



EBA/GL/2015/05

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## Final Guidelines

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on the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets under Article 42(14) of Directive 2014/59/EU

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# 1. Executive summary

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Article 42(14) of Directive 2014/59/EU mandates the EBA to issue guidelines to promote the convergence of supervisory and resolution practices regarding the determination of when the liquidation of the assets or liabilities under normal insolvency proceeding could have an adverse effect on one or more financial markets.

The guidelines set out three elements that should be considered by resolution authorities when assessing the market situation for the assets concerned and the potential direct and indirect effects on financial markets:

- (a) whether the market for these assets is impaired;
- (b) the impact of a disposal of these assets on the markets where they are traded;
- (c) the situation of the financial markets and the direct and indirect effects of an impairment the markets for these assets.

For each of these elements, the guidelines identify a list of factors that resolution authorities should assess, with a particular view to the risk of putting additional pressure on prices and causing contagion.

## 2. Background and rationale

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Holdings of impaired assets and depreciation were the cause for most cases of financial distress of institutions during the global financial crisis of 2008 and the following years. Many Member States established asset separation schemes ('bad banks') to relieve banks' balance sheets of these depreciated assets and the risks linked to them. In a comparable way, the asset separation tool under Directive 2014/59/EU enables authorities to transfer the assets, rights or liabilities of an institution under resolution to a separate vehicle to wind these activities down in an orderly manner while maintaining the continuance of critical functions of the institution under resolution. However, the directive stipulates that the tool may only be used in conjunction with other tools to prevent an undue competitive advantage for the failing institution. For the same reason, Article 42(5) limits the use of this power: It may only be used if the situation of the particular market for those assets is of such a nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on one or more financial markets, or where the transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution or to maximise liquidation proceeds.

The EBA is mandated to issue guidelines to promote the convergence of supervisory and resolution practices regarding the determination of when the liquidation of the assets or liabilities under normal insolvency proceeding could have an adverse effect on one or more financial markets. The scope of the guidelines is limited to this condition in point (a) of Article 42(5) and does not relate to points (b) and (c). The guidelines set out three categories of elements that should be considered by resolution authorities when assessing the market situation for the assets concerned and the potential direct and indirect effects on financial markets:

- (a) whether the market for these assets is impaired;
- (b) the impact of a disposal of these assets on the markets where they are traded;
- (c) the situation of the financial markets and the direct and indirect effects of an impairment of the markets for these assets.

The latter categories are based on the former ones, and the guidelines identify for each of them a non-exhaustive list of factors that resolution authorities should assess. As far as the urgency of the matter permits, resolution authorities should analyse the situation of the market for these assets and comparable asset classes, the general condition of financial markets and competitors of the institution in resolution, with a particular view to the risk of putting additional pressure on prices or causing contagion. However, neither a deterioration in the quality of the assets concerned nor dysfunctional markets are indispensably required for the conclusion that the liquidation could have an adverse effect on one or more financial markets.

The mandate speaks of a liquidation of assets or liabilities. A liquidation of assets may occur if assets and liabilities are linked together in a portfolio, for example of derivatives. The guidelines

establish that resolution authorities should have regard to the specific features of derivative portfolios, as their liquidation or transfer may have a considerable impact on counterparties.

# 3. EBA Guidelines on the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets under Article 42(14) of Directive 2014/59/EU

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## Status of these guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC ('the EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines.

Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to which guidelines are addressed to comply with guidelines. Competent authorities to which guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

## Reporting requirements

Pursuant to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise provide reasons for non-compliance, by dd.mm.yyyy. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided in Section 5 to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/2015/05'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3).

## Title I - Subject matter, scope and definitions

1. The guidelines promote the convergence of supervisory and resolution practices in accordance with Article 42(5) of Directive 2014/59/EU regarding the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on the financial market.
2. The guidelines apply to resolution authorities.

## Title II - Adverse effect of the liquidation of assets or liabilities on the financial market

3. When assessing whether the market for certain assets or liabilities is of such a nature that the liquidation of these assets under normal insolvency proceedings could have an adverse effect on one or more financial markets, resolution authorities should assess the situation of the market for these assets, and the impact of a disposal of these assets on the markets where they are traded and on financial stability. However, resolution authorities should not assume a deterioration in the quality of the assets concerned or dysfunctional markets as necessary requirements for the conclusion that the liquidation could have an adverse effect on one or more financial markets.
4. Resolution authorities should assess at least the following elements, taking into account the urgency of the resolution action:
  - (a) whether the market for these assets is impaired, based on the following indicators:
    - (i) the development of the liquidity of the markets for these assets or comparable asset classes;
    - (ii) whether these assets or comparable asset classes have been classified as impaired for accounting purposes and whether provisions have been set up by institutions in respect of these assets;
    - (iii) incurred losses and unstable cash flows under these assets;
    - (iv) downward value adjustments of the assets or corresponding price developments of associated hedges or comparable asset classes;
    - (v) high volatility in prices compared to the market in general, in particular uncommonly high price differences between different markets that typically show an identical development;
    - (vi) reduction of share prices and deterioration of ratings and refinancing conditions of institutions holding high amounts of these assets, compared to the rest of the market;

