Single Resolution Mechanism

A pro-active approach to resolution planning
November 2015
Over the coming year, the Single Resolution Mechanism (SRM) will undertake two exercises that will shape banking in the Eurozone. First, it will assess the resolvability of Eurozone banks, and second, it will set the minimum requirement for own funds and eligible liabilities (MREL) for each of them. For banks judged to be unresolvable, the Single Resolution Board (SRB) may mandate that the bank remove impediments to resolution. This could involve changes to the bank’s structure and increases in capital.

Banks in the Eurozone need to take a proactive approach to these exercises. This will ensure resolution authorities understand the bank’s preferred approach to resolution and how the authorities might execute that approach. In turn, this will help authorities assess resolvability and minimize the level of MREL that they will require.

This document focuses on resolution planning for banks in the Eurozone, and more specifically on the 122 significant Eurozone banks under the direct supervision of the European Central Bank (ECB), for whom the SRB assumes direct responsibility as resolution authority.
In June 2012, Eurozone leaders vowed to break the “doom loop” that makes governments dependent on banks. As a result, the EU introduced the Single Supervisory Mechanism (SSM) and the SRM as two pillars of the Banking Union framework for the Eurozone. While the SSM seeks to prevent bank failures by strengthening their supervision, the SRM aims to make banks “safe to fail.”

The Eurozone’s recovery and resolution framework rests on two main legal texts:

1. The Bank Recovery and Resolution Directive (BRRD), which applies to all EU countries. The BRRD took effect in July 2014 and was due to be transposed into national laws by January 2015, while bail-in provisions should be implemented at national level no later than January 2016.

2. The SRM regulation, which applies only in the Eurozone and in EU Member States that opt to join the SRM voluntarily. The SRM regulation entered into force in August 2014.

The SRM regulation centralizes resolution decision-making within the Eurozone under the aegis of the SRB, but relies on national resolution authorities (NRAs) to help prepare and execute those decisions. The SRB is directly responsible for the Eurozone’s 122 significant banks, but it will also oversee the resolution of all entities concerned by the SRM regulation. The resolution of banking groups with entities outside the Eurozone will be organized under colleges of resolution authorities, where the SRB represents Eurozone NRAs.

Under the SRM regulation, the SRB will be vested with full bail-in powers from January 2016. The SRB will also be in control of the Single Resolution Fund (SRF), which mutualizes contributions by national banking sectors and ensures the availability of medium-term funding support, if required, after shareholders and creditors have been bailed-in to a minimum level.

Bank failure management will include three levels of intervention under the BRRD:

1. If a bank is facing difficulties but remains a going concern, the SRB or NRA can order the bank to implement its recovery plan, if the bank has not already done so.

2. If the situation worsens and the bank meets some triggering criteria, the SRB or NRA can take early intervention measures to stabilize the bank.

3. If the bank approaches the point of non-viability (PoNV), either the ECB or the SRB can determine whether it is time to initiate either the liquidation or resolution (under the BRRD) of the bank.

In principle, liquidating a failing institution through normal insolvency proceedings should always be considered first, with a resolution only carried out when it is necessary in the public interest. In practice, the SRB, NRAs, national central banks and finance ministries are all expected to have a voice in determining whether a non-viable bank should be liquidated or resolved.

Furthermore, if the failing bank is due to be resolved, the SRB will decide on the actual resolution strategy and tools to be employed, subject to agreement with the European Commission and Council. The tools at the SRB’s disposal include the sale to, or merger with, a private sector purchaser; the creation of a bridge institution; asset separation and bail-in (write-down of liabilities and conversion of debt to equity in order to effect a recapitalization). If these tools are not sufficient, the SRB may, under certain bail-in conditions, approve a recourse to SRF funding.
The SRB will be responsible for developing resolution plans for all banks it covers directly, including the 122 significant banks. The SRB is expected to delegate the initial drafting of plans to NRAs for those banks that do not yet have one in place. Banks are required to provide NRAs with data packs to allow them to draft resolution plans. They can also be pro-active by conducting an internal assessment of their resolvability so as to allow for a more insightful dialogue with NRAs.

Resource constraints mean that the SRB is likely to focus first on global systemically important financial institutions (G-SIFIs), domestic systemically important financial institutions (D-SIFIs), and other banks that it considers a priority.

Drafting or updating resolution plans is an iterative process driven by the annual assessment of the bank’s resolvability. Resolvability is defined as the ability to resolve a bank without cost to the taxpayer or significant disruption to the financial markets or the economy at large, while maintaining the continuity of its critical services. Concerns identified in the course of the assessment will be addressed in a redraft of the resolution plans.

Resolvability assessment is a five-stage process led by the SRB, in consultation with the ECB and the relevant national supervisory and resolution authorities.

