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EU Draft Crisis Management Directive Requires Banks to Implement Recovery Plans

Overview

On June 6, 2012, the European Commission presented a draft directive on the recovery and resolution of credit institutions and investment firms (also referred to as the "Crisis Management Directive" or "CMD") after extensive preparatory work on the international level and within the European Union. The draft directive provides a framework for crisis management in the financial sector. It envisages implementation into national laws by January 1, 2015, with the exception of the regulations concerning "bail-in," which should be implemented by January 1, 2018. The aims of the draft directive are:

- To avert systemic risks for the financial sector resulting from a bankruptcy of credit institutions and investment firms;
- To resolve bank failures in an orderly way by, among other things, improving cross-border cooperation;
- To avert and prevent banking crises and spill-over effects and preserve financial stability; and
- To make shareholders and creditors pay for bank failures rather than using public funds.

The Crisis Management Directive is based on the assumption that ordinary insolvency regimes are not suited to deal with bank failures because (i) banks perform critical functions for the entire economy, (ii) they operate entirely on the basis of trust and bank failures undermine confidence in the banking system, (iii) of the long duration of traditional insolvency procedures and (iv) the financial crisis showed that resolution and maintenance of financial stability required significant funds from the public. The Crisis Management Directive focuses on the following parts: Prevention and preparation, early intervention, resolution and liquidation and resolution financing.

PREVENTION MEASURES

Member States are obliged to designate public administration authorities with special skills in the context of restructuring and liquidating credit institutions (resolution authorities). Suitable for this purpose can be existing supervisors, central banks and relevant ministries, as well as separately created authorities.

Coordinating tasks and decision-making powers will be given to the European Banking Authority ("EBA"), which is responsible for coordination among Member States, as well as for the development of various technical standards. Institutions are required to submit detailed financial recovery plans, at both the individual bank and the group level. A consolidating supervisory authority coordinates different national resolution authorities. EBA may be called upon for coordination or may act on its own initiative to coordinate competent authorities on national level.

Furthermore, resolution authorities are required to establish resolution and liquidation plans, at both the institutional and the group level. The detail required in the plan is dictated by the significance of a possible failure and the complexity of the structure of the relevant institution.

EARLY INTERVENTION RIGHTS

If the competent authority comes to the conclusion that a recovery plan is insufficient, or an institution has not filed a resolution plan, early intervention rights come into existence. These include the right to request a reduction of the complexity of an institution, the adaption of financial strategies or the preparation of capital measures.

Intra-group Financial Support

The Crisis Management Directive establishes a framework for intra-group financial support by group members in favor of other group entities. The parent company may determine the participating group entities. Support may not be granted without consideration, and the principle of reciprocity applies.

The creation of an intra-group support framework requires an application by the parent company. Any support may not endanger compliance with capital rules, but support measures may be granted notwithstanding any limitations of domestic laws. In this respect these rules do not have equivalents in national laws, e.g., neither German corporate law nor the German Restructuring Act allows such a far reaching intra-group support.

Appointment of Special Agent

In the case of a significant deterioration of the financial situation, or in the case of material infringement of laws or material irregularities, authorities may appoint a special agent to replace the ordinary management of an institution. The term of such special management is limited to one year, but it may be extended under certain circumstances. Groups may be submitted to a joint special agent and EBA has a coordinating role. Any appointment of a special agent cannot be regarded as a case of liquidation, resolution or termination.

RESOLUTION AND LIQUIDATION

Authorities will have the power to apply a number of resolution tools if an institution becomes insolvent or is at the brink of insolvency without action being taken, if interference with shareholders rights is justified or if there is no other solution available to restore the institution and the resolution measures are justified by public interest. These tools include:

- Sale of an institution or its business;
- Setting up a bridge institution;
- Spin-off of assets and liabilities; and
- Bail-in.

These tools can be applied in combination: however, a spin-off must be combined with other instruments. Additionally, domestic resolution tools may be applied if not conflicting with overall resolution of groups.

The “sale of business” tool does not require shareholder consent, and it envisages a sale on commercial terms. The “bridge institution” tool allows authorities to transfer systemically relevant parts to a publicly controlled bridge bank and aims at rescuing those parts of a failing institution. The purpose of the “spin-off” tool is to transfer distressed assets to an asset management vehicle that allows work-out over a longer period of time. The “bail- in” tool allows authorities to write-down claims of unsecured creditors and to make debt-equity conversions without creditors’ consent. However, certain creditors will be privileged and are not subject to a bail-in: e.g., deposits covered by deposit protection schemes, covered liabilities, short term liabilities with original maturities of less than one month and claims of employees and certain contractors, as well as tax and social liabilities.

In addition, and subject to the composition of total liabilities of the relevant bank, authorities may require banks to maintain a minimum debt eligible for bail-in. It can be predicted that these bail-in rules will have significant impact on the refinancing costs of financial institutions and that the line between debt and equity need to be reconsidered.

RESOLUTION FINANCING

The aim of the draft Crisis Management Directive is to avoid public funding of losses

generated by a resolution of financial institutions. Member States are required to set up special financing arrangements the aim of which is that losses resulting from bank failures shall be covered by contributions from the industry. Those national financing arrangements will have minimum funding levels based on model calculations, but it is envisaged that optimal funding levels should reach 1 percent of protected deposits.

Furthermore, national deposit protection schemes shall be included into resolution financing, and all national financing arrangements and deposit protection schemes are required to provide cross-financing to each other on an EU-wide level. In addition, the CMD provides for the mutualisation of those financing arrangements in the case of a group resolution.

The inclusion of national deposit protection schemes, as well as cross-border support, is highly controversial. Member States may be concerned that compulsory common lending between, and group mutualisation of, resolution financing arrangements will give rise to risks and unintended consequences such as contagion, moral hazard and strategic default. There is a possibility that a financial crisis could spread from Member State to Member State as national financing arrangements are exhausted and other Member States' resolution financing arrangements are obliged to lend to them.

