Chapter E: The US versus EU resolution regime

1. Introduction

Resolution frameworks should always seek two objectives. First, resolving banks should be a quick process and must avoid negative spill over effects to the rest of the financial system. Second, resolution regimes must be designed to protect taxpayers' money. **Besides common principles, there are major differences on how countries design the resolution regimes to achieve those two goals. A clear example of those divergences is the EU and US resolution frameworks.**

Table 2 shows a high-level comparative analysis between the US and the EU resolution regimes.

Table 2
High-level comparative analysis between the US and EU resolution regimes

	US (Dodd-Frank Act-Title II)	EU (BRRD)	Comparability
Goal	i) To resolve failing financial institutions quickly, ensuring the stability of the financial system ii) To minimize taxpayer contributions to resolution episodes		✓
Scope	Only large and complex banks	All credit Institutions and investment firms	X
Resolution Authority	Existing Federal Deposit Insurance Corporation created by the Congress to, among other things, insure deposits	New Resolution Board composed by national and European authorities	X
Trigger for resolution	i) Failing or likely to fail institutions ii) To protect public interest and financial stability; and iii) No private alternatives to prevent the default of the institution.		✓
Recovery Plan	No requirement	Annual review, update and submission to the resolution authority and supervisor	X
Resolution Plan	Annual review, update and submission to the resolution authority (FDIC); bank ownership	Annual review and update; resolution authority ownership	X
Resolution Strategy	Single-Point-of-Entry in the US. No specific reference to global resolution scheme	Multiple-Point-of-Entry or Single-Point-of-Entry with a global perspective	X
Bail-in - *Hierarchy of claims*	Four layers: Capital + senior debt +uncovered deposits + covered deposits	Four layers: Capital+ senior debt *paripassu* with uncovered corporate deposits + uncovered deposits of SME & households+ covered deposits	X
Resolution Fund - *Usage*	Liquidity support	Liquidity and capital support	X
Resolution Fund - *Funding*	Ex-post funding by the financial sector contributions (if needed)	Ex-ante funding by the financial sector contributions	X
Public support	Not allowed [8]	Limited to "a very extraordinary situation and systemic crisis"	X

Source: BBVA Research

This Chapter compares the differences between the US and the EU resolution frameworks, and is an attempt to answer three key questions: what, when and how are institutions resolved? As such, the Chapter is divided into three sections. First, it describes the scope and the resolution authorities of each resolution framework. Second, it describes the trigger conditions that activate the resolution process in the US and EU. And finally, it covers the resolution strategies and tools under both regimes.

8: Although the US regulation does not recognize the bail-out as a feasible alternative, the IMF considers that "excluding the possibility of government support for SIBs may be neither credible nor socially desirable" (See Chapter 3 of the Global Financial Stability Report, April 2014)

FSB Key Atributes

BRRD

SRM

US SPE aproach

US vs. EU

2. Different scope of institutions

In both cases, in the US and in the EU, much effort has recently been made to improve the legal framework for resolution of financial institutions. In this regard, both frameworks enable authorities to resolve failing financial institutions quickly, ensuring the stability of the financial system and preserving the main banking operations. In addition, both regulatory initiatives try to minimize taxpayer contributions to resolution episodes.

Each resolution framework will cover different types of institutions

In the US, the bankruptcy code is the common resolution framework. Nevertheless, large and complex financial companies (entities with consolidated assets of USD50bn or more) must be resolved under Title II of Dodd Frank Act called "Orderly Liquidation Authority" (OLA).

On the contrary, the BRRD covers all credit institutions and investment firms established in the European Union.

Table 3
Legal framework to resolve non-SIFIs and SIFIs

	NonSIFIs	Resolution framework for SIFIs
US	Traditional resolution process	New SPE resolution regime
EU	BRRD	BRRD

Source: BBVA Research

The FDIC is the Resolution Authority

As explained before, in the US, under the Dodd-Frank Act[9], the FDIC is the resolution authority for SIFIs. To be more precise, the FDIC as the resolution authority established the Single Point of Entry (SPE) as the resolution strategy using the bridge financial company tool.

