European framework for management of banks in crisis

Summary

The Committee has examined the European Commission's Communication on an EU Framework for Crisis Management in the Financial Sector (COM(2010)579). As a part of this examination the Committee held a public hearing in mid-April 2011. The EU Commissioner for the Internal Market and Services, Michel Barnier, participated in this hearing.

The financial crisis revealed considerable flaws in the crisis management capabilities of the European financial markets. Consequently the Committee welcomes the European Commission's proposal concerning a common EU body of regulations for the management and resolution of banks that are experiencing difficulties or a crisis. A common EU framework is vital in order to limit the effects and socio-economic costs of future crises and to reduce any excessive risk-taking in the finance industry, actions known as moral hazards.

The framework should be based on regulations and principles that clearly state that all banks, large or small, can be wound up. It will describe how this is to be carried out and that it will be the bank owners and creditors who will foot the bill, not the taxpayers, which for the most part was the case during the financial crisis.

In the opinion of the Committee, the Commission's proposal may, with certain extremely important amendments and additions, work as an acceptable framework for financial crisis management. The Committee also considers that it is important that the Commission examines the effects of their proposal more carefully than they have done in their communication. The framework must be properly balanced so that banks and other financial institutions are able to continue to run and to develop their operations in an efficient manner.

In the opinion of the Committee, the Commission's proposal should be regarded as a framework of necessary, but insufficient, regulations on how crises are to be prevented and measures coordinated between countries. The opportunity should be provided for countries to introduce additional powers, instruments and routines into their national frameworks as required i.e. measures that are not included in the Commission's proposal.

In the opinion of the Committee, its review has shown that the Commission's proposal is aimed at the management of individual banks that are experiencing problems. It lacks a broader discussion on how systemic crises are to be managed, i.e. situations similar to those experienced in Europe and the rest of the world in 2008 and 2009. If this framework is to be credible and effective, it is necessary that the Commission identifies and proposes routines, powers and instruments for how a systemic crisis is to be managed.

The Committee shares the opinion of Swedish authorities that the credibility of this framework is dependent on it permitting temporary state ownership, and that it must be possible for the state to issue guarantees and provide banks with additional capital. This type of measure is not included in the Commission's proposal, although Sweden has previously successfully applied measures of this kind which have been of a temporary nature and the capital provided has been recouped so taxpayers have not been forced to finance them. The point of departure of Swedish measures has been that if the state is to take over responsibility for, and administration of, a bank, then it will also take over its ownership. Responsibility and ownership go hand-in-hand. If this basic market economy principle is clearly stated and applied, it leads to a reduction of incentives for banks to take excessive risks. Through its ownership, the state gains opportunities to, for example in a future sale, recoup its costs by benefiting from any value increases. The Committee considers that it is vital that the future framework includes clearly-stated routines, legal powers and limits on this type of state intervention.

The Committee notes a lack of discussion of the roles of the governments and central banks in crisis management in the Commission's proposal. The Committee also considers that it is essential that the framework clearly delineates the areas of responsibility of the supervisory and resolution authorities, and how any differences of opinion between authorities are to be settled.

The Committee welcomes the requirement that recovery and resolution plans are established for banks. The Committee does, however, see a risk that the planning system could become administratively unwieldy and resource-consuming, which may lead to concentration on the wrong aspects. Consequently it is vital that the emphasis and scope of recovery and resolution plans are carefully considered in order to avoid the risk of poor focus.

The Committee shares the criticism made by the Swedish authorities concerning the proposal that authorities would be able to appoint a special manager for a bank. Appointing a special manager without taking over the ownership of the bank is in breach of the basic principle that ownership and responsibility go hand-in-hand. The shareholders should not be afforded the opportunity of reaping the benefit of a special manager or that the state has taken over operations. The situation may also arise where the special manager actually makes the situation worse; who then will bear responsibility for this?

The Commission's proposed framework implies, in the opinion of the Committee, extensive regulation which will exert major effects on national markets and national legislation. It is consequently of central importance that the Commission takes the necessary time to thoroughly analyse and assess the effects of this framework before a legislative proposal is submitted to the Council of Ministers, the European Parliament and the national parliaments. The Committee also considers that it is important to then establish a reasonable amount of time for consideration in the national parliaments and for national implementation.

Account of the matter

The matter and its consideration

It its communication of 20 October 2010 the Commission presented a proposal for an EU Framework for Crisis Management in the Financial Sector (COM(2010) 579). At the end of November 2010 the Government issued an Explanatory Memorandum on the Commission's Communication (2010/11:FPM32).

On 6 January 2011 the Commission presented a consultation report on the proposal. This report included more technical detail than the October proposal and, in certain cases, also included proposals that were not mentioned in the October Communication. At the same time the Commission announced a consultation for 3 March 2011 when the various stakeholders would be welcome to submit their views on the consultation report. The consultation period expired on 3 March 2011. According to information from the Commission, 150 replies had been received by the end of the consultation period, including a joint response from the Swedish authorities concerned: the Ministry of Finance, the Bank of Sweden, the Financial Supervisory Authority and the Swedish National Debt Office.

On 14 April 2011 the Committee on Finance held a public hearing on the proposed EU framework. Panel members included EU Commissioner Michel Barnier, Peter Norman (Swedish Minister for Financial Markets), Stefan Ingves (Governor of the Bank of Sweden), Martin Andersson, (Director-General of the Financial Supervisory Authority) and Irma Rosenberg (member of the Committee on Finance). During the hearing Commissioner Barnier informed the Committee that the Commission intended to submit a legislative proposal to the Council of Ministers and the European Parliament before the end of the summer of 2011. The minutes of the hearing are attached to this statement.

Background

The work with a European crisis framework was initiated in 2009. The De Larosière Group stated in their report presented in February 2009 that the lack of a standardised tool for crisis management and resolution in the EU put Europe at a disadvantage in comparison to the USA. The Group felt that this should be remedied by taking proper measures at EU level. At its meeting in June 2009, the European Council drew the conclusion that additional measures must be taken in order to construct an extensive framework to prevent and manage financial crises.