- (b) the impact of a disposal of these assets on the markets where they are traded, taking into account:
    - (i) the size of the markets concerned and the range of potential purchasers;
    - (ii) the impact the liquidation of the assets is expected to have on prices for comparable asset prices;
    - (iii) the expected timeframe for the liquidation of the assets under normal insolvency proceedings, including a potential accelerated distress sale;
  - (c) the situation of the financial markets and the direct or indirect effects of a disposal of these assets, taking into account:
    - (i) the risk of a systemic crisis, as evident from the number, size or significance of institutions that are at risk of meeting the conditions for early intervention or the resolution conditions or at risk of undergoing an insolvency procedure, or as evident from public financial support to institutions or extraordinary liquidity facilities provided by central banks;
    - (ii) whether the sale of the assets or an impairment of markets can result in contagion, in particular with regard to the amount of assets or comparable asset classes held by institutions, or where these holdings are valued at market prices;
    - (iii) a reduction in or an increase in prices of short- or medium-term funding available to institutions;
    - (iv) an impairment to the functioning of the interbank funding market, as particularly apparent from an increase in margin requirements, a decrease in ratings of institutions and a decrease in collateral available to institutions.
5. The elements listed in the paragraph above are without prejudice to further elements, the assessment of which resolution authorities will deem relevant in each specific case having regard to the particular circumstances.
6. Where the resolution authority is considering the transfer of assets and liabilities, in particular a portfolio of derivatives or trading assets and liabilities, that are legally or economically interlinked, the resolution authority should assess the elements under paragraph 3 also with respect to the portfolio as a whole and to comparable portfolios. In addition, the resolution authority should assess the impact that unwinding the portfolio could have on the financial markets, taking into account the effect on counterparties to these assets and liabilities, such as the discontinuance of hedging relations and the need to find a replacement for them, or the impact on or special requirements of central counterparties.

## Title III - Final provisions and implementation

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These guidelines shall apply as of 1 August 2015.

These guidelines should be reviewed by 31 July 2017.

## 4. Accompanying documents

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### 4.1 Cost-benefit analysis/impact assessment

#### Introduction

Article 42(14) of Directive 2014/59/EU requires the EBA to issue guidelines to promote the convergence of supervisory and resolution practices regarding the determination of when the liquidation of the assets or liabilities under normal insolvency proceeding could have an adverse effect on the financial market. The determination is in accordance with paragraph 5 of the same article and is applicable when:

- the situation of the particular market for those assets is of such a nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on one or more financial markets,
- the transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution; or
- the transfer is necessary to maximise liquidation proceeds.

As per Article 16(2) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any guidelines developed by the EBA shall be accompanied by an impact assessment annex which analyses ‘the potential related costs and benefits’. This annex shall provide the reader with an overview of the findings with regard to the problem identification, the options identified to rectify the problem and the potential impact of these options.

This annex presents the impact assessment with cost-benefit analysis of the provisions included in the guidelines described in this Consultation Paper. Given the nature of the guidelines, the impact assessment is high-level and qualitative in nature.

#### Problem definition and the baseline scenario

The current EU regulatory framework is in the process of building a resolution mechanism whereby Member States aim to achieve an orderly winding-up of the institutions under resolution by preventing potential adverse effects of the resolution process. Directive 2014/59/EU acknowledges the possibility of adverse effects during the process and gives Member States leeway as to when they should otherwise carry out the process in line with the standard procedures.

With regard to the assessment of whether the liquidation of assets and liabilities under normal insolvency proceedings can have an adverse effect on financial market(s), the criteria against which the resolution authorities assess a specific situation are not specified in Directive 2014/59/EU.

