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Rt Hon Greg Clark MP
Financial Secretary
HM Treasury
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12 December 2012

Dear Greg,

EM 11066/12: Bank Recovery and Resolution

We are writing to you with regard to Explanatory Memorandum 11066/12 on the Commission's proposal for a Directive on Bank Recovery and Resolution (RRD). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 December 2012.

We have today published our report on *Banking Union: Key Issues and Challenges*. In that report, we conclude that: "The Recovery and Resolution Directive is a necessary step towards strengthening the single rulebook. However, the harmonisation model that it encapsulates is no longer sufficient to ensure the effective operation of the euro area banking sector. While there is a need for further steps towards effective banking union within the euro area in the form of a single resolution mechanism, it is vital that these steps do not risk a deepening split within the single market."

Notwithstanding this, we acknowledge that the RRD proposal is an important one. We received a substantial amount of evidence on the RRD in relation to our inquiry into banking union, which can be summarised as follows.

Overview

Our witnesses recognised the necessity of the RRD. Commissioner Michel Barnier stressed that it was necessary to reduce the risk of moral hazard and of the taxpayer having to support failing banks, and Barclays stated that it was the most comprehensive attempt to establish such a framework. The Association for Financial Markets in Europe (AFME) stressed the industry's view that the Directive was necessary regardless of the outcome of the banking union debate. They also pointed out that the RRD draws considerably on the UK's Special Resolution Regime as set out in the Banking Act 2009. However, Professor Kern Alexander stated that it would require the UK to expand the scope of its resolution regime, in particular in relation to the depositor preference, intra-group support and cooperation agreement with third countries provisions.

We agree with our witnesses that the RRD proposal is a long-overdue and necessary tool to harmonise bank recovery and resolution mechanisms across the EU. We believe that this will help strengthen the EU banking sector and help break the vicious cycle between banks and sovereign states. We agree that all Member States should share a minimum common set of tools and powers to intervene quickly to avert or manage the failure of a financial institution, especially in a cross-border context. We acknowledge and welcome the fact that it broadly reflects the resolution framework as established in the UK. Nevertheless, we note the view of our witnesses that it will require adjustments to the UK's resolution regime. Do you agree? Which adjustments need to be made, and how do you propose to achieve this?

Bail-in

The most significant element of the proposal is the bail-in tool, which would give resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity. This is designed to eliminate the need for recourse to public money in the event of a bank failure, since banks would be required to recapitalise from within, using private capital.

The majority of our witnesses welcomed the tool, although several emphasised the need for it to be well-designed. Barclays were opposed to any exclusion from the tool on the grounds of differentiating between liabilities of the same class based on maturity, as they argued that it would incentivise short-term funding and would create *de facto* depositor preference. On the other hand the Royal Bank of Scotland supported an exclusion of liabilities with maturities of under six months on the grounds that including short-term maturities could make a bank run more likely. The British Bankers' Association asserted that the minimum requirement of bail-in liabilities that a firm should hold should be measured on the basis of Risk Weighted Assets rather than by reference to total liabilities. Barclays were also concerned about the proposal for a minimum requirement of bail-inable liabilities, since it would be at odds with the Basel III capital requirements. They were also unclear how bail-in would apply to deposit guarantee schemes.

We welcome the proposed bail-in tool, and believe that it would be a significant step towards ensuring that public money will not be required to bail out failing banks. Nevertheless the tool must be well-designed in order to ensure that it operates effectively. We particularly note the concerns of our witnesses regarding the exclusion of short-term maturities and the minimum requirement of bail-inable liabilities. What is the justification for these provisions, and how would you respond to the concerns that have been put to us? Do you anticipate that these provisions will be amended in the final version of the Directive? You have previously stated that you were seeking to clarify how national Deposit Guarantee Schemes would be affected by bail-in. What update can you give us?

