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COVER NOTE

from: Secretary-General of the European Commission,
signed by Mr Jordi AYET PUIGARNAU, Director

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to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European
Union

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Subject: COMMISSION STAFF WORKING DOCUMENT
SUMMARY OF THE IMPACT ASSESSMENT
Accompanying the document 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

Delegations will find attached Commission document SWD(2012) 167 final.

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COMMISSION STAFF WORKING DOCUMENT

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1. PROBLEM DEFINITION

Over the course of the financial crisis, the authorities' ability to manage crises both domestically and in cross-border situations has been severely tested. It quickly became evident that neither authorities nor banks were suitably prepared. Contingency planning for scenarios of financial distress was insufficient. Not all Member States had the power to intervene, stabilise and reorganise an ailing bank at an early stage. Authorities in many Member States did not have adequate tools and powers to handle bank failure. Since the failure of large, interdependent banks could have caused significant systemic damage, authorities were left with no choice but to use taxpayers' money to rescue them.

Furthermore, while the operation of cross-border banks has become highly integrated to the point where business lines and internal services are deeply interconnected across geographical borders of Member States, the authorities' power to intervene has remained national. As a consequence, if a cross-border bank fails, supervisors and other (resolution) authorities concentrate only on operations within their own territories. This may complicate cross-border cooperation and lead to inefficient and possibly competing approaches to resolution, with suboptimal results at EU level.

During the financial crisis, limited or no funds had been built up in advance ('ex ante') by the private sector to finance resolution measures.

Public intervention cost taxpayers substantial sums of money and even put some Member States' public finances at risk. Between October 2008 and October 2011, the Commission approved €4.5 trillion (equivalent to 37% of EU GDP) in state aid measures to financial institutions, of which €1.6 trillion (equivalent to 13% of EU GDP) was used in 2008-2010. Guarantees and liquidity measures account for €1.2 trillion, or roughly 9.8% of EU GDP. The remainder went towards recapitalisation and impaired assets measures amounting to €409 billion (3.3% of EU GDP).¹ Budgetary commitments and expenditure on this scale are not sustainable from a fiscal point of view, and impose a heavy burden on present and future generations. Moreover, the crisis, which started in

¹ Source: European Commission, State Aid Scoreboard, Autumn Update 2011 [COM(2011) 848].

the financial sector, pushed the EU economy into a severe recession, with the EU's GDP contracting by 4.2%, or €0.7 trillion, in 2009.

2. ANALYSIS OF SUBSIDIARITY

Although the banking sector is highly integrated within the EU, systems to deal with bank crises remain nationally based and insufficient to deal with cross-border institutions in difficulty. Coordination in such circumstances is likely to be complicated and the objectives pursued by each authority may differ. If authorities have limited options available to resolve banks, this increases the risk of moral hazard and generates an expectation that large, complex and interconnected banks will again need public intervention in the event of problems. Therefore only EU action can ensure that, in times of crisis, credit institutions are subject to coherent intervention that ensures a level playing field and promotes further integration within the Internal Market.

No EU action is needed to select resolution authorities and procedures for bank resolution. These can be decided on by Member States.

3. OBJECTIVES OF EU INITIATIVE

The general objectives are to maintain financial stability and confidence in banks and to avoid contagion. The proposal aims to minimise losses for society as a whole, in particular for taxpayers, and to reduce moral hazard. The proposed framework is also aimed at strengthening the internal market for banking services while maintaining a level playing field.

4. PREFERRED POLICY OPTIONS AND THEIR EXPECTED IMPACT

Preparation and prevention

The first objective of the bank recovery and resolution framework is to ensure that bank failures are avoided as far as possible and that authorities and banks are prepared for adverse developments. To this end, the following options were examined and selected.

Voluntary intra-group financial support agreements will enable financial groups to transfer assets between entities when one member of a group suffers financial difficulties. This could help to stop the financial problems of parts of a group becoming too serious and so benefit the group as a whole. However, transferring assets from a healthy entity could reduce its liquidity and capital and hence weaken the position of debt holders and depositors. Therefore the transfers should be executable only if they do not jeopardise the liquidity or solvency of the support provider. Supervisors could give their agreement to the framework, which would provide safeguards for all stakeholders. In certain situations supervisors could even ask banks that are part of a voluntary group support agreement to help another entity in the same group. This scope for optimising the allocation of assets in emergency situations would also strengthen the internal market.

