Financial Services User Group's (FSUG)

response on

Technical details of a possible EU framework for bank recovery and resolution

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GENERAL REMARKS

The Financial Services User Group welcomes the Commission's initiative to develop a possible EU framework for the management of failing credit institutions and an appropriate class of investment firms. We fully support the main scope of such a framework that seeks to provide a harmonised EU regime for crisis prevention and bank recovery and resolution, that will ensure that market exit remains a credible option, not only a theoretical possibility.

We are of the view that even the existence of an EU framework for bank recovery and resolution that will indicate that authorities are willing and able to effect a managed resolution of a financial institution, may encourage financial institutions and groups to focus more closely on financial risks.

We support the seven principles mentioned in the Commission's Communication of October 2010, which seem to capture several aspects of the crucial situation of troubled and failing banks.

We are of the view that one of the main causes of the recent global financial crisis was the poor regulatory framework in several aspects of the banking industry activities. A possible EU framework for bank recovery and resolution is expected to provide a regulatory path for failing banks with the least possible consequences to the financial sector and thus to economy and the consumers. Within this framework, supervisors and resolution authorities should have enough power and tools to be able to safeguard public interests.

However, we believe that the current framework should be viewed as a necessary part of several different measures to be taken in a new integrated EU crisis management framework whose main objective is to prevent a future financial crisis or at least minimize the burden on financial services users and on taxpayers, should such a crisis occur. Otherwise, the current framework faces the risk to be restricted to deal with isolated situations of at most average-sized troubled and failing credit institutions. As a matter of fact, OECD[1] has identified a number of causes for the recent financial crisis (inconsistent macroeconomic surveillance, taxation, regulation, structure of firms, corporate governance, executive pay, competition, education/safety net) that should also be taken under consideration.

Therefore, we would like to draw the Commission's attention into the following aspects:

1. The 'too big to fail issue'.

2. The high level of interconnectedness.

3. The nature of business (the 'universal banking' approach).

4. Saving very large financial institutions should not be done at the expense of financial services users.

The above mentioned aspects are interrelated and thus jeopardise the applicability of the whole initiative. The 'too big to fail issue' was identified as one of the key problems arising from the 2008 financial crisis and is not really addressed on a pre-emptive basis. This is an even bigger problem in Europe than in the USA because:

[1] *The Current Financial Crisis: Causes and Policy Issues*, Blundell-Wignall A., Atkinson P. and S Hoon Lee, ISSN 1995-2864, Financial Market Trends, OECD 2008.

- The USA have now passed regulations to prohibit commercial banks (which have the unique and free privilege of access to central banks funding) from proprietary trading activities. So far European authorities do not seem to even consider such action to reduce the ex ante risk of excessive bank size and systemic impact.
- Contrary to the USA (a legacy of the Glass Steagall Act that was repelled in 1999), a majority of the largest European based asset management groups are 100 % affiliates of commercial banks, which also own very large insurance companies ('universal' banking approach). The 'universal banking' nature of business has contributed in a. shaping too big to fail institutions and b. increasing the risk of financial transactions for these huge institutions. Furthermore, besides the conflict of interests these relationships generate, they also make European Governments more dependent upon commercial banks which are now the biggest holders of European Government debt, either directly or through their asset management and insurance affiliates. In fact, according to the Financial Times, the first 'quantitative easing' actions of the European Central Bank in 2010 consisted in using public funds to help some big commercial banks to unload more risky Euro Government bond portfolios (Greek, Irish, etc.) that these banks lately found themselves over exposed to.
- This problem is increased by the re intermediation of capital markets in Europe, helped by the MiFID (we refer to our reply to the MiFID review consultation). Indeed, the share of non financial end investors (individual and institutional) and of non financial issuers in capital markets (equity and fixed income) has been shrinking steadily to a quite low share.

Overall, 'too big to fail' credit institutions are not easily resolved without causing systemic risks. The FSUG is concerned that the EC is not even alluding to this serious problem, and does not propose pre-emptive measures to solve this issue. We are aware of the preventative powers of the Supervisor that could in theory enable it to require such structural changes as selling assets or businesses from any European bank. But that is very far from really addressing the problem described above.

