



# LUXEMBOURG

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### TECHNICAL NOTE—MANAGING PROBLEM BANKS AND SYSTEMIC BANKING CRISES

August 2017

This Technical Note on Managing Problem Banks and Systemic Banking Crises for Luxembourg was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in July 2017.

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July 2017

## TECHNICAL NOTE

MANAGING PROBLEM BANKS AND SYSTEMIC BANKING  
CRISES

Prepared By  
**Monetary and Capital Markets  
Department and  
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This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Luxembourg. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

BCL	Banque centrale du Luxembourg
BRRD	European Union Bank Recovery and Resolution Directive (2014/59/EU)
CBL	Clearstream Banking Limited
CMG	Crisis Management Group
CRD IV	European Union Capital Requirements Directive IV (2013/36/EU)
CRR	European Union Capital Requirements Regulation (Regulation (EU) 575/2013)
CSSF	Commission de Surveillance du Secteur Financier
CPDI	<i>Conseil de Protection des Déposants et des Investisseurs</i> (the Depositors and Investors Protection Council)
D-SIB	Domestically Systemically Important Bank
DGS	Deposit Guarantee Scheme
DGSD	European Union Deposit Guarantee Scheme Directive (2014/49/EU)
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECJ	European Court of Justice
EDIS	European Deposit Insurance Scheme
ELA	Emergency Liquidity Assistance
ERC	European Resolution College
EU	European Union
FGDL	Fonds de garantie des dépôts Luxembourg (the Deposit Guarantee Fund)
FMI	Financial Market Infrastructure
FOLTF	Fail or Likely to Fail
GLRA	Group Level Resolution Authority
G-SIB	Globally Systemically Important Bank
IGA	Intergovernmental Agreement
IRT	Internal Resolution Team
JST	Joint Supervisory Team
LFA	Loan Facility Agreement
LFS	Law on Financial Sector
LSI	Less Significant Institution
MoF	Ministry of Finance
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NCA	National Competent Authority
NCWO	No Creditor Worse off than in Liquidation
NRA	National Resolution Authority
PDI	Depositor and Investor Protection Department
PRS	Preferred Resolution Strategy
RC	Resolution College
SI	Significant Institution
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism

## EXECUTIVE SUMMARY

**The landscape for managing problem banks in Luxembourg has changed fundamentally in recent years.** As part of the euro area, Luxembourg is now part of a “Banking Union” (BU) where the European Central Bank (ECB) has exclusive competence to directly supervise significant institutions (SIs) while the Commission de Surveillance du Secteur Financier (CSSF), under the oversight of the ECB, directly supervises less significant institutions (LSIs). Competences for bank resolution are shared between the Single Resolution Board (SRB) and the CSSF. By transposing the BRRD and DGSD in late 2015, the authorities introduced a new resolution framework and a public deposit insurance scheme. The Resolution Board and the Depositor Protection Council were established within the CSSF to carry out resolution and administer the deposit insurance scheme respectively.

**In addition to increasing staffing for resolution, the CSSF should pay attention to any potential conflicts of interest in the decision-making process related to supervisory and deposit insurance functions.** Operational tasks related to resolution are conducted by the CSSF’s Resolution Department. In view of its significant work load, the authorities should continue their efforts to increase Resolution Department staffing. While supervision and resolution functions are structurally separated from each other within the CSSF, the same does not appear to be true for supervision and deposit insurance functions. As allowed under the current framework, the Director responsible for the Banking Supervision Department is also the Director responsible for the Depositor and Investor Protection Department (PDI) and in that capacity, chairs the Conseil de Protection des Déposants et des Investisseurs (CPDI). Structural arrangements should be put in place to address any potential conflicts of interest between the supervisory and deposit insurance functions.

**The CSSF began to implement recovery planning requirements in 2013.** All banks have now submitted at least their initial recovery plans and the relevant authorities (the CSSF for LSIs or the ECB for SIs) have formally provided feedback and recommendations for improvements. Most of the more significant banks have submitted revised plans.

**Early intervention triggers and powers are adequate.** The intrusiveness of the measures available to the ECB and the CSSF increases gradually from requiring the bank to hold additional capital and liquidity to intervention in the management function of the bank by appointing a temporary administrator.

