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SWEDISH NATIONAL DEBT OFFICE

REMISSVAR
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Finansdepartementet
103 33 Stockholm

Konsultation avseende EU-kommissionens förslag till krishanteringsdirektiv

Finansdepartementet har bett Riksgälden att lämna synpunkter på EU-kommissionens förslag till direktiv om hantering av banker i kris, som publicerades den 6 juni 2012. Förslaget är omfattande och tekniskt komplicerat. Det är heller inte lätt i alla delar att tolka vad avsikten med eller innebörden av de olika reglerna är. Möjligheterna att bedöma effekterna blir därefter. Vårt intryck är att förslaget har tagits fram under tidspress och är otillräckligt genomarbetat. Detta är olyckligt med tanke på hur viktiga och svåra frågor som behandlas. Den förhandlingsprocess som nu ska inledas blir på så sätt utomordentligt viktig.

Den korta tid som stått till buds sedan förslaget presenterade gör att vi inte har haft utrymme för mer än en översiktlig genomgång av kommissionens förslag. Synpunkterna lämnas således med reservation för att vi inte hunnit analysera förslagen och deras konsekvenser i tillräcklig grad. Missförstånd rörande förslagens innebörd kan också ha smugit sig in. Tonvikten i våra kommentarer ligger på vad vi uppfattar som brister och inkonsistenser. Därtill pekar vi på några punkter där förslagen framstår som extra svåra att tolka. Det bör även nämnas att vi inte studerat kommissionens bakgrundsdokumentation.

Riksgälden står självfallet till Finansdepartementets förfogande för ytterligare diskussioner av förslaget och de frågor som kan komma att väckas under de kommande förhandlingarna i Rådet.

Därtill uppmanade i följebrevet från Finansdepartementet lämnar vi synpunkterna på förslaget på engelska.

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1 General comments on the framework

The Swedish National Debt Office (SNDO) fully endorses the ambitions behind the directive proposal. It is essential that there are effective tools to deal with failing financial institutions (banks) in such a way that contagion is avoided and critical functions of the financial system are maintained. A bank resolution regime is therefore needed. This is true also in Sweden. The current Bank Support Act was crucial during the crisis in 2008–2009, but in terms of resolution powers its scope is more limited than the framework envisaged in the directive proposal.

The SNDO also supports the ambition to improve the tools available for early intervention, including the obligation for banks to prepare resolution plans. Such a plan can be as useful to the bank's management – as a means of creating a clearer picture of the bank's structure and potential weaknesses – as it is to supervisors. We also support the proposal that plans only have to be made for institutions that are considered systemically important.

However, we do not endorse the idea of using special management as a tool of early intervention. This tool has so far-reaching consequences that it should be seen as part of resolution.

It can be argued that, functionally, recovery planning and early intervention (as well as rules on intra-group support) would fit better into the CRD rulebook than together with resolution. We see it as important to maintain a clear line between supervisory tools and interventions, aimed at prevent banks from failing, and resolution, dealing with banks that have failed or is about to fail.

While generally supportive of the ambitions, we are not convinced that the proposed directive offers an appropriate solution to the intricate problem of organising bank resolution. This applies both to the overall structure and some of the detailed rules. In particular, it must be considered that resolution may involve far-reaching intervention into privately owned entities and changes the risks involved in owning banks and in lending to banks.

It is unavoidable – and indeed the intention – that resolution affects the behaviour of banks and their creditors also in normal times. It is important, however, to calibrate the measures in such a way that the provision of credit via banks continues to function properly. It is essential that banking regulations – regarding resolution as well as other dimensions – are structured in such a way that banks do not become too reluctant to take risks. So while careless bank practices should be curtailed and losses caused by bad banking should be allocated to shareholders and creditors, the framework must avoid the impression that drastic measures will be taken also against banks that end up in difficulties due to circumstances beyond their control. Concern among owners or creditors of banks – actual as well as potential – that resolution may be triggered by events not clearly related to the behaviour of individual banks will be detrimental to both the function of banks in normal times and to stability in times of stress.

Moreover, circumstances that may trigger strains in financial markets include not just risky behaviour of individual banks, but also unwise decisions by policy makers; experience indicates that serious financial crises almost invariably are the result of a combination of bad banking *and* bad policy (e.g. in stabilisation policies and/or prudential policies). To focus solely on the bad banking aspects – as the current directive proposal seems to do – may be politically expedient, but it is unlikely to lead to a framework that will work well in situations characterised by general fragility.

A careful balancing of the powers and tools of resolution is therefore necessary. This aspect is especially important when it comes to the treatment of liquidity induced strains on a bank, an aspect that we return to below.

This brings up another more general aspect, namely, the extent to which the framework proposed in the directive is applicable in crises of truly systemic proportions. Our assessment is that – despite indications to the contrary – it is not; see section 3 below.

We are also of the opinion that it might be inappropriate to try to develop such a framework based on this set of resolution tools. In practice, it is not possible to consider putting several systemically important banks into resolution at the same time. It may not even be possible to consider using bail-in in a single major bank, since the contagion effect on other banks might be too severe in such a fragile environment. A systemic crisis therefore requires a different set of tools.

In particular, it is essential also to consider carefully the role of the state in a systemic crisis. Measures should be taken to decrease the likelihood of systemic crises, including a proper resolution framework. However, if such a crisis emerges, experience indicates clearly that the state must take action to *prevent* failures, measures that go well beyond dealing with banks one by one. This is illustrated, for example, by the extensive guarantee programs for securities funding introduced in 2008. This aspect is not covered in the proposed directive. It acknowledges here and there – almost indirectly – that state intervention, use of state funds etc. may be required in some circumstances, but the there is no consistent treatment. It is not clear to us that the proper place for such a treatment is in a resolution directive. At this stage we can only note that the proposal does not give a consistent picture of how to deal with a system- wide disturbance or of the role of the state in such a situation.

This lack of perspective on the circumstances in which the resolution tools and powers are to be used and exercised gives rise to a concern for the general applicability of the framework. Will it really work and if so when?

These concerns are not reduced by how the proposed directive is structured. On the one hand, there are detailed descriptions of a set of resolution tools and how these are to be applied. This is to be complemented by more detailed delegated acts and even by supervision of resolution actions by EBA. On the other hand, there is (much later in the directive) a list of general powers the resolution authority shall be given. These powers are in some ways more far-reaching than those linked to the specific resolution tools. Why should the resolution authority be directed to use specific tools that may or may not be adapted to the situation at hand, when it also has more general powers? Conversely, if the powers are the key to successful resolution, why spend so much effort on defining specific tools?

Perhaps this is a reflection of the apparent lack of time to give the proposal a sufficiently careful review and editing before publication, but it may also reflect more fundamental gaps in the analysis of how an effective framework for bank resolution should be structured. If so, this is in some sense understandable, because there is no escaping that the subject matter of this directive is exceedingly complex. At the same time, the consequences of legislation that fails to handle these complexities could be damaging, which argues for caution in the formulation of the rules. The process to convert this proposal into a final directive that now follows is therefore very important.

It must also be borne in mind that the resolution rules interact with a whole host of other regulatory changes under way. Also in this broader context a careful balance must be struck between the desire to give banks incentives to act prudently and the need to ensure that credit and other essential banking functions are provided to households and firms on reasonable conditions in normal times as well as in crises. The fact that some of the powers and tools given under the proposed directive directly overlap with those already applied in the capital requirement framework (CRD) makes the need for coordination of the legislative process all the more obvious. The generally fragile environment in many Member States only enhances the importance of considering the aggregate effects of all proposed changes the rules governing banking.

