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The Hungarian resolution regulation in the light of the European Union resolution framework for credit institutions and investments firms

Thesis of the Dissertation

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I. Short summary of the task of the research

The lessons learnt from the economic-financial crisis started in 2007 necessitated worldwide the introduction of regulation which entitled resolution authorities with powers in order to manage the crisis of failing financial institutions without any recourse to public money. The European Commission (Commission) approved enormous State aid for bailing out the financial sector between 2008 and 2010 therefore the public debt highly increased in most of the countries[1]. Since then, it has been obvious that a financial crisis cannot be managed with the same tools. A common thinking was started to elaborate prudential requirements and a resolution framework which on one hand facilitates the resilience of financial institutions and on the other hand manages their crisis and restores their long-term viability by minimising the usage of public money.

The Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (Bank Recovery and Resolution Directive – BRRD) was adopted in 2014. Hungary was among the first Member States which transposed the directive into its national law and the Central Bank of Hungary (Magyar Nemzeti Bank – MNB) was among the first resolution authorities which conducted resolution process in line with BRRD.

In the frame of the research, I scrutinized how the legal institutions regulated by the directive served its enforcement, how these institutions were applied in the different resolution processes across the European Union with special regard to Hungary.

II. Objective and short description of the research, analysis, methodologies of the elaboration

Based on the above, the aim of the new resolution framework is to allocate the burden of the crisis management first to the shareholders of the institution under resolution and after them to the creditors instead of using public money or with its minimalization. Therefore, the aim of the current research was to map the enforcement of this principle, in particular what kind of legal institutions are available for the relevant resolution and other authorities involved in the process, how this principle was implemented with special regard to the Hungarian experiences.

In the frame of the dissertation, I provide an overview on the transposition of the international standards of the Financial Stability Board (FSB) seated in Basel, about the main elements of the

[1] Prof. Dr. Csaba Lentner: A bankszabályozás tudományos rendszertana és fejlődéstörténete (2013) In: Lentner Csaba (editor) Bankmenedzsment, Budapest, Magyarország, Nemzeti Közszolgálati és Tankönyv Kiadó Zrt. p 30.

relevant EU law, including the national solutions for the implementation of the relevant legal institutions within the frame provided by the directive in the different Member States and what kind of changes I consider necessary in the EU legislation which might increase the applicability and effectiveness of resolution as a crisis management tool.

In the frame of the research I took into account the Commission delegated acts which were adopted based on the mandates set out in BRRD, the guidelines of the European Banking Authority (EBA) and certain regulations of the Member States, in particular on the Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system (Hungarian Resolution Act) and on the resolution related Government decrees, moreover the policy papers of the Commission, EBA, the Single Resolution Board (SRB) and the resolution authorities of the Member States. I note that although the United Kingdom has left the EU, but both the British resolution regulation and the policy papers of the Bank of England regarding resolution have had significant impact on the European Union resolution framework therefore I considered necessary their presentation.

Since the State aid framework of the EU shall be fully taken into account during resolution, therefore the elaboration of the relevant rules of the Treaty on the Functioning of the European Union and the communications of the Commission on the compatibility of aid with the internal market provided for financial institutions during their crisis management are also part of the dissertation. I scrutinized the individual decisions of the Commission on the prior adoption of State aids not only from the aspect of the compliance with the internal market, but from the perspective of the compliance of the resolution measures with BRRD.

Although, it is important to note that resolution is an exceptional procedure compared to normal insolvency procedure which is to be applied as a rule for crisis management of the failing institutions. In the EU, only 18 resolution processes have been conducted till March 2022. Further reasons (the avoidance of potential burden-sharing of retail bondholders or large depositors, application of alternative crisis management tools) for the few resolution processes are pointed out in the dissertation.

Due to the relative novelty of resolution and only few practical experiences in the EU, its academic literature has been published mostly in foreign language – although there is literature written in Hungarian – and apart from some legal studies and books cover rather issues which belong to economic sciences.

The research task is specific since the elements of finance and finance technics will be dominant, although since resolution is an administrative procedure therefore the dissertation balances on the edges of financial law (science of finance) and administrative law taking into consideration all of its advantages and disadvantages.