**Resolution planning is at an early stage and there are many challenges ahead.** Resolution plans for the largest banks are being developed by the SRB and the CSSF Resolution Department, which is also preparing plans for the most important LSIs. Resolution planning for these banks began in 2015, with initial plans now having been reviewed by the SRB where appropriate. Under SRB leadership, revised plans for most large banks have been finalized recently or will be prepared in 2017. At present the plans for banks that would likely meet the “public interest test” for the use of the resolution tools set out in the BRRD and Luxembourg’s 2015 Law are currently focused on the use of the bail-in to absorb losses and recapitalize a bank in resolution. The means to use other resolution tools, such as the sale of business tool and the bridge bank tool, have yet to be well

addressed, nor have the means to ensure adequate liquidity funding in resolution. As bail-in alone may not prove sufficient to resolve a bank, work on these matters should be accelerated. Additionally, under SRB policy, resolution planners cannot contemplate the use of the Single Resolution Fund (SRF) in their plans. Thus, plans do not address how the SRF access requirements would be met. To contribute to adequate planning, this policy should be reconsidered. The goal should be to have in place credible and feasible resolution plans for the most important Luxembourg banks as soon as possible.

**Certain characteristics of the Luxembourg financial system present special challenges.** Given the importance of the investment fund (e.g., Undertakings for Collective Investment in Transferrable Securities) industry to the Luxembourg economy, the authorities could decide at their discretion to exclude the deposits held by investment funds with the resolved banks to avoid potential systemic consequences of a bail-in. But doing so in the case of some banks (e.g. those also engaged in private wealth management services) could give rise to significant claims under the so-called “No Creditor Worse Off” (than in liquidation) safeguard in the event other creditors in the same class are subject to bail-in. The large intragroup claims of Luxembourg subsidiaries on their foreign parents and affiliates, if still outstanding at the time the parent or affiliate entities are put into resolution, also present a challenge in that they could be potentially bailed-in (and effectively written-off) to support loss absorption in the parent/affiliate, which in turn may adversely affect the viability of the subsidiaries.

**There is room for improvement in cross-border cooperation.** The designation of a branch as “significant branch” under the CRD IV allows the host Member State to participate in cooperation mechanism within the EU (supervisory colleges, resolution colleges, Joint Supervisory Teams, and Internal Resolution Teams) and thus review recovery and resolution plans. The recent conversion of several Luxembourg subsidiaries into branches indicates that Member States hosting branches that are not “significant branches” but that provide “critical functions” to the local economy also have an interest in reviewing recovery and resolution plans, but their access to cooperation mechanisms are constrained. This should be taken into account by EU level initiatives addressing the implications of branchification. There is also a need for the SRB to continue, and the CSSF to seek, to establish cooperation and coordination arrangements with third-country authorities.

**The powers to transfer the assets and liabilities of a bank during winding-up procedure should be made explicitly available.** Although insured deposits are to be paid out in 7 days, transfer powers are needed for orderly liquidation of banks, which would also maximize value for creditors and reduce costs for the Fonds de garantie des dépôts Luxembourg (FGDL). In that regard, there is a need to make such transfer powers explicitly available in liquidation. Finally, the creditor hierarchy plays a vital role for the implementation of the new resolution framework in respect of loss allocation, and the application of No Creditor Worse Off than in liquidation safeguard. The creditor hierarchy in Luxembourg is determined by different laws, which is difficult to interpret with clarity. The authorities could seize upon the recent European Commission (EC) proposal on the harmonization of the creditor hierarchy as an opportunity to enhance the clarity of creditor hierarchy rules.

**While the discussions on a common euro area deposit insurance scheme is ongoing, a new deposit insurance scheme is in place in Luxembourg, which lacks back-up funding.** The new deposit insurance scheme targets a fund balance twice that required in relevant EU legislation, and the timetable for being able to make rapid payouts is well advanced. However, at present, there are no backstop funding arrangements in place and these should be pursued. As a last resort, however, public funding in compliance with the state aid rules could be necessary.

**The Banque centrale du Luxembourg (BCL) has a contingent framework in place for the provision of ELA.** However, these arrangements have not been communicated to the resolution authorities, which may impede adequate resolution planning. Also, the general terms and conditions of a possible state guarantee for the extension of ELA have not yet been laid out by the BCL and the MoF—progress on this front would be needed.

**In principle, the SRF is available to support resolution funding, subject to certain conditions.** Backup funding arrangements for the unfunded portion of the national compartment are in place, but a common BU wide backstop for the SRF is not. Contingency plans should be in place to address a situation where the SRF is insufficient.

