High Level Seminar on Selected Legal Issues of the Resolution Framework

Speech by Martin Merlin,

Head of the Financial Services Policy Unit, European Commission, Directorate General Internal Market and Services

Ministry of Finance, Warsaw

2 October 2013

TO BE CHECKED AGAINST DELIVERY

Dear Minister, Ladies and Gentlemen,

The ambition and novelty of introducing a harmonised resolution framework in the 28 Member States has raised many legal challenges. The work will not stop when the proposals of the European Commission are adopted by the colegislators. In fact it will begin as national legislators will be requested to implement the framework, and Courts may be called upon to review decisions of national authorities in implementing the framework. The legal robustness of the framework will be tested and will determine the ability for authorities to take decisions which preserve financial stability while respecting the legitimate rights of affected parties. Therefore it is utterly relevant to take some time now to focus on the legal dimension.

I. There is no way to understate the importance of a sound resolution framework for financial stability.

The financial turmoil which followed the collapse of Lehman Brother illustrated with utmost strength how damaging disorderly failure can be, not only for financial markets, but also for real economy at large. Authorities across the globe realised that many financial institutions are too big or too interconnected to fail, and that conventional insolvency tools are ill suited to preserve the financial systemic components of a bank. They reacted swiftly to contain the haemorrhage with the only tools which seemed fit at the time: state support to banks in the form of loans and fresh capital. This resulted in a wave of systematic bail-out. In the EU, Member States have provided banks with no less than 1600 Billion Euro in liquidity and solvency support between 2008 and 2011. These bail-outs did fulfil their first aid function but nevertheless created a major strain on public finances already impacted by plummeting growth and booming unemployment. This also created a major perception of moral hazard, as taxpayers and healthy operators were asked to foot the bill rather than the shareholders and creditors of failing banks. Against this background, the leaders of the G20 committed to "*develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard*". The roadmap was fleshed out by the FSB in October

2011, which laid down all the Key Attributes of an effective resolution framework, including the ability of authorities to force restructuring measures on failing banks to preserve stability and the principle that losses should be assumed by the shareholders and creditors of a failing bank rather than taxpayers. Work followed suite across the globe, with similar framework in the US, UK, Switzerland etc. The European reform is therefore consistent with a well-thought and collectively agreed international agenda.

II. The Commission released in June 2012 what we consider the most faithful implementation of the FSB Key Attributes.

The proposal contains the basic components to ensure the introduction of an effective resolution framework throughout the single market:

- a network of resolution authorities in each of the 28 Member States
- an extensive toolbox, including early intervention tools, compulsory recovery and resolution plans, and powers to force the restructuring of a distressed bank in order to preserve the sustainability of essential functions such as deposits and payments systems;

- means to ensure swift and consistent solution for the resolution of cross-border groups;
- resolution financing arrangements financed by the industry to facilitate resolution operations, for example to provide temporary funding or fresh capital to a bridge bank, without exposing tax payers money

The negotiation is going on. The ECON Committee of the European Parliament has adopted its Report in May. The Council has concluded a General Approach in June, and we are well on track to finalise the text by the end of the year for an implementation by early 2015 for most of the Directive, and 2018 for the bail-in tool.

Admittedly, the final text will be different from the initial proposal. This is a democratic process, and some of the most far-reaching components of the regime have proven sensitive, such as systematic binding mediation between home and host resolution authorities or mutual lending among national resolution funds. Given the national anchor of supervision, resolution financing and budgetary responsibility, it is understandable that a shift towards integrated decision making raises some concerns.

The measures proposed by the Commission in the context the Banking Union have partly aimed at addressing these objections. The Single Supervisory Mechanism has now been approved by the co-legislators and should be up and running by … . European supervision paves the way for a more integrated resolution process, on the basis of the Commission proposal for a Single Resolution Mechanism and a Single Resolution Fund within the Banking Union.

III. The Resolution reform undeniably raises important legal challenges commensurate with the objectives it pursues

Undoubtedly, the reform entails a shift of paradigm from a situation where banks can theoretically fail but in practice cannot, to a situation where authorities intervene to prevent contagion to the system while putting the burden on shareholders and creditors.