III. Short summary of the academic results, their utilization and possible utilization

1. The harmonisation of the resolution framework at international and Union level was facilitated by the global financial crisis similar to the evolution of the resolution regulations at national level which were always brought into being by the individual crisis situations in the given country (for example in Cyprus). The EU directive relied on the US modell and on other existing national frameworks. Despite of the fact that the legal harmonisation was achieved in the form of a directive, there was a narrow level playing field available for the Member States to form their own national rules.
2. BRRD set out a relative freedom for the Member States to develop their resolution authority provided that they comply with the operational and structural separations and the requirements regarding the conflict of interest. I came to the conclusion based on the lessons learnt from the conducted resolution processes that the most effective solution is for establishing the resolution authority when as much relevant functions regarding resolution as possible are concentrated within one authority. The Hungarian legislator allocated the resolution function to the central bank similar to the British, Dutch, Italian and several other European Union examples which I treat as the most advantageous solution since all the administrative powers regarding the micro-, macroprudential and resolution powers of the financial organisations beside other departments responsible for maintaining financial stability belong under the umbrella of the central bank which enables an extremely swift information flow and decision-making in crisis situations that is important in order to take into account every aspect during the adoption of decisions since the decisions of the resolution authority might have spill-over effects.
3. As pointed out above, the resolution activity has two main areas, resolution planning and resolution execution. As a rule, failing financial institutions shall be wound up under normal insolvency procedure, resolution can only be applied in exceptional cases when the conditions for resolution are met. As a consequence, the resolution strategy can only be chosen in the course of the resolution planning when the winding up under normal insolvency procedure is not feasible and credible.
4. The consolidated and individual minimum requirements for own funds and eligible liabilities (MREL-requirements) can only be determined depending on the resolution strategy and on the

resolution measures to be applied. The MREL-requirement consists of two components, the loss-absorbing and recapitalisation capacity which main aim is to build up an adequate burden-sharing capacity for a potential implementation of a resolution process. Where the resolution plan provides that the entity is to be wound up under normal insolvency proceedings, the MREL-requirement is limited in the loss-absorbing capacity which is equal to the capital requirement. In my view, in that case it is unnecessary to prescribe the MREL-requirement since the institution shall meet its capital requirements at all times based on the legal and supervisory requirements. In my opinion, the procedure for determining the MREL-requirement would become more simplified when the resolution authority should require the compliance with the MREL-requirement only for those entities which resolution plans envisage resolution strategy.

5. The amendment of BRRD entering into force in June 2019[2] (BRRD II) has improved significantly the rules regarding the calculation and fulfilment of the MREL-requirement. In my view, based on the new rules, the stock of liabilities necessary for loss-absorption and recapitalisation can be estimated more precisely. It is progressive that the requirement expressed in the proportion of the risk-weighted assets which mirrors better the likelihood of the necessity for a potential crisis management. At the same time the requirement expressed as a percentage of the leverage ratio and to be fulfilled parallel is treated as a lower threshold for the less risky institutions. In my opinion, beside the more significant consideration of riskiness regarding the determination of the degree of the requirement, the introduction of the compulsory subordination requirement under certain conditions prescribed by the law serves for a more effective loss-absorption and recapitalisation. I consider especially important the role of the subordination requirement in the predominance of the No Creditor Worse-Off (NCWO) principle.
6. I consider it reasonable to harmonise the rules regarding the capital and MREL-requirements, in particular concerning the waiver of the individual MREL-requirement. As I mentioned above, the conditions for the application of the waivers for individual capital- and MREL-requirements are the same, however different authorities (supervisory and resolution) make their own decisions and they are not bound by each other's decisions. There can be a case when the supervisory authority may waive the individual capital requirements, in that case the resolution authority does not have probably other choice, but to waive the MREL-requirements as well since without individual capital requirements it cannot calculate individual MREL-requirements or it set the individual MREL-requirements equal to the consolidated amount. The rules

[2] Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC

regarding the transitional period for complying with the MREL-requirement shall also be completed since they only refer to entities which already have authorization. I think it would be important to elaborate rules on the transitional period of newly established entities. Finally, it should be necessary to overrule the Commission delegated regulation 2016/1450/EU supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities. Although, in my opinion, BRRD have priority over the delegated regulation, but because of their parallel regulatory scope, keeping the delegated regulation in force would cause legal uncertainty.