The rest of our comments are organised mainly according to the structure of the directive, i.e. we proceed article by article, with some references to the Explanatory Memorandum and the preamble where warranted. It should be noted that this is for convenience only. The directive would benefit from a restructuring of how the rules governing resolution is presented. However, we begin with some comments on the proposed role of EBA and of delegated acts, a theme that recurs in the proposal.

2 The role of EBA and delegated acts in resolution

The SNDO notes that the subsidiarity principle is given a rather cursory treatment in the proposal. As so often in Commission proposals, the case for solutions at the union level is more or less taken for granted. This is too big an issue to address thoroughly in these preliminary comments, but we would like to raise two specific aspects that are related to this broader topic, namely, the role of EBA and delegated acts to be adopted by the Commission as a means to standardise the application of the resolution framework.

In paragraph (78) of the preamble the Commission writes "Technical standards in financial services should ensure consistent harmonisation and adequate protection of depositors, investors and consumers across the Union. As a body with highly specialised expertise, it would be efficient and appropriate to entrust EBA, with the elaboration of draft regulatory and implementing technical standards which do not involve policy choices, for submission to the Commission." This statement raises questions.

In particular, we are not certain that EBA currently has specialised expertise on resolution. It is a body made up of banking supervisors. Supervision is in our opinion a different responsibility than resolution.

Moreover, giving this role to EBA seems to run against a stipulation in Article 3(3): "Member States shall ensure that, within the competent authorities, central banks, competent ministries or other public administrative authorities there is a separation between the resolution function and the supervisory or other functions of the relevant authority." It stands to reason that a similar separation is maintained also in the body entrusted to standardise and monitor the application of resolution tools and powers. We are not in a position to propose an alternative body, but a minimum conclusion is that the structure of EBA should be reviewed before it is given far-reaching responsibilities in the field of resolution. However, with reference to a recent debate to give the ECB a role as European resolution authority, we note that it would be difficult for Sweden to accept this idea, given that Sweden has no say in the decision making bodies of the ECB.

Paragraph (80) of the preamble contains a list of things that the Commission asks to be empowered to regulate in delegated acts. The list is too long to discuss in detail here, but we want to emphasise that it contains matters that most definitely involve policy choices and as such are unsuitable for delegation. There is always a trade-off regarding the amount of detail to be included in Level 1 legislation, but when dealing with complex issues where important policy choices are affected by detail it is necessary to address them. The temptation to pretend otherwise and simply leave matters to the Commission – in order to simplify the legislative process or for other reasons – should be firmly resisted.

3 The resolution authority (Article 3)

We support the proposal to create a resolution authority and that this should be a government agency (public authority). We also think – although this is not covered by the directive (apart from a detail in Article 24(1)(g); cf. below) – that the resolution authority should be kept separate from the authority responsible for supervision. Resolution effectively involves running banks and it is not appropriate for supervisors to manage entities under supervision.

However, we object to Article 3(5). In substance, the rule is reasonable, but it is not appropriate to give directions on the relations between the resolution authority and the Government of the Member State in an EU directive. Such matters must be settled based on national rules and conditions.

4 On the treatment of systemic events (Articles 6 and 9)

Regarding both recovery and resolution plans it is stated that plans covering individual banks should include preparation for system wide events; see Articles 6(2)(b) and 9(2). Moreover, it is stated that plans shall not assume any extraordinary public financial support (beyond use of central bank facilities; see below). This is neither realistic, nor consistent with other elements of the proposal.

First, by their very nature system wide events will trigger policy actions, for example, in the form of public support measures. To assume otherwise runs against all experience, past and present. It is therefore pointless for banks and resolution authorities to make plans on an assumption to the contrary.

Second, the basic prudential rules for banking are laid down in the form of capital requirements, liquidity buffers etc. in the CRD framework. By construction, these rules are set *(inter alia)* to provide banks with sufficient buffers to withstand financial stress. To use a different regulatory framework to require banks to maintain additional buffers with the argument that this is required for them to withstand financial stress effectively says that the CRD rulebook is insufficient. This may be so, but the Commission had presented no analysis to support such an assessment.

Third, a bank must be able to base its recovery plan on the assumption that it can meet a liquidity squeeze by selling assets from its liquidity buffer. But it is impossible for many banks to be sellers of the same instruments at the same time without risking a breakdown of the markets for these instruments. Recovery plans based on banks using their liquidity buffers therefore have to be rejected, putting the whole notion of prudential liquidity buffers into doubt.

In the limit, it is open to question whether there exists a set of recovery plans drawn up in line with these exacting standards that are compatible with continued reliance on fractional reserve banking. Such a restructuring of the financial system is theoretically possible, but it would be absurd to engineer it via the recovery plans of individual banks.

A possible escape from this dilemma in the case of liquidity crises would be to assume that the central bank will intervene. This possibility is mentioned in Article 5(3). But central bank facilities for liquidity support are rarely so clearly defined and predictable that they can form the basis for an obviously credible recovery plan. Such a setup would – as a minimum – require a significant reduction in the discretion that central banks exercise when deciding on how and to whom liquidity support is to be provided.

Third, plans covering systemic events must take into account interdependencies between what different banks are doing. For example, the requirement in Article 6(2)(b) that individual plans should be possible to implement while other banks are implementing their plans assumes that the supervisor can assess all plans jointly. If plans turn out to be mutually inconsistent, the supervisor will have to decide how to balance the plan of one bank against the plan of another. This implies also that a suggested change in one bank's recovery plan can necessitate simultaneous reviews of the plans of all other banks. This is a completely unrealistic undertaking.

Indirectly, the rules on resolution can be interpreted as acknowledging this fact. Thus, in Article 15(5) it says: "Resolution authorities shall not base a determination [to remove impediments to resolution] on impediments resulting from factors beyond the control of the institution". One example of such a factor is how other institutions are set up. But given this condition it is hard to see that the resolution authority can force banks to change how they conduct their business even if it comes to the conclusion that plans are not mutually consistent. Consequently, it lacks the power to address situations where it finds that resolution plans cannot be implemented in the case of system wide event.

One possible remedy would be to revise Article 15(5) so that interdependencies can be addressed. However, this would put resolution authorities in the same predicament as supervisors, namely, to draw up state contingent plans for handling all banks simultaneously. This is beyond human capacity, even in a small country like Sweden with just four obviously systemic institutions. There are simply too many options in a resolution (and too many possible scenarios) for this to be feasible.

Our conclusion is that the only realistic way forward is to abandon the ambition to handle system wide events on the basis of plans drawn up according to this directive. The demands on banks, supervisors and resolution authorities from a more limited version of the directive, targeted at handling one institution at a time, are still daunting.

5 Resolution plans (Articles 9-16)

Broadly speaking, the SNDO considers that the directive gives too much emphasis on detailed planning. A resolution plan might be useful in the event of a failure of an individual institution. Then it should be feasible to, for example, sell assets and businesses to other institutions in an orderly manner.

In a system wide event, however, it is hard to implement resolutions measures that do not rely on keeping the whole institution going. First, more drastic resolution measures can have contagion effects in such a fragile environment. Second, it is highly unlikely that you can find willing buyers of failing institutions when (be assumption) all institutions are at risk. Consequently, we consider that planning with respect to individual institutions should be limited to idiosyncratic cases.

We are also sceptical regarding the level of detail indicated in the proposed directive and the idea of giving EBA such a central role and preparing scenarios. It is not clear to us that standardised crisis scenarios that are relevant in all Member States can be constructed. And more likely than not, the actual crises that resolution authorities will face will be quite different from those envisaged in these scenarios. In our assessment, bank crisis management is about general preparedness and flexibility, based on a well-designed set of powers and instruments, not about detailed scenario-based planning.

