

# **CRISIS RESOLUTION IN THE FIELD OF THE FINANCIAL PRUDENTIAL SUPERVISION – SOME LEGAL AND ECONOMIC ASPECTS**

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## **Abstract**

The financial crisis of 2008 has challenged fundamental ideological changes among the financial policy makers and the regulatory authorities. The financial crisis was only “indicator” in the configuration of the new financial supervision framework of the EU, because it was the real need of the international financial markets, formed as a result of the change in the past decades.

The aim of the paper is to outline the causes and most important features of the global financial crisis and to introduce the evolving crisis management programs from the aspect of monetary and financial law regulation. Besides we introduce the newly established authorities of financial supervision at EU level and the legal method, the regulation of the Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

The main conclusion of our paper is that the financial crisis may mark a new era and result a paradigmatic change in the relationship of the markets, not only in the field of financial economy, but at the field of law sciences as well.

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**Keywords:** Financial crisis resolution, recovery and resolution directive, resolution authority, bail-in tool

## **Introduction – Some critical points in the field of financial prudential supervision**

### **The new supervisory framework**

The financial governance, which comprises the regulation and supervision of the institutions, instruments and markets, suddenly disclosed severe and unknown problems when it was faced with the recent financial crisis. Indeed, national and international regulatory and supervisory systems revealed major weaknesses in almost every function: prevention, early detection, crisis management and ex post resolution.

Following the main conclusions of the "de Larosière Group" report in 2009 February, the European Commission published a communication for a reform of the "European financial supervision" (May 2009), which was approved by the Ecofin Council and then by the European Council. A package, comprising five legislative propositions was then published, 23 September. This architecture for a new supervisory framework was adopted and now it has two pillars:

- the European Systemic Risk Board (ESRB), with the support of the ECB (macro prudential level), to assess risks to the stability of the whole financial system, and to issue risk warnings and, when necessary, recommendations
- the European System of Financial Supervisors (ESFS) for the supervision of individual financial institutions (micro prudential level); it comprises three sector oriented European Supervisory Authorities (ESAs):

- European Banking Authority (EBA);
- European Insurance and Occupational Pensions Authority (EIOPA);
- European Securities and Markets Authority (ESMA).

The system also comprises national supervisory authorities, which remain supervisors of individual financial institutions; the objective of the European supervisory authorities is to improve the functioning of the internal market by ensuring appropriate, efficient and harmonised European regulation and financial supervision.

### **The European Banking Authority (EBA)**

The European Banking Authority is an independent EU Authority which was established on 1 January 2011<sup>13</sup> as part of the European System of Financial Supervision (ESFS) and is in charge of ensuring effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking whose objective is to provide a single set of harmonised prudential rules for financial institutions throughout the EU. The Authority also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector.

### **The new legal methods for crisis resolution**

#### **The new directive on establishing a framework for the recovery and resolution of credit institutions**

The financial crisis has shown that there is a significant lack of adequate prudential tools at Union level – and at Member State level too – to deal effectively with unsound or failing credit institutions and investment firms. Some Member States have already enacted legislative changes<sup>14</sup> that introduce mechanisms to resolve failing institutions; others have indicated their intention to introduce such mechanisms. So far there was no harmonisation of the procedures for resolving institutions at Union level. Some Member States apply the same procedures to institutions that they apply to other insolvent enterprises, which were adapted for institutions in certain cases, but a wide range of procedures and regimes existed at Member State level. A well-based system and regime of prudential supervision is therefore needed to provide authorities with a credible set of tools to intervene sufficiently early and quickly in an unsound or failing institution so as to ensure the continuity of the institution's critical financial and economic functions, while minimising the impact of an institution's failure on the economy and financial system. Therefore it has been a milestone when the European Parliament and the Council adopted the directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

### **Authorities responsible for resolution**

According to the directive, each Member State shall designate one or, exceptionally, more resolution authorities<sup>15</sup> that are empowered to apply the resolution tools and exercise the resolution powers. The authorities may be national central banks<sup>16</sup>, competent ministries

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<sup>13</sup> The EBA took over all existing responsibilities and tasks of the Committee of European Banking Supervisors.

<sup>14</sup> e.g. in Hungary the Act XXXVII of 2014 on strengthening the financial prudential framework

<sup>15</sup> It shall be a public administrative authority or authorities entrusted with public administrative powers.

<sup>16</sup> In Hungary the resolution authority is the Hungarian National Bank.

or other public administrative authorities or authorities entrusted with public administrative powers.

Member States shall ensure that, within the competent authorities, there is operational independence between the resolution function and the supervisory or other functions of the relevant authority<sup>17</sup>.

Decisions taken by competent authorities, resolution authorities and EBA in accordance with this Directive shall take into account the potential impact of the decision in all the Member States where the institution or the group operate and minimise the negative effects on financial stability and negative economic and social effects in those Member States.

Member States shall ensure that each resolution authority has the resources and operational capacity to apply resolution actions, and is able to exercise their powers with the speed and flexibility that are necessary to achieve the resolution objectives.

### **Recovery plans (Article 5, 6)**

Member States shall ensure that each institution, which is not part of a group subject to consolidated supervision<sup>18</sup>, draws up and maintains a recovery plan providing for measures to be taken by the institution to restore its financial position following a significant deterioration of its financial situation.

Competent authorities shall ensure that the institutions update their recovery plans *at least annually or after a change* to the legal or organisational structure of the institution, its business or its financial situation, which could have a material effect on, or necessitates a change to, the recovery plan. Competent authorities may require institutions to update their recovery plans more frequently.

Recovery plans shall include an analysis of how and when an institution may apply, in the conditions addressed by the plan, for the use of central bank facilities and identify those assets which would be expected to qualify as collateral.