Banks and authorities will be required to develop contingency plans for crisis situations. Recovery plans drafted by banks could help supervisors identify appropriate action to

restore bank soundness at an early stage. Drafting recovery plans would also help the banks themselves to review their operations, risks and necessary actions in a problematic situation. Resolution plans drafted by the authorities would enable any measures to be taken more quickly, more efficiently and more effectively, which could substantially decrease the (social) cost of bank failure. If resolution authorities are fully aware of the ways in which they can effectively resolve or liquidate a failing bank or group in an orderly fashion, the likelihood of success is substantially higher.

Resolution authorities will be given additional powers to enable them to require changes to banks' operational and business structures and to limit the banks' exposure and activities. The measures aim to ensure that banks are resolvable in case of failure; they would contribute to removing the implicit state support (a likely bail-out) from those banks that are too complex, big or important to fail. This would reduce moral hazard and force banks to operate more prudently. If banks are resolvable, the extensive use of taxpayers' money to bail them out is not the only solution, as 'managed failure' becomes an option. However, removing the implicit state guarantee would probably increase banks' funding costs. Moreover, while the increased powers of resolution authorities would help to defend the public interest, they might limit the fundamental rights of shareholders and management to operate in the way that best suits their objectives and business strategies. Hence, any measures to remove impediments to resolution would have to be proportionate to the systemic importance of the credit institution and the likely impact of its failure on financial stability. Measures should be non-discriminatory and serve the public interest.

Early intervention

The existing early intervention framework managed by supervisors will be further developed. Supervisors will be able to intervene at an even earlier stage (i.e. upon a likely breach of the Capital Requirements Directive² (CRD) as opposed to an actual breach as at present) and will be equipped with an expanded list of tools and powers. In this way supervisors could avoid further deterioration of any problems at a bank.

An expanded, harmonised set of early intervention tools could pre-empt or correct problems at supervisory level and therefore greatly increase the overall effectiveness of crisis management in the EU. Measures such as requiring divestment of certain activities could substantially reduce excessive risks accumulated by institutions, thus preventing their failure. The appointment of a special manager would enable authorities to stop mismanagement of banks immediately and to implement corrective measures to prevent adverse situations from deteriorating.

Having a larger, more consistent set of tools available to all supervisors will improve cooperation between them and enable important measures that are presently not available in all Member States where cross-border banking groups operate.

Some of the tools could, however, limit the freedom of management (e.g. limiting business, replacing managers with a special manager) and shareholders (e.g. suspending dividend payments). Such measures could therefore be introduced only together with

² Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

safeguards that ensure that they will not be misused, will serve the public interest and are proportional.

To enable banks to increase their capital in an emergency situation, legislation will be amended to give the general meeting of shareholders the power to decide in advance of any crisis that a general meeting can be called at reduced notice should the need arise for an emergency capital increase.

Resolution

The introduction of a minimum set of special bank resolution tools (e.g. sale of business, asset separation, bridge bank) in all Member States will significantly increase the authorities' chances of achieving successful and effective resolution (managed, timely failure of banks) and hence of maintaining the continuity of key financial services and the stability of the financial system as a whole. In contrast to normal insolvency procedures, a special resolution procedure for banks would give authorities the ability to use techniques which are more suited to the needs of the banking business and allow a more appropriate balance of priorities to be struck with regard to stakeholders (resolution favours depositors, continuity of services and, ultimately, financial stability).

A supplementary mechanism would enable banks' debt to be written down or partially converted into equity ('bail-in'). This can be beneficial in cases where other tools may not be sufficient to resolve a large, complex and interdependent financial institution in a way that protects financial stability and taxpayers' money.

The bank resolution framework will reduce or remove the implicit state guarantee of the debt of even the largest and most important banks. As a natural consequence, the funding costs of banks are expected to increase somewhat. In other words, the costs previously borne by taxpayers will now be borne by bank stakeholders (creditors and owners). Increased bank funding costs could reduce GDP slightly.

The conditions for the use of resolution tools and powers need to ensure that authorities are able to take action before a bank is economically insolvent in order to increase the realistic chances of successful and effective resolution. Managed failure, where the management and shareholders bear the losses first, will also reduce moral hazard. At the same time, resolution measures could limit the fundamental rights of shareholders and debt holders. Therefore they would only be applied in exceptional situations and in the interest of the general public.