At their summit meeting in Pittsburgh in September of 2009, the G20 Group undertook to act jointly to "develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future."

In response to this the Commission, in October 2009, issued a Communication concerning a European Framework for Cross-border Crisis Management within the Banking Sector (COM(2009)561) in which they argued for, and discussed, various proposals for a framework to secure future financial stability. In May 2010, as part of these framework activities the Commission issued a communication on bank resolution funds (stability funds) in which it was proposed that bank resolution funds would be established in EU countries in order to finance and facilitate the winding up of banks in crisis. (COM(2010)254). In the opinion of the Commission these funds should be financed by an ex-ante charge levied on banks, i.e. the charges would be paid before and not after the occurrence of crisis and bankruptcy.

At its meeting in Toronto in June 2010, the G20 Group went one step further in that participants agreed to design and implement systems that would provide government agencies with powers and tools for the recovery or resolution of all types of financial institutions in crisis, without the taxpayer having to foot the final bill.

Summary of the Commission Communication

The Commission's overall points of departure

In the opinion of the Commission, the financial crisis has proved that a robust framework for crisis management is necessary at both national and EU level. As a result of a lack of clearly stated regulations, member states had been forced to guarantee the debts and assets of financial institutions in various ways . State support during the financial crisis amounted to a total of 13% of EU GDP according to the Commission.

The overall objective of the Commission proposal is that all financial institutions that are experiencing difficulties, irrespective of type and size, will be able to go bankrupt without risking general financial stability and without taxpayers having to foot the bill. The bankruptcy protection that previously, in practice, covered the majority of financial institutions will be limited - incentives for excessive risk-taking, i.e. moral hazards, are to be reduced. Costs for resolution are to be borne by the shareholders, creditors and the banking industry generally through their resolution and stability funds. One important principle should be that shareholders and lenders will not suffer greater losses than what would have been the case if the institution had undertaken a standard bankruptcy procedure.

In the opinion of the Commission, the framework must be purpose-designed, objective and flexible and contain opportunities for authorities to maintain a certain level of banking services even during a crisis situation. The framework must encompass all national and cross-border credit institutions and certain investment companies. The Commission will continue to work with crisis management arrangements for other financial institutions such as insurance companies, investment funds and clearing companies. These findings are to be reported no later than the end of 2011.

The Commission states seven principles for the framework.

- Prevention and preparation will be the first step. Planning and preventative measures will assist authorities and companies to prepare resolution.
- Authorities must possess credible tools to ensure that they are able to wind up institutions in a manner that minimises risks of contagion and ensures that basic financial services continue without interruption.
- Authorities will be given well-defined powers and processes to enable rapid decision-making as well as removing insecurities as regards the legal situation that affects which measures authorities may take and when they may take them.
- Moral hazards are to be reduced by distributing liability for losses in a suitable manner between shareholders and creditors and by protecting public funds. Costs for resolution must be borne by the shareholders at least and, as far as possible, by the lenders in accordance with normal priority ranking. If necessary costs are also to be borne by the banking sector as a whole.
- Resolution of cross-border company groups is to be facilitated in order to avoid disturbances in the internal market, to ensure fair distribution of costs and to maintain basic banking services.

- The legal situation is to be clearly stated. Suitable protective measures for third parties are to be introduced. Any collisions between ownership rights and what is essential and justified in the interest of the general public should be limited. Creditors will receive the same treatment as they would have if the bank had been wound up.
- Competition distortions are to be limited. State support that is granted within the framework must be in compliance with treaty regulations and the internal market.

One of the bases of the Commission's proposal is that all member states form or identify a resolution authority. This resolution authority is to be administrative in character and preferably separate from other supervisory authorities in the field. The Commission proposes measures within the following five areas: preparatory and preventative measures, measures for early intervention, resolution measures, coordination of cross-border crisis management and financing of resolution costs. Measures included in each area are briefly described below.

Preparatory and preventative measures

- Improved supervision On an annual basis, the supervisory authority will establish a supervision programme for all relevant financial institutions. Supervisory examinations will, to a greater degree than was previously the case, take place at the institution itself and be implemented in a more systematic manner. A system of more clearly-stated and more robust standards must be established and supervisory assessment is to be far more intrusive and forward-looking.
- Recovery and Resolution Plans Recovery and resolution plans are, in the opinion of the Commission, a vital and essential element of planning for the failure of major financial institutions. Consequently the Commission proposes a new requirement that all credit institutes establish and maintain such recovery plans. These plans are to include information and details on how the institution is to act in different situations in order to improve liquidity, increase capital and reduce risk-taking in their operations. Recovery Plans are to be submitted to, and assessed by, the relevant supervisory authority. The resolution and supervisory authorities will, jointly with the companies concerned, establish updated resolution plans for all institutions. These resolution plans are to describe how the institution is to be wound up in the event of a crisis and must also contain information on Group structure, in-house Group guarantees, debts, contracts, counterparties, custody arrangements, etc. Plans are to be established at both Group and company level and must be approved by the EU supervisory and resolution colleges (read more about these authorities under the heading Coordination of cross-border crisis management below).
- Extended preventative powers The supervisory and resolution authorities will, in connection with the design and establishment of resolution plans, be able to assess whether the institution's exposure is to be limited or changed, that certain operations are to be restricted or wound down or that the institution's reporting is to be increased in various areas.
- Transfer of assets The regulations for transfer of funds within an institution are to be more clearly defined in order to protect the financial stability of the member state where the transferring units are established, as well as protecting the interests of shareholders and creditors.

In the Commission Consultation Report from the beginning of January 2011, the proposal on stress tests is further developed. The Commission proposes that supervisory authorities should implement annual stress tests of the financial institutions under their supervision. The supervisory authority should also carry out regular stress tests on the resilience of the entire banking system in the country.