As illustrated on this page, the first step involves determining whether an institution could be liquidated under normal insolvency proceedings, rather than be resolved. In the second stage, authorities will identify a preferred resolution strategy and alternative strategies most appropriate to the bank’s structure and business model.

The third and fourth steps consist of evaluating the feasibility and credibility of these strategies:

► A strategy is deemed feasible if it can be applied effectively within an appropriate time frame, and if there are no impediments that could hinder the resolution process in terms of both the short-term stabilization of the bank and its long-term reorganization.

► To determine the credibility of a strategy, the SRB will estimate its impact on the bank’s ability to continue providing its critical functions, on the financial system (including market confidence, market infrastructures, and funding costs for other banks) and on the economies of Member States.

The table below lists items that the SRB may examine to identify impediments to resolvability.

### Resolvability assessment process

1. Draft resolution plan, or re-draft
2. Assess possibility to liquidate
   - **If not**
3. Identify a preferred resolution strategy
   - **Then**
4. Assess the feasibility of the preferred resolution strategy
   - **Then**
5. Assess the credibility of the preferred resolution strategy

### Assessment of impediments to resolvability

<table>
<thead>
<tr>
<th>Area</th>
<th>What may be assessed</th>
</tr>
</thead>
</table>
| **Structure and operations** | Core business lines and continuity of critical functions
|                        | Service agreements                                        |
|                        | Payment and settlement systems                            |
| **Financial resources**     | Intragroup guarantees and back-to-back transactions       |
|                        | Funding (needs, sources and ability to transfer across entities) |
|                        | Eligible liabilities (amount, type, loss absorbency and issuing entities) |
|                        | Assets qualifying as collateral for central bank facilities |
|                        | Amount of write-down or recapitalization                  |
| **Information**         | Management information system (MIS)                      |
|                        | Processes to identify depositors and amounts covered by the Deposit Guarantee Scheme (DGS) |
| **Cross-border issues**  | Third-country authorities                                 |
|                        | Laws relative to contractual termination rights           |
| **Legal issues**         | Regulatory approvals and authorizations for resolution    |
|                        | Termination of contracts                                 |
|                        | Prohibitions on the transfer of assets or liabilities      |
The resolvability assessment could have a profound impact on banks' business operations. Once impediments to resolution have been identified, a bank will have four months to propose measures it will take to remove them. If a bank fails to do so, or if the SRB deems these measures insufficient, it may be required to take measures including any of those listed below.

The SRM regulation emphasizes that the SRB will prefer less intrusive measures wherever possible, and their application should be proportional to the threat posed to financial stability. Yet, the wide-ranging and potentially disruptive nature of these measures should provide banks with a powerful incentive to cooperate with regulators – and in particular to provide timely, accurate and high-quality information.

As witnessed in the case of the G-SIBs (which have prepared resolution plans under US and UK legislation since 2012), banks have voluntarily undertaken considerable structural changes in order to improve their sustainability and ensure their resolvability, including around the following themes:

► Lowering the risk profile of business models and de-risking their balance sheet (measures taken include balance sheet deleveraging, and the ring-fencing or sale of activities that are riskier).
► Maintaining adequate capitalization and liquidity at the correct levels in the group.
► Reviewing their legal structure and revenue booking practices to maximize efficiency and assure compliance with regulations.
► Revamping contract structures and creating new operational servicing capabilities and models to ensure continuity of critical functions.
► Upgrading information systems to produce the information needed to execute their resolution plan.
► Reviewing HR agreements.

### Area

<table>
<thead>
<tr>
<th>Measures that can be imposed to remove impediments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Structure and operations</strong></td>
</tr>
<tr>
<td>► Revise intragroup financing agreements</td>
</tr>
<tr>
<td>► Set up a parent financial holding company</td>
</tr>
<tr>
<td>► Change legal or operational structures to reduce complexity, and to ensure that critical functions can be separated when applying resolution tools</td>
</tr>
<tr>
<td>► Implement new operational servicing models (e.g., service companies) to ensure continuity in resolution and to support post-resolution restructuring</td>
</tr>
<tr>
<td>► Draw up service agreements to cover the provision of critical functions</td>
</tr>
<tr>
<td>► Limit or cease specific activities</td>
</tr>
<tr>
<td>► Restrict the development of business lines or the sale of products</td>
</tr>
<tr>
<td><strong>Financial resources</strong></td>
</tr>
<tr>
<td>► Limit maximum individual and aggregate exposures</td>
</tr>
<tr>
<td>► Divest specific assets</td>
</tr>
<tr>
<td>► Issue liabilities</td>
</tr>
<tr>
<td>► Take other steps to meet the MREL</td>
</tr>
<tr>
<td><strong>Information</strong></td>
</tr>
<tr>
<td>► Provide additional information relevant to the resolution process</td>
</tr>
</tbody>
</table>

1The need to reduce banks’ risk profile may be turned into an explicit requirement under the EU’s Bank Structural Reform. This reform aims at reducing systemic risk through the ban of proprietary trading and the segregation of other risky trading activities. It is currently under negotiation at the EU Parliament where it is the subject of strong debate between parliamentary groups.
The other component of the SRM that will have a direct impact on banks is the requirement to hold a minimum of loss-absorbing liabilities in the form of the MREL.