Furthermore, financial institutions are highly interconnected as is evident from the recent financial crisis which started in the US and was globally spread due to this high level of interconnectedness. This high level of interconnectedness can also be viewed as a result of the universal banking paradigm and the shaping of big financial institutions. However, the most important characteristic of interconnectedness is the risk of systemic crisis. Some argue that the interconnectedness of financial firms is a more important influence on systemic risk than is the size of the firms. This does not seem to be addressed in the EU crisis framework as well.

Last, the 2008 financial crisis has shown that the first victims were first the non insider shareholders in banks and other financial institutions, then the consumers and the taxpayers. On the other hand, to our knowledge, not one financial institution, financial executive or other entity responsible for the crisis in Europe has been required to indemnify any victim.

The consultation paper also does not quantify the full cost to Governments and taxpayers of the 2008/2009 rescue of the European 'too big to fail' institutions (RBS, Fortis, ING, Dexia, etc.).

At the very least, these 'too big to fail' financial institutions should pay an insurance premium to Governments to cover the risk and cost of failure. EFI also failed to see proposals in this consultation document that will balance the need to address the 'too big to fail issue' with the need to protect financial services users' interests.

Again, in the USA (but also in the UK and in Belgium for example), regulators have become aware of the conflict of objectives between the prudential control and the users protection. They have opted (or are about to opt) for the so-called 'twin peaks' financial supervision approach.

Unfortunately, the very recent reform of the European financial supervision did not address this critical issue, and the financial services users' protection comes only as the sixth and very last objective of the three new European financial authorities (ESMA, EBA and EIOPA). This is a major concern for the hundreds of millions of EU citizens and financial services users who are suffering from the financial crisis. This Consultation does not address this open EU level issue.

Therefore, it is necessary that the current framework is accompanied with further initiatives to deal with the above mentioned problems, so that an integrated EU crisis management framework will be efficient, realistic and fair to EU citizens as well.

In this regard FSUG is concerned that any future resolution regime should commence from a stable financial base among all Member States. This is not the reality at this time with the possibility that three or more of them are facing the increasing risk and likelihood of a disorderly sovereign default with resultant social and economic cost for the Member States themselves, their consumers and taxpayers and the EU as a whole. The situation is further exacerbated as these States also have banking systems which are increasingly unable to secure adequate working funding other than through highly priced bond sales or ECB borrowings. The results of the current round of EU- wide stress testing of banks will trigger requirements for further capitalisation injections for these and other Member State banks causing even greater pressure on governments' resources and ultimately on their consumer taxpayers.

In order to prevent such occurrences in the future and to create an adequate financial support to enable an effective system of resolution FSUG suggests that an EU managed Resolution Fund be established contributed to by the banking industry on a basis to be determined- transactions, turnover or assets. However, it should be underlined that the role of the EU managed fund should be distinct and the fund should not affect or be related in any way with national funds of each Member State intending to cover specific financial elements (i.e. the Deposit Guarantee Schemes).

Due to time restriction we are unable to respond to every question. Therefore, we have focused on some of the high level issues and most of consumer related matters.

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Questions and answers

Institutional scope

1a. What category of investment firms (if any) should be subject to the preparatory and preventative measures tools and the resolution tools and power?

1b. Do you agree that the categories of investment firm described in Question Box 1 are appropriate? If not, how should the class of investment firm covered by the proposed recovery and resolution framework be defined?

1c. Are the resolution tools and powers developed for deposit-taking credit institutions appropriate for investment firms?

We support the view of the services of DG Internal Market and Services to apply a resolution regime to all credit institutions and an appropriate class of investment firms. Specifically, we believe that it is appropriate to extend the application of a resolution regime to some investment firms on ground of the activities or services they carry out, their size and their interconnectedness, and the fact that they are part of a banking group.

Furthermore, we believe that although the resolution tools and power developed for deposit-taking credit institutions are also appropriate for investment firms, there may be some alterations regarding the prevention and the early intervention tools and powers. Specifically, the level of risk of commercial versus investment banks differs significantly (with the latter group bearing very risky activities)[2], in such a level that a separation of commercial and investment activities should also be considered. Consequently, prevention and early intervention tools may be more demanding for investment firms than for purely commercial banks.

2a. Do you agree that bank holding companies (that are not themselves credit institutions or investment firms) should be within the scope of the resolution regime?

