which would have preference** e.g. uninsured deposits of natural persons and SMEs are included in bail- in but only AFTER other claims have been bailed in.