**Arrangements for the management of a system-wide financial crisis in Luxembourg have yet to be fully developed.** The MOF should take the lead to ensure that the domestic authorities in coordination with the BU authorities have a clear understanding of their respective roles in the case of such a crisis. Contingency plans should be developed and they should be tested by means of crisis simulation exercises.

**Table 1. Luxembourg: Summary of Recommendations**

Recommendation	Authority	Time
<p><i>Institutional Arrangements</i></p> <ul style="list-style-type: none"> <li>• Develop structural arrangements to safeguard the autonomous conduct of different functions</li> <li>• Continue staffing Resolution Department</li> </ul>	<p>CSSF</p> <p>CSSF</p>	<p>NT</p> <p>C</p>
<p><i>Recovery and Resolution Planning and Resolution Implementation</i></p> <ul style="list-style-type: none"> <li>• Provide more guidance for recovery and resolution planning (e.g., on defining critical functions, including with respect to custodian functions, and addressing large intragroup claims)</li> <li>• Streamline SRB decision-making to ensure timely resolution action and clarify the ECB's role in triggering resolution for LSIs under the direct remit of the SRB</li> <li>• Advocate the integration of host countries into cooperation mechanisms for recovery and resolution planning where they host branches providing critical functions</li> <li>• Develop cooperation arrangements with third-country authorities</li> <li>• Accelerate resolution planning in most significant banks</li> <li>• Give consideration to fallback resolution strategies in the event the preferred resolution strategy cannot be implemented</li> <li>• Reconsider blanket preclusion of the use of the SRF in resolution plans</li> <li>• Provide guidance and ensure clarity on essential policy issues (e.g., liquidity funding in resolution, core business lines and material entities, terms and conditions for bridge bank)</li> <li>• Develop policies and procedures to address challenges in implementing sale of business tool (e.g., in the case of critical domestic retail/commercial and custodian functions) and bridge bank tool</li> <li>• Clarify that the departure from <i>pari passu</i> treatment of creditors is allowed with respect to all resolution tools</li> <li>• Allow the transfer of assets and liabilities during liquidation</li> <li>• Ensure the clarity and transparency of creditor hierarchy, including the BCL's lien right and the ranking of SRB's preferential claims</li> </ul>	<p>ECB, SRB</p> <p>EU*/ECB and SRB</p> <p>ECB, SRB and CSSF</p> <p>CSSF, SRB</p> <p>CSSF, SRB</p> <p>CSSF, SRB</p> <p>SRB</p> <p>SRB</p> <p>CSSF, SRB</p> <p>EU*/SRB</p> <p>MoF</p> <p>MoF</p>	<p>I</p> <p>NT</p> <p>NT</p> <p>NT</p> <p>I</p> <p>I</p> <p>NT</p> <p>I</p> <p>NT</p> <p>NT</p> <p>NT</p> <p>MT</p> <p>NT</p>
<p><i>Financial Safety Net and Funding in Resolution</i></p> <ul style="list-style-type: none"> <li>• Continue advocating BU-wide backstop for the SRF and a common BU-wide DGS</li> <li>• Arrange for backstop funding for FGDL.</li> <li>• Discuss the terms and conditions of state guarantee for ELA</li> <li>• The BCL should continue to pursue additional contingent FX funding arrangements</li> </ul>	<p>MoF</p> <p>CSSF</p> <p>MoF, BCL</p> <p>BCL</p>	<p>C</p> <p>MT</p> <p>NT</p> <p>MT</p>
<p><i>Systemic Crisis Management</i></p> <ul style="list-style-type: none"> <li>• MOF should seek to achieve clarity and agreement on the roles and responsibilities of the domestic authorities, and eventually the ECB and the SRB, in dealing with a system-wide crisis</li> <li>• Contingency plans should be tested and enhanced via simulation exercises</li> </ul>	<p>MoF</p> <p>MoF, CSSF, BCL, CAA</p>	<p>MT</p> <p>NT</p>
<p>C–Continuous; I–Immediate: within 1 year; NT–near term: 1 to 3 years; MT–medium term: 3–5 years.</p> <p>*Relevant addressees of these recommendations are to be identified in view of the competences of the EU institutions regarding the adoption of legislative acts under the Treaty on the Functioning of the European Union.</p>		

# INTRODUCTION<sup>1,2</sup>

## A. Scope

**1. This Technical Note analyzes the bank failure mitigation and resolution regime, as well as arrangements for managing a financial crisis, in Luxembourg.** It summarizes the findings of the FSAP mission undertaken during the period November 29–December 14, 2016. It focuses on the supervision of recovery planning by banks, early intervention in banks by the authorities when problems are identified, resolution planning by the resolution authorities, the institutional and legal framework for bank resolution and financial safety nets, and the authorities' preparedness to deal with a potential system-wide crisis. The assessment presented in this note is based on an analysis of the legal framework and documentation relating to policies and procedures, and on discussions with and representations made by the authorities and private sector.