2b. Should resolution authorities be able to include bank holding companies in a resolution even if the holding company does not itself meet the conditions for resolution: i.e. is not failing or likely to fail (see conditions for resolution)?

2c. Are further conditions or safeguards needed for the application of resolution tools to bank holding companies?

We believe that bank holding companies should also be within the scope of the resolution regime, mainly because of the group financial support agreement rationale, as described in the intra-group financial support section of the current framework, that implies potential capital flows among all undertakings that comprise the group, and thus may ultimately affect the viability of the holding company as well.

Resolution authorities should include a bank holding company in a resolution, as long as it meets the conditions for resolution, but not otherwise.

[2] *Bank Activity and Funding Strategies, The Impact on Risk and Returns*, Policy Research Working Paper 4837, Demirguc-Kunt A. and H. Huizinga, The World Bank Development Research Group, Finance and Private Sector Team, February 2009.

Authorities

3a. Do you agree that the choice of the authority or authorities responsible for resolution in each Member State should be left to national discretion? Is this sufficient to ensure adequate coordination in case of cross-border crisis?

3b. Is the functional separation between supervisory and resolution functions within the same authority sufficient to address any risks of regulatory forbearance

3c. Is it desirable (for example, to increase the checks and balances in the system) to require that the various decisions and functions involved in resolution – the determination that the trigger conditions for resolution are met; decisions on what resolution tools should be applied; and the functional application of the resolution tools and conduct of the resolution process – are allocated to separate authorities

3d. Even if resolution authorities are a matter of national choice, should an EU framework specify that they should act in accordance with principles and rules such as those set in this document to take account of the fact any bank crisis management action in one Member State is likely to have an impact in other Member States?

We believe that the choice of the authority or authorities responsible for resolution in each Member State should indeed be left to national discretion. National authorities are expected to be more flexible and carry less administrative costs than a single European single authority for all Member States. Nevertheless, a European Authority is vital to ensure a high level of harmonisation in bank insolvency regimes across all Member States, to resolve potential disagreements between national resolution authorities and to coordinate a cross border crisis.

Supervisory and resolution functions should be separate and cooperative.

The various decisions and functions involved in resolution should be allocated in one authority to ensure a smooth continuity during the resolution steps of the fragile bank resolution situation.

As mentioned above, considering that a harmonised regime is needed at the EU level, an EU framework that would specify common principles and rules is essential. The essentiality of a harmonised regime lies directly on the fact that a cross border crisis is very probable within the EU single market and thus any bank crisis management action in one Member State may have an impact in other Member States as well.

Supervision

4a. Should the stress tests be conducted by supervisors, or is it sufficient for institutions to carry out their own stress tests in accordance with assumptions and methodologies provided by or agreed with supervisors, provided that the results are validated by supervisors?

4b. The current crisis has shown that stress test disclosure is necessary to reassure markets and to bring to light potential problems before they become too large to be managed. It cannot, however, be excluded that in some circumstances disclosure without consideration of the possible impact in the market could do more harm than good. Do you agree that under exceptional circumstances the results of the stress tests should be made public only after appropriate safeguards have been agreed and introduced?

4c. Do you agree that in an integrated European market, stress testing should be conducted on the basis of a common methodology agreed at the EU level and subject to cross verification?

We believe that it is not sufficient for institutions to carry out their own stress test and so stress tests should be conducted by supervisors. The main reason is that quantifying the risks at large financial institutions is a complex and costly process that is vulnerable to manipulation[3]; thus, a stress test being conducted by an independent organisation (namely the supervisor) would be vital in order to ensure confidence.

Stress tests information disclosure can be viewed indeed as an obvious thing to do, within the scope of transparency and diminishing information asymmetry. However, information disclosure may not be as simple as it may seem. Negative consequences do exist in the following two ways: a. possible negative signalling effects that could do more harm than good and b. a higher cost of collecting the information from the supervisor's side. The former reasoning is straightforward and does not need any further analysis. According to the second reasoning, broad information disclosure may incentivise the credit institution to keep information quiet in bad times and thus make it harder for the supervisor to collect the information in the first place[4]. Considering that consumers' interests will be at most safeguarded by actually diminishing information asymmetry between banks and their supervisors, there may be circumstances where the results of stress tests should be made public only after appropriate safeguards have been agreed and introduced.