Measures for early intervention

The Commission proposes a number of measures to enable authorities, at an early stage, to manage imminent problems in financial institutions. The aim of these measures is to prevent the situation deteriorating and increase recovery opportunities for the companies concerned. It must be possible for authorities to apply measures if an institution does not fulfil, or it is probable that an institution will not fulfil, requirements as stated in the Capital Requirements Directive, or as concerns the institute's future liquidity requirements.

- Extended powers for supervisory authorities The powers of supervisory and resolution authorities are to be extended and defined more clearly. Authorities will, for example, have the power to forbid the payment of dividends and coupons of hybrid instruments included as part of the regulatory capital base. The authorities will also be able require an institution to replace its upper management or a bank to divest itself of activities or business lines that may risk eroding the bank's finances.
- Requirements concerning implementation of Recovery Plans In order to ensure that institutions attack potential operational problems at an early stage, at the request of the relevant authority, the institutions will present and implement the measures they deem necessary in order to reconstruct the company.
- Special administration If it emerges that an institution's recovery plan is not credible, or that it has not been implemented in a satisfactory manner, the supervisory authorities will be able to appoint a special manager who, for a maximum period of one year, will take over the management of the institution or assist the existing management. This special manager will have the same powers as the previous management, and owners will be forced to approve the measures taken by the manager. The decision to appoint a special manager should, in the opinion of the Commission, not imply any form of state guarantee. Nor should the supervisory authorities bear responsibility for the measures taken by the manager.

Resolution measures and powers

The point of departure should, in the opinion of the Commission, be that insolvent credit institutions are to be liquidated within the framework of ordinary insolvency proceedings. This, however, seldom occurs, especially when the situation concerns institutions essential to the system. The Commission states that it will review insolvency legislation with a view to identifying how it can be reformed so that liquidation becomes a realistic alternative for banks and credit institutions.

In the opinion of the Commission, however, it will always be necessary to wind up certain financial institutions outside ordinary insolvency proceedings in order to secure financial stability, basic financial payment and service functions in society and to maximise the value of the remaining assets.

The Commission considers that authorities should be granted access to the following measures and legal powers (among others) in order to implement the orderly winding up of a bank or financial institution.

- **Sale of businesses** The authorities must be able to sell a credit institution or parts of its business, to one or several buyers without the agreement of the shareholders.
- **Bridge Bank** Authorities will be granted the opportunity to transfer the business, or parts of the business of a credit institution (including deposits and mortgages), to a temporary bridge bank.
- **Resolution entities such as Securum and Retriva** Authorities must be able to transfer weak, or what is commonly referred to as toxic, assets to a separate company in order to clean up a bank's balance sheet.

- **Write-down of share capital and debt conversion** The Commission is also considering awarding the relevant government authorities the power to write down share capital in an institution and write down debts or convert them to share capital in order to restore the institution's equity (known as haircut and bail-in). These, in the opinion of the Commission, should be regarded as extraordinary measures for managing problems in major, complex institutions that would seriously threaten financial stability and the financial sector's efficiency and effectiveness if they were closed down too rapidly. These measures improve authorities' opportunities to maintain business operations (permanently or until further notice) in order to limit ripple effects and secure financial stability. The Commission does, however, note that write-downs and debt conversion involve many technical and legal problems. One proposal under discussion is that all subordinated debt capital in an institution would be converted to share capital once it is established that the company is no longer viable or when the authority intervenes to take necessary measures.

Safeguards for counterparties during resolution

The Commission proposes that the resolution framework must encompass safeguards for counterparties and market arrangements that are affected by a transfer of property, assets or liabilties. In addition the framework must encompass regulations concerning legal examination in order to guarantee that the parties concerned possess appropriate rights to challenge the thr actions of authorities and seek financial redress.

Coordination of cross-border crisis management

The fact that supervisory and resolution authorities in all EU countries are allocated the same powers and tools will, in the opinion of the Commission, facilitate the coordinated action between countries in order to manage cross-border financial groups who are, or who are on their way to becoming, insolvent.

In the opinion of the Commission, however, additional measures are necessary in order to promote cooperation and prevent a variety of different actions based on national situations. The Commission would prefer that the resolution of cross-border groups be managed by a central EU body in order to secure rapid and fair resolution process. However, the Commission feels that this is not possible at the moment.

Instead the Commission proposes that resolution colleges be established in which the resolution authorities affected by the winding up of cross-border group entities collaborate in various ways in order to manage the crisis. Resolution colleges will be established around the core of the already existing supervisory colleges. The Chair of each resolution college will be the resolution authority that is responsible for the parent company of the relevant financial institution in the EU, and the task of the college will be to bear responsibility for crisis planning and the preparation of resolution plans for the group concerned (including principles for burden-sharing). In the event of a crisis the resolution colleges will function as a forum for information and coordination of resolution measures.

The resolution college should, in the opinion of the Commission, be authorised to take decisions concerning resolution procedure in cases of group failure. Such decisions must be taken quickly, and while waiting for this decision the national authorities should be prevented from adopting national measures that could prejudice the effectiveness of the resolution scheme.

In addition the Commission proposes that the European Banking Authority (EBA) be assigned a central role in this cross-border coordination by acting as an observer in the resolution colleges and participating in the establishment and coordination of the recovery and resolution plans.