6 Assessment of resolvability and preventive powers (Articles 13-14)

Article 13 repeats the ambition to make resolution plans that are capable of dealing also with system wide events. In Article 14, powers to address any impediments to such resolution are given. For the reasons presented above, we question this approach.

The list of powers considered necessary by the Commission to device such plans is also telling. It includes measures bringing the resolution authority far into the management of the institution, including the business strategy, the organisational structure and details of the capital structure. The end result is that the responsibility for managing the institution is handed over to the resolution authority already at the planning stage.

Ignoring for the moment whether this is a reasonable approach, it is clear that the powers of the resolution authority overlap with those of the supervisor. The powers given to supervisors in assessments of recovery plans in Article 6 are worded somewhat differently, but in substance they deal with the same matters. Effectively, this means that banks are subject to supervision and regulation from two arms of government. These public authorities are also supposed to use the same instruments, creating an obvious risk of inconsistency in their application. This is unlikely to be practical.

Moreover, it is important to consider the consequences of making government authorities responsible for the effective and operative management of banks. This is seen first in the case of early intervention. Based on the powers given to the supervisor – and the expectations that they entail – it seems inevitable that any bank failure would be consider the responsibility not just of the board and management of the bank, but also of the supervisor. Whatever goes wrong, supervisors would have had the powers to prevent the bank from failing, either by directly stopping the activities triggering the failure or by putting stringent enough conditions into the recovery plan. Moreover, this puts the level of expectation of what supervision can achieve very close to that of securing a system where banks never fail. This is neither realistic, nor desirable.

Similarly, if the resolution of a bank runs into any difficulties related to how the bank's business is organised, this must be interpreted as the result of a failure of the resolution authority to restructure it appropriately. Just like the supervisors they had the powers to demand any changes deemed necessary.

We consider this degree of state involvement in the management of banks as fundamentally inappropriate for any number of reasons. It undermines the basic corporate governance structure of banks. The responsibility for defining the business strategy of a company – obviously within the limits set in regulation – should remain with the bank's board, acting on behalf of the owners. Requiring a bank to hold capital proportionate to the risks it takes is an essential responsibility of supervisors, but to micro-manage the bank is not. Blurring of the lines of responsibility in this regard is unlikely to lead to better banking. And it makes the task of supervision even more difficult than it already is.

Such blurring is not unique to this directive proposal. But its consequences come out especially clearly in the context of early intervention and crisis management. We would suggest that an approach based on effective powers and tools for actually handling a bank in crisis – combined with strict capital requirements – would significantly reduce the incentives for risk taking in banks. This means in turn that the need for preventive intervention in how banks are managed – be it for recovery or resolution planning – is also reduced. We therefore recommend that the powers to intervene in the micro-management of banks in normal times given to the competent authority and the resolution authority are revised and scaled back.

7 Early intervention (Article 23)

Early intervention is already an established tool of supervision. Some of the measures outlined in Article 23 are also part of the existing rules, for example, the rights to convene a shareholder meeting and to remove key decision makers that are considered unfit for their positions. Similarly, competent authorities have the right to ask for any information. At first glance, only the points (a), (e) and (g) contain new elements (in relation to Swedish legislation). Point (a) refers specifically to the recovery plan, but this mandate is in effect covered by point (b) which deals with action programs of any kind, including a recovery plan prepared in advance.

This leaves points (e) and (g). They bring in elements that seem closely related to resolution. Point (e) refers a requirement to plan for negotiation of debt restructuring with creditors. This could have effects similar to a debt write-down, albeit in a format that is in principle voluntary. To require an institution to "plan" is easy, but there is no indication of whether the plan has to be realistic or of the consequences of a failure of the plan to lead to a successful debt restructuring. In the recovery phase, there are no formal ways of forcing the creditors to accept a debt restructuring, but the negotiations may well be influenced by the threat of resolution as a next step. This implies that this tool could trigger a credit freeze for the bank, similar to fears of resolution, but without the other powers that are provided in a proper resolution. We would therefore be hesitant to include this as a tool of early intervention.

Point (g) most clearly crosses the line to resolution. It mandates the competent authority to "contact potential purchasers to prepare for the resolution of the institution". We reject the proposal to give such a task to the competent authority. It blurs the line between recovery and resolution. This in turns blurs the lines of responsibility between the competent authority and the resolution authority. Moreover, it involves supervisors in active decisions on restructuring of the banking industry. This may affect the supervisor's incentives in dealing with the entity that bought the bank more strongly than in cases where it just gave OK to a new entity merger created on the initiative of someone else.

We strongly believe that a clear functional separation between supervision and resolution should be maintained. The proper action for a supervisor concerned for the survival of an institution is therefore to inform the resolution authority to give it a chance to prepare appropriate measures, including contacting potential purchasers, as the case may be.

We would therefore recommend a substantial review of Article 24. This should include elimination of powers already given to competent authorities in current legislation and the deletion of point (g). Point (e) should also be given careful consideration.

8 Special management (Article 24)

We do not understand the rationale and the function of a special manager as a recovery tool. It involves too many of the features of resolution to be used on a bank that is not in or nearing insolvency.

First, in its more drastic forms, the result of the decisions of a special manager can be the same as those of a resolution. For example, the takeover by another institution (mentioned in Article 24(3)) seems functionally equivalent to the sale of business tool. The powers of the special manager are also similar to those of an administrator supposed to be appointed after a bail-in. Considering also the strong control of the special manager that can be exercised by the supervisor (cf. Article 24(4)), this instrument appears to be a pre-emptive resolution done under the control by the supervisor. We do not see the justification for such a procedure.

Second and assuming that the special manager stops short of organizing a takeover, it appears that upon termination of special management the institution shall be returned to the original owners. Effectively, this implies that the government (via the supervisor acting via the special manager) takes responsibility for reorganising the institution *on behalf of* the owners. Starting from a situation where there has been "a significant deterioration in the financial situation" the owners are given back an institution that is "sound".

We do not see why the supervisor should have the responsibility for such turnaround management. If the original owners are not capable of doing this on their own – obviously while subject to regular supervision – it seems strange to assume that they are any more suited to run the institution after the turnaround. If they were imprudent before, the fact that they have been side-lined for a certain period is not in itself a reason to believe that they have changed. This seems to give an unfair advantage to incumbent owners.

The opposite case can also arise, for example, if the special manager organises a takeover of the institution on terms the owners consider unfavourable; it is not clear from the directive what legal remedies are available to owners that object to a decision to appoint a special manager or to the actions she takes. The rules covering the rights of owners only refer to resolution.

On the other hand, it is not obvious that the supervisor – even when working via a special manager – is best suited for taking responsibility for hands-on reorganization of banks. The primary skills of supervisors are unlikely to be in bank management. The principle that supervision should be done at arm's length from an institution, not from within, should be retained.

If the supervisor considers it necessary to reorganise a bank, it should require the owners of the bank to do so, based on regular powers of supervision. If the owners want to do this by appointing a specialised turnaround manager, this should be their call. The supervisor can then assess, using regular procedures, whether the actions taken are sufficient to rectify the situation. If this turns out not to be the case, it is appropriate to consider revoking the license and, if this is warranted in the circumstances, begin proper resolution of the institution.

An internally appointed manager would not have the extraordinary powers given to the special manager in the proposed directive. On the other hand, it is hard to see that the situation where a special manager is supposed to be called in would justify powers to "override any other duty of management under the statutes of the institution or national law, insofar as they are inconsistent" (cf. Article 24(3)); after all, the crisis is not (yet) such that it would be appropriate for the supervisor to revoke the license. Such drastic measures should be reserved for situations where proper resolution is called for. In effect, it appears that the management of a bridge institution – as described in Articles 34 and 35 – is *more* constrained by existing rules and regulations than a special manager. This is another telling illustration of the strange nature of special management as a tool of early intervention.

