COUNCIL OF THE EUROPEAN UNION

Brussels, 22 October 2010

15375/10

EF 150
ECOFIN 653

COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	20 October 2010
to:	Mr Pierre de BOISSIEU, Secretary-General of the Council of the European Union
Subject:	Communication from the Commission to the European Parliament, the Council, European Economic and Social Committee, the Committee of the Regions and the European Central Bank An EU Framework for Crisis Management in the Financial Sector

Delegations will find attached Commission document COM(2010) 579 final

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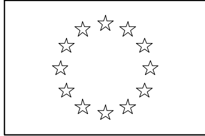
Encl.: COM(2010) 579 final



EUROPEAN COMMISSION

Brussels, 20.10.2010
COM(2010) 579 final

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN CENTRAL BANK

An EU Framework for Crisis Management in the Financial Sector

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN CENTRAL BANK

An EU Framework for Crisis Management in the Financial Sector

(Text with EEA relevance)

1. INTRODUCTION

During the financial crisis, governments discovered that banks and other systemic financial institutions could not be allowed to fail. Put bluntly, there was no simple way for a bank to continue to provide essential banking functions whilst in insolvency, and in the case of a failure of a large bank, those functions could not be shut down without significant systemic damage. The actions that governments were forced to take to deal with banking institutions in distress – capital injections, asset relief measures, guarantees on assets and liabilities and liquidity support – succeeded in stabilising the financial system. However, they also propped up failing institutions and supported creditors at huge costs to public finances: EU governments committed aid amounting to around 30% of EU GDP, while the aid used amounts to 13%.[1] These public interventions have had a significant impact on the level playing field within the internal market.[2]

There is consensus that this must never happen again. Banks must be allowed to fail, like any other business. Authorities must be equipped with tools that enable them to prevent the systemic damage caused by disorderly failure of such institutions, without unnecessarily exposing taxpayer to risk of loss and causing wider economic damage. Alongside tougher regulation reducing the chances of a bank becoming distressed, a credible regime is needed to re-instil market discipline associated with the threat of failure and to reduce moral hazard – the implicit protection from failure that those in the banking sector currently enjoy.

The Commission has been developing an EU policy response, and to date has adopted two Communications related to crisis management and resolution. The first, in October 2009,[3] considered what changes were needed to make possible effective crisis management and resolution or orderly winding up of a failing cross-border bank, and was the subject of a public consultation. The results of that consultation were presented at a conference on crisis management organised by the Commission in March 2010.[4] In spring 2010 the Commission established a group of insolvency law experts to assist with the preparatory work. The second Communication published in May 2010[5] explored the financing of resolution in a way which minimises moral

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1 Commission services and information provided by Member States via the Economic and Financial Committee, up to December 2009.

2 The European Commission has therefore required, where appropriate, burden sharing and measures to limit such competitive distortions in accordance with EU treaty provisions.

3 COM(2009) 561

4 Information on that conference, including presentations and papers are published on the Commission website at: http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#conference

5 COM(2010) 254

hazard and protects public funds.[6] A report by the European Parliament has also made important recommendations on Cross-Border Crisis Management in the Banking Sector (the Ferreira Report).[7]

The Commission is helping to shape the work of the FSB and the G20, and is also closely monitoring other international developments. The G20 summit held in Toronto in June 2010 committed to the design and implementation of systems whereby authorities have the powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden. The G20 also called on the FSB to consider and develop concrete policy recommendations to address problems associated with, and to resolve, systemically important financial institutions by the Seoul Summit in November 2010.[8] In the US, the Dodd-Frank reform[9] has established a resolution framework for systemic institutions at group level.

This Communication sets out the policy orientations the Commission intends to pursue on the basis of the work done to date on crisis management and resolution. The Commission will continue its preparatory work along these lines with a view to presenting legislative proposals in Spring 2011. That proposal will be accompanied by an impact assessment, and will complete the Commission's implementation of the principal G20 reforms in the area of financial regulation. A public consultation on technical details of the legislative framework under consideration will be launched in December 2010. Section 6 of this Communication also outlines further work on the reform of insolvency law and the resolution of cross-border groups.

2. SCOPE AND OBJECTIVES

The framework outlined in this Communication will apply to all credit institutions and some investment firms,[10] irrespective of whether they operate cross-border or domestically. However, the Commission will carry out further work on resolution of other financial institutions, reporting by the end of 2011.That work will consider, in particular, what crisis management and resolution arrangements, if any, are necessary and appropriate for other financial institutions, including insurance companies, investment funds and Central Counterparties.

The overriding objective of a European resolution framework should be that ailing institutions of any type and size, and in particular systemically important institutions, can be allowed to fail without risk to financial stability whilst avoiding costs to taxpayers. To achieve this in the banking sector, the Commission is developing a framework for prevention, crisis management and resolution based on the following objectives:

[6] The text of the two previous Commission Communications may be found at:http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

[7] European Parliament, A7-0000/2010, Committee on Economic and Monetary Affairs, rapporteur: Elisa Ferreira.