Financing of resolution costs

The point of departure for the various proposals by the Commission is that costs for the resolution of a financial institution will primarily be borne by its shareholders and creditors. However, in the opinion of the Commission this is not sufficient and an additional financing system is necessary in order to secure the resolution procedure and make resolution a credible alternative

The Commission proposes the establishment of a system of national funds to support bank resolution, the equivalent of the Swedish stability funds. These funds would be used to finance the resolution measures proposed in the framework. The Commission considers that it is vital for the development of these funds that they be coordinated at EU level. Areas that should be coordinated and identical in all these funds include:

- Ex-ante funds All banks encompassed by the Commission's framework must pay in the fund fees in advance. These funds should also be supplemented with systems and arrangements for ex post financing in order to ensure that there is sufficient financing capital. Resolution costs in excess of the fund's capacity must be recovered from the banking sector at a later date.
- **Scope of compulsory contributions** Contributions to funds should, in the opinion of the Commission, reflect supervisory and crisis management responsibility, i.e. the resolution fund of a member state will receive contributions from institutions who possess permits to operate in the state concerned. These contributions will also cover any branches of the financial institution in other member states.
- **Basis for calculating institution contributions** The Commission considers that the information on which the calculations of contributions are to be based should be harmonised between all the EU member states but that, for an interim period, these may be allowed to differ between countries. Consequently member states may choose to use an alternative basis for calculation provided that this would not result in distortions of the internal market and that such measures are justified by the structure of the country's financial system, the financial situation generally and potential resolution costs. The Commission states that its staff will be comparing the advantages and disadvantages of different systems.

In addition the Commission considers that these funds should be phased in. The contributions (fees) should initially be lower and then they should increase in pace with the recovery of the European economy. As concerns fund size the Commission states that one point of departure would be the costs for resolution measures that were implemented during the financial crisis. However, the Commission also considers that fund size should vary depending on the effects of the various reforms e.g. increased capital requirements, loss-absorbing quality of capital and increases in the deposit guarantee.

The Commission also states that it will continue to study the synergy effects that may exist between the countries' resolution funds and deposit guarantee systems. In a previous Communication in July 2010 (COM(2010)368) the Commission proposed that the ex-ante funds in the deposit guarantee system may also be used for bank resolution in cases that concern transfer of funds to another company, for example sales to or merging with another company within the private sector or transfer to a bridge bank. This arrangement would be applied, however, provided that the funds transferred do not exceed the amount that would have been necessary to repay depositors.

Debt write-down (Bail-in Instrument)

The Commission is also considering awarding the relevant government authorities the power to write down equity in an institution and write down debts or convert them into equity order to

restore its capital position (known as haircut and bail-in). These, in the opinion of the Commission, should be regarded as extraordinary measures for managing problems in major, complex institutions that would seriously threaten financial stability and the financial sector's efficiency and effectiveness if they were closed down rapidly. These measures improve authorities' opportunities to maintain the businessof an institute (permanently or until further notice) in order to limit ripple effects and secure financial stability. The Commission does, however, note that write-downs and debt conversion involve many technical and legal problems. One proposal under discussion is that all subordinated debt capital in an institution could be converted into equity once it is established that the company is no longer viable or when the authorities intervene to take the necessary measures.

In both the original proposal and in the consultation report, the Commission deals with the bail-in issue in a special appendix.

Future measures

In its communication the Commission states that it plans to examine whether an additional regulatory framework is necessary concerning the harmonisation of insolvency proceedings for banks. The aim would include examining opportunities to introduce the same procedure, regulations and stipulations for material insolvency in all EU countries for the resolution and liquidation of banks. According to the Commission, a report on further harmonisation will be published by the end of 2012 at the latest.

The Commission also writes that it intends to examine how a more integrated framework for the resolution of cross-border company groups can be best designed. This is to be carried out parallel with the review of the Ordinance concerning the European Bank Authority in 2014.

The Government’s explanatory memorandum on the Commission’s communication

The Government considers the Commission’s communication in Explanatory Memorandum 2010/11:FPM32 (dated 26 November 2010). Below follows a summary of the memorandum.

The Government states that, in general, it welcomes the Commission’s proposal as it has become clear that there is a need for effective international instruments for dealing with financial crises. The Government supports the timetable presented by the Commission in the communication and considers, further, that it is crucial that harmonised insolvency proceedings for financial institutions are introduced.

It is essential that an effective framework for crisis management is introduced in the EU to counteract the occurrence and mitigate the effects of future financial crises, and to protect taxpayers in Europe. In the opinion of the Government, the costs of financial crises should be borne by the shareholders, creditors and financial sector by means of stability funds.

The Commission’s proposal only contains overall principles. This is a step in the right direction, but in the opinion of the Government, the proposal still needs a number of changes and improvements.

The Government considers it especially important that measures are taken to ensure that a future framework really does have the capacity to deal with a systemic crisis, that is, a situation in which several institutions find themselves in crisis simultaneously. In this regard, there are shortcomings in the Commission's proposal, and the Government considers that future work should put a greater focus on dealing with such a situation.

The Government also considers it important that the framework enables the state, by means of capital injections, to take over ownership of a crisis-afflicted institution. By introducing such a possibility, it would also be possible to ensure that a future growth in value in a financial institution would go to the taxpayers, and the taxpayers would receive reasonable compensation for risks taken.

The Government notes in its Explanatory Memorandum that the Commission's proposal will have a significant impact on Swedish legislation. Among other things it will affect the Government Support to Credit Institutions Act (2008:814) and, at a later stage, also competition legislation.

The aim of the Commission's proposal is to reduce both the likelihood of an institution finding itself in a crisis situation and the expected costs of such a situation. This will also reduce the likelihood of the state having to intervene with taxpayers' money to secure financial stability. A reduced likelihood of financial crises also means positive effects on public finances, since it will hopefully be possible to avoid the long-term, very sizeable costs in the form of higher unemployment and weaker economic growth that are associated with financial crises.

The Commission's proposal will also give the Financial Supervisory Authority and the future resolution authority better crisis management tools. In the opinion of the Government, this will not only increase their efficiency, but also their need for resources.

Swedish authorities' responses to the Commission's consultation report

On 3 March 2011, four Swedish authorities (SA) - the Ministry of Finance, the Riksbank, the Swedish Financial Supervisory Authority and the National Debt Office - sent a joint response to the Commission's consultation report. A summary of the SAs' response is given below.