9 The presentation of the framework for resolution

According to the Explanatory Memorandum "resolution authorities will have the power to take control on an institution that has failed or is likely to fail, take over the role of shareholders and managers, transfer assets and liabilities and enforce contracts" (p. 12). The key words here are "take control", as this is an essential feature of crisis management and the start of any resolution process. Yet, in the directive proposal much of the focus is on the specific resolution tools, without much of an explanation of how they fit in to the broader picture.

It would seem to be more appropriate to present the power to take control (and other general powers enumerated in Chapter V) first and then describe the tools as concrete examples of those powers. Although this is partly a matter of exposition, we believe that it is an important one, as it might help to describe the intended process of resolution better. And by describing the process better, one may also discover ways to improve it more effectively.

10 Resolution objectives (Article 26)

This article is based on a list of things that are all defined as "objectives". Moreover, it is stated that all items on the list are of equal significance. We find this confusing.

The reason is that the list includes both proper objectives – like continuity of critical functions and financial stability – and elements that are (at most) constraints to take into account when pursuing these objectives. In particular, we would regard protection of public funds as a constraint, not an objective at par with financial stability.

Moreover, it cannot be of equal importance to maintain financial stability and to protect depositors covered by deposit guarantee schemes. The latter are – by definition – already protected to an extent deemed appropriate in the rules establishing the deposit guarantee. Similarly, point (f) indicates a level of protection that goes beyond the ambitions of the deposit guarantee and investor protection schemes, again for no apparent reason.

Consequently, this article should be restructured in a way that distinguishes the fundamental objectives – which we would argue are in points (a) and (b) – from constraints. We would also suggest deleting points (e) and (f) entirely.

11 Conditions for resolution (Article 27)

We consider the first two criteria for resolution to be self-evident. They refer directly or indirectly to balance sheet problems of the institution. The other two are more problematic.

Point (c) says that an institution should be put into resolution if "the institution [...] is or there are objective elements to support a determination that the institution [...] will be, in the near future, unable to pay its obligation as they fall due". This seems to indicate that liquidity problems in a balance-sheet solvent bank can act as a standalone trigger for resolution.

There may be circumstances when a liquidity problem is an appropriate trigger, but the case seems less clear-cut than when the capital has been exhausted. This is also acknowledged in the Commission's text. In the Explanatory Memorandum it is said that "a bank should enter into resolution at a point very close to insolvency" (p. 5). Inability to pay may quickly lead to depletion of the capital buffer and thus make the bank balance-sheet insolvent, but if so the condition for resolution in Article 27(2)(a) is sufficient.

The issue is potentially even more subtle, since the mere expectation among creditors that a bank may end up in resolution can trigger a liquidity crisis. For example, creditors wanting to avoid involvement in a bail-in will refuse to lend to the bank. If such a creditor run triggers resolution, the expectations become self-fulfilling. Including liquidity problem as a trigger for resolution may therefore prove destabilising.

The assessment – by the resolution authority or by creditors – of whether a balance-sheet solvent bank is likely to have liquidity problem is tied to what is assumed about its access to central bank liquidity support. If solvent banks can expect liquidity support, this conditions for resolution is unlikely to be relevant in practice (and unwarranted creditor runs are unlikely). If liquidity support is a more discretionary decision by the central banks, more complex issues arise for supervisors and resolution authorities. Again, this points to the importance of creating more transparent and predictable rules regarding central bank liquidity facilities.

It should also be noted that a decision to put a balance-sheet solvent institution into resolution is likely to lead to more complex valuation issues. It is quite likely that the equity capital in an institution that is solvent at the time of resolution has a positive value. This implies that when determining the share of losses to be borne by different stakeholders some form of compensation should be paid to shareholders. In such circumstances, the valuation covered in Article 30 will take on greater economic significance. Since such valuations in practice are highly judgmental, there are a priori reasons to avoid situations where they become important. (See also section 12 below.)

Article 27(2)(d) stipulates that the conditions for resolution are met if the institution "requires extraordinary public financial support". This criterion is somewhat difficult to interpret. As constructed it can also have unwanted side-effects.

First, it is not clear whether "requires" refers to actual or hypothetical public support. For example, an assessment may indicate that an institution requires public financial support in order not to fail. If it then receives support, resolution is triggered under point (d). But the reason it needed public support was that it was likely to fail absent such support, i.e. it could have been put into resolution based on points (a) or (b). Moreover, once in resolution, the need for public support (as defined in the proposal) may disappear, for example, because it receives support from the resolution fund. Thus, it is not obvious that this criterion plays an independent role. It should be considered to eliminate it from the list of conditions for resolution.

Second, in explaining the nature of "extraordinary public financial support", exemption is made for central bank liquidity support and for guarantee programmes of securities funding of solvent institutions, as those launched by many Member States in 2008-2009. This is highly appropriate. However, we would reconsider the three-month time limit set on use of guarantee programmes. Such programmes were used – and accepted under State aid rules – for a considerably longer period in 2008-2009. An unconditional time limit seems inadvisable.

We also note an inconsistency between the treatment of state guarantees for central bank liquidity support in this article and in paragraph 21 of the preamble. Here it is said that such state guarantees are acceptable, whereas the opposite appears to be stated in the preamble. This has to be clarified. We would argue that such state guarantees should be acceptable. The reason is that in certain circumstances only the central bank is in a position to create the amounts of liquidity that a major bank may require. A loss of central bank liquidity support to a systemic bank can therefore endanger a resolution action aimed at securing financial stability. Such an outcome is unacceptable. It must therefore be possible for the state to issue guarantees to the central bank.

We would also like to point out that the conditions listed in paragraph 21 refer to circumstances that can only be determined when liquidity support is provided, for example, the nature of the collateral provided. Therefore, it does not make sense to see these as constraints on the assumptions made in recovery or resolution plans. If anything, these conditions appear to regulate the conditions under which central banks provide liquidity support. This may be justified, as we note elsewhere in these comments, but it would seem to fall beyond the scope of this directive to write rules governing central banks.

Finally, regarding Article 27(1) and (3) we note that as long as special management is included as a tool of early intervention that contains actions with identical consequences to those achievable via resolution, it is likely to be hard to assess whether resolution action is necessary in the public interest. This illustrates the inconsistencies created by including a tool with resolution-like features among the instrument given to the supervisors.

12 Valuation (Article 30)

The starting point Article 30(1) is that independent valuation should be completed *before* resolution action is taken. This is not realistic. Experience from the SNDO's actions regarding Carnegie Investment Bank in 2008 indicates that it can take several weeks to assess the value of even a very small bank.

This means that while it is conceivable to postpone application of specific resolution tools until after a valuation has been completed, it is not possible to postpone the first step of resolution, namely, the decision to take control over the failing institution. This is thus an example of where the focus on tools – at the expense of resolution powers – that we point to in section 9 above can be misleading. So, while valuation is an essential part of resolution, it must come second to the taking of control.

The valuation principles in Article 30(2) seem broadly appropriate. However, the exception made for situations where "the market for a specific asset or liability is not functioning properly" and "the long-term economic value" should be taken into account appears problematic.

First, it is obvious that this runs against the principle that resolution should give results similar to an ordinary liquidation. Second, it appears to give less protection to owners of institutions dealt with using the sale-of-business tool. There the payment to the owners is determined by what is received when assets are sold, a valuation that will reflect current market values and nothing else. (See also section 13.)