[8] The ideas set out in this document are consistent with the recommendations being developed by the FSB.

[9] The Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173).

[10] The Commission's policy aim is to cover those investment firms the failure of which risks causing systemic instability, and is considering options as to how that category might be defined.

- **Put prevention and preparation first:** comprehensive planning and preventative measures should help authorities and firms prepare for resolution, and should complement other reforms to reduce risks in the financial system;

- **Provide credible resolution tools** ensuring authorities have options to resolve institutions in a way that minimises risks of contagion and ensures continuity of essential financial services, including continuous access to deposits for insured depositors;

- **Enable fast and decisive action**, by putting in place well defined powers and processes and eliminating legal uncertainty about when authorities can intervene and the actions they can take;

- **Reduce moral hazard** by ensuring an appropriate allocation of losses to shareholders and creditors and protecting public funds. This implies, at a minimum, the costs of resolution should be borne by the shareholders and, as far as possible, the creditors of the institution in question reflecting the normal order of ranking and if necessary by the banking industry as a whole;

- **Contribute to a smooth resolution of cross border groups** to ensure minimum disruption to the internal market, fair sharing of costs and the preservation of essential banking services;

- **Ensure legal certainty,** appropriate safeguards for third parties and restrict any interference with property rights to what is necessary and justified in the public interest. The framework should aim to ensure that creditors receive a treatment similar to that which they would have received if the bank had been wound up;[11]

- **Limiting distortions of competition**, which derive from interventions that distort the level playing field in the financial sector at European level. This implies that State aid granted under the resolution framework must be compatible with the Treaty rules and the internal market.

A crisis management framework based on these objectives should ensure that banks in difficulties exit the market without jeopardising financial stability. Without such a framework, there may be no realistic alternative in a future crisis to bailing out financial institutions again.

3. PRINCIPAL ELEMENTS OF THE FRAMEWORK

The crisis management framework that the Commission is developing comprises three classes of measures: preparatory and preventative measures; early supervisory intervention; and resolution tools and powers. Some of these tools already exist under national regimes but some would be new in some Member States. It will therefore be necessary to ensure a smooth transition between the current national arrangements and the future framework. The early intervention and resolution measures must give authorities a wide range of options and, subject to the triggers, the framework should not be prescriptive as to which measures are used in a particular case.

[11] In the sense that the creditors are neither better nor worse off than they would have been if the bank would have been wound up.

3.1. Authorities responsible for crisis management

Powers of early intervention will continue to be exercised by prudential supervisors under the Capital Requirements Directive ('CRD').[12]

The new crisis management framework will require each Member State to identify a resolution authority to exercise the resolution powers. Those authorities should be administrative rather than judicial, but it does not appear necessary at this stage to prescribe further which national body should act as the resolution authority. This will allow Member States to retain existing national arrangements under which, variously, the Ministry of Finance, the Central Bank or the Deposit Guarantee Scheme may be responsible for resolution. The Commission notes, however, that in many jurisdictions resolution authorities are appropriately separated from supervisors and considers such separation to be important to minimise the risks of forbearance.

3.2. Preparatory and preventative measures

The Commission is considering a number of measures designed to increase the chances that developing problems will be identified and addressed at an early stage, and to enhance the preparedness of firms and authorities to deal effectively with serious difficulties.

Reinforced supervision

Failures in effective supervision preceded and contributed to the recent crisis. The Commission therefore intends to reinforce the supervisory regime under the CRD to require the annual preparation of a supervisory programme for each supervised institution on the basis of a risk assessment; greater and more systematic use of on-site supervisory examinations; more robust standards and more intrusive and forward-looking supervisory assessment.

Asset transferability

The Commission is considering measures that would specify the circumstances and conditions under which institutions regulated under the CRD may transfer assets within a group, including in situations where group entities are experiencing liquidity stress.[13] The objective would be to establish an enabling framework for intra-group liquidity management which must include the safeguards necessary to preserve financial stability in Member States where transferring entities are established and to protect the rights of creditors and shareholders.

Recovery and resolution plans

Work on recovery and resolution plans as an essential element of planning for the failure of major institutions is ongoing at international level, and they are widely regarded as a necessary component of an effective crisis management regime. The Commission is participating in this work and will seek consistency with the outcome of developments at international level.

All credit institutions and investment firms covered by the regime would be required to prepare and keep updated recovery plans setting out measures the institution or group would

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[12] Directives 2006/48/EC and 2006/49/EC.

[13] The treatment of such a transfer under the applicable tax regime will need attention. The accounting treatment may also need separate consideration.

take in different scenarios to address liquidity problems, raise capital or reduce risk. The plans would be expected to be detailed and realistic, and should not assume access to any support from public funds. However, the requirement to prepare a recovery plan should be applied proportionately, reflecting the size of the firm, the nature of its sources of funding and the degree to which group or other sectoral support would be credibly available. Institutions would be required to submit plans to supervisors for assessment as to whether they are comprehensive and likely to restore the viability of the institution.