The core problem that the guidelines aim to address is the lack of a harmonised approach when the resolution authorities interpret these elements for assessment. A lack of consistency and potential variations in the interpretation of these elements may lead to:

- Asymmetric information between resolution authorities. This is important in particular when the institution in question has a large cross-border dimension. To handle cross-border cases, resolution authorities may need to work in cooperation. Asymmetric information between resolution authorities and a lack of information can represent an obstacle for effective and smooth cooperation and delay the orderly resolution process.
- Spill-over effect of adverse consequences. Financial stability in several jurisdictions can be affected by a lack of timely implementation of resolution action on the part of a third jurisdiction that has a different approach.
- A lack of a level playing field for institutions in the EU, i.e. different treatment of various entities belonging to the same cross-border groups due to different supervisory/resolution practices.
- (Ex-ante) different signals to the market players, i.e. the agents such as counterparties, infrastructure providers, depositors, liquidity providers and the wider market players may have different expectations of the regulatory process. Different expectations may also turn into uncertainty when there is a cross-border dimension since the same agent may receive different signals from different resolution authorities.

Currently, none of the Member States has developed a framework to tackle these potential adverse effects of non-coordinated resolution and insolvency frameworks applicable to institutions. The baseline scenario therefore assumes that the starting point for all Member States to comply with the framework suggested in the draft guidelines is the same.

## Objectives

The objective of the guidelines is to promote convergence of supervisory and resolution practices regarding the interpretation of the circumstances amounting to a material threat to financial stability, the elements relating to the effectiveness of the sale of business tool and to financial stability, and the criteria to assess the potential adverse effects of the standard liquidation of assets and liabilities on the financial markets. [Table 1](#) presents the objectives of the draft guidelines.

[Table 1: Operational, specific and general objectives of the guidelines](#)

Operational objectives	Specific objectives	General objectives
<b>Equip competent authorities and resolution authorities with more effective, precise and accurate tools (e.g. criteria and circumstances) for handling effective resolution.</b>	Improve the regulatory system to achieve optimal resolution practices.	Reduce the probability of systemic banking crises and mitigate threats to financial stability.
<b>Harmonise practices in relation to resolution actions across Member States.</b>	Improve cross-jurisdictional cooperation in relation to the resolution of cross-border institutions.	Promote the effective and efficient functioning of the internal market.

Technical options for the determination of when the liquidation of assets and liabilities under normal insolvency proceedings can have an adverse effect on financial markets

This section presents the major technical options discussed by the EBA during the preparation of the draft guidelines and presents qualitatively the potential costs and benefits associated with the preferred options.

#### a. Technical options related to the elements

**Option 1:** Exhaustive list of elements for the assessment of the impairment of the market situation.

**Option 2:** Non-exhaustive/indicative list for the assessment of the impairment of the market situation.

The assessment includes whether the draft guidelines should include an exhaustive list or a non-exhaustive of elements to investigate the impairment of the market situation for the assets. The argumentation is similar to the one presented in the previous sub-section and the same theoretical reasoning applies.

Option 2 is the preferred option due to its capacity to handle the resolution process in a crisis situation in a flexible, more effective and more efficient way. The option is deemed to be more dynamic and accommodate features peculiar to jurisdictions, institutions and the crisis environment, including circumstances that cannot be anticipated at present.

The minimum list suggested in the draft guidelines covers elements related to the price and liquidity conditions of the assets, the market share and the relative importance of the assets in the market, and therefore the potential impact of the disposal of the assets on the banking sector.

Option 1 is expected to be more expensive for both the resolution authorities (higher administrative cost) and the public (higher opportunity cost and higher risk). Costs associated with the implementation of Option 2 are not expected to go beyond those associated with the work that the resolution authorities need to carry out within the framework of the Level 1 text.

In terms of benefits, a more precise and harmonised regulatory framework is expected to tackle the identified problems. Resolution authorities are expected to benefit from symmetric information and more effective and efficient cooperation across jurisdictions. This then decreases the probability of the systemic risk and bank failure-related risk to the public.

## 4.2 Views of the Banking Stakeholder Group (BSG)

The BSG supported the overarching objective of the guidelines, which is to establish a framework on the use and application of the resolution tools, and expects that they will provide the convergence of supervisory and resolution practice in the implementation of these tools by ensuring consistent and high regulatory standards in this area and a level playing field across the EU. The BSG pointed out that it is fundamental to consider the impact of the guidelines on other institutions and financial markets, including infrastructure providers and non-financial institution customers.

With regard to the liquidation of assets or liabilities tool, the BSG expressed the conviction that it is one of the most useful tools in the event of a crisis where the consequence would be the loss of value and liquidity of certain assets. Although the BSG considered the criteria to be subjective to a certain extent, it appreciated the progress on common criteria at EU level.