The requirement, created under the BRRD and due to be implemented by national regulators from January 2016, is similar in nature to the Financial Stability Board’s (FSB) total loss-absorbing capacity (TLAC) effective from 2019. Both aim to ensure that there is enough investor capital outstanding to resolve a bank without recourse to public funds.

The BRRD creates an order by which a bank’s liabilities will be bailed in, and losses imposed. It starts with common equity tier 1 (CET1) and proceeds to additional tier 1 capital (AT1) and tier 2 capital (T2), followed by other subordinated liabilities, senior debt and uncovered deposits as per the ranking of their claims under normal insolvency rules. The subordination of senior debt to other liabilities with which it ranks pari passu, such as corporate deposits, is currently being considered at national level. Last in the queue are deposits covered under deposit guarantee schemes (retail or SME deposits below €100,000). However, insured depositors will not themselves bear losses, as these will be incurred by the DGS.

Eligible liabilities for the MREL include capital instruments (CET1, AT1, T2), other subordinated debt, senior debt and other eligible liabilities (e.g., senior unsecured debt and uncovered corporate deposits) with a residual maturity over one year, and DGS loss liquidation (up to 50% of the DGS size). Resolution authorities and Member States can adapt the MREL eligibility criteria.

For more information, please refer to Article 45(6) of the BRRD and to the EBA's final draft Regulatory Technical Standards (RTS) on MREL published on 3 July 2015.
The level and eligibility of liabilities for MREL will be individually determined for each institution by the relevant resolution authority on the basis of a set of harmonized criteria. The level of the MREL needs to be sufficient to meet the first criteria below, and could be further increased to meet the subsequent requirements:

1. The bank shall be resolved through the application of the resolution tools, including bail-in, by ensuring that there are enough funds and eligible liabilities available to (i) absorb losses and (ii) recapitalize the bank’s post-resolution operations.
   - The existing regulatory capital requirements (both Pillars 1 and 2) and buffers already reflect the level of unexpected losses the bank should be able to absorb. NRAs must check whether some components of the regulatory capital are not suitable for loss absorbency, and also if additional MREL is required to mitigate an impediment to resolvability.
   - The amount of recapitalization required under the preferred resolution strategy should ensure that:
     - The bank complies with the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) immediately after resolution (e.g., minimum 8% total capital ratio, any Pillar 2 capital and leverage ratio requirement applicable).
     - Capital buffers are brought back to an appropriate level when compared with the bank’s peer group in order to restore market confidence in the bank.

2. The MREL should be sufficient even if the resolution authority excludes certain classes of liability from contributing to loss absorption or recapitalization.

3. Contributions from a DGS to the financing of the resolution should be taken into account but are limited to the lesser of (i) the amount of losses covered that depositors would have borne in insolvency, or (ii) 50% — or a higher percentage set by the Member State — of the target level of the DGS.

4. The bank’s size, business and funding models, and risk profile should be considered — in particular whether these factors are already adequately mitigated by prudential capital requirements or other supervisory risk mitigants under the Supervisory Review and Evaluation Process (SREP), or by measures adopted to remove or reduce impediments to resolvability.

5. If failure of the bank would adversely impact financial stability, the level of MREL should be sufficient to ensure that the conditions for use of the SRF would be met (i.e., loss absorption and conversion of not less than 8% of the total liabilities and own funds of the bank, or under certain conditions, 20% of risk-weighted assets).

---

2 The determination will be made by the SRB after consulting with the competent authorities, including the ECB, for the banks directly overseen by the SRB, and by NRAs for all other entities.
The level of MREL will therefore be directly influenced by the chosen resolution strategy, the cost of removing impediments in a resolution, and the perceived risk in the execution of the strategy. Additionally, resolution strategies for banking groups will need to include an assessment of whether the home resolution entity will take the lead (single point of entry, or SPE), or if each country will resolve group entities in their respective jurisdictions (multiple points of entry, or MPE). The choice could determine by which entities the MREL should be held within the group. Banks should be aware that such assessment may not have been completed at the time of resolution, so the amount of MREL may need to be sufficient to accommodate either option.

EU authorities view MREL and TLAC as being largely aligned in terms of their impact on bank capital. This is despite their many differences, such as calculation methods or eligible liabilities. The MREL is nonetheless projected to result in a requirement equal to, or higher than, that of the TLAC – which is already expected to be set at between 16% and 18% of risk-weighted assets.