We agree that stress testing should be conducted on the basis of a common methodology agreed at the EU level and subject to cross verification.

[3] *Prudential Stress Testing in Theory and Practice: Comments on 'Stressed Out: Macroprudential Principles for Stress Testing'*, unpublished manuscript, Lacker J. M., 25.2.2011.

[4] *Should Bank Supervisors Disclose Information About Their Banks?*, Edward Simpson Prescott, Federal Reserve Bank of Richmond Economic Quarterly, Winter 2008, vol. 94, no. 1, pp. 1-16.

Recovery planning

6. Are the required contents of preparatory recovery plans suggested in section B1 sufficient to ensure that credit institution undertake adequate planning for timely recovery in stressed situations? Should we include additional elements?

Recovery plans exist because a problem may occur and has to be dealt with. Thus, perhaps the first arrangement would be to evaluate the fair value of the troubled asset and estimate the funds needed to overcome the problem.

Furthermore, there should also be an arrangement referring to the time dimension and set detailed and realistic deadlines.

7a. Is it necessary to require both entity-specific and group preparatory recovery plans in the case of a banking group? How to best ensure the consistency of recovery plans within a group?

7b. Should supervisor of each legal entity be allowed to require any changes to entity specific recovery plans, or should this be a matter for the consolidating supervisor?

7c. Is a formal joint decision (in accordance with the procedure set out in Article 129 CRD) between the consolidating supervisor and the other relevant competent authorities appropriate for decisions regarding the group preparatory recovery plan?

7d. Should the EBA play a mediation role in the case of disagreement between competent authorities regarding the assessment of group preparatory recovery plans?

We believe that it is necessary to require both entity-specific and group preparatory recovery plans in the case of a banking group. There may be circumstances where an entity, although it belongs to a group, may independently and successfully apply a recovery plan. Thus, the availability of both entity-specific and group recovery plans, though more costly, offers more alternatives.

There may be situations where entity-specific recovery plans refer to intra-group funds transfers agreements that may affect the group's financial stability and viability. Thus, we believe that the consolidating supervisor should be informed and be able to disagree in any changes required by the supervisor of legal entity. A joint decision would be best, but there may also be cases of disagreements between competent authorities. In those cases, the EBA should play a mediation role regarding the assessment of group preparatory recovery plans.

Resolution plans

21a. Should resolution plans be required for all credit institutions or only those that are systemically relevant?

21b. Would the requirements for resolution plans suggested above will adequately prepare resolution authorities to handle a crisis situation effectively? Are additional elements needed to ensure that resolution plans will provide adequate preparation for action by the resolution authorities in circumstances of both individual and wider systemic failure?

21c. Please estimate:

- the one-off costs in EUR (e.g., investments in IT or other systems);
- the additional ongoing annual cost (e.g. human, subcontracts etc.), including the cost and number of full-time equivalent employees,

that your institution would be likely to incur in complying with requirements related to recovery and resolution plans.

Resolution plans should be required for all credit institutions, not only for those that are systemically relevant, in order to safeguard consumers' interests and avoid public financial support.

Regulation authorities should also require information on the interconnectedness of the credit institution with other institutions, so as to better assess the level of systemic risk, and thus prepare a more realistic resolution plan.

Preparatory and preventative powers

22a. Are the preparatory and preventative powers proposed in Section D3 sufficient to ensure that all credit institutions can be resolved under the framework proposed? Are any further specific powers necessary?

22b. Specifically, should there be an express power to require limitations to intra-group guarantees, in order to address the obstacles that such guarantees may pose to effective resolution? (The FSB has identified such an obstacle: the guaranteed activities may be more difficult to separate from the rest of the organisation in times of stress, and may limit the ability to sell the guaranteed business.)

22c. In what cases, if any, might the exercise of such powers have an impact on affiliated entities located in other Member States? In such cases, should the EBA play a mediation role, or should the group level resolution authority make the final decision about the application of measures under section D4 to single group entities (irrespective of where they are incorporated)?

As described in the introduction, the resolution of a credit institution is a complex issue. The proposed preparatory and preventative powers could most probably be sufficient to ensure a smooth resolution, under the framework proposed, considering however that this framework does not seem to tackle important issues as those described in the introduction.