However, in the EU, under the BRRD, each Member State will designate public authorities to act as resolution authorities. In case of the Eurozone (EU-18) the BRRD[10] will define a Single Resolution Authority (SRA), which will be the European Commission, or the Council. In any case, independently of the SRA in Europe, the resolution decision scheme will be more complex and less agile than in the resolution decision scheme in the US, due to the "more complex" EU institutional structure.

3. When is resolution activated?

The trigger conditions for activating the resolution process are similar in the US and the EU. They share the three key conditions to start a resolution process: i) an institution is failing or likely to fail, ii) to protect public interest and financial stability; and iii) there are no private alternatives to prevent the default of the institution. However, the US has one additional condition, when a regulatory agency has ordered the institution to convert all of its convertible debt instruments. This condition is not included in the BRRD (see Table 4).

9:Title II of the Dodd Frank Act provides the FDIC with new powers to resolve SIFIs by establishing the orderly liquidation authority (OLA). Under the OLA, the FDIC may be appointed as receiver for any US financial company that meets specified criteria, including being in default or in danger of default, and whose resolution under the US Bankruptcy Code (or other relevant insolvency process) would be likely to create systemic instability.
10:The BRRD provides the technical tools for the SRM to develop resolution powers in the Eurozone in the near future.

Resolution actions should be taken when all the following conditions are met:

Table 4
Trigger conditions

	US	EU
Likely to fail	Institution is in default or in danger of default (when it is likely to file for bankruptcy, has incurred debts that will exhaust all or most of its capital, has greater debts than assets, or will likely be unable to pay its debts in the normal course of business)	Institution is failing or likely to fail (when it is in breach, has greater debts than assets, or will likely be unable to pay its debts, extraordinary public financial support is required).
Public Interest & Stability reasons	The failure of the institution resolution under other applicable law would have serious adverse effects on financial stability in the US. Any effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants, as a result of actions to be taken is appropriate on financial stability in the US.	A resolution action is necessary in the public interest.
No private alternatives	No viable private-sector alternative is available to prevent the default of the financial company.	There is no reasonable prospect of any alternative private-sector measures.
Debt Conversion	A Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order.	

Source: BBVA Research

4. How is the resolution implemented?

In the resolution phase, we can differentiate two types of tools: ex-ante resolution tools which have a pre-emptive character meanwhile ex-post measures that come into force once the resolution starts.

Ex-ante resolution tools

The ex-ante resolution tools' goals are i) to build up buffers to deal with bank losses and therefore to protect taxpayers' money in the case of resolution; ii) to make plans to help financial institutions to recover – or be allowed to fail – and thereby ensure a quick resolution process.

Setting a Gone-Concern Loss-Absorbing Capacity (GLAC) ratio and defining recovery and resolution plans are examples of ex-ante measures.

Has a Gone-Concern Loss-Absorbing Capacity (GLAC) requirement been defined?

The GLAC is an additional requirement that institutions must fulfil to overcome the "too big to fail" issue and complements other solvency requirements such as capital, liquidity or leverage ratios.

The discussion about the definition of a minimum GLAC in the FSB is at an early stage and the consultation paper is not expected until mid-2014. However, it is worth mentioning that the regulatory debate in some jurisdictions is several steps ahead. In particular, European authorities obtained a final agreement on the BRRD in December 2013 and the US authorities have launched a consultation paper[11]requesting comment on, inter alia, the GLAC's level and cost concerns.

In Europe, the BRRD establishes the Minimum Requirement of Eligible Liabilities (MREL) ratio. This ratio is defined as an institution's own funds and eligible liabilities expressed as a percentage of its total liabilities and own funds, excluding net derivatives. At present, the EU framework does not set a legal minimum requirement of bail-inable liabilities but the European Banking Authority (EBA) will be responsible from defining it by October 2016. In this respect the difference in business models and individual idiosyncrasy will be considered.US regulators have used the language of 'gone concern' loss absorbency and a regulatory proposal is expected imminently[12].

