C. Recovery and resolution

During the year under review, the Bank's work on recovery and resolution mainly concerned resolution in the banking sector. While the European institutional framework remained relatively stable, its implementing provisions – some of which have yet to be defined – were discussed at European and international level. At the same time, a new category of unsecured creditors was introduced in Belgian law in order to facilitate the application of the bail-in instrument. The Single Resolution Board (SRB), in cooperation with the national resolution authorities, continued to draw up resolution plans for significant credit institutions and the financing of the European and national resolution funds was stepped up. The Bank also published a Circular[1] on the implementation of the various EBA guidelines on crisis management, concerning both recovery and resolution plans and various modalities of intervention or resolution.

As regards financial market infrastructures, at the end of 2016, the European Commission had published a proposal introducing a legal framework for the recovery and resolution plans of central counterparties whose importance is growing in view of the obligation to clear certain types of derivatives via such institutions. The discussions at European level continued during the year under review.

As regards insurance companies, the European Insurance and Occupational Pensions Authority (EIOPA) analysed the various national recovery and resolution regimes. As it found wide variations between Member States, it made recommendations aimed at greater harmonisation of those regimes. Implementation of those recommendations would entail future adjustments to the regulatory framework.

1. Resolution of banks and investment firms

1.1 Institutional and legal framework

The European institutional and legal framework concerning resolution remained relatively stable during 2017. It is based on the BRRD, which defines a framework for the recovery and resolution of credit institutions and investment firms, and on the SRM Regulation[2], which establishes the single resolution mechanism (SRM).

While the European framework defines an overall approach to resolution, some of its implementing provisions have yet to be determined, e.g. by the EBA or the SRB in accordance with their respective competences. In particular, the SRB launched a reflection with the aim of devising, within the Banking Union, an approach on a range of horizontal topics including, for example, the definition and calibration of the MREL, the mapping of critical functions performed by European banking groups, the operational continuity of entities in resolution, and the access to market infrastructures in resolution.

Some international developments also enriched the discussions on the implementation of the resolution framework in Europe. For example, in December 2016, the FSB launched a consultation on the internal total loss-absorbing capacity, or internal TLAC, i.e. the loss-absorption capacity of the subsidiaries of a banking group subject to a single point of entry resolution strategy (i.e. a banking group in which the bail-in instrument would only

(1) Circular NBB_2017_29 of 30 November 2017 – EBA guidelines on crisis management.
(2) Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010, OJ L 225 of 30.7.2014.

be applied to one legal entity within the group, the single point of entry, in order to cover all the group's losses). In response to the FSB consultation, in February 2017, the NBB stressed the importance of such a mechanism in the implementation of the single point of entry resolution strategy, and raised a number of technical arguments demonstrating that some instruments, such as collateralised guarantees, cannot ensure that one of the conditions necessary for implementing such a strategy is met, namely the upstreaming of losses to the parent company and the downstreaming of capital to the subsidiaries in resolution. The FSB published the final version of its guiding principles on the internal total loss-absorbing capacity in July 2017.

At the same time, the implementation of the European framework also required adjustments to the Belgian legislation in order to facilitate the use of the new resolution instruments that it introduces. In 2017, Belgium followed the initiative already taken in several Member States, including France, to facilitate the application of the bail-in instrument by introducing a new class of debt instrument (Non-Preferred Senior).

In the event of a bank resolution, the shareholders must be the first to bear the losses, followed if necessary by the institution's creditors. In accordance with the no-creditor-worse-off (NCWO) principle, no creditor may incur greater losses than those it would have incurred if the institution had been wound up under normal insolvency proceedings. The creditors have to contribute towards the losses according to the ranking of their claims in bankruptcy, and creditors of equal rank must receive equal treatment (*pari passu*).

The resolution authority identified a number of obstacles concerning unsecured creditors, hampering the use of the bail-in instrument. The first is the presence in this rank of unsecured deposits. While the legal framework permits the absorption of losses by unsecured deposits, including corporate deposits, the resolution authorities nevertheless face a considerable risk of contagion for the real economy.

Next, among the unsecured creditors, there are highly complex products, such as structured products (which package various financial instruments, such as derivatives, within a single debt instrument), so that it may prove impossible to effect their write-down or conversion within a reasonable period of time.