The problematic of individual rights in insolvency proceedings is not new, but it takes a much more acute dimension in resolution. While traditional liquidation is aimed at optimising value from the perspective of creditors, resolution is underpinned by an exogenous consideration which is the preservation of the stability of the financial system.

In order to achieve this objective, limitations to essential rights such as the right to property, the freedom to conduct business, and the right to judicial review are necessary but must be constrained by a number of safeguard. The European Union is indeed bound to by an increasingly sophisticated corpus of human rights law deriving both from constitutional traditions common to the Member States, the treaty and the Charter of fundamental rights, and international law such as the European Convention of Human Rights. These rules apply not only to the EU but also to Member States when implementing EU secondary law.

And what do these sources teach us? That no limitation to fundamental rights is possible? No, but rather that limitations can be introduced provided they are commensurate to a legitimate objective of general interest and do not affect the essence of these rights. And this is the delicate balance which the EU and many jurisdictions in the world have sought to find.

1. Naturally, **property right** features prominently in these interrogations. Resolution authorities will be able to force the transfer of assets and liabilities to a bridge or a purchaser. Using the bail-in tool, they will be able to write down shares, and if necessary write-down and convert into shares subordinated and senior claims with a

view to ensure the sustainability of the activity, which in turn could dilute other existing shareholders.

This is compatible with the European Convention on Human Rights to which Member States are bound, as long as it is justified by the higher objective of preserving financial stability, and as long as operational safeguards are in place to ensure that the owners are provided with a fair compensation.

These safeguards are laid down in the bank resolution proposal, which foresees an independent valuation process to establish the financial reality of the distressed institutions, the funding needs of the resolution process, and most importantly to ultimately ensure that creditors have not borne losses superior to those they would have borne in case the bank would have to be liquidated.

Naturally, some creditors will tell you they would have preferred a public bail-out by the taxpayer, but this anomaly cannot serve as a reference: in a market economy, a failing operator must be able to fail and expose its creditors and shareholders to losses. If a bank has to be resolved, resolution must be seen as an alternative to proper liquidation. And in most cases, even with the bail-in, creditors will walk

out of the resolution process in fact better off than in a disorderly liquidation which can cause value destruction beyond any grasp.

2. The next issue is that of the **control of these safeguards by the judiciary**, including at which stage affected parties will be able to challenge resolution actions, and what can be the intensity of the judicial scrutiny.

The Commission has sought to strike the right balance between:

- on the one hand, the right of effective remedy which ensures that rights are not mere declarations of intention,
- on the other hand the need for authorities to take swift decisions in emergency and preserve legal certainty for third parties.

Accordingly, the proposal foresees judicial review but limits the effects of the review on the resolution process:

- The lodging of an application would not have an automatic suspension effect
- Courts would not be able to issue suspension orders
- Resolution actions would be immediately enforceable
- And an annulment would not affect any subsequent act based on the review decision where this is necessary to protect the interest of third parties acting in good faith.

➔ Ultimately, the rights of affected parties will therefore be resolved through compensation damages.

The Commission is confident that this balance is appropriate, although the exact setup might still evolve as the discussions in Parliament and Council develop. For example, the Council has suggested an option for Member States to introduce ex ante judicial approval and limited liability for authorities and their personnel.

Conclusion

Ladies and gentleman,

This reform has attracted attention from a multitude of practitioners and authorities around the world. It has also benefited from the experience – including negative experience – developed in many jurisdictions in Europe and elsewhere.

Early examples of bank resolution decisions have already been challenged. But as the Northern Rock judgment of the European Court of Human Rights has illustrated, the legitimacy of authorities to limit fundamental rights in order to protect financial stability has been acknowledged, including a wide discretion in identifying the appropriate measures.

Naturally, discretion does not mean arbitrary decision. The European Union is committed to the rule of law and I know how important this principle is to this country. Ensuring that limitations to rights are framed in a legally secure and commensurate way is precisely the aim of the legislative proposals currently on the table, and I believe this objective will soon be achieved.

Thank you.