## B. Banking Industry Landscape

**2. Luxembourg's financial sector is large relative to its economy and global in scope.** Its main components are the investment fund and money market industry (€3.8 trillion in assets under management or 72.2 times GDP), the banking industry (€747 billion in assets or 14.3 times GDP), the insurance industry (€205 billion or 3.9 times GDP). In general, the banking sector is engaged in four functions. A small number of banks engage in domestic retail and commercial banking services and dominate the local mortgage market. Most banks are internationally-oriented, providing (i) investor services to Luxembourg domiciled international investment funds (safekeeping/custody, fund accounting, and transfer agent services), (ii) private wealth management, and (iii) intragroup liquidity management and treasury services. The banking sector is overwhelmingly comprised of foreign-owned subsidiaries and branches: of the 144 banks domiciled in the country, just five are domestically owned (accounting for 7 percent of industry assets), including two wholly state-owned banks.<sup>3</sup> One bank is a financial market infrastructure (FMI) that clears and settles international payments and securities transactions and offers related securities depository services globally.<sup>4</sup>

**3. A number of banks in Luxembourg are systemically important or significant.** Four banks of the six banks designated by the CSSF to be domestically systemically important (D-SIBs) in Luxembourg are subsidiaries of banking groups deemed globally systemically important (G-SIBs) by the Financial Stability Board (FSB) in Basel. Four other FSB-designated G-SIBs operate significant subsidiaries in Luxembourg. As of the start of 2016, six banks were designated as "Significant Institutions" (SIs) by the ECB, but by early 2017 this number will have been reduced to three, in two cases by virtue of a change in legal status from subsidiary to branch (Table 2). In addition to SIs

<sup>1</sup> Given the 'supranational' nature of the Banking Union, some recommendations in this note go beyond national responsibilities and legislation.

<sup>2</sup> This note was prepared by David Scott, External Expert for the Monetary and Capital Markets Department, and Ender Emre (Counsel), IMF Legal Department.

<sup>3</sup> Banque et Caisse d'Épargne de l'État and Société Nationale de Crédit et d'Investissement.

<sup>4</sup> Clearstream Banking Luxembourg.

headquartered in Luxembourg, many Luxembourg-based entities are branches or subsidiaries of SIs in other Banking Union member states. In total, 61 of 143 banks in Luxembourg were under the direct supervision of the ECB as of June 30, 2016.

<b>Table 2. Luxembourg: Status of Key Luxembourg Banks</b>					
<b>Bank</b>	<b>Group HQ</b>	<b>D-SIB</b>	<b>LU SI</b>	<b>OTHER SI</b>	<b>G-SIB</b>
Banque et Caisse d'Épargne de l'État (BCEE)	LU	X	X		
Precision Capital S.A. (PCAP)	LU		X		
• Banque Internationale à Luxembourg (BIL)		X	X		
• KBL European Private Bankers S.A. (KBL)			X		
Société Générale S.A.	FR			X	X
• Société Générale Bank and Trust		X		X	
BNP Paribas	FR			X	X
• BGL BNP Paribas		X		X	
Deutsche Bank	DE			X	X
• Deutsche Bank Luxembourg		X		X	
Credit Agricole, S.A.	FR			X	X
• CACEIS Bank Luxembourg (to be converted to a branch on January 1, 2017)		X		X	
JP Morgan Chase	US				X
• J P Morgan Bank Luxembourg (JPM)			X		
State Street	US				X
• State Street Bank Luxembourg S.C.A. (became an LSI in 2016 under EU-wide group restructuring)			(X)		
UBS	CH				X
• UBS (Luxembourg) S.A. (became a branch of UBS Germany in 2016)			(X)		
Royal Bank of Canada	CA				
• RBC Investor Services Bank			X		
Clearstream International S.A.	DE				
• Clearstream Banking S.A. (CBL)					
D-SIB = Domestically systemically important bank in Luxembourg (O-SII in EU terminology). LU SI = Banks/groups designated Significant Institutions (SIs) in Luxembourg by the ECB. Other SI = Banks/groups designated SIs in other Banking Union states. G-SIB = Globally systemically important banks as defined by the Financial Stability Board (G-SII in EU terminology). (X) = SI at start of 2016 but no longer.					