We believe that in cases where impacts affect more than one Member States, the EBA should play a mediation role.

23a. Do the provisions suggested in sections D4 to D6 achieve an appropriate balance between ensuring the effective resolvability of credit institutions and groups and preserving the correct functioning of the single market?

23b. Do you consider that only the group level resolution authority (rather than the resolution authorities responsible for the affected entities) should have the power to require group entities to make changes to legal or operational structures (see point (e) in the list of possible preparatory and preventative powers in (E4))?

23c. Are there sufficient safeguards for credit institutions in the process for the application of preparatory and preventative measure that is proposed in sections D4 to D6?

It is difficult to define the appropriate balance between ensuring the effective resolvability of credit institutions and groups and preserving the correct functioning of the single market. Preparatory and preventative powers consist by default regulatory intervention that affects the functioning of the single market. However, effective resolvability should be ensured and is expected to lead in the correct functioning of the single market in the long-run. The provisions suggested in sections D4 to D6 seem to effectively pursue this balance.

We believe that group level resolution authorities should have the power to require group entities to make changes to legal or operational structures; however in situations where these changes may affect the affiliated entities, the corresponding resolution authorities should be able to question these changes.

Early intervention

24a. Is the revised trigger for supervisory intervention under Article 136(1) CRD (i.e. extended to include circumstances of likely breach) sufficiently flexible to allow supervisors to address a deteriorating situation promptly and effectively?

24b. Are the additional powers proposed for Article 136 sufficient to ensure that competent authorities take appropriate action to address developing financial problems? Are there any other powers that should be added?

We believe that the proposed powers include a wide variety of tools that enable them to cover several situations that could cause moral hazard actions and simultaneously seem to shape the necessary preconditions to address developing financial problems.

25a. Should supervisors be given the power to appoint a special manager as an early intervention measure?

25b Should the conditions for the appointment of a special manager be linked to the specific recovery plan (Option 1 in Section E2), or should supervisors have the power to appoint a special manager when there is a breach of the requirements of the CRD justifying intervention under Article 136, but the supervisors have grounds to believe that the current management would be unwilling or unable to take measures to redress the situation (Option 2 in Section E2)?

25c. If the conditions for appointment of a special manager are based on Article 136, is an express proportionality restriction required to ensure that an appointment is only made in appropriate cases where justified by the nature of the breach?

We believe that supervisors should be given the power to appoint a special manager as an early intervention measure. In the modern executive compensation environment where employee stock options and similar compensation products are widely met, incentives for moral hazard actions by bank managers should not be excluded. Thus, special managers appointed by the supervisors are expected to overcome this situation.

We believe that the appointment of a special manager should be linked to the specific recovery plan and thus we opt for Option 1; however, the time dimension should also be incorporated in each case, denoting that progress should be made according to predetermined deadlines.

Recovery plans

26a. Do you agree that the decision as to whether a specific group recovery plan, or the coordination at group level of measures under Article 136(1) CRD or the appointment of special managers, are necessary should be taken by the consolidating supervisor?

26b. Should the supervisors of subsidiaries included in the scope of any such decision by the consolidating supervisor by bound by that decision (subject to any right to refer the matter to a European authority that could be the EBA)?

26c. Is a mechanism for mediation by a European authority appropriate in this context and should the decision of that Authority be binding on all the supervisors involved?

26d. Is the suggested timeframe (24 hours) for decisions by the consolidating supervisor and the EBA appropriate in the circumstances?

In line with our answer in Question 7, both entity-specific and group preparatory recovery plans in the case of a banking group should be required. In the case of a group plan, its implementation procedure and respective decisions should be taken by the consolidating supervisor. However, the supervisors of subsidiaries should also be included in the scope of any such decision, as any group-level action may affect subsidiaries. Joint decisions would be best, but there may also be cases of disagreements. In those cases, a European authority (that could be the EBA) should play a mediation role and the decision of this authority should be binding on all the supervisors involved.

No comments regarding the timeframe.

27. Do you agree that the consolidating supervisor should be responsible for the assessment of group level recovery plans?

In line with the answers in Questions 7 and 26, in case there is no disagreement regarding the group level recovery plan, the consolidating supervisor should be responsible for the assessment. Otherwise, a European authority should be responsible for its assessment.