The information required to assess the MREL for G-SIBs by January 2016 will be available, as their resolution plans have already been reviewed and assessed for resolvability by NRAs. However, this is not the case for D-SIBs, whose initial MREL requirements are therefore expected to be mild until the resolution planning work has been carried out to a sufficient degree of detail. Resolution authorities can also phase in the MREL over a period that shall not exceed four years from January 2016. Nevertheless, as seen in the case of Basel III capital requirements, markets may expect banks to meet the target requirements on a fully loaded basis well ahead of the phase-in calendar – a possibility for which banks should be prepared.
Conclusion

Resolution planning for each bank will require an ongoing and iterative discussion between resolution authorities and regulators on the interconnected themes of prudential assessment of business models, resolution strategies, resolvability and regulatory capital requirements.

Banks are therefore presented with an urgent need as well as a real opportunity to cooperate with the authorities in addressing the complex task of resolution planning. They will be required to provide quality and timely information packs. They can also benefit from being pro-active and conducting an internal resolvability assessment.

Banks that are able to provide comfort to NRAs and the SRB that (i) the planning exercise is understood and under way, (ii) their business model and operations will be adjusted to facilitate resolution, and (iii) impediments to resolvability will be identified and mitigated upfront, may well benefit from lower MREL requirements and will limit the need for unplanned operational transformation.

Banks should take the following actions when initiating their resolution planning exercise:

► Assess the implications of the new regime on MREL
► Identify structural issues, exposures (intragroup and external), assets, products and legal and operational complexities that might increase MREL requirements
► Analyze the business change and cost to optimize against MREL levels, while considering other elements such as the Business Model Assessment (BMA) and Bank Structural Reform (BSR)
► Determine a resolution strategy that reflects their revised business model and group strategy, and draft internal resolution plans
► Establish a “culture of resolvability” in regular bank governance
# How can EY help

<table>
<thead>
<tr>
<th>Steps in resolution planning process</th>
<th>EY support</th>
</tr>
</thead>
</table>
| **Organization of resolution planning** | ◀️ Methodology, scoping, planning and resourcing  
▶️ Identify internal constraints (e.g., data consistency) |
| **Resolution strategy preparation** | ◀️ Analyze the entity and the various factors impacting resolution planning  
▶️ Set criteria for resolution planning  
▶️ Review and help to optimize business model and operational structure in light of regulation (e.g., SRM, BMA, BSR) against MREL level  
▶️ Identify a preferred resolution strategy |
| (Re-) drafting of internal resolution plan | ◀️ Support the drafting of internal plans  
▶️ Provide training and technical assistance |
| **Resolvability assessment** | ◀️ Run crisis simulation exercises  
▶️ Identify strengths and weaknesses in the internal resolution plan  
▶️ Identify impediments to resolvability and advise on their mitigation |
| **Implement change to business model** | ◀️ Assets disposals, optimization of funding structures, tax and corporate structure, asset valuations, creation of servicing companies, collateral management, adapt Management Information System (MIS) |
| **Dialogue with the authorities** | ◀️ Prepare for dialogue with the resolution and competent authorities on the resolution exercise and resolvability assessment |
| **Further possible advice:** | |
| MREL funding optimization | ▶️ Composition and capital allocation in the group |
| Preparation for valuations | ▶️ Create valuation parameters and templates to be used during the implementation of a resolution |
| Data preparation | ▶️ Help to prepare data pack for the resolution authorities  
▶️ Enable the timely preparation of data for valuation at the point of resolution  
▶️ Integrate the efficient production of data into daily management |
| Recovery and resolution implementation | ▶️ Handle actual recovery and resolution execution cases |

## Why EY?

- **Specific understanding of the recovery and resolution planning process** through a wealth of experience with entities and authorities across the globe
- **Thorough experience in dealing with supervisors**
- **Intelligence of EY’s Global Regulatory Network** connected with local and supranational supervisors
- **Experienced team** with proven, relevant recovery and resolution planning experience
Contact information:

**Alexander Beijer**, Partner  
Banking & Capital Markets Leader NL  
alexander.beijer@nl.ey.com  
+ 31 88 4071181

**Jeroen van der Kroft**, Executive Director  
Financial Services Advisory  
jeroen.van.der.kroft@nl.ey.com  
+ 31 88 4071018

**Jeroen Wiggers**, Manager  
Financial Services Advisory  
jeroen.wiggers@nl.ey.com  
+ 31 88 4072381

**Naomi Jacobs**, Manager  
Financial Services Advisory  
naomi.jacobs@nl.ey.com  
+ 31 88 4071910
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CQ0288
19564.indd (UK) 11/15. Artwork by Creative Services Group Design.
ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com