The BSG considered the guidelines to be sufficiently comprehensive and detailed. Nevertheless, it recommended considering that there are 'non-core' assets that must be included in a 'bad bank' when this tool is applied, for example on the basis of business or geographic units.

However, the guidelines are limited to specifying the conditions in Article 42(5)(a) (that the situation of the particular market for those assets is of such a nature that the liquidation of the assets concerned under normal insolvency proceedings could have an adverse effect on one or more financial markets), but do not specify conditions (b) and (c) (that the transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution; or to maximise liquidation proceeds).

### 4.3 Feedback on the public consultation

The EBA publicly consulted on the draft proposal contained in this paper.

The consultation period lasted for three months and ended on 22 December 2014. Three responses were received, one of which was published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

In many cases, several industry bodies made similar comments or the same body repeated its comments in the response to different questions. In these cases, the comments and EBA analysis are included in the section of this paper where the EBA considers them most appropriate.

Changes to the draft guidelines have been incorporated as a result of the responses received during the public consultation.

## Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Responses to questions in Consultation Paper EBA/CP/2014/24</b>			
<p>Question 1 Should the elements listed above further be specified by any qualitative or quantitative factors to ensure convergent practices? Are there further relevant elements which should be included?</p>	<p>Given the complexities and differences between entities and asset classes, one respondent was of the view that the list of elements as stated in the Consultation Paper will provide sufficient guidance when making the assessment. Any further qualitative and quantitative indicators may potentially further complicate the situation. The respondent further pointed out that any such assessment would best be made in close consultation with the crisis management group (CMG) and the entity involved. While it could be said to be implied in (a) in the list of elements, it may be worth explicitly mentioning that the public opinion of any deployment of the resolution tool should be considered as any adverse public reaction may further exacerbate the stress on the system.</p>	<p>The directive provides for the procedural framework and the cooperation between resolution colleges and further authorities and stakeholders concerned.</p>	<p>No amendment.</p>
<p>Question 2 Which specific considerations should apply regarding the liquidation of derivative portfolios? Is the assessment of the impact of the unwinding of derivative</p>	<p>One respondent recommended that resolution authorities should give due consideration to the underlying hedging activities when assessing the unwinding of a derivative portfolio. Some derivatives in the portfolio could be used to hedge the economic risk of a non-derivative trading</p>	<p>The EBA believes that the directive and the current guidelines leave the option to respect existing hedging relationships when using the asset separation tool.</p>	<p>The text has been clarified to particularly include trading assets and liabilities.</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
portfolios practicable? How could it be made more practicable?	asset/liability and, if unwound on its own, could leave the entity exposed to market risks from the trading asset/liability which may exacerbate the stress situation. These derivatives (or the trading asset/liability) should be excluded (or included) in the portfolio of derivatives when considering the sale.		
Question 3 Are there further relevant examples of assets and liabilities linked to each other?	One respondent recommended trading assets/liabilities to be considered in relation to the underlying derivative hedges (if any).	See previous question.	See previous question.
Question 4 How could the exercise of judgment by resolution authorities be constrained to ensure convergence in practices in assessing the situation of the financial markets and the impact of the disposal of assets?	One respondent expressed the view that the guidelines are sufficient to ensure consistency in considerations amongst different regulators. Given the complexities involved in a potential resolution scenario, we do not think that further binding requirements are necessary. Based on this set of guidelines, the CMG together with the entity should, during 'business as usual' times, identify and agree on the clusters of assets/liabilities that can be sold and identify the risks associated with their sale.	The identification of assets/liabilities that can be sold and of risks associated with their sale may indeed be part of the resolvability assessment of the institution. In accordance with the mandate, the guidelines do not address this question.	No amendment.

## 5. Confirmation of compliance with guidelines and recommendations

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Date:

Member/EEA State:

Competent authority

Guidelines/recommendations:

Name:

Position:

Telephone number:

E-mail address:

I am authorised to confirm compliance with the guidelines/recommendations on behalf of my competent authority:  Yes

The competent authority complies or intends to comply with the guidelines and recommendations:  Yes  No  Partial compliance

My competent authority does not, and does not intend to, comply with the guidelines and recommendations for the following reasons<sup>1</sup>:

Details of the partial compliance and reasoning:

Please send this notification to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu)<sup>2</sup>

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<sup>1</sup> In cases of partial compliance, please include the extent of compliance and of non-compliance and provide the reasons for non-compliance for the respective subject matter areas.

<sup>2</sup> Please note that other methods of communication of this confirmation of compliance, such as communication to a different e-mail address from the above, or by e-mail that does not contain the required form, shall not be accepted as valid.