Overall points of departure

- With certain necessary additions, the Commission's proposal can serve as a credible and effective crisis management framework, in the opinion of the SAs.
- Even if it is important to secure financial stability and effective handling of financial crises it is, in the opinion of the SAs, equally important that the financial system can carry out its fundamental tasks in normal times. The

regulations now being introduced are so complex and cover so many different areas that it is difficult to analyse and evaluate their impact.

- The SAs support the Commission's seven principles for the framework. They note that the principles primarily concern resolution. The prevention and recovery principles are not as clear. Measures for prevention and recovery should, in the opinion of the SAs, also be principle-based. It is, for example, important to clarify the responsibility of the supervisory authorities and of the banks and their owners.
- According to the SAs, it is not clear from the Commission's proposal how the measures for prevention and for early intervention are linked to the resolution measures. The point of departure must be to create a resolution regime that can deal with all banks that experience a crisis and that cannot be dealt with by means of ordinary bankruptcy legislation. The point of departure should not be to prevent failure at all costs. This means that the more effective the resolution regime, the less necessary it is to give the supervisory authorities power to exercise micro supervision over the banks (something that the SAs consider difficult to exercise).
- There should be a greater focus on ensuring that the resolution procedures are correctly designed. The process is sufficiently complex as it is, especially in view of the short time available for implementation of the framework in the Commission's proposal. This speaks in favour of aiming for a narrower reform agenda in certain areas, for example, as regards the issue of special management.
- The Commission's proposal is not sufficient for a situation of systemic crisis of the kind experienced in 2008, when the existence of all banks was at risk. According to the SAs, it is not possible to remodel all banks at the same time as "bridge banks" or to sell a large number of banks in the middle of a comprehensive financial crisis. The Commission's proposal only works in a situation in which one larger, or a few smaller, banks need to be dealt with. During the financial crisis, other measures (e.g. capital injections and guarantees) were implemented than those now presented by the Commission. In the opinion of the SAs, this is not only because the countries had no framework for resolution, but that these were measures that worked. The framework needs to be perceived as credible, even in a situation of systemic financial crisis.
- The SAs consider that the authorities should be able to implement measures that require full back-up from the state. In the opinion of the SAs, it is important that all legal impediments to extraordinary instruments, such as capital injections and partial or full nationalisation of banks, are removed. Without clear legal powers in this area, there is a risk that crisis management measures will lead to the bail-out of shareholders and other creditors.

According to the SAs, the Swedish Government Support to Credit Institutions Act (2008:814) is a good example of how a framework can be designed.

Preparatory and preventative measures

The SAs consider that annual supervisory programmes can be effective, provided the programmes are implemented on the basis of a risk analysis. The SAs question the benefit of supervisory programmes for smaller financial institutions. Instead, they propose that the programmes are only applied to larger institutions and other institutions that are the subject of reinforced supervision.

The SAs are positive to annual stress tests. Nevertheless, the SAs maintain that it is important that the supervisory authorities can use different test methods for different institutions; one method may for example be required for larger institutions and another for smaller institutions. The results of the stress tests may be a good point of departure for a constructive and concrete dialogue between the supervisory authorities and the tested institutions, in the opinion of the SAs.

The SAs are also positive to reinforced supervision. Reinforced supervision based on risk assessment is, in the opinion of the SAs, a natural part of supervision of banks.

The SAs are positive to the financial institutions establishing and developing recovery plans. However, the SAs consider that the Commission's proposal that all financial institutions and certain investment firms should establish recovery plans will lead to a heavily increased workload for the supervisory authorities, without obvious effects on financial stability. The requirement should therefore be limited to larger institutions and other institutions that are the subject of reinforced supervision.

The SAs are positive to the Commission's proposal for a regulatory framework for the transfer of assets between entities within the same financial group. However, many issues relating to this framework remain to be analysed. For example, the tax implications need to be examined.

The SAs consider that a requirement should be introduced that financial institutions draw up resolution plans, but that the requirement should be limited to larger institutions or other institutions that are the subject of reinforced supervision.

Decisions concerning the division of responsibility between national authorities should be taken at the national level, but in the opinion of the SAs, it is important to distinguish between supervisory authorities and resolution authorities. It is also important to clarify at the national level which authority is responsible for what as regards preventative measures and resolution measures. It should also be clarified how differences in opinion between national authorities are to be resolved.

The Commission does not state what role the finance ministries and central banks should have in the framework, their involvement in the resolution plans and how they should contribute to early intervention and resolution. A future framework should clearly define the role of the finance ministries and central

banks, since these are closely involved in the work of financial stability, both at the national level and between countries.

The SAs are positive to extended preventative powers, but consider that these need to be designed so that they contribute to the overall objective of the regulatory framework. Several of the measures proposed by the Commission involve the management of the institutions' activities. The SAs oppose measures that mean that the supervisory authorities take over responsibility for the institutions' activities at an early stage.

The SAs also consider that the responsibility for initiatives for extended preventative measures should lie with the supervisory authorities rather than the recovery authorities, in order to avoid any conflicts between the authorities.

Measures for early intervention

The SAs welcome greater opportunities for supervisory authorities to intervene at an early stage, or before a crisis has developed. In the opinion of the SAs, an important component of crisis management is that the supervisory authorities have a tool-box that can already be used at an early stage of a crisis.

However, the SAs also consider that several of the Commission's proposals mean that the supervisory authorities take over responsibility for the management of the institutions' activities. This is, in their opinion, not a good solution.

If a bank's management cannot manage to lead an institution's operations, it should be replaced. While the authorities should be able to demand that the board and managing director are replaced, the institution should not be permitted to continue banking operations, but should be wound up if the owners cannot or refuse to replace the management. The SAs oppose a solution whereby the supervisory authorities or a manager specially appointed by a supervisory authority takes over operations for a long period (at the same time as shareholders retain ownership). The regulatory framework should not be designed so as to avoid failure at all costs. In order to limit moral hazard, institutions should be allowed to fail and be wound up. It is also likely that the appointment of a special manager will be perceived to mean that the state is giving the institution an implicit state guarantee, which creates moral hazard and competition problems.

