EBA written statement to Bundestag hearing on proposed German resolution law

The German draft bill presented by the Federal Government on the Implementation of the Banking Resolution Mechanism (Implementation of Regulation (EU) No 806/2014) proposes various legislative measures relating to the procedural and substantial aspects of resolution, among these changes to the German banking act changing the ranking of certain tradable liabilities with the idea to enhance the effectiveness of the bail-in tool. It is very encouraging to see Member States taking prompt and concrete steps to address resolvability. Major progress has been made on increasing banks' capital and liquidity levels and in other areas of regulation to strengthen their resilience, but resolution is essential to fix the too-big-to-fail problem and needs to progress quickly. The cornerstone of credible resolution is to ensure loss absorption by shareholders and creditors.

Beside the requirement of sufficient loss absorption capacity in quantitative terms, the main policy issue from the perspective of the quality and credibility of loss absorption is how to deal with statutory and exceptional exclusions from the bail-in tool, and as a consequence, the possibility for creditors to be treated differently in resolution, even when in a normal insolvency process they would have the same rights to recoveries from the assets of a failed bank.

The BRRD establishes strong safeguards around these exclusions, first to protect the property rights of creditors, and second to allow investors to understand the risks they face and price them. This will in particular give well-informed long term investors the option to assert more effective monitoring of the risks of individual banks, and so incentivise banks to run themselves in a less risky fashion. The BRRD provides several levels of safeguards, including:

i. Restrictions on the option to depart from the insolvency hierarchy (for example, Article 48 requires that capital instruments bear losses first before applying the bail-in tool) and requiring resolution authorities to follow the creditor hierarchy unless expressly provided for in the directive (Article 34)

ii. A right to compensation if creditors (or shareholders) are treated more harshly than an independent valuer's estimate of how they would have been treated in insolvency (the 'No Creditor Worse Off' standard)

In this area, the BRRD follows the recommendations of the Financial Stability Board's Key Attributes of Effective Resolution Regimes[1].

Resolution authorities will of course seek to avoid using resolution fund money to pay compensation to creditors, by adopting resolution strategies which minimise any departure from the insolvency hierarchy. In addition, contributions of the resolution fund to recapitalisation of institutions under resolution are subject to the conditions and limitations

[1] Key Attribute 5: http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

pursuant to Article 44 of the BRRD. As a step to minimise the need for using resolution fund money, the EBA's technical standards on resolution planning require resolution authorities to identify any liabilities which will not absorb losses under their proposed resolution strategy.

This should include, under a bail-in, both liabilities which are completely excluded from the application of the bail-in tool (such as secured liabilities) and any which the resolution authority expects to be excluded by effect of the exceptional power in Article 44. And the EBA draft technical standards on the minimum requirement for eligible liabilities (MREL) require authorities to assess whether the costs of these exemptions are sufficiently widely spread across loss absorbing liabilities to avoid a breach of the No Creditor Worse Off standard.

There are several possible approaches to reducing the risk of such a breach. One option is to simply issue more credibly loss-absorbing liabilities, spreading the costs of protecting some creditors more widely. This is not ruled out under the BRRD or the EBA technical standards, but the FSB's proposed rules on total loss absorbing capacity take the view that this would not be sufficient, at least for the largest, globally systemic banks.

The other possibilities aim to change the insolvency hierarchy by ensuring that liabilities which from a financial stability perspective should absorb losses first in resolution do the same in insolvency. This can be done:

i. Through contractual provisions in certain liabilities. This is relatively simple and can be feasible for banks themselves to execute. But in some cases it may conflict with the terms of existing subordinated debt, and/or require time to establish a new investor base.

ii. By issuing 'structurally' subordinated debt from a holding company that is not an operating bank, so that the creditors do not have any direct claim on most of the bank's assets. This avoids the need to put the operating bank through a resolution process, which may simplify the resolution, and has been attractive in jurisdictions where banks have existing holding companies and insolvency law enforces clear distinctions between legal entities in a group, such as the US and the UK. But it takes time for banks to transition to such a structure, may involve other costs, and may not be legally possible for some types of bank (notably cooperatives).

iii. By changing the statutory insolvency hierarchy, as is proposed in the draft bill under discussion. Notably the BRRD already requires Member States to give covered and eligible deposits preferred status in insolvency. This approach has the advantage of providing a large amount of loss absorbing capacity immediately and providing legal certainty. However it may not be effective for foreign subsidiaries of banks, and relies on foreign jurisdictions recognising that a domestic insolvency process would have jurisdiction, which may be especially challenging in third countries.

Each approach has advantages and disadvantages and the EBA does not have a preference between them. However there may be a need to review whether differences in implementation between Member States could affect competition or the implementation of cross-border resolution. Some areas where implementation may differ are highlighted below.

An important difference between the contractual and the structural approach on the one hand and the proposed statutory approach is the impact on cost of funding for existing and newly issued debt. While the cost for newly issued contractually and structurally subordinated debt are expected to be relatively higher as long as the share of subordinated debt in the institution's liabilities is low, these costs would be relatively lower if existing debt is subordinated; in this case the costs would be borne by the holders of the existing debt who would face the risk of higher losses and, as a consequence, potentially lower ratings for the debt instruments affected.

Another difference which should be considered is the scope. Contractual and structural approach may be applied to individual banks on a case-by-case basis (for example only to globally important financial institutions). This would hardly be possible for a statutory approach which needs clear unequivocal criteria for determining whether the subordination applies.

There are also a number of technical issues to consider in designing a subordination approach. These include a) how closely the resulting insolvency hierarchy aligns with the exemptions from bail-in in Article 44(2) of the BRRD, which exempt for instance interbank liabilities with a maturity of less than seven days; b) whether to further distinguish the treatment of liabilities which do not count towards the MREL (e.g. those with remaining maturity of less than one year) or proposed TLAC requirements (e.g. structured notes); and c) how to ensure the law makes as clear as possible to investors to which types of liabilities the subordination applies, also with a view to liabilities issued under foreign and third country law.