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*The new EU resolution regime changes our perception of banks,
even during times of 'normal' banking business*



Banking restructuring used to be government-led and resulted in highly individual bailout solutions.

'No More Bailouts'

During the peak of the subprime crisis in 2007/2008, rescuing financial institutions was the dominant aim in US and European crisis management. According to research, financial institutions wrote off approximately USD 1,750 bn – a significant share of which was shouldered by the taxpayers in the form of tax credits, direct ownership, or state aid. When the market eventually restabilized, most institutions and their financiers had been saved. In the EU, state aid rules were activated and additional precautions were taken with regard to competition. However, bailing out banks was the normal course of action.

Workout Units

Often, the rescue led to the establishment of government-sponsored institutions, so workout was organized by keeping immediate market pressure out. Be it in Switzerland (UBS), the UK (RBS, Lloyds Bank), and in many cases in the Eurozone, the resources committed to this approach escalated. Free market rules were infringed, and capacity remained in the market.

Recovery and Resolution

Now, as the Banking Recovery and Resolution Directive (BRRD, 2014/59/EU as of 15 May 2014) and the Single Resolution Mechanism (SRM, Regulation (EU) No 806/2014 as of 15 July 2014) are transposed in more and more countries in the EU, a more standardized and structured approach will determine future public interventions – and will change the rules in banking, even when markets remain calm.

Supervision and Intervention

The BRRD and the SRM are an integral part of the banking reform projects in the EU. With the introduction of the Single Supervisory Mechanism (SSM), a step forward was taken to harmonize banking supervisory processes under the umbrella of the ECB (i. e., for large or complex institutions). Clearly, bank regulation is not just about capital ratios and risk monitoring; it is also about the supervisory and decision-making process. When it comes to interventions, a rule-based approach using detailed knowledge is highly desirable. The recovery and resolution regime is a leap forward in this respect, and it is worth understanding its rules and specifics. Significant banks nowadays lay down their own emergency recovery plan, containing a detailed analysis of rescue instruments. Based on such detailed data, regulators plan their emergency measures – the resolution strategy. All difficulties anticipated are to be considered, and obstacles to straightforward resolution are to be removed in good times.



“Core”

Business units relevant for maintaining the bank – can be profit or cost centers

“Critical”

Banking services with high relevance for the economy – can be direct (functions, services) or indirect

Resolution Tools

The BRRD defines four alternatives for orderly resolution, and by doing so creates a banking-specific insolvency regime. Its intension is to minimize the disadvantages of resolution to direct stakeholders as well as to the economy. Ex ante, any of these alternatives may be appropriate to achieve this aim. Among them, the *bail-in* has attracted wide interest, as it specifically creates a new subordination among the bank’s creditors. Some short-term investors or, presumably weak parties, continue to be protected. If capital markets risk being affected, derivatives or repo counterparties may be spared.

And yet, the bail-in is still a financial restructuring instrument. It will not be sufficient when the ultimate target is not merely stabilizing the financial markets and the real economy, but resolving a failing institution. This, inevitably, requires a decision as to which parts of the bank are to be discontinued.

While *asset separation* allows critical parts to be distinguished from the rest, both the *bridge institution* tool and the *sale of business* tool target resolution directly: the former assuming that the resolution agency will temporarily assume ownership of the important parts of the failing bank, the latter focusing on a strong buyer to take over the parts considered relevant.



Decision making

In resolution, the regulators face an enormously complex situation. Depending on what will be considered “critical” and “core,” the shape of the banking business to be continued needs to be determined. This already has a number of consequences, mostly for clients, borrowers, creditors, and the bank’s own staff. Also, determination of the resolution tool(s) can affect other stakeholders’ positions.

In a sale of business, relevant parts will be taken over by an acquirer. By contrast over the medium term the bridge institution will remain a properly regulated bank under the ownership of the resolution agency. All non-relevant parts face short-term resolution.

As questions are numerous and complex but time is scarce, there will be an inherent incentive to go back to the recovery plan originally developed by the bank’s own management. The resolution plan, while a more appropriate instrument for the resolution authorities, be inadequate if the failure was not caused by foreseeable reasons but by any other unexpected risk.

Critical and core

While “critical” might then still be a valid differentiator, “core” has the downside that it fluctuates business prospects. Eventually, the regulators will need to assess the bank’s perspectives, unit by unit, and commit to the results.