Resolution tools and powers

The SAs welcome the Commission's proposal to harmonise measures and powers for the management and resolution of problem banks. However, the proposal has a number of shortcomings which need to be dealt with. In the opinion of the SAs, the Commission's proposal should be viewed as a minimum list of measures that may be implemented.

Experience from the financial crisis shows, in the opinion of the SAs, that traditional resolution tools are not sufficient to deal with a systemic crisis. The bail-in measures described in the Commission's proposal are untested, and even

if they turn out to work to a reasonable extent, it is possible that these measures will not be sufficient either to deal with a systemic crisis.

Systemic crises, such as the most recent financial crisis, are extremely costly. For a framework to be credible, it must include tools and powers that make it possible to deal with both systemic crises and individual banks with problems.

The SAs consider that if the Commission's framework is to be credible and if it is to be used in conjunction with systemic crises, it needs to be supplemented with - at least - the following three instruments:

- legislation on the temporary nationalisation of banks, followed by capital reinforcements (dealing with the possibility of implementing this under certain stringent circumstances);
- capital injections;
- the issue of state guarantees.

These measures must be included in the framework, among other things, because it is impossible during a crisis to remodel a large number of banks as bridge banks. Nor is it possible, during a systemic crisis, to sell off a large number of banks.

The SAs note that the Commission does not mention state guarantees in its proposal. According to the SAs, it was the state guarantees in different countries that prevented the entire banking system from collapsing during the financial crisis.

Temporary state ownership is, in the opinion of the SAs, not an end in itself; state ownership combined with capital injections are an important means for restoring confidence, maintaining crucial banking services and giving the authorities control over the failing bank. The rise in value ensuing from the state intervention and support should be returned to the taxpayers as compensation for the risks and costs taken by the state. In the opinion of the SAs, opportunities for temporary state ownership and capital injections are extra important on markets characterised by oligopoly-like competition, such as the Swedish market. The direct and indirect links between different institutions on such a market should not be underestimated, in the opinion of the SAs.

The SAs welcome the use of bridge banks. However, they consider that such banks are best suited to dealing with larger financial institutions or a few smaller institutions.

Bridge banks are best suited to institutions that can be divided into entities that the resolution authorities wish to maintain, and entities that the authorities wish to wind up. Whether or not a bridge bank is effective depends largely on the institutions' resolution plans. If a bank cannot be divided up, the bridge bank solution will instead resemble a nationalisation of the institution. In this case, temporary state ownership is a better solution, in the opinion of the SAs.

In order to restore confidence and facilitate the future sale of a bridge bank, the bank needs to meet the same capital requirements as other financial institutions.

This means, in the opinion of the SAs, that capital injections and/or bail-in instruments must be possible. Liabilities and assets that are placed outside the bridge bank should be liquidated under insolvency proceedings. It is important that shareholders take the losses and that lenders also carry their share of the burden. The SAs are strongly opposed to any profits or residual values of a sale of a bridge bank being returned to the original shareholders.

An important principle in the Commission's proposal is that the shareholders and lenders, in the case of resolution (or when using a bridge bank) must not suffer greater loss than they would have done if the institution had been declared bankrupt. In the opinion of the SAs, this principle is fair but it is the content of the practical rules that will determine how well the principle can be achieved. The SAs discuss different methods of evaluation as a basis for dealing with the various creditors when an institution with problems is remodelled as, for example, a bridge bank. The SAs recommend using the liquidation value as a valuation i.e., that compensation shall be paid on the basis of what the net value of liabilities and assets would have been if the institution had been put into liquidation instead of being remodelled as a bridge bank. The valuation should be carried out by an independent evaluator and the principles for the evaluation should be regulated in law.

According to the SAs, a bridge bank is a temporary solution. In most cases, it will probably be sufficient for the bridge bank to have a lifespan of two to three years. However, no time limit should be given for the lifespan; in certain cases it may take longer before it is possible to sell the bank.

Like the Commission, the SAs consider that a judicial review of the resolution authority's actions in connection with a crisis should be possible. According to the SAs it is important that the provisions for the review are in line with the European Convention on Human Rights. The Commission's proposal requires further analysis from this perspective.

Safeguards for counterparties during resolution

The SAs welcome the Commission's proposals on rules for safeguards and the circumstances in which these should apply. It is important to protect the parts of the markets that are critical to the effective functioning of the markets and where legal uncertainty can disturb the functioning of the markets. The rules need to be much clearer. The Commission should supplement its proposal with safeguards for trading systems, and clearing and set-off systems.

Coordination of cross-border crisis management

The SAs are positive to greater coordination between countries during a financial crisis. Uncoordinated national measures can lead to suboptimal solutions to the crisis. The resolution colleges should serve as coordination bodies and a forum for information exchange. However, the SAs consider that coordination must be voluntary and that major decisions must be taken at national level. A resolution

college should not be able to block national decisions with great significance for the economic development of the individual country.

The SAs do not consider it necessary to draw up rules on when and how resolution measures may be used as regards a resolution that affects several countries. No two financial crises are the same, which is why excessively detailed regulation runs the risk of excluding measures that may be useful in situations that are impossible to predict today.

Financing resolution

The SAs welcome the use of funds for financing resolution. They consider it important, in broad terms, to define what the funds are to be used for. Should they be used to finance the resolution of an individual bank or should it also be possible to use them to finance measures in a systemic crisis?

In the opinion of the SAs, it should be possible to use the resolution funds, for example, for capital injections (recapitalisation) and also for other measures taken by the state which are not covered by special fees.

For the framework to be credible, the financing arrangements must also be credible. In the case of a serious crisis, it may become clear that the banking sector alone cannot bear the losses. In this case, it is crucial that central government can serve as a "lender of last resort". In the opinion of the SAs, this can be solved by ensuring that the funds have a special state guarantee.