7. The independent valuation provides very important information on the determination of the resolution conditions, initiating resolution procedure and on the application of the resolution measures. If independent valuation cannot be implemented beforehand or posteriorly, it would cause harmful effects since the reasons of the resolution decisions can be doubted and in that regard the interests of the persons affected by the burden-sharing could also be injured. In crisis situations, it is challenging to select independent valuer who complies fully with the requirements stated by the law taking into consideration the criteria of independence and conflicts of interest. Therefore, in my view the register of the independent valuers elaborated by the Hungarian law can be a model for other Member States to handle this challenge.
8. Regarding the conditions for resolution, I would like to point out that the specification of the public interest is necessary in line with the views expressed in the literature, since currently, there is a wide range of level playing field available for authorities to determine the public interest methodology. A forward-looking solution shall be elaborated which would extend the scope of institutions which might be placed under resolution breaking with the legislator's intention that resolution is a crisis management method only for systemic relevant entities. The necessity of the clarification of the public interest condition is underpinned by the fact that the resolution processes have been conducted only against small- and medium-sized institutions, at most with domestic systemic relevance, in certain cases triggering serious debates (for example in case of the liquidation of two small banks of province Veneto in Italy.). Beside the greater harmonisation of the public interest resolution condition, the harmonisation of the rules on the normal insolvency procedures is also a timely task as pointed out in the literature already[3].

[3] König Elke: Why we need an EU liquidation regime for banks, 2018. szeptember 5. https://srb.europa.eu/en/node/622 Downloaded: 6 May 2021
Enria Andrea: Crisis management for medium-sized banks: the case for a European approach, ECB 15 January 2021 https://www.bankingsupervision.europa.eu/press/speeches/date/2021/html/ssm.sp210115~e00efc6968.en.html?utm_source=ecb_twitter Downloaded: 6 May 2021

9. Despite the fact that the principle of resolution is the minimalization of extraordinary public financial support, State aid was provided in resolution processes several times, especially in the first years after the establishment of the new resolution framework, in particular stemming for the resolution financing arrangement, therefore State aid pays an important role continuously in crisis management. The precondition for the usage of the resolution financing arrangement is the prior approval of the Commission. The relevant communications of the Commission have been unchanged since 2013. In the course of their planned revision in 2023 – similar to the determinations of the European Court of Auditors[4], the communications shall be harmonised with the resolution regulation and its practice, in particular regarding the adequate burden-sharing and the commitments. I suggest that when the failing situation cannot be traced to the insufficient operation and structure of the institution (for example when the reason leading to the failure is a temporary disturbance in demand due to an epidemic), the commitment for drawing up a restructuring plan or structural commitments can be waived since the failure was not stemming from internal grounds.
10. The greatest novelty is the introduction of the legal institution of the bail-in tool which was applied in very few cases. Although it was designed for facilitating the loss-absorption and recapitalisation of systemic relevant cross-border institutions, it has not been applied to such an institution yet. The resolution authorities map the measures necessary for the implementation of the write down or conversion power to be done by other authorities, participants such as market authority, central depository, stock exchange in favour of a successful bail-in process[5]. In my opinion, the legal background of the necessary measures and the detailed rules of cooperation among the relevant participants shall be elaborated for implementing bail-in which are regulated neither in BRRD nor at national level taken into account the characteristics of the laws in the different Member States.
11. Based on the legal environment and the published policy documents I draw the conclusion that it is necessary to simplify the exercise of the administrative approval and suspension powers to facilitate the application of the resolution tools, in particular that the approvals regarding merger control are not needed during resolution, moreover when the exercise of certain suspension powers (such as trade in the regulated market) is not within the scope of the resolution authority, the relevant authority shall exercise its power upon request of the resolution authority.

[4] European Court of Auditors: Control of State aid to financial institutions in the EU: in need of a fitness check, Special Report 21/2020: https://op.europa.eu/webpub/eca/special-reports/state-aid-banks-21-2020/en/ Downloaded: 14 March 2022. paragraph 49
[5] EBA/GL/2022/01 Guidelines on improving resolvability for institutions and resolution authorities under articles 15 and 16 BRRD (Resolvability Guidelines)