**4. The internationally-oriented banks are often providers of liquidity to their parents or affiliated groups entities outside Luxembourg.** Many banks have large exposures to their foreign parents or affiliated group entities. The main source of this funding is deposits placed with the

Luxembourg banks associated with the provision of investor services. The Luxembourg authorities have availed themselves of provisions in the CRR that provide for a waiver of the large exposures limit in the context of intragroup exposures.

## C. Legal Framework

**5. The legal framework for managing problem banks in Luxembourg has changed fundamentally in recent years.** As part of the euro area, Luxembourg is now part of a “Banking Union.” This resulted in the conferral of certain powers to the ECB and SRB in accordance with the Single Supervisory Mechanism (SSM) Regulation and Single Resolution Mechanism (SRM) Regulation respectively. Also, the authorities transposed the BRRD and DGSD by “the Law of 18 December 2015 on the Resolution, Reorganization and Winding up Measures of Credit Institutions and Certain Investment Firms” (the 2015 Law). In addition to establishing a new resolution framework and a public deposit insurance scheme, this law amended the Law on Financial Sector (LFS) to introduce recovery planning and new early intervention measures. The 2015 Law also amended the CSSF’s organic law to establish new internal bodies and departments to carry out the duties and tasks related to resolution and deposit insurance.

# INSTITUTIONAL ARRANGEMENTS

## A. European Institutions

**6. In Luxembourg, as a member of the BU, the ECB and SRB play a significant role in bank supervision and resolution.** The roles of the ECB under the SSM and the SRB under the SRM mainly fall into three categories: (i) the exercise of direct supervision powers by the ECB, and resolution planning and resolution decision-making powers by the SRB over the institutions under their respective remits; (ii) the oversight of the NCAs by the ECB and NRAs by the SRB in the discharge of their competences; and (iii) where necessary to ensure consistent application of supervisory and resolution standards, the exercise of their respective powers for the institutions under the purview of NCAs and NRAs. The roles of the ECB and SRB, and the institutions under their remit will be elaborated further in the subsequent sections of this note.

## B. Domestic Institutions

**7. Despite the transfer of significant competences to the ECB and SRB, the domestic institutional setting remains important.** The domestic authorities contribute significantly to the work of the ECB and SRB with respect to Luxembourg banks by participating in Joint Supervisory Teams (JSTs) and Internal Resolution Teams (IRTs), respectively, and through information exchange. Domestic authorities are also responsible for all banks not under the remit of those two institutions.

The domestic authorities relevant to this Background Note are the CSSF, the FGDL, the BCL and the Ministry of Finance (MoF).<sup>5</sup>

**8. The CSSF plays a key role in its different capacities.** The CSSF is a public institution established under the direct authority of the MoF. The governance structure includes a non-executive board and three boards responsible for decision making regarding the CSSF's functions on supervision (Executive Board), resolution (Resolution Board) and depositor protection (Depositors and Investors Protection Council). The non-executive board is responsible for adopting the budget of the CSSF before it submits to the Government, setting the general policy of the CSSF and giving opinions upon a request on the dismissal of members of the Executive Board (see below).<sup>6</sup> This non-executive board approves the rules and regulations of the Executive Board but has no power regarding supervisory decisions, nor is it involved with resolution functions or deposit insurance functions.

**9. The CSSF is the "national competent authority" (NCA), the supervisory authority, responsible for early intervention and supervision of recovery planning for all "less significant institutions" (LSIs).** Decisions in this regard are taken by the Executive Board (Direction) composed of five Directors, including the General Director, who are appointed to renewable five-year terms by the Grand Duke on a proposal from the Government.

**10. The CSSF is the "national resolution authority" (NRA) for banks not under the remit of the SRB, and implements resolution actions in all banks.** Decisions regarding resolution are taken by the newly established Resolution Board (Conseil de Résolution), composed of five members, including the Resolution Director (who serves as Chairman), the Director of the Treasury, the Director General of the BCL, the CSSF Director in charge of banking supervision, and a magistrate appointed by the Grand Duke. The Resolution Director heads the Resolution Department, which carries out its tasks separately from other CSSF departments. To that end, it has its own budget that is consolidated under the CSSF's budget. Its staff is recruited and dismissed by the Resolution Director and directly reports to the Resolution Director. The members of the Resolution Board and Resolution Department staff enjoy legal protection in the discharge of their duties unless they acted with gross negligence and are indemnified for legal expenses incurred when defending themselves. The Resolution Board and Resolution Department have access to information held by the other departments of the CSSF. The Resolution Board has recently adopted its "Internal Rules" regarding information sharing and cooperation with the Executive Board and the CPDI (described below).