The SAs outline two financing resolution options, one with two funds and the other with just one fund.

With the two-fund option, the deposit guarantee fund could be used for recovery or resolution of an institution if this proved to be cheaper than liquidating the company. The stability fund could be used to counteract systemic crises. It could, for example, be used for recovery of systemically important institutions.

With the one-fund option, the fund could be used for all purposes: payment of the deposit guarantee, resolution of an individual institution and handling of systemic crises.

In the opinion of the SAs, the fee for the funds should be charged ex ante. It is also important that the fees are risk-differentiated.

Debt write-down (bail-in instrument)

The SAs support the development of bail-in instruments at international level. However, such bail-in instruments have not yet been fully developed and no tests have been conducted to see whether they are of use in a systemic crisis. In the opinion of the SAs, the Commission's framework is too heavily based on untested bail-in instruments.

Bail-in instruments can be useful when dealing with institutions that are too big to fail. They can improve the incentives for more cautious risk management and thus also reduce the states' implicit guarantees to these institutions. Bail-in also

means that all creditors bear the losses in case of failure, which limits the risk of privatising all profits and socialising all losses.

If analyses and experience show that bail-in is a useful instrument, it should be used as a complement to the regular resolution tools (sale and bridge bank), rather than as a third option.

It is sometimes necessary, for reasons for stability, to continue to run a bank with problems even though the bank is no longer economically viable. If the bank concerned is a major, systemically important bank, it is in the opinion of the SAs, crucial that it is possible to write down debts in order to reduce the risk of losses for taxpayers. It should therefore be possible to demand that these banks emit contract-based bail-in securities that can be written down. The requirement should be that they emit as much as is needed for the authorities, through conversion to share capital and debt write down, to be able to make the bank economically viable.

In the opinion of the SAs, however, one can never be sure that the emitted, contract-based, bail-in securities will be sufficient to restore the bank’s economic strength. They therefore consider that the contract-based securities must be supplemented with a statutory right for the authorities to implement further write-downs of low-priority debts. However, the SAs consider that this right needs further analysis.

It is a tempting thought that bail-in instruments can solve several of the major problems that surfaced during the financial crisis. However, it remains to be seen whether and how bail-in instruments can be used in a future banking crisis. One question that requires further examination is whether bail-in will actually be used in a severe crisis or whether the politicians choose instead not to implement bail-in in order not to start a sale of similar instruments for other banks, conclude the SAs.

Other consultation replies

The Commission’s consultation report which was presented in early January 2011 had, by the end of the consultation period on 3 March 2011, generated some 150 consultation replies from public authorities, organisations and companies. Unfortunately it was only possible to gain access to a few of the consultation replies during the Committee’s consideration of the matter. Normally the Commission publishes a summary of the consultation replies approximately one month after the end of the consultation period. As regards the report on a framework for management of banks in crisis, no replies had been published in mid-May 2011.

The Committee’s deliberations

The position of the Committee on Finance

The Committee has examined and considered the European Commission's Communication on an EU Framework for Crisis Management in the Financial Sector (COM(2010) 579). In order to further highlight the issue, the Committee held a public hearing in the middle of April on the Commission's proposals in the communication. In addition to representatives of Swedish agencies, the EU Commissioner for the Internal Market and Services, Michel Barnier, also participated.

To begin with, the Committee would like to state that the Financial crisis which began in 2008 revealed considerable flaws in the crisis management capabilities of the European finance markets. The crisis also demonstrated the great mutual dependence that exists between member states and how quickly financial problems and an incorrect handling of financial problems spread to other member states. The Committee therefore welcomes the European Commission's proposal for a common EU regulatory framework for the management and resolution of individual banks that are experiencing difficulties or a crisis.

Cross-border banking activities in Europe are considerable, and in order to limit the effects and socio-economic costs of future crises, it is vital in the opinion of the Committee to create a common European rule system governing how to prevent and deal with banks systems that are experiencing a crisis both at the national and cross-border level.

A common regulatory framework is also vital to reduce any excessive risk-taking in the finance industry, actions known as moral hazards. A framework for crisis management should therefore be based on regulations and principles that clearly state that all banks, large or small, can be wound up, how this is to be carried out and that it will be the bank owners and credit providers who will foot the bill, not the taxpayers, which for the most part was the case during the financial crisis.

The Director General of Finansinspektionen (Swedish Financial Supervisory Authority) stated at the Committee's public hearing that the implicit state guarantee for banking activity, that is that owners and investors expect the state to intervene and save an entity with tax funding when there are problems, amounted to around 25 to 30 billion SEK per year during the financial crisis just for the four main Swedish banks. This calculation not only shows how considerable indirect state subsidies of banking activities are, but it also shows how important it is that a framework be based on principles that limit the implicit guarantee and can calculate the correct costs for excessively risky financial activities.

The Commission's proposals encompass measures in the areas of both prevention and preparedness, early intervention, resolution, coordination of cross-border crisis management and the financing of resolution. The Commission proposes that member states establish resolution funds similar to the Swedish stability fund.

The Committee considers that the Commission's proposal may, with extremely important amendments and additions, work as an acceptable framework for financial crisis management.

At the same time, in the opinion of the Committee, it is important that the Commission thoroughly consider more possible effects of the proposal than they have done in the communication. The framework must be carefully balanced so that banks and other financial companies can continue to run and develop their operations in an efficient manner. The regulatory framework must be constructed in such a way that the negative effects it may have do not outweigh its usefulness.

The financial markets vary in different member states. Therefore, the Committee considers that the Commission's proposal should be regarded as a framework consisting of necessary but

insufficient regulations on how crises are to be prevented at the national level and measures coordinated between countries. Individual EU member states should be given the opportunity to supplement their national framework with additional authorisations, instruments and routines that would suit each country, but are not included in the Commission's proposed framework.