A requirement for up to date resolution plans would apply to all credit institutions and investment firms covered by the regime, with the aim of ensuring the planning necessary to enable the business of the bank or firm to be transferred or wound down in an orderly manner in the event of its failure. These plans are prepared by resolution authorities and supervisors, in close cooperation with the firms which would be required to supply the necessary information.[14] For example, resolution plans would require detail on group structure, intra-group guarantees and service level agreements, contracts and counterparties, debt liabilities, custody arrangements, as well as operational information about IT systems and human resources.

Recovery and resolution plans would be required both at entity and group level and would be agreed jointly in the context of resolution colleges.[15]

Preventative powers

As a complement to measures on resolution planning, the Commission considers that authorities should have clear preventative powers which may be applied in cases where resolution authorities consider that there are impediments to the resolution of an institution or group under the applicable regimes. The objective would be to allow supervisors,[16] after consultation with resolution authorities, to require institutions to adopt measures, including changes to business operations and corporate structure, necessary to ensure that resolution was viable under the applicable legal framework. The preventative powers under consideration include requirements to limit or modify exposures; to increase reporting; to restrict or prohibit certain activities; or to change to group structures (including the mapping of specific activities with legal entities). Given that powers to require changes to legal structures and business arrangements are without doubt intrusive, appropriate checks and balances would therefore be necessary. These would include a right for the firm to challenge any requirement for restructuring imposed by the supervisor or resolution authority.

3.3. Triggers

The triggers for early intervention and for resolution need to ensure that the relevant authorities are able to take timely action, and should be sufficiently clear and transparent to minimise uncertainty on the part of supervisors, firms and market counterparties as to whether the conditions for intervention are satisfied.

Triggers for Early Intervention

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14 The normal restrictions on disclosure by supervisors and other authorities of confidential information would apply.

15 See Section 4.1.

16 The consolidating supervisor, within the meaning of Directive 2006/48/EC, would be responsible for deciding any changes required at group level.

The CRD currently provides early intervention powers for supervisors to impose measures on banks that fail to meet a requirement of that Directive.[17] In order to ensure that supervisors can intervene at a sufficiently early stage to address effectively a developing problem, the circumstances in which supervisors can impose such measures could be expanded to include cases where a bank or an investment firm is *likely to* fail to meet a requirement of the CRD. Because the requirements of the CRD are wide ranging, a breach or likely breach of a requirement will not necessarily mean that the institution in question is encountering serious problems of a kind that, if unmanaged, will lead to decline and potential failure. The early intervention measures that could be made available under the CRD range in intrusiveness, and supervisors would be expected to select them in a way that is appropriate and proportionate to the nature and severity of the breach.

Triggers for Resolution

For reasons of financial stability, the threshold conditions for the use of resolution tools and powers need to ensure that resolution authorities are able to take action before a bank is balance sheet insolvent.[18] Delaying intervention until the bank has reached that point is likely to limit the choice of effective options for resolution or increase the amount of funds that would need to be committed in support of such an option. However, because the tools may involve a significant interference with the property rights of shareholders and creditors, the triggers for resolution must also ensure that resolution action is not taken before all other realistic recovery options are exhausted and that the intervention is in the public interest.

The Commission is considering a range of options that aim to capture the requirement that an institution should be in serious distress without any realistic prospects of recovery in a timeframe that is appropriate to the risks to financial stability posed by the institution's distress and likely failure. Possible threshold conditions aimed at the solvency or liquidity of an institution include an assessment by supervisors that the institution has incurred or is likely to incur losses that will deplete its regulatory capital; that its assets are likely to be less than its liabilities; that it is likely to be unable to pay its obligations in the normal course of business; or, more broadly, that it does not have adequate resources to carry on its business. More qualitative options include a supervisory assessment that the institution no longer meets, or is expected to fail to meet, the conditions of its licence to carry on banking or investment business. There is obviously a degree of overlap between these options, and the Commission will consider further which strike the best balance between flexibility and objectivity.

In addition to qualitative or quantitative triggers of the kind outlined above, the Commission proposes to include a further condition that resolution is necessary in the public interest. The public interest test would be met, for example, if winding up the institution under ordinary insolvency proceedings did not ensure the stability of the financial system or continuity of essential financial infrastructure services. If the public interest condition not satisfied, the institution should be wound up once the threshold for insolvent liquidation is reached.

Even if triggers for early intervention and resolution are harmonised, the risk remains that authorities will delay intervention or even fail to realise in time that the triggers are met. This risk can be minimised by the development of common indicators and agreed methodology

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[17] Article 136 of Directive 2006/48/EC. These powers apply to investment firms by virtue of Article 37 of Directive 2006/49/EC.

[18] Balance sheet insolvency is generally the threshold for the purposes of ordinary insolvency proceedings.

that would provide further guidance about when intervention should take place. The scrutiny of peers within colleges should also help reduce the risks that developing problems will not be identified or addressed.

3.4. Early intervention

This section describes measures under consideration in order to address developing problems at entity and group level at an early stage, prevent them from aggravating and secure recovery.

