# Europe's New Toolbox Aims to Minimize Impact of Troubled Banks

Skadden

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.


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Europe's latest legislative response to the recent financial crisis — the Bank Recovery and Resolution Directive (BRRD) — is intended to establish a minimum common toolbox for regulators in each member state to address bank solvency issues sooner, maintain key financial functions and minimize the impact of any failure.

The BRRD has to be implemented in each member state at the beginning of 2015 following its adoption by both the European Parliament and the Council of the EU, and it follows other measures to improve banks' capital structure in order to make failure less likely.

The BRRD has five principal purposes, namely to:

- Develop preparatory and preventative measures;
- Enable early intervention by regulators;
- Provide a set of resolution tools;
- Promote cross-border crisis management among regulators; and
- Establish national resolution funds.

Each bank or investment firm established in the EU will have to draft and maintain a recovery plan that must be updated at least annually. A recovery plan should provide for measures that may be taken by the institution to restore its financial position following a significant deterioration in its financial situation. There are special provisions for groups. Banks must identify critical functions, likely obstacles and a framework of indicators to pinpoint stages at which action might be taken. The recovery plans must undergo scenario testing and demonstrate their likely efficacy and ease of effective implementation. There also is scope to impose lesser requirements on smaller institutions where an insolvency would not have a significant impact on other institutions or the wider economy.

Banks also must assist their resolution authority to develop a resolution plan. A resolution authority is a public authority in each member state that is responsible for exercising resolution powers pursuant to the BRRD in the event of a bank failure or circumstances in which such a failure is likely. These provisions are analogous to the living wills requirements in the U.S. (See "Lawmakers and Regulators Continue Focus on Strategies for Resolving SIFIs.")

In exercising its powers, the key objectives of a resolution authority are to ensure the continuity of critical functions, maintain the stability of the financial system, minimize the use of taxpayer funds, protect insured deposits, and protect client funds and assets. Protections for stakeholders include the principle that losses are borne first by equity holders and then by creditors in ascending order of seniority, and the "no creditor worse off" rule. This rule means that a stakeholder is entitled to receive compensation if it receives less value through the operation of resolution powers than it would have through a winding up of the bank.


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In the event of a bank failure, the BRRD provides several mechanisms for resolution. The "sale of business tool" involves the transfer of shares and/or assets, rights and liabilities by a resolution authority to a third party. A sale should be on commercial terms but is likely to be done in a very short period of time and with very limited opportunity to conduct a due diligence exercise. The "bridge institution tool" involves the transfer of shares and/or assets, rights and liabilities by a resolution authority to a bridge institution, which is a publicly owned institution controlled by the relevant resolution authority. This tool may be used where it is not practicable to effect a sale to a third party immediately. The transferred part of the business may be run by the bridge institution and a sale to a third party may follow later. The "asset separation tool" is the transfer of assets, rights or liabilities by a resolution authority to an asset management vehicle that must be wholly or partly government-owned. The transfer may be made from the institution itself or a bridge institution. The intention is for the asset management vehicle to maximize value through an eventual sale or an orderly wind-down. Finally, the "bail-in tool" is a means whereby a bank's balance sheet insolvency is eliminated through the recapitalization of liabilities, which may include conversion of debt to equity and the reduction of the principal amount of debt.

The resolution powers can be used without regard to normal corporate law requirements, such as shareholder approval. This reflects the broad policy aims behind the resolution powers and should facilitate their speedy exercise in a crisis.

Implementing the BRRD will require very significant new legislation across the European Union, which will take time to create and implement, even where (as in the U.K. and Germany) some elements are already in place. It is contemplated that detailed rules and technical standards will be developed by the European Banking Authority and introduced in the future by the European Commission. The detailed content of recovery plans and resolution plans will therefore likely evolve significantly over time as new rules come into force. It also is anticipated that the regime will eventually be extended to states in the European Economic Area that are not within the EU. Overall, the BRRD represents a major development in the treatment of distressed and failing financial institutions in Europe, and it's not alone. Legislators worldwide are trying to develop strategies for addressing insolvent banks before the next crisis.

In December, the U.S. House of Representatives passed H.R. 5421, the Financial Institution Bankruptcy Act of 2014, which addresses many of the same areas as the BRRD. Nonetheless, important differences between the two measures exist. Cross-border coordination of financial institution insolvencies remains a critical element of the successful wind-down of a large bank. To date, such coordination has been largely episodic and yielded varied results and uncertainty.