Although the legal framework provides for the possibility, in exceptional circumstances, of excluding from the scope of application of the bail-in instrument certain liabilities normally eligible for bailing in, that option needs to be qualified as it could contravene the NCWO principle. "Traditional" debt instruments which, unlike the debt instruments which would be excluded, can be more readily written down or converted would consequently have to bear greater losses, after which the holders of those traditional debt instruments would be entitled to claim compensation from the resolution fund.

To resolve these two problems, a new category of unsecured creditors (Non-Preferred Senior) was created which, in the event of competing claims on the credit institution's assets, would be repaid after the ordinary unsecured creditors but before creditors holding subordinated debt. For the application of the bail-in instrument, this means that they will have to bear part of the losses after the subordinated creditors but before the ordinary unsecured creditors.

To qualify as Non-Preferred Senior, debt instruments must meet a range of requirements. They must be debt instruments with an initial maturity of not less than one year and the contractual terms must stipulate that the holder is a junior unsecured creditor. Debt instruments subject to conditions which would make it too difficult to apply the bail-in instrument are excluded.

With this initiative, Belgium anticipated the European Directive [1] amending the BRRD on the basis of which a new category of debt instruments is introduced into the creditor hierarchy at a rank directly above that of the subordinated instruments issued by banks (see section D.3.1. below).

At European level, the year under review was marked by the resolution of a number of banking crises which provided a test for the new European resolution rules (see box 10).

(1) Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending the Bank Recovery and Resolution Directive as regards the ranking of unsecured debt instruments in insolvency hierarchy.

Box 10 – Italian and Spanish banking crises

The year 2017 saw the resolution of several banking crises which enabled the new resolution rules adopted at European level to be put to the test.

The Monte dei Paschi di Siena bank had to resort to Italian state aid to support its liquidity and solvency positions, notably by means of a capital increase amounting to over € 5 billion. This government aid did not require resolving the group as the increase in capital could be considered precautionary[(1)], being justified by the results of a stress test exercise conducted by the competent authorities. In accordance with its policy on state aid, however, the European Commission stipulated that the holders of subordinated debts of the Monte Paschi group must share in the losses by accepting a reduction in the amount of their claims equal to over € 3 billion. Nevertheless, private investors were partially spared these losses as it was considered that they had not been adequately informed of the risks incurred when investing in the form of subordinated debts and that, consequently, they should receive compensation on the grounds of mis-selling (sale of products inappropriate to the investor's knowledge and risk profile).

The competent supervisory authority had to deem the Italian banks Banca Popolare di Vicenza and Veneto Banca failing or likely to fail due to their inability to restore their profitability and solvency in a sustainable way. In view of the activities and size of these institutions, the SRB considered that these two banks did not meet the public interest requirement as defined by the BRRD. It therefore concluded that no resolution measure was necessary, the consequence being the liquidation of these two institutions. The Italian authorities were able to avoid a disorderly liquidation by first recapitalising these two entities for an amount of € 4.8 billion and transferring their healthy assets and deposits to the Italian banking group Intesa for € 1. The remaining assets and liabilities of the residual entities of these two banks essentially comprise a portfolio of non-performing loans and the capital and existing subordinated debts, which will be used to cover the losses. The difference was financed by debt guaranteed by the Italian government to the tune of € 12 billion in order to facilitate an orderly liquidation.

In Spain, Banco Popular similarly had to be deemed failing or likely to fail due to a severe liquidity crisis, which was the result of a loss of confidence among the creditors following the difficulties the bank experienced in improving its financial situation, weighed down by an excessive volume of non-performing assets. In view of the size of Banco Popular in Spain, the SRB considered that resolution measures aimed at preserving the bank's essential activities were necessary. It therefore proceeded immediately with a valuation of the assets and concluded that the whole of the capital and the subordinated debts had to be used to cover the existing losses. That made it possible to sell the Banco Popular to the Santander group for € 1.

In the above four crisis cases, the authorities used the tools introduced by the BRRD to preserve financial stability, the risk of a bail-in for depositors. However, it must be said that state aid was still needed to resolve some crisis situations, as in the case of the Italian banks. The local authorities considered that the aid was inevitable to avoid economic disruption in Italy, and more particularly in the regions where the banks in question operated. These cases show that it is difficult to exclude, *a priori*, state aid in a crisis situation, particularly if several large institutions are affected at the same time.