Supervisory powers

Supervisors' powers of early intervention will be expanded and clarified. New measures available to supervisors might include clear powers to prohibit payment of dividends and, where feasible, coupons of hybrid instruments eligible as regulatory capital; to require the replacement of managers or directors; or to require a bank to divest itself of activities or business lines that pose an excessive risk to its financial soundness. As indicated above, these powers would be available in the event of a breach or likely breach of the requirements of the CRD, and are therefore distinct from the preventative powers discussed in the preceding section.

Implementing recovery plans

With the aim of ensuring that institutions take timely steps to address problems at an early stage, banks and investment firms covered by the framework should be subject to a new obligation, on demand from supervisors, to submit a plan containing the measures they intend to take to restore the institution in a specific situation of financial stress. This obligation would apply where an institution is failing to meet the solvency requirements of the CRD or any future requirements relating to liquidity. It is expected that in most cases, the plan will draw on and apply contingency measures already set out in the firm's recovery plan.

Special management

In addition to expanded supervisory powers under the CRD, supervisors could be given the power to appoint a special manager for a limited period of up to one year to take over the management, or assist the existing management, of an institution that is failing to meet the requirements of the CRD and either has not submitted a credible plan as mentioned in the previous paragraph or fails to implement that plan effectively. The special manager would exercise all the powers of the management but his primary duty would be to restore the soundness of the institution. Shareholders' rights would not be otherwise affected, and shareholder approval would be required for any action by the special manager that would require consent if taken by the directors. The decision to appoint a special manager should not imply a state guarantee or expose supervisors to liability for the actions of the special manager. The extent of liability of the special manager merits further analysis.

3.5. Resolution

The general rule should be that failing credit institutions should be liquidated under ordinary insolvency proceedings. However, unlike in other sectors of the economy, in the financial sector it has generally been the case that failing financial institutions, and particularly those of systemic importance, have not been dealt with under ordinary insolvency proceedings. The Commission will consider what reform of bank insolvency law is necessary to ensure that

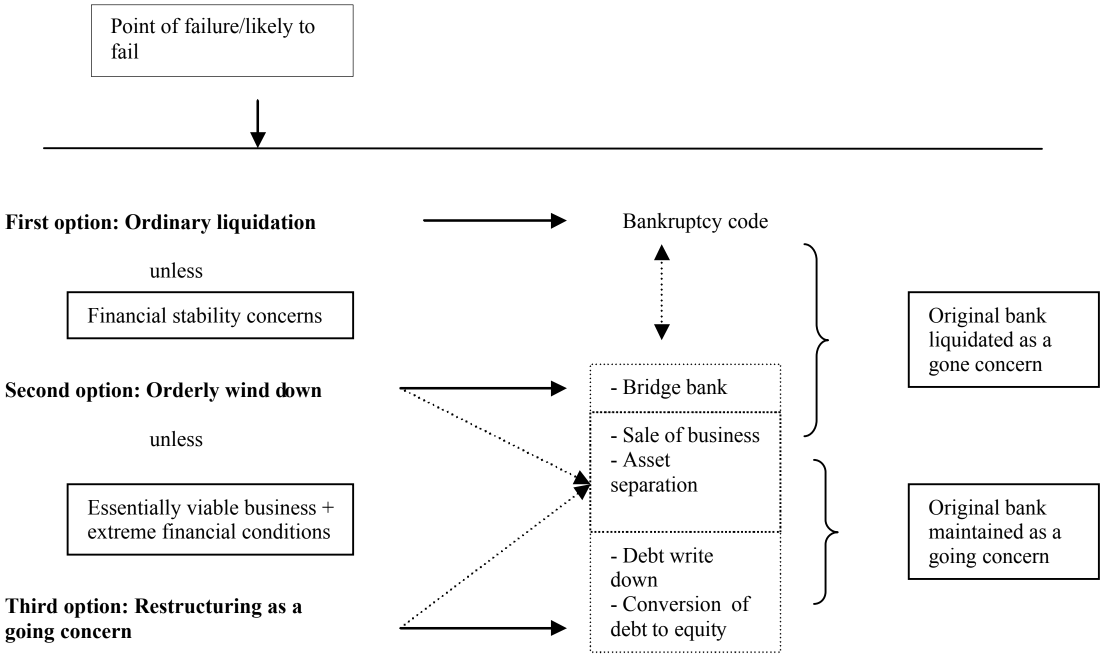
failed banks can be liquidated as a second phase, as outlined in Section 5, with the ultimate aim of ensuring that liquidation is a realistic option.

However, it will not always be feasible to liquidate a bank or investment firm under ordinary insolvency proceedings. In some cases, an orderly winding down through resolution will be necessary in the public interest for reasons of financial stability: that is to minimise contagion, ensure continuity of vital economic functions, maximise the value of remaining assets and facilitate their return to productive use in the private sector.[19]

Measures aimed at maintaining the entity as a going concern - such as the power to write down debt or convert it to equity[20] - should be a last resort, and only used in duly justified cases. This would help to underpin market discipline.