The Recovery and Resolution Plans' requirements

In the US, the Dodd-Frank Act requires that bank holding companies with total consolidated assets of USD50bn or more periodically submit resolution plans to the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC). (See Table 5). However, in the US there is no framework for elaborating recovery plans.

Table 5
Number and type of banks that have submitted resolution plans

More than USD250bn	11
Between USD100bn and USD250bn	4
Between USD50bn and USD100bn	116
Total	131

Source: BBVA Research

In Europe, the BRRD requires all entities to submit recovery plans to the resolution authority on an annual basis. Nevertheless, the resolution authority is the one responsible for elaborating the resolution plan in collaboration with the institution. The recovery plan is the firm's complete "menu of options" for addressing extreme financial stress caused by internal or system failures. Figure 18 summarizes the resolution information pack.

In the US, there is no legal framework that requires developing a recovery plan. Nevertheless the resolution plan has to be developed by the institution. The US resolution plan includes the following information: i) a map of their core business lines, and critical operations to material entities; ii) summary financial information; iii) Summary financial information regarding assets, liabilities, capital and funding; iv) derivative and hedging activities; v) memberships of material payment, clearing, and settlement systems; vii) description of foreign operations; viii) material supervisory authorities ix) principal officers; x) resolution planning corporate governance structure and related processes; xi) description of material Management Information Systems and xii) summary of resolution strategies.

In contrast, in the EU the **resolution plan is prepared by the resolution** authorities in cooperation with supervisors in normal times. Authorities may require institutions to assist them in the drawing up and annual updating of the plans. Group resolution plans shall include a plan for resolution of the group headed by the EU parent undertaking as a whole, either through resolution at the level of the EU parent undertaking or through break-up and resolution of the subsidiaries. It will set out options for resolving the institution (or its groups) in a range of scenarios, including systemic crisis when trigger conditions for resolution is reached. Such plans

11:FDIC (December 2013), consultation paper on "The resolution of systemically important financial institutions: the Single Point of Entry"
12: The Fed's Governor D. Tarullo and FDIC's Chairman M. Gruenberg recently signaled that they will issue a proposal that requires US banks to hold minimum amounts of long-term unsecured debt at the holding company level

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should include **details on the application of resolution tools** and ways to ensure the continuity of critical functions in order to minimize the cost of resolution to public funds.

Ex-post resolution tools

The ex-post resolution tools constitute the effective comprehensive tools in case a resolution takes place.

What are the resolution strategies and tools?

As the FSB[13] published in July 2013, there are two stylised resolution strategies that global banks may apply: the Single-Point-of-Entry (SPE) and the Multiple-Point-of-Entry (MPE). The application of these resolution strategies should take into account the firms' particular characteristics – business model, corporate and legal structure (See Box 1 for further details).

In this context, it is important to note that the majority of the US SIFIs are domestic and are generally organized in a holding company structure with a top-tier parent and operating subsidiaries that comprise hundreds, or even thousands, of interconnected entities. As a result of this, Dodd Frank Act establishes the SPE strategy as the benchmark for resolving banks in the US. The central point of the SPE strategy is that a resolution should take place at the holding company level only, leaving subsidiaries to continue operations. In the European context, the BRRD leaves more room for manoeuvre and allows both strategies, MPE and SPE.

When can the resolution fund be used?

The way in which the resolution fund is used and the discretionality that is applied in its use by the resolution tools are the key differences regarding the resolution framework.

In the US, the Orderly Liquidation Fund (OLF) is established at the Treasury and it is available to the FDIC in order to borrow funds (neither capital nor guarantees). On the other hand, under the BRRD, where each Member State establishes its own financing arrangements, these EU resolution funds would be available to support institutions under resolution via loans, guarantees, asset purchases or capital for bridge banks.