Cross-border cooperation

Cooperation among resolution authorities will be institutionalised and formalised. Various options such as providing EU authorities with resolution powers and setting up an EU resolution authority were discussed. The preferred option is to make arrangements for cooperation through resolution colleges. Resolution colleges would ensure that national authorities inform each other of emergency situations, discuss them and decide on joint or coordinated actions in the event of a failure among cross-border banks. The participation of the European Banking Authority (EBA) in resolution colleges would further ensure that the interests of all Member States and stakeholders are taken into account and fragmentation of the internal market is avoided.

Financing

Jointly calibrated ex-ante resolution funds (RFs) and deposit guarantee schemes (DGS) financed by the industry will increase the success of resolution measures and provide further safeguards for taxpayers. Although DGS and RFs differ in scope, designing them in combination will produce a number of synergies. There would be economies of scale, as resolution reduces the risk of contagion and optimal calibration of resolution funding reduces the financing requirements for DGS.

Based on model calculations, the optimal target size of the DGS and RFs would be at least 1% of covered deposits held by EU banks. Ex ante funds could possibly be accumulated in DGS, but in that case DGS should be able to finance resolution. If a Member State does not allow the DGS to finance resolution, a separate fund would be needed.

Under this policy, other options such as setting up national resolution funds strictly in isolation from DGS and a resolution fund at EU level were also assessed but rejected.

Overall impact

The proposed crisis management framework at EU level is intended to further enable financial stability, reduce moral hazard, protect depositors and critical banking services and save taxpayers money. In addition it aims to protect and further develop the internal market for financial services.

The framework is expected to have a positive social impact, firstly by reducing the probability of a systemic banking crisis and a resulting fall in GDP, and secondly by preventing taxpayers' money from being used to bail out banks again in a future crisis. The cost of crises, if they happen, should be borne by bank shareholders and debt holders in the first instance.

The costs of the framework derive from the potential increase in the funding cost of banks due to the removal of the implicit state support and from the costs of setting up resolution funds. Banks might pass on the increased cost to customers or shareholders by pushing rates on deposits lower, increasing lending rates and banking fees or reducing returns on shares. However, competition might reduce banks' ability to pass on the costs in full.

Increased funding costs might reduce GDP, while the stability of the financial sector and reduced risk of taxpayers' money being needed to recapitalise failing banks would have a positive effect on GDP. The new capital requirements under the Basel III accord (which reduces the probability of bank failures) are expected to generate net benefits equal to 0.14% of the EU's GDP annually. The jointly calibrated DGS and RF are expected to bring positive net benefits equal to 0.2-0.3% of the EU's GDP annually. The debt write-down tool (bail-in) could produce economic net benefits equal to 0.3-0.6% of the EU's GDP annually. Overall, these measures are expected to generate a cumulative net benefit equal to 0.7-1.0% of the EU's GDP annually.

The preferred options do not lead to any significant administrative burden. Some elements of this proposal could be seen as entailing an administrative burden, but based on the public consultation these are assumed to be immaterial.

The proposal has been scrutinised to check that its provisions are fully compatible with the Charter of Fundamental Rights and notably the right to property (Article 17) and the right to an effective remedy and to a fair trial (Article 47). Limitations on these rights and freedoms are allowed if they are necessary and genuinely meet the general interest objectives recognised by the EU or the need to protect the rights and freedoms of others.

Impact on EU budget

The above policy options will have implications for the budget of the Union.

The present proposal would require EBA to (i) develop around 23 technical standards and 5 guidelines (ii) take part in resolution colleges, mediate and make decisions in case of disagreement, and (iii) provide for recognition of third country resolution proceedings and conclude non-binding framework cooperation arrangements with third countries. The delivery of technical standards is due 12 months since the entry into force of the Directive which is estimated to be between June and December 2013. Since EBA will have to develop an expertise in a completely new area, it is estimated that 5 temporary and 11 national seconded experts will be needed for 2014 and 2015 to deliver the required technical standards and guidelines and other tasks as explained in (ii) and (iii) above.

This proposal has no impact on the environment.

5. MONITORING AND EVALUATION

Since bank failures are unpredictable and the aim is to avoid them, one cannot plan to monitor bank resolution on the basis of how real bank failures are handled. However, the preparation and prevention phase, especially the development of recovery and resolution plans and the measures implemented by the authorities based on these plans could be monitored. This could be the task of the European Banking Authority. The transposition of any new EU legislation will be monitored under the Treaty on the Functioning of the European Union.