The Commission considers that this resolution framework, coupled with the preventative powers aimed at simplifying legal and business structures in cases where a firm would otherwise be un-resolvable, will ensure that resolution authorities can manage the failure of all institutions covered by the framework, irrespective of their size and interconnectedness, without jeopardising financial stability.

Resolution and insolvency



The resolution framework will need to consist of resolution tools that comprise a combination of resolution powers. The framework will specify both the tools and the powers, together with threshold conditions that must be satisfied before they can be applied and exercised.

The **resolution tools** include a sale of business tool which will enable authorities to effect a sale of the credit institution or parts of its business to one or more purchasers without the

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[19] In both ordinary liquidation and orderly wind down the firm essentially disappears in full or in part. Therefore it is treated as a gone concern.

[20] See Section 3.6.

consent of shareholders;[21] a bridge bank tool which would enable authorities to transfer some or all the business of a failing credit institution (including its deposits or mortgage book) to a temporary bridge bank;[22] an asset separation tool to enable authorities to transfer under-performing or 'toxic' assets to a separate vehicle (a 'bad bank') in order to 'cleanse' the balance sheet of a troubled bank; and a debt write down tool which is discussed further in Section 3.6. The **resolution powers** are the various legal powers that, in different combinations, authorities exercise when applying the resolution tools. These include the core powers to transfer shares in, or assets, rights or liabilities of, a failing bank to another entity such as another financial institution or a bridge bank; powers to write off or cancel shares, or write down or convert debt of a failing bank; power to replace senior management and power to impose a temporary moratorium on the payment of claims. Supplementary powers may also be needed, including a power to require continuity of essential services from other parts of the group.

The application of these tools and powers may interfere with the rights of shareholders and, in most cases, creditors. Accordingly, the framework would include safeguards and mechanisms for compensation where necessary. The guiding principle for compensation that the Commission is considering is that affected stakeholders should suffer no greater loss than they would have suffered if the institution had been wound up under the applicable insolvency regime.[23]

In addition, the framework will also include safeguards for counterparties and market arrangements that may be affected by a transfer of property, assets or liabilities, together with provisions on judicial review to ensure that affected parties have appropriate rights to challenge the actions of authorities and seek financial redress. Finally, the Commission considers that the framework should include provision for a temporary stay on rights to close out netting where authorities transfer relevant contracts as part of a resolution measure, and will consult with experts on the details of such a provision. Further consideration may also need to be given to the exercise of close out rights in connection with early intervention measures.

It is proposed that the framework should not be rigidly prescriptive about the legal means by which the powers are exercised. A number of models currently exist in Member States, including administration, receivership and the simple exercise of executive power. It does not appear necessary for efficient cooperation to impose a single model at this stage.

These tools and powers must be applied and exercised in a way that complies with the EU treaty provisions, and in particular with the State aid framework where applicable.

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[21] Sales of institutions or parts of their business should, as far as is feasible in the circumstances, be carried out in a manner that is open, transparent and non-discriminatory. This is the best way of ensuring that a fair market price is paid and thus that no State aid is granted to the acquirer. However, the Commission recognises that there will be circumstances in which a sale must be completed in a very short period to preserve financial stability. In such cases, a normal process of public tender will not be possible, but the requirements of transparency, openness and non-discrimination will need to be respected as far as possible.

[22] The purpose of a bridge bank structure is to facilitate continuous access to insured deposits or the preservation of essential banking functions for a limited period, with a view to onward sale to the private sector when market conditions stabilise.

[23] This principle is currently applied in a number of jurisdictions.

3.6. Debt write down

The challenge of resolving large, complex financial institutions ('LCFIs') is the focus of current international discussions. Policy makers recognise that there may be circumstances in which the other resolution tools described above may not be sufficient to resolve a LCFI in a way that protects financial stability. For example, in a systemic crisis traditional resolution procedures may not enable authorities to maintain the systemically crucial activities of a large commercial bank, such as its payment systems and lending functions. This business may be too large to sell to other banks in the prevailing conditions without government support or without a significant anti-competitive impact, while if it is wound down its market functions may not be readily replaced by existing or new entrants. The Commission is therefore considering supplementary mechanisms designed to enable the institution to continue as a going concern, so that it can be re-organised or, where appropriate, certain activities wound down in an orderly manner that minimises contagion.

One such mechanism under consideration is to write down all equity and the conversion of the debt of a troubled institution into equity, to restore its capital position so as to allow it to continue (either temporarily or permanently) as a going concern. However, significant legal and policy questions exist. These include:

– whether the mechanism should be based on a statutory power for authorities to write down or convert debt under specified conditions, or on mandatory contractual terms for write down or conversion which would be required to be included in a proportion of the debt issued by financial institutions covered by the crisis management framework;

– if the power is statutory, the classes of debt that should be covered (for example, difficult legal and policy questions arise in respect of trade creditors, derivatives, wholesale deposits, secured debt, intra-group liabilities[24]) and the impact that the scope of application would have on the ranking of debt;[25]

– the impact on the cost of financing, the risk of driving funding to short term or secured debt, the need to regulate the liabilities side of the balance sheet, and the possible need to change ranking of certain creditors;

– the complexities of applying this tool to a cross-border group, and the need to ensure recognition of any write down or conversion by foreign courts where the debt is booked in or governed by the law of a non-EU jurisdiction.

