BANCO DE PORTUGAL
EUROSYSTEM

XXVII Lisbon Meeting
9 October 2017

Governor of Banco de Portugal, Carlos da Silva Costa
The international financial system: challenges from the creation of Banking Union in Europe[1]

Introduction

In the Lisbon Meetings of the last few years I have addressed the challenges that the construction of the Banking Union in Europe poses to our countries' financial systems from a variety of angles:

- The institutional and regulatory changes introduced and their implications for recognising the equivalence of supervisory regimes of third countries;
- The need to strengthen regulations and practices to prevent money laundering and terrorist financing in order to safeguard the correspondent relationships between our financial institutions;
- The enhancement of exchange of information and transparency mechanisms to identify the ultimate control over the various collective structures operating in our financial systems.

To complete this cycle related to the challenges stemming from the creation of the European Banking Union, today I will address the implications resulting from the new resolution framework, focusing on third countries.

The Banking Union rests on three complementary pillars:

- The Single Supervisory Mechanism in operation since November 2014;
- The Single Resolution Mechanism in operation since January 2016; and
- A Common Deposit Guarantee Scheme, still under construction.

[1] As prepared for delivery.

What is the Single Resolution Mechanism and how does it work?

The Single Resolution Mechanism's purpose is to **ensure, within the euro area, an orderly resolution of failing banks without affecting the financial stability of the countries where they operate** with **minimal costs to taxpayers and to the real economy**.

Responsibility for credit institutions' resolution is shared between the Single Resolution Board and the national resolution authorities of the countries participating in the Banking Union.

The Single Resolution Mechanism also includes the **Single Resolution Fund, financed by the banking sector**, which, inter alia, is intended to support banks' resolution, after other options, such as the bail-in tool, have been exhausted.

The Single Resolution Board:

- **Is directly responsible for the planning and resolution phases and decides** on resolution schemes to **banks directly supervised by the European Central Bank (ECB) and** to all **cross-border banks having their head office in a European Union Member State;**
- Decides on the **use of the Single Resolution Fund**, being also responsible for all resolution cases **involving recourse to the Single Resolution Fund**, including less significant institutions**.**

The **national resolution authorities** (including Banco de Portugal) are responsible for planning and adopting resolution plans in respect of **those banks for which the Single Resolution Board is not directly responsible**.

In addition to the Single Resolution Board and the national resolution authorities, the following entities also intervene in the Single Resolution Mechanism:

- The **Council of the European Union** which, inter alia, determines how the ex-ante contributions to the Single Resolution Fund are to be made by the banking sector and, in certain cases, may object to a particular resolution scheme; and
- The **European Commission**, which is responsible for endorsing the resolution schemes adopted by the Single Resolution Board.

Resolution strategies

When the resolution authorities define and plan their resolution strategies they use two approaches:

1. **Resolution with a single point of entry**, where the tools are only applied to the entity at the top of the group and by a single resolution authority.

This strategy aims to ensure the total absorption of group losses at parent-undertaking level and, thereby, an adequate recapitalisation of all entities within the group, with the group's corporate structure, in principle, remaining unchanged.

2. **Resolution with multiple points of entry**, where resolution measures are directly applied to different parts of the group by two or more resolution authorities acting in a coordinated manner.
   This strategy may involve the use of distinct tools in the various points of entry, and splitting the group into two or more parts (based, for instance, on geographic criteria or business lines, or even a combination of both).

Therefore, **choosing the resolution strategy takes into account a number of criteria, namely the structure of the group in question, its characteristics, its business model, and its geographic dispersion.**

Challenges inherent to the planned resolution strategies

A single point of entry resolution poses two big challenges, at two different points in time:

- **In the planning phase** there is a strong need for **discussion and consensus among the group's various resolution authorities to ensure that all of them are confident and comfortable with: the strategy defined;** and **the capacity of the parent-undertaking's resolution authority to implement** the measures as planned;
- **In the resolution phase**, it may not be possible to avoid **exogenous factors preventing the absorption of losses and the recapitalisation of all entities within the group** (in particular those having their head office in other jurisdictions) and, hence, keep the group in its prior structure (for instance, when the activity is to be sold to another credit institution and the buyer sets as a condition that a specific subsidiary is not included in the transaction's perimeter, or when other public authorities, such as the Directorate-General for Competition, prohibit the resolution authority from keeping certain subsidiaries abroad, including in third countries).

In contrast, **resolutions with multiple points of entry,** albeit **more complex in operational terms for the authorities of the countries where the subsidiaries are established,** enable direct action on the parts of the group where problems emerge, through local, relatively autonomous, decisions adopted by the authorities better acquainted with each subsidiary and tailored to the various jurisdictions involved. However, the splitting and fragmentation of a group implies potential losses of value, and **the implementation of these strategies require increased coordination and cooperation between the various resolution authorities**.

However, I emphasise again that **while there should always be a preferred resolution strategy for each group, this strategy may be altered, if justified, at the time of adoption of a resolution decision.** This situation is particularly challenging if a single point of entry strategy is planned but, at the time of implementation, intervention in various points of entry is required.

In these cases, there may be potential **impediments to resolvability** (which should have been identified in the planning phase) that, if not removed, may result in the **inability to apply resolution measures under a multiple point of entry strategy.** Ultimately, this situation may lead to **the disorderly liquidation of some institutions, with the subsequent usage of the national Deposit Guarantee Funds and with costs to the public finances in the respective countries**.

In this regard, **I want to stress how important it is for all the countries with subsidiaries of banks having their head office in the European Union to have in place legal resolution frameworks consistent with international best practice**, as this is a ***sine qua non*** **for dealing with the application of resolution measures to cross-border groups where, for any reason, it is not possible to implement a single point of entry strategy**.

In sum, in the context of the Banking Union, the **room for discretion** in decision-making by political, supervisory and resolution authorities of the country of origin of financial institutions operating at international level **is quite limited**. **Therefore, coordination and cooperation between the resolution authorities of the various countries is paramount**.

This implies, inter alia, the existence **of prior cooperation agreements between the European resolution authorities and the resolution authorities of third countries,** to guarantee effective planning, timely exchange of information, and adequate coordination when it is necessary to implement resolution strategies.