13 The sale of business tool (Article 32)

According to Article 32(1)(a) the resolution authority shall have the right to transfer "shares or other instruments of ownership of an institution under resolution". Such an action is tantamount to an expropriation and subsequent sale where the original owner gets whatever is obtained through the sale. It is also similar to what happens when shares that have been held as collateral are sold and any surplus is transferred to the original owners of the shares. A rule like this thus creates a situation where all bank shares effectively are controlled by the resolution authority in the same way as if they had been posted as collateral.

Like any expropriation, the sale of business tool raises issues related to the right to property that require careful analysis. One key issue is the price that will be obtained. The proposal appears ambiguous in this regard. There are some rules that serve to protect the original owners, whereas others include quite drastic exemptions

On the one hand, Article 32(4) states that steps should be taken to obtain a price that is "in conformity with the fair and realistic valuation conducted under Article 30". However, as noted above, a price from a market transaction will never reflect anything but the current market conditions. The relation between the value obtained in the sale and the valuation rules set out in Article 30 must be clarified.

The ambiguity is not reduced by the fact that, according to Article 33(3) the marketing requirements can be waived when financial stability is threatened. This is a very far-reaching power, as it might leave the original owners without anything even if the bank had a positive net asset value when it entered resolution. Moreover, such a situation may be especially likely when markets are not functioning. Would it then be possible to legally challenge the sales price with reference to Article 30? And, more generally would it be possible to challenge the decision on the basis that use of a different tool would have given a better outcome for the owners?

Based on our experience form 2008-2009, we would consider it highly likely that any sales price will be challenged in court. Such legal proceedings may turn out to be complicated – and potentially expensive to the state – unless the rules in this regard are made very precise.

Looking at the sale-of business tool from the point of view of securing expedient crisis management, it appears undesirable to force a delay of its use until a valuation based on Article 30 has been conducted. One of the advantages of this tool may be that it would allow a quicker exit from resolution.

There are also highly practical matters to consider if the sale of business tool is to work. For example, it is not obvious that a transfer to new owners actually can be accomplished in all circumstances. What happens if the shares (or other assets that are to be sold) in question are in physical form?

14 The bridge institution tool (Articles 34–35)

The creation of a bridge bank is reasonably well explained in the draft proposal. Many questions still arise regarding how it is supposed to function.

For example, it is stipulated that the bridge bank shall be controlled by public authorities. At the same time it is acknowledged that private agents may become owners through a debt-to-equity conversion using the bail-in tool. Effectively, this seems to imply that the private agents' shares are non-voting while resolution is under way. Then in Article 35(3)(b) it is stated that the operation of the bridge bank shall be terminated upon "acquisition of the majority of the bridge institution's capital by a third party". But what if the debt-to-equity conversion leads to a situation where previous bond holders hold more than 50 per cent of the shares in the bridge bank? Should this trigger immediate termination of resolution? If not, because the previous debt holders are not "a third party", say, how can the resolution authority ensure that an acquirer obtains the majority of the capital unless it can force some or all of those that obtained shares in the debt conversion to sell their shares?

Or is this a constraint on the use of the debt conversion tool in the case of a bridge bank implying that it can never happen that the public authorities control less than a majority of the shares? If so how is this constraint imposed?

And why base the exit condition on the acquirer being **a** (i.e. one) third party? Could not a public offering of the shares achieve the objectives as well?

We are also uncertain about the reasoning behind Article 35(7) second paragraph. It says that any proceeds from the termination of the bridge institution shall benefit the institution under resolution. It appears that such a rule could have the result that value improvements during the time when the resolution authority manages the bridge bank benefit the failed institution's claimholders, potentially including the shareholders. This is not obviously desirable from a policy point of view, since it weakens the principle that losses should be borne by shareholders.

From a legal point of view, it is also not clear how this rule shall be interpreted given what is said on valuation in Article 30, which specifically refers to the bridge bank tool. Is it not this valuation that is to determine the payment to the claimholders of the institution under resolution, rather than what is obtained when the bridge bank is sold?

15 The asset separation tool (Article 36)

This tool allows the resolution authority to set up asset management vehicles. Experience shows that this may be a useful tool in bank resolution. Whether the inclusion of asset separation as a special tool in this context adds much in substance is less clear, however. The measures seem to largely coincide with those to be used in the set-up of a bridge institution.

Moreover, also in this case we find the relation to the valuation rules difficult to interpret. In Article 36(5) it is said that transferred asset shall be valued according to the principles in Article 30. According to Article 36(9) claimholders of the institution under resolution no longer have any rights over the assets once they are transferred to the asset management vehicle. This seems clear cut. Yet in Article 36(10) the Commission has found it necessary to introduce a specific rule that takes away any responsibility towards for how assets are managed. Since the only action that should matter for shareholders of the institution under resolution is the valuation, this paragraph should be superfluous. As it stands, it reintroduces uncertainty about the role of the valuation made under Article 30.

We also note that asset separation is notoriously difficult when the transfer is made between entities with different owners. Then the valuation takes on huge significance, since it determines the relative position of the two groups of stakeholders. And given that theoretical valuation is inherently inexact, also when asset markets are functioning normally, asset separation may lead to quite arbitrary redistributions.

Consequently, asset separation can be expected to work reliably only when transfers are made between entities with one owner, for example, when separating good and bad assets held by a state-owned bridge institution. Then the assessed values take on much less significance.

16 The bail-in tool (Articles 37 and 38)

The bail-in tool raises complex issues. These relate both to the circumstances in which it can successfully be applied and how it is intended to function once it is applied.

The underlying reasoning behind the bail-in tool is straightforward: Just like in the case of lending to non-banks, it is desirable that creditors have incentives to evaluate and monitor banks. Moreover, experience has also shown that it might be difficult to create such incentives in systemically important banks, because creditors have only rarely been forced to bear losses.

It is easier to identify this problem than to find a solution, however. The technique proposed here is essentially to create an additional buffer of contingent capital, based on statutory powers to write down or convert to regular equity capital certain types of debts. As a technical matter this clearly works. The practicalities are far more complex.

First and foremost there is the issue of how bail-in would affect the dynamics of a crisis. It seems unavoidable that a bank that is perceived to be in difficulties will face financing problems earlier than if bail-in was not possible. Access to funding markets involving debt instruments that can be bailed in will be cut. If such a response is isolated to one bank, this might be manageable and even considered desirable. If the bank is about to become insolvent, it can be brought into resolution and handled in an orderly manner.

Problems are typically not isolated to one bank at a time, however. Financial crises often occur as a result of common shocks. Then many banks end up in difficulties at the same time and a speeding up of funding problems is anything but desirable. The impact of such disturbances in funding market is affected by many factors, including the liquidity buffers maintained by individual banks and by the actions that might be taken by central banks and others to support the funding of solvent banks.

It is not possible to assess with any precision how bail-in of the form proposed by the Commission would affect the risk of liquidity crises. The only point that can be made at this stage is that the tool has to be calibrated very carefully, for example, when considering the instruments that are exempt from bail-in. Moreover, it may have to be accompanied by changes to other instruments, for example, the rules for access to central bank liquidity support.

Turning to the specific rules, Article 37 deals with the purposes for which bail-in may be used. These are to recapitalise a bank so that it can be reorganised as a going concern or to provide capital to a bridge bank. The first of these options can only be used if there is a realistic prospect that the reorganisation will be successful. As this is the option that will be used for the systemically most important banks, we doubt that such a constraint will have much effect. These banks will have to be kept going, if necessary with the use of extraordinary public support in some form.