The Commission notes that a range of initiatives with similar objectives of enhancing loss absorption through conversion of debt to equity or write down of debt before the bank is a gone concern are under consideration. These include the proposed requirement discussed in the Basel Committee consultation paper of 19 August that all subordinated debt capital should be convertible to equity at the point of non-viability or public intervention. The Commission will consult further on its implementation of any new rules on contingent convertible capital that may be adopted, and will ensure that the development of any proposal on debt write down as a resolution tool is coordinated with this.

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[24] Attention should be paid in designing the tool so as not to disadvantage certain categories of investors such as retail investors and SMEs

[25] The Commission believes that as a matter of principle any debt write down should be applied in a way that respects the ranking in insolvency.

In spite of the technical challenges presented by the design of a debt write-down mechanism, the Commission considers that it offers an additional resolution tool that would significantly enhance the ability of authorities to resolve LCFIs. If there are no effective mechanisms for managing the failure of such institutions without systemic disruption, then at a minimum the argument for additional prudential requirements, alongside structural measures designed to ensure resolvability as an alternative to improved loss absorbency becomes stronger.

4. COORDINATION OF CROSS-BORDER CRISIS MANAGEMENT

4.1. Coordinated resolution of EU banking groups

The measures outlined in Section 2 will ensure that resolution authorities have the same tools and powers at their disposal. This will facilitate coordinated action in the event of a failure of a cross-border group, but further action appears necessary to promote cooperation and prevent fragmented national responses.

In principle, an integrated framework for resolution of cross border entities by a single European body would deliver a rapid, decisive and equitable resolution process for European financial groups, and better reflect the pan EU nature of banking markets. However, the Commission recognises that it would be difficult to establish an EU integrated resolution model for cross-border banking groups in the absence of a harmonised insolvency regime and of a Single European Supervisory authority for those entities. The Commission considers that the European approach to resolution should mirror the broader approach to supervisory arrangements.

For that reason, the Commission favours, as a first step, a coordination framework based on harmonised resolution tools and a requirement for authorities to consult and cooperate when resolving affiliated entities. To this end, the Commission is considering two principal reforms.

First, resolution colleges would be established around the core of the existing supervisory colleges through the inclusion of resolution authorities for group entities. Resolution colleges would be chaired by the resolution authority responsible for the EU parent credit institution ('the group level resolution authority'), and would be responsible for crisis planning and the preparation of resolution plans including, if appropriate, principles for burden sharing. In the event of a crisis, the resolution college would provide a forum for the exchange of information and the coordination of resolution measures.

Second, group level resolution authorities should have the power to decide in cases of group failure whether a group resolution scheme is appropriate. Pending that decision, which would need to be taken quickly, national authorities would be required to refrain from adopting national measures that could prejudice the effectiveness of the group resolution scheme. The group level resolution authority, in cooperation with the other authorities in the resolution college, may conclude that separate entity resolution best suits the structure and organisation of the group, and in that case each national authority would take independent decisions. A group resolution scheme would be based on the group resolution plan already prepared by the relevant authorities and would be implemented by national authorities using the resolution tools and powers under the new framework.

The production of a group resolution scheme in appropriate cases should facilitate coordinated resolution that is more likely to deliver the best result for the group. However, because resolution powers are applied to individual legal entities and the competence for

resolution would remain national, the group resolution scheme would not be binding. National authorities that disagreed with the scheme would not be prevented from taking independent action where they considered that necessary for reasons of national financial stability, but in doing so would be required to consider the impact of that action on financial stability in other Member States, give reasons for their decision to the resolution college and, where feasible within the time constraints, discuss those reasons with the other members of the college before taking individual action.

This framework would strike an appropriate balance between the coordination of national measures that is necessary to deal coherently with a failing group, and the proven need for authorities to act quickly and decisively where the situation requires it.

4.2. Coordination framework with third countries

Effective resolution of internationally active groups requires, as a minimum, mutual recognition and enforcement of measures taken by resolution authorities in the relevant jurisdictions. The international agreements necessary to achieve this will be easier if resolution regimes are based on common principles and approaches, and the Commission strongly supports the FSB and G20 work in this regard. The Commission also supports the development of firm specific cooperation agreements between the national authorities responsible for managing the failure of global firms, with a view to ensuring effective planning, decision-making and coordination in respect of international groups.