	RECOVERY	RESOLUTION
Lead	Bank management	Resolution authority/authorities
Alternatives	<ul style="list-style-type: none"> • Cost cutting • Operational restructuring • Sale of assets • Sale of subsidiaries • Merger • (...) 	Resolution tools: <ul style="list-style-type: none"> • Sales of business • Bridge institution • Asset separation • Bail-in
Protection and financiers	Conventional, corporate law	Bail-in cascade: retail clients
Law	Corporate transformation law	Resolution law
Preparation	(Group) Recovery plan	(Group) Resolution plan
Contents	<ul style="list-style-type: none"> • Responsibilities • (Group) Interdependence • Early warning/trigger • Recovery options • Stress scenarios 	<ul style="list-style-type: none"> • (Group) Structure • Critical functions • Critical shared services • Core businesses • Resolution strategy
Outlook/Use	Yearly update (minimum)	Removal of impediments

Values

It is a well-understood fact that in any liquidation, a large amount of value is lost simply by a change in perspective. While higher asset values are justified in healthy companies as they allow the company to reap the rewards of their activities, resolution eventually lacks such positive perspective. Such a loss in asset values, however, can easily have a devastating effect on banks already hit by a crisis. The new banking resolution regime bridges these two views by creating a situation of temporary calm in which going-concern values can be applied.

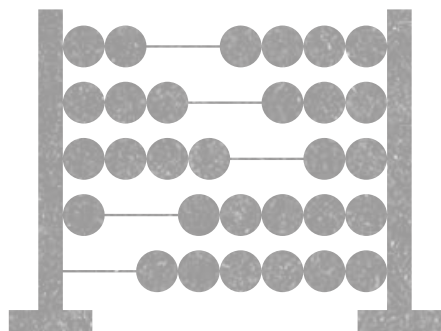
This helps to gain time until financial and operational stabilization takes place. However, this is a temporary effect, and further analysis is required to determine the adequate moment for a departure from that comfortable position.

Valuations

Authorities must exercise their powers in such a way that taxpayers are spared, values are maintained, and property rights are respected. To reach this goal, various independent valuations are carried out. Valuation 1 is used as a basis for determining whether the conditions for resolution are met, or whether a write-down or conversion of capital instruments ought to take place. It can be based on the trigger criteria defined in the recovery plan, but will also require a forward-looking analysis. By contrast, valuation 2 supports regulators in their immediate decision making. Numerous interdependent and multiannual aspects need to be considered to arrive at the optimum resolution strategy.

Performance of a *company valuation* is therefore required to assess these effects simultaneously. As economic value is the guiding principle for the resolution decision, a decision value, calculated from a neutral perspective, can best serve the purpose. If more than one resolution option comes into question, distinct scenarios may help determine the most effective alternative.

Inevitably, a company valuation in a distressed situation requires an intensified asset quality test.



IF: “Ex ante valuation 1” – Resolution Trigger

WHAT: “Ex ante valuation 2” – Resolution Assessment

HOW MUCH: “Ex post valuation” – Resolution Results

Key issues to be solved in the company valuation:

- Equity requirements
- Cost of equity
- Capital benefit
- Refinancing costs
- Subordination
- Profit distribution
- Loan quality
- Intangibles
- Legal disputes
- Financial instruments
- Market and prudent values
- Quality of earnings
- Quality of business plan

Market values of liquid financial instruments or loan defaults should not be ignored in this decision support exercise.

Sensitivities

To allow for orderly resolution, the distribution of valuation results is relevant. As in any restructuring, unforeseeable aspects can have a major impact, and a sufficient buffer for additional losses should be considered.

Looking back

The ex post valuation must make sure once resolution is finalized, creditors have received compensation equal to what their welfare position would have been in liquidation under normal insolvency proceedings. For this comparison, specific liquidation values at the date of the resolution decision can be compared to the inflows received over time.

The new normal

As has been the case in the past, banking resolution can save or destroy value – both are possible.

Once the most suitable resolution alternative is determined, resolution decisions can be taken much faster and therefore help reduce uncertainties. This inevitably creates new demands and risks for the quality of the regulators' decision making.

Banks' creditors will need to reassess their claims and collateral in the light of bail-in. Banks, given their complex and immaterial business, should expect to be challenged more regularly on the quality and relevance of their business models.



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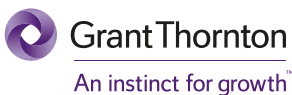
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