Recovery and resolution tools

Although there was broad contentment with the other proposed recovery and resolution tools, several witnesses emphasised the need to distinguish between their use in recovery and resolution situations, stressing the importance of maintaining the Point of Non Viability (PONV) as the dividing line between the two. HSBC argued that use of bail-in or the 'Special Manager' tool (whereby a Special Manager could be appointed in place of the management of an institution for a limited time in order to restore the financial situation of the institution and the sound and prudent management of its business) before PONV would send a negative signal to markets about a bank's credibility. The British Bankers' Association stressed that

the power to require an entity to plan for debt restructuring should not be used until PONV had been passed. They were also concerned about the impact of the proposal for the supervisor to contact potential purchasers to prepare for resolution of the institution, and expressed concern about the amount of discretion left to resolution authorities in deciding when to intervene. Others warned that the proposals for intra-group financial support could create a risk of contagion, although it was noted that the mechanism was optional.

We broadly welcome the proposed suite of recovery and resolution tools, although we recognise the concerns put to us about the use of certain tools before the Point of Non Viability has been reached. We share your fears that the Special Manager tool could undermine confidence in an already distressed institution. It is important to ensure that the use of such tools does not unnecessarily undermine the credibility of a financial institution whilst recovery remains a possibility. How would you respond to these concerns? Do you share the concerns of some of our witnesses concerning the amount of discretion left to resolution authorities when deciding when to intervene? What criteria should be used to determine when it is appropriate for a resolution authority to intervene? We note your concerns over the danger of contagion arising from the intra-group support mechanism. To what extent are such anxieties negated by the fact that it remains an optional mechanism?

The role of the EBA

The RRD proposes to give the EBA a binding mediation role in relation to cross-border group resolution and in reaching agreements with third countries. Barclays argued that a binding mediation role would provide an incentive for resolution colleges to reach a decision, but questioned why national resolution authorities were not given powers in relation to agreements with third country authorities. The British Bankers' Association echoed the Government's view that the timescales envisaged for EBA mediation could prove problematic when a decision was required urgently, and questioned whether it had the necessary expertise to take on the role. However we note the view of Andrea Enria, Chairman of the EBA, that it makes sense to have a single entry point to establish agreements with third countries on how cross-border resolution can be managed.

We again stress the EBA's importance as a rule-setting body. However we note your concern at the proposed binding mediation powers for the EBA, stressing that decision-making should lie with national authorities. How would you respond to the argument that the EBA's binding mediation role could provide an incentive to reach a decision? If the EBA does retain such a role in the final version of the Directive, do you envisage any way in which the timescale envisaged for its mediation role could be sped up? You have previously expressed concern at the implications of the proposed role for the EBA for Member States' ability to establish cooperation arrangements with third country authorities. How would you respond to Mr Enria's argument that a single entry point for such agreements would be advantageous?

Resolution financing mechanisms

You previously expressed concern that the proposal to create and maintain an *ex ante* resolution fund could generate moral hazard and undermine the credibility of resolution tools. What update can you give us on negotiations on this point?

The timetable and the progress of negotiations

Some of our witnesses expressed concern that the banking union proposals could delay the implementation of the Directive. We share these fears. What is your response? Now that it is clear that the Commission's aim of implementation by the end of 2012 will not be met, what do you believe is a realistic timetable for agreement on the Directive?

You have not written to us on this proposal since 4 October, and we would be grateful for an update on negotiations, in particular in relation to the issues discussed above. In addition, your predecessor agreed, in his letter of 29 August, to keep us updated on negotiations around questions of subsidiarity and proportionality as they relate to the proposals. What update can you give us? We would also be grateful for information on the position of other Member States on these points.

We would be grateful for a response to these questions by Monday 7 January 2013. In the meantime we will retain the document under scrutiny.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Paul Hardy, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Laura Hanoman, Kunal Patel, Robert Dougless, Kenny Thomas and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

The Lord Boswell
Chairman of the European Union Committee