4.3. The role of the European Supervisory Authorities in crisis management

The framework outlined in this Communication is fully consistent with the recently agreed Regulations establishing the European Supervisory Authorities. As a result of negotiations in the European Parliament and the Council, the ESA Regulations extend the role of the ESAs to several areas including in the area of crisis management, preparation and preventative actions. In particular, the EBA (in cooperation with the ESMA where appropriate) could, within the limits set by EU law, be given oversight of and specific tasks in relation to aspects of the preparatory, preventative, early intervention and coordination parts of the framework, including powers to investigate breaches of EU law, of mediation, and of decision making in emergency situations.[26] Furthermore, the EBA would play a key role in cross border coordination under the framework, being an observer in resolution colleges and playing an important role in contributing to and participating in the development and coordination of recovery and resolution plans.[27] In areas where the ESA's powers of mediation and emergency decision making apply, the fiscal safeguard[28] would also apply, ensuring that any ESA decisions do not impinge in any way on the fiscal responsibilities of Member States.

As regards resolution, where authorities other than supervisors may be involved, the Commission will consider carefully where the EBA could best support the process. For example, the EBA could usefully act as a coordinating body at the EU level in much the same way as supervisors support the actions of resolution authorities nationally. However, the risk

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26 Articles 9, 10 and 11 of the compromise texts of the ESA Regulations as agreed by the Council and the European Parliament.

27 Article 12c ff. of the compromise texts of the EBA Regulation as agreed by the Council and the European Parliament.

28 Article 23 of the compromise texts of the ESA Regulations as agreed by the Council and the European Parliament.

of conflicts of interest must also be borne in mind: one reason supervisors and resolution authorities in many jurisdictions are separated is to reduce the incentives for regulatory forbearance.

5. FINANCING RESOLUTION

The cost of resolution should primarily be paid by shareholders and creditors but in most of the cases this would not be enough. If resolution is to be a credible option, appropriate financing arrangements should be put in place. As announced in the Commission's Communication of 26 May, the Commission intends to propose the establishment of national funds to support bank resolution.

The Commission believes that a coordinated approach at EU level is needed to ensure a clear link between funding mechanisms and the new resolution framework. Credible resolution financing arrangements should contribute to strengthening financial stability and result in a more resilient system. By eliminating any potential differences and distortions, a common approach would also improve the prospects for effective cross-border cooperation. The Commission believes that a system of ex ante funded resolution funds would in the long run reduce costs for society as a whole.

Furthermore, the Commission believes that a common approach to private sector financing could facilitate agreement on appropriate burden sharing arrangements for the costs of resolution, which will be important for the efficient resolution of cross border entities.

5.1. Use of resolution funds

The existence of resolution funds will ensure that resolution is a credible option. Concerns about the potential increase in moral hazard associated with the existence of resolution funds will be mitigated if use of the funds is restricted to providing financial support for resolution tools, for example by financing a temporary bridge bank or guaranteeing its liabilities to prevent the withdrawal of credit.

In cases where the objective of resolution measures (such as debt write-down) is to restore a troubled entity to a going concern, any ancillary provision of temporary financing must be accompanied by appropriate measures to restructure the entity, remove culpable management, write down unsecured creditors and dilute or write off the claims of existing shareholders.

Any provision of financing in support of resolution (including capital, liquidity, guarantees or other measures) must comply with the EU Treaty, and in particular with the State aid framework where it involves the use of state resources[29] and where an advantage that could distort competition and affect intra EU trade is provided to an economic entity that continues to operate in the market, even in a limited way.

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[29] State resources are generally considered to be involved where funds come from contributions made compulsory by State legislation and are managed and apportioned in accordance with that legislation, even if they are administered by institutions separate from the State (see for example Case 173/73 *Italy v Commission* [1974] ECR 709, paragraph 16).

5.2. Resolution funds and Deposit Guarantee Schemes

Resolution funds and Deposit Guarantee Schemes do not have the same purpose. Nevertheless, in some Member States, DGS are already able to provide certain forms of resolution financing. The Commission proposed in July[30] that the ex-ante funds of DGS could be used for bank resolution measures involving the transfer of deposits to another entity (for example, sale to or mergers with another private sector entity, or a bridge bank) provided that the amount of DGS funds used does not exceed the amount that would have been necessary to repay depositors.

The introduction of a new crisis management framework may extend the need for financing beyond measures aimed at preserving guaranteed deposits. Costs of such further measures might then fall to the resolution fund. Furthermore, a resolution financing system that is funded solely on the basis of insured deposits would unfairly penalise smaller and more specialised deposit taking institutions to the advantage of larger, universal banks that have a more diversified balance sheet structure and are potentially more systemically important. Nevertheless, potential synergies between DGS and resolution funds will be further explored.

5.3. Design of resolution funds

Although the Commission does not consider it necessary to prescribe every aspect governing the operation of funds, the following features should, in its view, be coordinated:

- Banks subject to the crisis management framework would contribute to ***ex ante funds***, backed by ex post financing arrangements to ensure that financing is available irrespective of the size of the failed bank, and costs exceeding the capacity of the fund are subsequently recovered from the banking sector.

- ***Requirements to contribute to the funds*** should reflect the allocation of responsibility for supervision and crisis management. Like DGS, each resolution fund would receive contributions from institutions licensed in the same Member State, and the contribution would cover their branches established in other Member States.