That aid was considered compatible with the European rules on state aid and with the BRRD. In the case of Banca Popolare di Vicenza and Veneto Banca, the aid was intended to facilitate the liquidation of banks which would cease to operate. In the case of Monte Paschi, the aid could be granted on the basis of a special BRRD provision which permits a precautionary recapitalisation. In accordance with its general policy, the European Commission ensured that the shareholders and holders of subordinated debt bore the losses, to prevent the state

(1) The BRRD makes provision for the precautionary recapitalisation mechanism, which enables a state to recapitalise a bank without triggering a resolution mechanism. The amount of the recapitalisation must be based on the level of theoretical losses estimated by the supervisory authority in a stress test exercise, and cannot be used to cover existing losses.

aid being used to cover existing losses. That policy highlighted the difficulty of using debt instruments held by retail customers to cover the losses incurred, as that could damage customers' confidence, whereas one of the aims of the crisis resolution is to restore confidence in the financial system.

The speed with which other entities could be found to take over the activities of the banks in crisis also helped to maintain financial stability. Without the rapid takeover of the entities and activities concerned by other investors, it would probably have been very difficult for the authorities to stop cash withdrawals and avoid a disorderly liquidation. It thus seems that having access to sufficient liquidity sources in the case of a bank resolution is essential for the success of a resolution procedure.

Finally, these cases also highlighted the importance, in the event of resolution, of considering the situation of not only the failing bank but also the entities associated with it, more particularly the foreign banking subsidiaries. Those subsidiaries may be affected by the failure of the parent institution and by the resolution or restructuring measures taken, which could disrupt financial stability in the host countries of those subsidiaries.

1.2 Resolution plans

The BRRD requires a resolution plan to be developed for each European banking group. The preparation of a resolution plan is aimed at improving a group's resolvability. Under the Directive, a banking group is deemed resolvable if the resolution authority can either liquidate all its constituent legal entities via normal insolvency proceedings or resolve it by applying the various resolution tools and powers at their disposal while safeguarding the stability of the financial system and ensuring the continuity of critical functions performed by the group.

The SRM Regulation gives the SRB responsibility for preparing the resolution plans of significant and/or cross-border credit institutions, and those subject to the ECB's direct supervision. Responsibility for drawing up the plans for other less significant institutions falls to the national resolution authorities.

Designing resolution plans is an iterative process which, depending on the complexity of the banking group, may extend over several years. In that connection, the SRB devised a sequential approach defining various stages in the preparation of resolution plans. In order to design a plan that fully complies with the BRRD's requirements, the SRB defined five stages in resolution plan development. The first stage is the transitional resolution plan. It is followed by the phase 2, 3, 4 and 5 resolution plans. The transitional resolution plan defines the bases of a resolution plan and of the resolution strategy itself. Both are further developed in the phase 2 to phase 5 plans by an iterative process, each plan comprising an additional decision factor in the light of the MREL or the identification of impediments to resolvability.

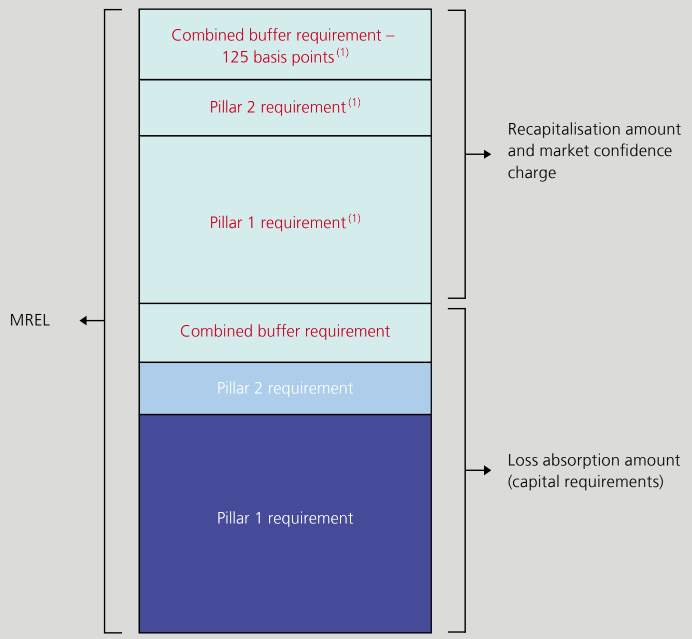
During 2017, in cooperation with the national resolution authorities, the SRB developed mainly transitional, phase 2 or phase 3 resolution plans. Unlike the phase 2 plans prepared in 2016, the phase 3 plans incorporate a binding consolidated MREL requirement.