The directive deals with the definition of the *Group recovery plans* too, in this case the Union parent undertakings draw up and submit to the consolidating supervisor a group recovery plan.<sup>19</sup>

### **Resolution plans (Article 10)**

The resolution authority – after consulting the competent authority – shall draw up a resolution plan for each institution that is not part of a group subject to consolidated supervision.<sup>20</sup> This plan shall consist of the *resolution actions* which the resolution authority may take where the institution meets the conditions for resolution. The resolution plan shall not assume any of the following: extraordinary public financial support or central bank emergency liquidity assistance.

Resolution authorities may require institutions to assist them in the drawing up and updating of the plans. Plans shall be reviewed, and where appropriate updated, at least annually and after any material changes to the legal or organisational structure of the

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<sup>17</sup> The staff involved in carrying out the functions of the resolution authority pursuant to this Directive shall be structurally separated from, and subject to, separate reporting lines from the staff involved in carrying out the tasks pursuant to Regulation (EU) No 575/2013 and Directive 2013/36/EU or with regard to the other functions of the relevant authority.

<sup>18</sup> pursuant to Articles 111 and 112 of Directive 2013/36/EU

<sup>19</sup> Group recovery plans shall consist of a recovery plan for the group headed by the Union parent undertaking as a whole.

<sup>20</sup> pursuant to Articles 111 and 112 of Directive 2013/36/EU.

institution or to its business or its financial position that could have a material effect on the effectiveness of the plan or otherwise necessitates a revision of the resolution plan.

The directive mentions Group resolution plans as well.

### **Early intervention measures (Article 27)**

Where an institution infringes or, is likely in the near future to infringe the requirements of any EU Regulation<sup>21</sup> – concerning especially the minimum capital requirement and solvency – Member States shall ensure that competent authorities have at their disposal at least the following measures:

- require the management body of the institution to examine the situation, identify problems and draw up an action programme to overcome those problems and a timetable for its implementation,
- require the management body to convene, or if the management body fails to comply with that requirement convene directly, a meeting of shareholders of the institution,
- require one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties,
- require the management body of the institution to draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan, where applicable,
- require changes to the institution's business strategy.

### **Temporary administrator (Article 29)**

Where replacement of the senior management or management body is insufficient, Member States shall ensure that competent authorities may appoint one or more *temporary administrators* to the institution, either to replace the management body temporarily or to work temporarily with the management body. If the competent authority appoints a temporary administrator to work with the management body of the institution, the competent authority shall further specify at the time of such an appointment the role, duties and powers of the temporary administrator. Authorities have the exclusive power to appoint and remove any temporary administrator<sup>22</sup>. The appointment of a temporary administrator shall not last more than one year. That period may be exceptionally renewed if the conditions for appointing the temporary administrator continue to be met.

### **Resolution objectives (Article 31)**

When applying the resolution tools and exercising the resolution powers, resolution authorities shall have regard to the resolution objectives<sup>23</sup>, and choose the tools and powers that best achieve the objectives that are relevant in the circumstances of the case. The resolution objectives are of equal significance, and resolution authorities shall balance them as appropriate to the nature and circumstances of each case.

The resolution objectives are the following:

- to ensure the continuity of critical functions;
- to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline;

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<sup>21</sup> No 575/2013, Directive 2013/36/EU, Title II of Directive 2014/65/EU or any of Articles 3 to 7, 14 to 17, and 24, 25 and 26 of Regulation (EU) No 600/2014

<sup>22</sup> A temporary administrator may be removed at any time and for any reason.

<sup>23</sup> Shall seek to minimise the cost of resolution and avoid destruction of value unless necessary to achieve the resolution objectives

- to protect public funds by minimising reliance on extraordinary public financial support;
- to protect depositors and investors (covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC);
- to protect client funds and client assets.

### **Conditions for resolution (Article 32)**

Resolution authorities shall take a resolution action in relation to an institution only if the Authority considers that all of the following conditions are met:

- the determination that the institution is failing or is likely to fail has been made by the competent authority,
- having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures taken would prevent the failure of the institution within a reasonable timeframe;
- a resolution action is necessary in the public interest.

### **General principles governing resolution (Article 34)**

When applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

- *There is no priority rule in accordance with the principles, nevertheless we may consider two of these principles the very most important: no creditor shall incur greater losses than would have been incurred if the institution had been wound up under normal insolvency proceedings and covered deposits are fully protected.*
- the shareholders of the institution under resolution bear first losses;
- creditors of the institution under resolution bear losses after the shareholders<sup>24</sup>;
- management body and senior management of the institution under resolution are replaced<sup>25</sup>;
- management body and senior management shall provide all necessary assistance for the achievement of the resolution objectives.

### **The bail-in tool (Article 43)**

Member States shall ensure that resolution authorities may apply the bail-in tool to meet the resolution objectives.

Member States shall ensure that resolution authorities may apply the bail-in tool only if there is a reasonable prospect that the application of that tool will restore the institution financial soundness and long-term viability. *We may consider the application of the “bail-in tool” in the Crisis resolution a unique and unconventional legal method and rule, since before this directive the European Financial Law did not apply this kind of resolution tool.*

### **Conclusion**

Regarding the project of reforming the regulatory and supervisory model in the EU, we have to follow whether the new structures are able to operate adequately. On the one hand, the supervisory institutions are already established at EU level, however on the other hand, the supervisory authorities at the level of member states should also take part efficiently in the common framework. In order to achieve such a properly working

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<sup>24</sup> in accordance with the order of priority of their claims under normal insolvency proceedings

<sup>25</sup> except in those cases when management body and senior management appropriate to the circumstances

framework of supervision the national legislations should consider and adopt the regulations in the Directive for recovery and resolution.

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