- The ***basis for contributions*** will need to be considered carefully. While the Commission in principle considers full harmonisation based primarily on liabilities to be the preferable proxy for the costs of resolution, other options could be considered at this stage, with a view to harmonising the basis for the contributions later. If justified by the structure of their financial system, the broader fiscal context or the potential costs of resolution, Member States could be given the flexibility to decide on a different basis for contributions, provided that this would not result in distortions of the Internal Market. The Commission will consider the costs and benefits of each approach and carefully listen to the views of different stakeholders.

Whilst it appears appropriate to aim for a network of national resolution funds at the first stage, the Commission believes that a Single EU fund would better serve the purpose of an efficient EU resolution regime. Such fund would require a harmonised basis for the contributions.

[30] COM(2010) 368.

5.4. Size of funds

The Commission recognises the need to calibrate the size of harmonised national funds in view of the burdens imposed by other financial sector reforms. Funds should be phased in gradually and contributions initially charged at a lower level, increasing as the economy recovers.

In order to determine the target size of funds, the Commission will pay specific attention in its impact assessment to the cost of recent resolution measures and taking into account that the size of the fund should depend also on the impact of reforms such as increased capital requirements and improvements in the loss-absorbing quality of capital, as well as the effectiveness of other shock absorbers (for example DGS), which may mitigate both the likelihood and impact of bank failure. Furthermore, since part of a resolution fund's expenditure may be recovered (for example, on sale of a bridge bank), this may further reduce the target size. Finally, it will be possible to adjust the amounts held in funds in the light of ongoing experience so that they reflect anticipated financing needs more precisely.

6. NEXT STEPS AND FUTURE WORK

6.1. Next Steps: A coordination framework (2011)

The Commission is now working on a framework for crisis management and the impact assessment that will inform its development and accompany the formal proposal in Spring 2011. Before adopting its proposal, the Commission will consult on the technical details of its possible provisions in December 2010. This framework will cover policy areas outlined in this Communication: the harmonisation of tools, the coordination of national measures and financing arrangements.

For this purposes of this framework, national insolvency laws will only be modified to the extent that is necessary to support the measures outlined above. This might include modifications needed to confer the necessary protections for creditors and shareholders of the transferee where assets are transferred between group entities (Section 3.3), and depositor preference if that is desirable in the light of a statutory debt write down power.

6.2. Future work

An insolvency framework (medium term)

The Commission will examine the need for further harmonisation of bank insolvency regimes, with the possible aim of resolving and liquidating banks under of the same procedural and substantive insolvency rules. This includes:

The desirability of administrative liquidation proceedings for banks to facilitate a faster and more orderly liquidation than the standard court-based procedure. Harmonisation of core principles of bank insolvency law, including priority rankings and rules on claw back actions.

The Commission will publish a report on the further harmonisation of insolvency law by the end of 2012.

An integrated framework (longer term)

Alongside the review of the EBA Regulation in 2014, the Commission will assess how a more integrated framework for the resolution of cross-border groups might be best achieved. This could involve an EU authority; however the operational capacity of such an authority would depend on the establishment of an EU resolution and insolvency regime and an EU resolution fund financed on a harmonised basis.

7. CONCLUSION

The future policy actions outlined in this Communication would significantly reinforce the resilience of the financial system by ensuring that firms and authorities are better prepared for problems and better able to address them at an early stage. The Commission will proceed with these actions in accordance with the attached work programme, so that authorities in Europe have the necessary tools and financial resources to intervene effectively and to manage the failure of a bank or investment firm in an orderly manner that minimises the systemic impact and the ultimate costs to public finances and taxpayers.

Future policy actions

Objectives	Proposed action	Time line
Coordination framework		
To ensure that all member States have an effective crisis management regime for banks and certain investment firms, with sufficient and harmonised powers of early intervention and resolution	Proposal for a Directive on crisis management to include: - expanded supervisory powers - requirements for adequate planning, including recovery and resolution plans - harmonised resolution tools	Spring 2011
Ensure effective cooperation and coordination between authorities in the case of failure of a cross-border firm	Proposal for a Directive on crisis management to include a cross-border coordination framework	Spring 2011
Ensure that private sector funding is available to support crisis management actions	Proposal for a Directive on crisis management to include provision for the establishment of national resolution funds	Spring 2011
Assess what crisis management measures are required for other financial institutions	Report to the Council and European Parliament	End 2011
Insolvency		
Assess what EU reform of bank insolvency regimes is required to ensure that liquidation is a realistic option for failing banks and to address the current deficiencies in insolvency procedures for cross-border banking groups.	Report to the Council and European Parliament, coupled, if appropriate, by legislative proposal	End 2012
Integrated resolution for cross-border banking groups		
Assess how a framework for the integrated resolution of cross-border banking groups might be best delivered, including by the involvement of an EU Authority in resolution	To be considered alongside the review of the EBA Regulation	2014
Assess the need for an EU resolution fund to complement an integrated approach to the resolution of cross-border banking groups	To be considered alongside the review of the EBA Regulation	2014