Main Differences Between Draft EU-Directive and US Approach

In contrast to the proposed EU Crisis Management Directive, the resolution framework established in the United States by the Dodd-Frank Act's Orderly Liquidation Authority ("OLA") does not contain preventive measures aimed at averting the failure of large systemically significant financial companies. Instead, OLA establishes a framework to address systemic risk through the liquidation process by placing failing financial companies (including bank holding companies, broker-dealers and other companies engaged primarily in financial activities) into a special resolution framework with the Federal Deposit Insurance Corporation ("FDIC") acting as receiver.

While OLA does not contain preventative measures, other parts of the Dodd-Frank Act impose enhanced supervisory and capital requirements on banks and bank holding companies, which are designed to prevent the insolvency of these types of entities. OLA is not intended to replace the existing United State Bankruptcy Code as the primary method of resolving financial companies, rather, it would be used in very limited special situations to preserve financial stability.

The FDIC's powers as receiver in an OLA proceeding are very broad, and are similar to those currently possessed by the FDIC for bank receiverships. Under OLA, the FDIC would be tasked with liquidating the business. It would likely accomplish this liquidation by either transferring the business of the company to an existing bank or bank holding company or to a newly created "bridge company" (for subsequent sale) or by winding down the relevant institution through the sale of assets and business lines.

Areas for Discussion

PROCESS FOR SETTING UP RECOVERY AND RESOLUTION PLANS

Although the EU Crisis Management Directive becomes effective only on January 1, 2015 (2018 with respect to the bail-in provisions), European regulators already now require banks, in particular global systemically important institutions (G-SIFIs), to set up resolution plans (so called "living wills"). Until the Crisis Management Directive becomes effective, the legal basis for living wills is, in many EU countries, still general regulatory law. For example, in Germany, neither the Restructuring Act nor the Banking Act contains specific legal requirements for living wills. Hence, banks are depending on close cooperation with their regulators in order to determine the content and detail of resolution planning. Guidelines are provided by the terms

of the Crisis Management Directive, as well as by the "Key Attributes of Effective Resolution Regimes for Financial Institutions" published by the Financial Stability Board[1] and the EBA Discussion Paper on a Template for Recovery Plans.[2]

CONNECTION WITH ENVISAGED EUROPEAN BANKING UNION AND THE ROLE OF THE ECB

The proposals of the EU Commission for a European Banking Union and the allocation of specific tasks to the ECB concerning prudential supervision and the CMD are parallel working streams. However, it may be expected that the potentially new supervisory role of the ECB will trigger certain amendments to the CMD.

Indeed, the CMD is specifically considered in the Communication outlining the Commission's overall vision for banking union, which was published alongside the proposal for banking union.[3] Somewhat unexpectedly, the Communication did not promise a future proposal for a single resolution fund or a single deposit guarantee scheme, but it did cross-refer to the CMD and another proposal currently being negotiated—the recast of the deposit guarantee schemes directive[4]—and asked the European Parliament and the Council to reconsider both these proposals in light of the proposal on banking union.

The Commission called on the European Parliament and the Council to reach agreement by the end of the year on both of these proposals. Once agreement on these proposals has been achieved, the Commission plans to publish a proposal creating a single resolution authority for countries within the banking union, which would have the ability to resolve banks and to coordinate the application of resolution tools.

The creation of a single resolution authority for countries within the banking union would clearly impact on the framework envisaged by the CMD, and so it is somewhat surprising that it will be proposed immediately after agreement is reached on CMD. The banking union proposals themselves appear also to impact on some of the proposed provisions of the CMD, in particular those on resolution financing.

As explained above, the proposed CMD contains provisions that oblige the national financing arrangements of all 27 Member States to lend to each other and mutualises those financing arrangements in the case of a group resolution. The original proposal to recast the deposit guarantee schemes directive contained a similar provision, which mandated mutual borrowing, but this has been deleted in Council negotiations as Member States had serious concerns about both practical funding and consequential risks.

There is a logical argument that supervisory control and fiscal responsibility are linked. If this argument is accepted, then it could be said to follow that banks that are not subject to banking union ought not to benefit from provisions that establish a common fiscal backstop, and, equally, that Member States should not be obliged to accept fiscal responsibility for banks over which they do not have supervisory control. This may lead to the provisions on common lending and group mutualisation, particularly their application to countries outside the banking union, being reconsidered.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Dr. Jörg Wulfken
Partner, Frankfurt
T +49 69 7941 2951
jwulfken@mayerbrown.com

Jeffrey P. Taft
Partner, Washington DC
T +1 202 263 3293
jtaft@mayerbrown.com

Jean-Pierre Lee
Partner, Paris
T +33 1 53 53 43 43
jplee@mayerbrown.com

Dr. Salomé Cisnal de Ugarte
Counsel, Brussels
T +44 20 3130 3398
scisnaldeugarte@mayerbrown.com

Alexandria Carr
Of Counsel, London
T +44 20 3130 3398
acarr@mayerbrown.com

Francisco José Bauzá
Partner, Madrid
Ramón y Cajal Abogados
T +34 91 576 19 00
FJBauza@ramoncajal.com

Rafael Bazán
Partner, Madrid
Ramón y Cajal Abogados
T +34 91 576 19 00
RBazan@ramoncajal.com

Endnotes

[1] Available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

[2] Available at http://www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/DP%202012%2002/Discussion-Paper-on-Template-for-Recovery-Plans.pdf.

[3] Communication from the Commission to the European Parliament and the Council, "A Roadmap towards a Banking Union" (COM(2012) 510 final).

[4] See http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

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