Article 38 includes a list of liabilities that are not subject to bail-in. These include liabilities with an original maturity of less than one month. With reference to the concerns expressed above, we consider one month as too short a period. Access to short-term funding is vital in a crisis situation, especially for a bank that is locked out of markets for longer-term funding. Concerns that banks rely too much on short-term funding should be addressed in the liquidity rules in the CRD framework, not here.

We also note that collective action clauses – an instrument with some similarities to bail-in – are never included in the terms of short-term debt instruments. While Article 38(3) opens up for other exemptions when the resolution objectives are in jeopardy, we would argue for an explicit exemption for at least up to three months.

Finally, it can be argued that the exemption for short-term financing instrument should be extended to deposits, as these are also contractually short-term liabilities. This would imply that the idea to force the deposit guarantee scheme to participate in resolution in the same way as holder of long-term claims should be rejected. We return to this issue below in the section on financing arrangements.

17 Minimum requirements for eligible liabilities (Article 39)

This article instructs Member States to impose requirements on the amounts of liabilities that can bailed in. These are to be set for each institution based on a listed set of criteria, but in the Explanatory Memorandum the Commission indicates that 10 per cent of total liabilities could be appropriate.

Since this requirement excludes regulatory capital, it works like an additional capital requirement. At the same time the list of criteria is very general and based entirely on qualitative assessments. Effectively, it would work much like an additional pillar in the capital requirement rule book. This is especially so for smaller banks that do not have access to bond markets and would have to meet any requirement using own funds.

We also note that the article only refers to "the aggregate amount". This seems to imply that own funds and liabilities that can be bailed in are to be included with equal weight. This would be inappropriate given that equity is a more valuable buffer also in resolution.

We are thus not convinced that adding another layer of capital requirements makes sense, either functionally or structurally. As a minimum, these rules must be carefully calibrated with other capital requirements.

We also think that the vagueness of the criteria leaves too much discretion to the Commission that wants to have the right to adopt delegated acts specifying the rules.

18 Implementation of the bail-in tool (Articles 41–47)

The essence of a bail-in is to ensure that a bank following a failure is recapitalised. The process is easiest to envisage in the case where the losses – assessed through a valuation of all assets and liabilities – have wiped out more the whole equity base, i.e. when there is negative equity (what sometimes called "a hole in the balance sheet"). The first step is then to cancel existing shares. The second step is to write down debt instruments (according to their position in the hierarchy of claims) until the hole in the balance sheet has been filled. The third step is to convert enough of remaining debt claims into new equity to ensure that the bank meets relevant capital requirements. The claimholders whose claims have been converted to equity would then also be the new owners of the bank.

The articles in this subsection deals with precisely these issues, but we find it hard to see the clear distinction between debt write-down and equity conversion identified in the preceding paragraph. Write-down and conversion are in several instances used as if they had equivalent effects and could be used interchangeably. This we find hard to interpret given that they have very different consequences for both the bank and the affected claimholders. In one case claims are eliminated, in the other previous creditors become owners of the bank.

This may be a matter of exposition, where we have failed to grasp the intentions of the text. But we also do not find any description of the role of the holders of the new equity instruments. They would seem to be the legal owners of the bank, but they appear to have no role in its management. Instead, all the powers are to be given to an administrator, whose task it is to put the bank back on sound footing. To do this the administrator shall present a business reorganisation plan, to be implemented subject to approval from the resolution authority. (In passing we note that the text does not mention any relation between the business reorganisation plan and the resolution plan, making it somewhat unclear what the role of the latter is in the case of a bail-in.)

According to Article 47(2), the plan shall aim to put the bank in order within a period not longer than two years. But in contrast to the rules on the bridge institution tool, there is no indication on what is supposed to happen at the end of the period, when the bank is once more sound. Logic would seem to require that it is then taken out of resolution. Logic would also seem to imply that control of the bank is then handed over to the owners, i.e. those whose claims were converted into equity at the time of the bail-in.

Despite the internal logic of this outcome , we find it hard to accept. Just like in the case of special management, administration implies that the state takes responsibility for reorganising a bank and then hands it back to private sector owners once the job is done. In this case it is not the original owners but previous lenders to the failed institution, but the end result is similar.

Again, we find it hard to see why the state should take on the responsibility to run banks on behalf of private agents. In cases where the equity capital and possibly also some non-equity claims have been wiped out by losses, temporary public ownership is the preferred option. Capital can be injected using funds from the financing arrangement, giving the state full control of the institution under resolution. Once safety and soundness has been restored and the market for bank share has recovered, the bank can be sold back to private agents. If this action gives a surplus (as it well might) the profits go to the financing arrangement, thus strengthening the resources to deal with future crises. If the financing arrangements are set up properly as a state-owned fund, this may also more directly benefit the state; see comments below.

We are aware that there is a trade-off here in the sense that (other things equal) injecting new capital through a debt-to-equity conversion implies that creditors carry a greater share of the risk than if capital is injected from the financing arrangements. However, a bail-in while maintaining the institution as a going concern is especially likely in cases where the bank is big and of high systemic importance. Such banks will typically be brought back to health in one way or another. This implies that the holders of new equity does not bear that big a risk, and can expect to be given a healthy bank once resolution is over. The equity in such a bank is thus likely to have a positive expected value from the outset. The disciplining effects of this part of a bail-in are therefore not that strong, bringing the argument that the state as responsible for the rescuing the bank also should have the upside to the fore.

Given the lack of clarity in these articles on the use and consequences of debt-to-equity conversion, an outcome with temporary public ownership is not necessarily excluded. However, Article 92, specifying the use of financing arrangements, indicates that contributions (of capital) can be made only to a bridge institution, i.e. not to an institution kept in business under administration.

To summarise, we find the reasoning in Articles 41-47 to be (at best) ambiguous. The role of debt-to-equity conversions and the position of the claimholders whose claims are converted to equity should be reviewed and clarified.

19 Write-down of capital instruments (Articles 51-55)

These articles are technically complicated and we have not had time to analyse them. However, we have noted an apparent incongruity in Article 52. In point (a) it is stated that Common Equity Tier 1 is to be written down proportionately to the losses. This seems appropriate, but in point (b) it is said that "relevant capital instruments", defined to include Additional Tier 1 and Tier 2 instruments, are to be written down to zero, apparently irrespective of the size of the losses. This seems to put a bigger burden on these capital instruments than on Tier 1 capital, which we find strange.

20 Resolution powers (Articles 56-64)

Article 56 contains a list of general powers that the resolution authority shall have. As such it is an important article. As we noted above, we think that these powers should be given a more prominent place in the directive. It is also essential to assess whether these powers are both necessary and sufficient for effective resolution, but we are unable to attempt such an assessment in this context.

These powers are presented as general descriptions of what is needed for the resolution tools to work. Some of them also seem to extend beyond the powers related to the specific instruments. For example, Article 56(1)(m) mentions the power to amend or delay repayments or interest payments. This right does not seem to be linked to any particular tool, which once more illustrates the point that the focus on tools in the structuring of the rules is excessive and potentially misleading.

We also find it strange to put the right to require information as item (a) in the list and the right to take control of the failing institution as item (b). This does not reflect their relative importance.

According to Article 56(2)(a) the resolution authority shall not be required "to obtain approval or consent from any person either public or private". We are not convinced that this degree of autonomy is appropriate. As we noted above, we find the rule in in Article 3(5) that the resolution authority shall take decisions in consultation with the competent ministry to be more sensible, considering the economic and financial matters that may be at stake in bank resolution. We are also not convinced that the relation between the resolution authority and the Government of the Member State should be guided by this directive.