The consolidated MREL requirement is determined in accordance with the methodology adopted by the SRB in 2017. The requirement comprises a loss absorption amount, a recapitalisation amount and a market confidence charge. The first is based on the capital requirements, namely the Pillar 1 and Pillar 2 requirements and the combined buffer requirements (see chapter D below). The recapitalisation amount is equivalent to the Pillar 1 and 2 requirements applied to the amount of the risk-weighted assets (total risk exposure) as determined after resolution. That amount may therefore recognise, within certain limits, a reduction in the risk-weighted assets resulting from the materialisation of certain risks. Finally, it is supplemented by an amount intended to ensure market confidence, equal to the combined buffer requirements less 125 basis points, again applied to the post-resolution risk-weighted assets.

A consolidated MREL is insufficient for a single point of entry resolution strategy which assumes that the bail-in, aimed at absorbing all the group's losses, is applied at a single point. That is why the consolidated requirement would need to be supplemented by a requirement at individual level to be satisfied by entities covered by the single point of entry resolution strategy.

The SRB's resolution plans are drawn up by internal resolution teams comprising members of the SRB

CHART 89 BREAKDOWN OF THE MREL REQUIREMENT



Source: NBB.
(1) Requirements applied to post-resolution risk-weighted assets.

and representatives of national resolution authorities. During 2017 the Bank, as the national resolution authority, took part in developing three phase 2 resolution plans and three phase 3 resolution plans concerning significant credit institutions established in Belgium, as well as in developing transitional resolution plans for two other credit institutions likewise established in Belgium. In addition, the Bank contributed to the development of the resolution plans of nine major banking groups with subsidiaries in Belgium.

1.3 Resolution financing

The BRRD requires each Member State to establish a resolution fund, financed by the levying of contributions from credit institutions and investment firms. Each resolution fund must reach a target level of at least 1 % of the total volume of covered deposits by no later than 31 December 2024.

The SRM Regulation established the Single Resolution Fund (SRF) in the Banking Union on 1 January 2016. It replaces the national resolution funds for institutions contributing to the SRF. However, national compartments are maintained within the SRF for a transitional period. The Fund must be fully constituted within eight years. Its target level is set at a minimum of 1 % of the total amount of the covered deposits for relevant institutions licensed in the Banking Union. The SRB estimates the target level of the SRF at € 55 billion in 2023.

The SRB defines the annual target level of the SRF and calculates the contributions for each institution. The national resolution authorities work with the SRB at every stage in the process. More specifically, by no later than 31 January in each year, they collect the data necessary for the calculation, and they notify the institutions of the amounts of their contributions by no later than 1 May.

The method of calculating the SRF contributions is determined by a European Commission Delegated Regulation [1]. Small institutions pay a flat-rate contribution. A risk-adjusted calculation method is used to determine the contributions of larger institutions.

(1) Commission Delegated Regulation (EU) 2015/63 of 21 October 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to *ex-ante* contributions to resolution financing arrangements.

In 2017, the SRB levied a sum of € 250 million on the Belgian institutions liable for contributions, while in 2016 the sum collected was € 277.6 million. This decline is explained by the mutualisation of resources which is being phased in by the SRF during the transitional period and which modifies the basis of calculation. The change in the basis of calculation is beneficial for Belgian institutions because they have a quantity of covered deposits which is proportionately above the European average. The institutions were able to pay 15 % of their contribution in the form of an irrevocable payment commitment guaranteed by cash collateral. The total amount of the contributions from Belgian institutions in this form came to € 34.4 million in 2017. The SRF has already collected a total of € 17.4 billion from institutions covered by the SRM Regulation.

For institutions not subject to the SRF, i.e. branches located in Belgium of credit institutions or investment undertakings of a third country, and Belgian investment firms not covered by the ECB's consolidated supervision of their parent company, the Law of 27 June 2016 introduces a national resolution fund financed by the levying of annual contributions. The Law specifies that the contribution and payment arrangements are determined by the Bank's Resolution College, and that the national resolution fund collects those contributions. In 2017, the Resolution College adopted a Circular (1) specifying the calculation method applied for that year and informed the national resolution fund of the amount of the contributions due from institutions not liable for contributions to the SRF. The annual target level for 2017 amounted to just over € 450 000.

(1) Circular NBB_2017_28 – National Bank of Belgium Resolution College Circular on the calculation and collection of contributions to the Resolution Fund due from enterprises not subject to the Single Resolution Fund.