12. Regarding the write down and conversion power, in favour of the enforcement of the NCWO principle the hierarchy of claims under normal insolvency procedure has an important role during the loss absorption. Considering the fact that the ranking of deposits in the hierarchy of claims are based partly on BRRD, therefore in my view, the regulation shall be completed on EU level since the deposits of the shareholders shall be ranked in the hierarchy of claims based on their deposit characteristics opposite to other claims of the shareholders stemming from debt instruments (not in connection with the ownership rights) which rank junior compared to deposits. The priority of the burden-sharing of shareholders would be facilitated if the deposits of majority shareholders are satisfied in the same class of creditors as other claims of shareholders stemming from debt instruments.
13. With regard to resolution funding, I have demonstrated that in line with the literature[6], the usage of the sources of the deposit guarantee scheme has significant limits based on the law which shall be eased on European Union level in a way that the precondition for the usage regarding the hypothetical loss absorbing of the covered deposits should be cancelled. I suggest keeping one limit in the directive for the access of the financial means of the deposit guarantee scheme. This limit shall contain that the contribution of the deposit guarantee scheme to resolution funding shall not exceed the potential repayment liability of the deposit guarantee scheme in case of the freezing of deposits.
14. The resolution specific administrative law rules serve for the objective of general interest regarding the preservation of financial stability which necessitates under certain circumstances transparency, including the different publishment obligations or the compliance with the sale principles in case of the application of the sale of business tool in favour of predictability since depending on the resolution strategy, the market confidence shall be maintained against the institution under resolution, although in certain cases it is justifiable to limit certain rights of client based on the aspect of financial stability for at least a temporary period of time (for example limitation the right to access to documents when it endangers the successfulness of the procedure). Because of the need for a swift procedure in favour of the protection of the financial stability, there is a short period of time available for the resolution authority to fulfil its obligation to clarify the matter of fact. Therefore, it should be considered to implement the relevant institution of the Austrian General Administrative Act which can be applied not only in resolution processes. Based on that the resolution authority can make decisions in favour of

[6] Restoy Fernando: How to improve funding of bank resolution in the banking union: the role of deposit insurance, Bank of International Settlement speech https://www.bis.org/speeches/sp210511.htm Downloaded: 14 March 2022

implementing indispensable measures without conducting evidence procedures in emergency situations which decisions (Mandatsbescheid) shall be complemented in a later stage for securing completeness (Vorstellungsbescheid)[7]. The Austrian resolution authority has applied this institution in the resolution process of HETA ASSET RESOLUTION AG[8].

15. BRRD explicitly set out that the persons affected by the crisis management measures shall have the right of appeal against the decision[9]. Regarding the remedies against administrative acts, it is to be pointed out that the right to an effective remedy can be limited with regard the preservation of financial stability as an objective of general interest[10], although a protection mechanism has been established for the affected shareholders and creditors. They are entitled for payment from the resolution financing arrangement in case of a breach of the NCWO-principle[11]. In order to protect financial stability, to maintain market confidence, predictability, for the avoidance of any potential uncertainty in the future I consider very important that on one hand the abovementioned protection mechanism warrants that the shareholders and creditors can receive payment in case of the breach of the NCWO-principle, on the other hand the annulment of the underlying decision cannot affect the right of third-party acquirers acting in good faith.
16. The Hungarian legislator was among the first in the European Union transposing the European Union directive into national law and MNB was the first resolution authority across the European Union which set up resolution college and among the first conducting a successful resolution process.

In my view, the results of the dissertation can be utilized mostly in the development of the resolution related European Union and the thereon based national legislation and for the resolution playbooks in the frame of resolution planning.

[7] Allgemeines Verfahrungsgesetz Section 57. paragraph (1)
[8]Mandatsbescheid: HETA ASSET RESOLUTION AG 01.03.2015: https://www.fma.gv.at/heta-asset-resolution-ag/#collapse-630cae022fb56 Downloaded: 1 June 2022
Vorstellungsbescheid: HETA ASSET RESOLUTION AG 10.04.2016: https://www.fma.gv.at/heta-asset-resolution-ag/#collapse-630cae022fb56 Downloaded: 1 June 2022
[9] BRRD Article 85 (3)
[10] Court of Justice of the European Union Case C-410/20 points 36.; 47-48.
[11] BRRD Article 75

IV. Publications regarding the topic

Földényiné Láhm Krisztina – Kómár András – Stréda Antal – Szegedi Róbert: Bank resolution as a new MNB function – resolution of MKB Bank. In: Financial and Economic Review, Vol. 15 Issue 3., September 2016, pp. 5–26.

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Stréda Antal: Application of merger control for financial institutions in crisis within the European Union, JURA, Vol. 24 Issue 2 2018

Stréda Antal: The evolution of the single bank resolution framework in the European Union, JURA, Vol 27 Issue 3. 2021

Stréda Antal: Cooperation of authorities in the course of the resolution activity Kodifikáció és Közigazgatás (accepted, not published yet)

Stréda Antal: Thoughts on burden-sharing in banking crisis management cases after the adoption of the Bank Recovery and Resolution Directive in the European Union, JURA (accepted, not published yet)

Stréda Antal: European Union regulation of the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, Európai Jog (accepted, not published yet)

Stréda Antal: The European bank resolution framework with special regard to Hungary, PhD Tanulmánykötet (accepted, not published yet)