Moreover, as a matter of internal consistency, it seems difficult to reconcile these two articles as presented in the proposed directive, since a ministry must be regarded as a "public person". Similar questions can be raised regarding the obligation in Article 3(4) that resolution authority "cooperate closely" with the competent authority.

In Article 64, it is made clear that the resolution authority can exercise control directly of an institution under resolution. We think that this should be the base case, and that references to a semi-autonomous administrator (as in Articles 46 and 47) should be deleted. The means through which the resolution exercises control must be adjusted to the circumstances and decided without detailed guidelines set out in this directive.

21 Safeguards (Articles 65-73)

Article 65 articulates that shareholders and creditors shall receive in payment for their claims the same amounts as if the institution had been would up under normal insolvency proceedings. Article 67 stipulates that they are entitled to compensation if this is not the case. These are important principles, but they are not easy to implement.

One piece of the implementation comes in Article 66. It defines the valuation that shall form the basis for this assessment. It is said that this valuation shall be "distinct from the valuation carried out under Article 30". Quite what is meant by "distinct" is not clear, since the valuation, according to Article 66(3) shall be based on the same methods as the valuation under Article 30. We are concerned that vague rules in this regard can act as an invitation to lawsuits, where factors that were in fact not known at the time of the initial valuation are brought forth. Again, we see a risk of complex legal battles on the application of the valuation rules; all the more so if they are open to wide interpretations.

22 Procedural obligations (Articles 74-76)

Article 74 describes the procedures involved when a resolution process is initiated. This process starts with the competent authority, which is natural as it is through supervision that failure or the risk of failure can be identified. The article goes on to describe in great detail the steps that the resolution authority is supposed to take after it has been notified by the supervisor. While mostly sensible, it seems that this level of detail is unnecessary in the directive. We also see no reason for having the procedures further specified in delegated acts, except possible in cases involving group resolution. The administrative procedures for resolution of banks with no cross-border activities can well be set according to national practices.

Similarly, we see little justification for the specific requirement in Article 75(2) that EBA should be notified of a resolution action. At least, it appears odd to put EBA on par with the institution under resolution in this regard. It is difficult to imagine effective resolution that is done without involving the institution in question, while it is quite easy to see resolution powers being exercised without any involvement of EBA. The relation between a special notification to EBA and the requirement in Article 75 to make the action public is also not entirely clear. (As a drafting observation we also note that the obvious part of Article 75(2) duplicates what is said in Article 74(5).)

Regarding the rules on confidentiality in Article 76(3), we note that the competent ministries should be added to the list of parties with which information can be shared.

23 Rights to challenge resolution (Article 78)

Article 78(1) requires that all persons affected by the decision to open resolution proceedings [...] or by a decision of the resolution authority to take a resolution action have the right to apply for judicial review of that decision". Considering the extensive and intrusive powers given to the resolution authority under this directive, this is obviously an important rule. We also endorse the stipulations in Article 78(2) that resolution decisions shall be immediately enforceable and that remedies for a wrongful decision shall take the form of monetary compensation. Otherwise the whole basis of the resolution procedures may be undermined.

Possibly as a drafting comment, we are doubtful whether the use of the word "annulment" in Article 78(2)(d) is appropriate. The legal implication of a court decision that a resolution action has been incorrect is not an actual annulment, but payment of compensation to the injured party.

However, we are uncertain as to whether the right of judicial review can be extended to literally "all persons affected", as the ripples of a resolution decision can extend quite far. For example, other financial institutions can regard themselves affected, either by the impact on the competitive situation in the market place or via their contribution to a resolution fund. (Taken literally, also staff of the resolution authority would seem to fall within this category to the extent that their workload is affected.) It may be that this is a standard formulation in similar contexts, but we feel that the net here might be spread too wide.

Finally, we note that the absence of rights to challenge measures taken by the competent authority as part of early intervention. While we object to the special management tool, it is essential that banks have the right to appeal the decisions taken under special management, if such a tool were to be introduced, given that they can have effects that are equivalent to resolution actions.

24 Group resolution (Articles 80-83)

The rules governing group resolution are complex and detailed. It is quite possible that more detail is required here because the rules affect several Member States and a greater degree of standardization therefore is necessary. However, the complexity implies that we are not able to offer much in the way of substantive comments at this stage.

We are also inclined to think that there is a need for some sort of coordinating body at the level above Member States. However, we consider that the role envisaged for this body in the proposal goes very far. It becomes in effect a supervisor of resolution authorities and even has the power to rule in conflicts between resolution authorities. Considering the potential political and fiscal consequences of decisions in connection to resolution, this can involve a major restriction of national sovereignty and – at least in the proposal – one exercised by an unelected body. As noted above, we are sceptical about giving the supervisory role to EBA. Giving EBA the right to overrule decision that may have been taken at the level of the Government in a Member State is even more doubtful, of course.

25 Financing arrangements (Articles 90-99)

The proposed directive requires Member States to establish financing arrangements for resolution. According to Article 91(1), the purpose of such arrangements is "ensuring the effective application by the resolution authority of the resolution tools and powers". The actual links between the proposed financing arrangements and the efficacy of resolution is not spelled out.

In our assessment, these links are likely to be weak at best. We believe that the rules on how to finance resolution need to reviewed carefully and significantly modified. We offer our comments on the articles containing material rules according to the numerical ordering.

Article 92 specifies the purposes for which financing arrangements can be used. As we note above, it does not mention the option to inject equity capital into institutions under resolution, with the exception of "contributions" to bridge institutions. This seems strange, since experience indicates that this may be an important tool, especially in a major bank that may have to be kept together as a going concern if the resolution objectives are to be attained. One interpretation – given some support by paragraph (35) in the preamble – is that such capital injections are considered extraordinary public support. However, we have not seen any explanation of why capital injection from the resolution fund into a bank subsequent to a debt write-down should be ruled out. As we also note above, such capital injections may be an effective tool. And financing it from the resolution fund may be an equally effective way of making certain that control and ownership are in the same hands.

In practice, we see little reason to distinguish between support provided via the financing arrangement and public funds. Effectively, the financing arrangement is made up of means that are under public control, collected based on rules that are similar to a tax. This has implications also for the view taken on the target level and the structure of contributions that we return to below.

Article 93 sets the target level for the financing arrangements equal to 1 per cent of deposits with a time frame of ten years before that level is to be attained. We find the ambition expressed here to be less than modest. It is also strangely incongruent to the rest of the proposal.

Regarding the target level, we can simply compare it to what is available if one combines the stability fund and the deposit guarantee fund in Sweden. This corresponds to approximately 5½ per cent of total deposits. Even considering that budget funds of 15 billion kronor was contributed when the stability fund was set up, the target for the ex ante contributions from the financial institutions set in the proposal appears tiny in comparison. The fact that Member States are given ten years to reach this low level only strengthens this point.

Why the Commission has chosen this level is not clear. One reason could be a desire to avoid burdening financial institutions with too heavy ex ante contributions. But considering that the proposal has other elements – like the bail-in tool – that may fundamentally affect the funding conditions of banks, this degree of caution with regard to fees appears highly asymmetric. We cannot fail to observe that it is also very different from the attitude to putting levies on banks expressed by the Commission in the context of the proposal for a tax on financial transactions.

The target for the fund is also poorly aligned with the long list of uses of the financing arrangements and the emphasis on avoiding any form of public support (defined as use of funds from other sources than the financing arrangement), even in cases involving major losses in big and systemically important banks.

And this is more than an accounting issue, but goes to the heart of the realism of the proposed resolution framework. Because it is simply not realistic to assume that, say, a guarantee issued by the resolution authority based solely on the backing of these funding arrangements will be considered credible by prospective lenders to the guaranteed institution. And a resolution authority that cannot act in a way that instils confidence in markets and in the general public may undermine the whole resolution process.