The Committee's review has shown that the Commission's proposal is primarily aimed at dealing with individual banks that are experiencing problems. Unfortunately, the proposal lacks a broader discussion on how a systemic crisis is to be managed, i.e. a situation in which all banks and finance institutes experience problems, similar to the situation experienced in Europe and the rest of the world in 2008 and 2009. If a European framework is to be credible and effective, it is necessary in the opinion of the Committee both at EU and national level to identify and propose routines, powers and instruments that can be used for dealing with a systematic crisis.

In their reply to the Commission's consultation report, the Swedish authorities consider that in the event of a crisis they must be able to resort to measures that require full state backing. Their view is that the credibility of this framework is dependent on it permitting temporary state ownership, and that it must be possible for the state to issue guarantees and provide banks with capital contributions. Measures and instruments of this kind are not included in the Commission's proposal.

The Committee shares the opinion of the Swedish authorities completely, and would like to highlight Sweden's positive experience of such action. Sweden has made successful use of state guarantees, as well as state takeovers and capital contributions. The ownerships ave been of a temporary nature and the costs and capital contributions have been recouped so that taxpayers have not been forced to finance them. Most countries made use of these measures during the financial crisis in 2008-2009, for reasons that included the fact the these were the only type of measures that worked in practice in the systematic crisis that had arisen at that time.

The point of departure of Swedish measures has been that if the state is to take over responsibility for, and administration of, a bank then it will also take over its ownership. Responsibility and ownership go hand in hand. If this basic market economy principle is clearly stated in advance and clearly applied, it leads, in the opinion of the Committee, to a reduction of incentives for banks to take excessive risks. Through its ownership, the state gains opportunities to, through for example a future sale, recoup its costs by benefiting from any value increases.

At the Committee hearing, Commissioner Barnier's view of the framework was that state ownership and capital contributions must be seen only as a last resort, and he was not prepared to introduce measures of this kind into the framework. The Committee does not share this view. In the Committee's view, it is vital that the framework should include clearly stated routines, legal powers and limits on this type of state intervention.

The Committee also notes a lack of discussion of the roles of the governments and central banks in crisis management in the Commission's proposal. According to the Committee, it is important that a common EU framework should define their roles both at the national level and in the event of problems with a financial crisis that quickly spreads between member states. This is particularly significant in situations that could otherwise develop into a systematic crisis. An absence in the framework of definitions of roles may tend to conjure up things that would otherwise not have arisen.

The Commission proposes in the framework that member states should make a difference between supervisory authorities and resolution authorities. The Committee notes that the proposal is in line with the organisation that Sweden has in this area. However, the Committee considers it important that the Commission and the member states carefully clarify which areas of responsibility each of the authorities or agencies have and how possible differences of opinion between authorities should be resolved.

The Committee also welcomes the requirement that recovery and resolution plans be established for banks. It is essential that the authorities are familiar at an early stage with the situation in a particular bank, have full authorisation to find this out and can plan for which possible measures may need to be taken if necessary.

However, the Committee shares the concern surrounding the plans that was put forward during the public hearing. There is a risk that the planning system could become administratively unwieldy and resource-consuming, which may lead to concentration on the wrong aspects. Consequently, in the opinion of the Committee, it is vital that the emphasis and scope of recovery and resolution plans are carefully considered in order to avoid the risk of poor focus, and that they are limited.

The Commission proposes that it should be possible for the authorities to appoint a special mamnager for a bank. The Committee does not share this view. The Committee instead shares the criticism against the proposal on the part of the Swedish authorities and which was also put forward during the hearing. Appointing a Special Administrator without taking over the ownership of the bank is in breach of the basic market economy principle that ownership and responsibility go hand in hand, a principle which experience has shown to be applicable for example in Sweden. The shareholders should not be afforded the opportunity to reap the benefit of a special manager and the state taking over operations. The situation may also arise where the special manager actually makes the situation worse; who then will bear responsibility for this? In the opinion of the Committee, it should be possible for the authorities to decide that the board and managing director be replaced if the management cannot manage to run operations. But if the owners refuse or are not able to replace the management, the bank should not be permitted to continue banking operations and the bank should be wound up.

In conclusion, the Committee would like to stress how important it is that all other measures that are being planned or or have been carried out, for example new supervisory or resolution authorities at EU level, tightening up of capital requirements, regulation and supervision of rating institutes and derivative markets, etc., are now supplemented with a framework for financial crisis management. In this connection, the Committee notes that in the wake of the financial crisis a significant international discussion has arisen on the size of banking systems and individual banking groups in relation to the economies of individual countries. In the opinion of the Committee, this is an important issue that should also be addressed in future, for example in the EU and in EU member states.

The Committee further notes that the Commission has a very ambitious timetable for the implementation of the framework. A legislative proposal is to be submitted at the end of the summer. The framework will mean a substantial regulation which, in the opinion of the Committee, will have great effects on the national markets and national legislation. And as the Committee pointed out earlier, it is of central importance that the Commission takes the necessary time to thoroughly analyse and assess the effects of this framework before a legislative proposal is submitted to the Council of Ministers, the European Parliament and the national parliaments. In the opinion of the Committee, it is also important that a reasonable amount of time is then established for consideration in the national parliaments and for national implementation. Even if there are serious problems in the finance industry that have to be solved, this will serve as an important cog in the system for creating welfare in the European social economy.

Reservation

The Committee's proposal for a decision by the Riksdag and and position resulted in the following reservation.

European framework for management of banks in crisis - explanatory statement (SweDem)
by Johnny Skalin (SweDem).

Position

I do not consider that a common EU framework for the management and resolution of banks that are experiencing difficulties or a crisis should be introduced. It is both my view and that of the Sweden Democrats that there must be extensive national provision for Sweden and other individual countries to deal with situations of this kind. Individual countries know best how crises and difficulties of this kind should be dealt with, and the strategies of individual countries should therefore not be subordinated to a common regulatory EU framework for dealing with bank crises that is imposed upon them.