The main difference is that in the US there is no strict trigger to activate the use of the resolution fund to funding the bridge financial company. The OLF is used only when customer sources of funding are not available. Meanwhile, in the EU, when resolution authorities decide to exclude an eligible liability from bail-in, the resolution fund could be used after a minimum level of 8% of total liabilities have been bailed-in. At this stage, the resolution fund is used to cover any losses which have not been absorbed by eligible liabilities excluded from bail-in up to 13% of total liabilities. In addition it can be used to purchase shares or other instruments of ownership or capital instruments of the institution under resolution.

Another notable aspect is that the EU resolution fund must be financed ex-ante (the target level is 1% of the covered deposits in 10 years), while in contrast, in the US there is no ex-ante level.

The following table summarizes the comparison between the main aspects of the US and EU resolution funds.

13: Financial Stability Board, (July 2013), "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies"

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Table 6
Key aspects of US & EU resolution funds

	Resolution fund	
	US	**EU**
Purpose of resolution fund	Funding the bridge financial company	• Cover any losses of eligible liabilities excluded from bail-in • Recapitalisation.
Instruments	Funding (liquidity). No recapitalization.	Loans, guarantees, asset purchases or capital for bridge banks.
When the resolution fund is used	Customer funding is not available,	After 8% of total liabilities has been bailed.
Cap level of the use of the resolution fund	10% of the total consolidated assets of the covered financial company.	The contribution of the resolution fund will be capped at 5% of total liabilities.
Financing	Repayment of OLF- ex-post contribution: • Sale or refinancing of bridge financial company assets. • If not sufficient the receiver would impose risk-based assessments on eligible financial companies.	• **Ex-ante target level:** at least 1% of the covered deposits in 10 years. • **Ex-post contribution** • If the two previous options are insufficient, there are alternative financing sources as borrowings or other forms of support.

Source: BBVA Research

In Europe, in addition to the resolution tools, in a very extraordinary situation of a systemic crisis and when some conditions are met (after application of bail-in, complying with State Aid rules), the resolution authority may seek funding from alternative financing sources,including the use of government stabilization tools. These tools are temporary public ownership and a public equity support tool. That is to say, in the EU resolution framework public bail-out share not dismissed in very extraordinary situations (systemic crises). However, the US resolution regime does not envisage any public ownership.

What is the creditor hierarchy?

As regards the priority of claims, it is worth mentioning the similarities between the two resolution frameworks. In both regimes, the deposit preference has been established as a general principle. Under the US regime, insured and uninsured depositors are ranked ahead of unsecured creditors. However, in the EU there are different layers differentiating therefore the seniority of certain deposits (covered deposits have a higher priority ranking than that part of eligible deposits from households and SMEs, which exceed the coverage level), for that reason the risk of funding arbitrage and market fragmentation should not be minimized in the EU.

Moreover, under the EU framework, the Deposit Guarantee Scheme (DGS) funded by banks would be established to guarantee deposit amount up to EUR 100.000 per depositor. However, the FDIC insures an amount of USD250.000 per depositor.

In both cases the deposit guarantee scheme will only absorb losses under liquidation but not in the resolution scheme. In the EU, the DGS has been excluded from the bail-in tool.

The following table shows the hierarchy of claims for both frameworks (from the first to the last to absorb losses).

Table 7
Order of loss absorption

US Title II Dodd Frank Act	EU
1. Obligations to shareholders, members, general partners and other equity holders;	1. Common Equity Tier1 instruments;
2. Salaries of executives and directors of the company;	2. If writing down CET1 is not sufficient then authorities should reduce to zero the principal of Additional Tier 1 instruments and Tier 2 instruments,
3. Any junior obligation;	3. Only then followed by subordinated debt not classified as Additional Tier 1 or Tier2,
4. Any other general or senior liability of the company;	4. Senior debt and uncovered corporate deposits,
5. Contributions to employee benefit plans;	5. Uncovered SME and retail deposits,
6. Employee wages, salaries or commissions;	6. Deposits covered by the DGS.
7. The government;	
8. Administrative costs.	

Source: BBVA Research