The right to require ex post contributions or access to alternative funding means (according to Articles 95 and 96) does little if anything to improve the situation. Extraordinary contributions are supposed to be paid by banks. The costs of resolution are thus immediately transferred to the banking system as a whole. In a generally fragile environment, for example, after a macro shock of some sort, it is not clear that the banking system can shoulder this burden. Just the expectation that other banks will have problems as a result of ex post levies can trigger a systemic crisis. Access to alternative funding means may help by alleviating the pressure on banks to immediately finance the losses of the resolution fund, but these still constitute a debt, similar to deferred taxes. It would not be unreasonable to book it as a liability on the balance sheet, with further effects on banks' financial position.

Ultimately, the fragility of the financing arrangements brings us back to the issue of whether it is actually possible to construct resolution plans that conform to this proposal. When assessing resolvability one of the factors that the resolution authority has to take as given is the strength and credibility of the financing arrangements. If this is so weak that certain resolution tools cannot credibly be used, it would have to require the institutions to make adjustments so that they can be resolved in other ways. One option would be to force them to scale down their activities to such an extent that they fit within the constraints set by the funding arrangements. But, quite apart from the impact this may have in the banking market concerned, this runs up against the rule in Article 14(5) that the resolution authority cannot force banks to adjust with reference to the capacity of the financing arrangements.

This leads us to the conclusion that it is not at all unlikely that a resolution authority comes to the conclusion that it cannot deal effectively with crises in big institutions, while adhering to the rules of this proposal. Obviously, something has to give.

One change we believe is necessary, as argued above, is to take away the notion that resolution plans can deal with systemic crises. A second change, that we have alluded to several times above, is to base the directive on a consistent description of the role of the state when dealing with financial crises. The lack in this regard is clearly revealed by the description of the financing arrangements. It simply does not make sense to pretend that such a system can be made credible without the explicit backing of the state.

A telling illustration of what the unwillingness to address this issue can lead to comes in Article 96. There Member States are instructed to ensure that the financing arrangements can borrow from "financial institutions, central banks, or other third parties". We find it surprising to find the central bank on this list, and we see no qualifications as to the terms on which it is to lend.

On one interpretation, such lending would come very close to liquidity support to the banks that are spared the burden to make extraordinary contributions immediately. It would also expose the central bank to a credit risk to the extent that it is not clear whether these banks will actually be able to make the required extraordinary contributions. The standard practice of central banks – one also referred to in other parts of the directive – is to require collateral for such lending and charge penal rates. Symmetry and consistency would seem to require similar rules in this case, but the article includes nothing of this kind. There is anyway no guarantee that the banks (even as a group) could provide such collateral.

Another interpretation is that it is in effect the resolution authority that is borrowing from the central bank. This puts the central bank off the hook as far as credit exposure to banks is concerned, but on the other hand it would be in breach of the prohibition against monetary financing.

We conclude that this way of securing financing simply would not work. The way out of this impasse is to acknowledge explicitly that the state must stand behind the financing arrangements, just like it does in the case of the Swedish stability fund. As also illustrated by the Swedish solution, a backing by the state does not preclude the collection of ex ante contributions. We also note the importance of maintaining the possibility to base the financing arrangement on a notional fund, as is the case in the current Swedish stability fund. There is nothing explicitly in the proposal that rules out such a solution, and we believe that it should be kept that way.

There is still the question of the appropriate level of the ex ante fees and whether there should be a target level for the fund. These issues – in the Swedish context – are currently under review by the Financial Crisis Committee appointed by the Government. The SNDO is inclined to consider the conclusions from the Committee's report before forming a firm opinion.

We note, however, that an arrangement based solely on ex ante fees and without a target level for the fund would be broadly in line with how regular Swedish state guarantees are set up. Moreover, without a target level for the fund the fee works like an annual insurance premium, in effect in all periods. This has the added benefit that a risk adjusted fee will affect bank behaviour consistently through time. Ex post contributions are likely to give weak incentives for banks to adjust (especially the most risky ones), even if there is an attempt, as suggested in the proposal to use risk adjustment also when allocating ex post contributions. On this basis, we are tentatively inclined to favour a solution with ex ante contributions, but without a target level. Absent a target level, there is no basis for charging ex post contributions.

Regarding the question of whether and if so how contributions should be risk adjusted in the first place, there are arguments based on first principles to suggest that they should. The extent to which fine tuning of fees is justified in practice is another matter. This has partly to do with the overall level of fees. For example, we find it very hard to imagine that it would make sense to invest time and effort into calibrating fees set at the level indicated in the proposal. With a central value of one tenth of 1 per cent of deposits per year (and zero after ten years), risk differentiation is unlikely to make any difference whatsoever to banks' behaviour.

Fees at a significantly higher level can be considered, but then one also has to put these fees in the context of the general system of rules and regulations aimed at affecting bank risk taking. In principle, risk adjusted resolution fees can be a substitute for higher capital requirements, but in that case it is essential that it is actually treated as a substitute, not just as an add-on. As we emphasise in our general comments, the resolution framework must be carefully calibrated with other parts of banking regulation.

Article 97 contains rules on borrowing between financing arrangements. We are sceptical to such a set up. In particular, it makes little sense if financing arrangements are based on backing by the state. For example, for the SNDO, as resolution authority in Sweden, to turn to, say, the Portuguese resolution authority to ask for financing rather than turn to the debt management arm of the SNDO and have it issue regular government debt does not seem rational. Conversely, for Sweden to open up access to our already well-funded financing arrangements seems inadvisable. If such a borrowing facility were to be introduced, we suggest that it should be based on a common target level, not the actual level in any national arrangement.

Article 98 covers mutualisation of funding arrangements in the case of group resolution. This is an attempt to organise burden-sharing in cross border resolutions. While burden-sharing is important and merit more attention, we are uncertain as to whether mutualisation of financing arrangements is a useful way forward. This issue requires further analysis, as does other aspects of group resolution.

Article 99, finally, deals with the use of funds from deposit guarantee schemes to finance resolution. While the SNDO can see considerable merit in merging resolution and deposit guarantee funds, we are doubtful about the proposal in this article. The starting point is that the deposit guarantee scheme should be given equal treatment to other creditors. This argues for involving it in resolution, for example, after a bail-in. But as we noted above, it can also be argued that deposits are short-term liabilities and that equal treatment would imply that the deposit guarantee scheme is exempt from bail-in.

Moreover, unlike other creditors the deposit guarantee scheme remains liable to guaranteed depositors also after a bail-in. If the resolution ends in a bankruptcy, the deposit guarantee scheme may have to pay twice. Such an outcome results in the opposite of equal treatment and thus cannot be justified.

We see no recognition of this outcome except possibly in Article 99(6). There it is said that Member States must ensure that "members" of the deposit guarantee scheme "can immediately provide the scheme with the amounts that have to be paid". This sounds like a special funding rule for the deposit guarantee scheme aimed at ensuring that remaining banks immediate reimburse the deposit guarantee scheme when it has to pay out the second time. While protecting the deposit guarantee scheme as such this shift the burden to the banking system. Again, and disregarding if it is feasible to enforce such an obligation on banks, this implies that within the context of the proposal for funding arrangements, it is the banks that are forced to pay twice. We thus find it hard to see the justification also in this case.

Beslut i detta ärende har fattats av ställföreträdande riksgäldsdirektören Lars Hörngren efter föredragning av avdelningschefen Daniel Barr. I den slutliga handläggningen har även chefsjuristen Charlotte Rydin och juristen Jonas Opperud deltagit.

Lars Hörngren

Daniel Barr