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<sup>5</sup> The 2015 Law also established the resolution fund, Fonds de Résolution Luxembourg ("FRL"), operated by the CSSF. However, under the SRM, national financing arrangements are largely replaced by the SRF. Currently only 11 Luxembourg branches of third country institutions and 6 investment firms contribute to the Luxembourg Resolution Fund.

<sup>6</sup> Please see the TN on Banking Supervision for the recommendations on removing the Government's powers regarding the approval of the CSSF's budget and proposing to the Grand Duke the dismissal of the entire Executive Board (dealing with supervision) upon a policy disagreement.

**11. The Resolution Department is advised to continue bolstering its staff numbers. The Resolution Department had 10 staff at the end of 2016.** This is expected to be increased to 13 by the end of 2017. It can also leverage private sector experts (e.g., lawyers, valuation experts). Despite the increases, existing and planned staffing levels are not sufficient. Though progress has been made in staffing the SRB, the bulk of the operational work within the SRM continues to be performed by the NRAs. For example, due to the current scarcity of staffing, Resolution Department engages actively in 10 of the 40 Internal Resolution Teams (IRT) established within the SRB to coordinate the work related to SIs relevant to Luxembourg. Staffing is also needed to enable the Resolution Department to contribute to development by the SRB of policies required to help accelerate resolution planning. The authorities' efforts in increasing the human resources of the Resolution Department is laudable but should be stepped up.

**12. The Fonds de garantie des dépôts Luxembourg (FGDL), the deposit guarantee fund, was established in 2015 as a "pay box" operated by the CSSF.** To minimize the operational costs of the FGDL, the CSSF is charged with executing the FGDL's operational tasks. This function within the CSSF is carried out by the Depositors and Investors Protection Council (Conseil de Protection des Déposants et des Investisseurs, or CPDI). Also a Management Committee<sup>7</sup> was established within the FGDL with the same members of the CPDI. The CPDI is responsible for determining the contributions to the FGDL, and the amounts to be reimbursed to depositors in case of a payout event. In addition to payouts, FGDL is responsible for contributing to resolution upon a request by the Resolution Board if the latter considers that the resolution action is necessary to ensure depositors' access to their funds. The Management Committee is responsible for collecting contributions, paying out insured depositors at the request of the CPDI and determining the investment policy for the fund. Both the CPDI and the Management Committee are operationally assisted in their tasks by the CSSF's Depositor and Investor Protection Department (PDI). The members of these boards and the PDI staff are legally protected in the same manner as the members of the Resolution Board and staff of the Resolution Department.

**13. Structural arrangements should be put in place to address any potential conflicts of interest in the decision-making processes related to the supervisory and deposit insurance functions.** While the FGDL has its own separate legal personality and Management Committee, its key functions are carried out by the CSSF. This arrangement has been put in place for cost effectiveness purposes given the FGDL's sole "pay-box" mandate. While the supervision and resolution functions are structurally separated from each other, the same does not appear to be true for supervision and deposit insurance functions. As allowed under the current framework, the Director responsible for the Banking Supervision Department is also the Director responsible for the PDI and chairs the CPDI. Given that the supervisory function within the CSSF is also responsible for triggering deposit payouts for LSIs, this may result in a potential conflict of interest (e.g., forbearance) in the decision-making process related to the supervisory and deposit insurance functions. Structural arrangements should be in place within the CSSF to ensure the operational

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<sup>7</sup> The authorities initially planned the FGDL as solely a fund operated by the CPDI. During the legislative process, the FGDL was granted legal personality to ensure the separation of its funds from the CSSF.

autonomy of the supervisory and deposit insurance functions and reporting lines should be reviewed accordingly.

**14. The BCL may provide emergency liquidity assistance (ELA) outside normal Eurosystem monetary policy operations conducted by the ECB and is responsible for supervising the general liquidity situation of the markets as well as evaluating market operators for this purpose.** In that regard, the BCL is involved in Joint Supervisory Teams (JSTs) within the SSM for SIs. It also has an arrangement with the CSSF under which the BCL carries out liquidity surveillance of 25 large LSIs while the CSSF carries out liquidity surveillance for the remainder.<sup>8</sup> This division of tasks, however, does not affect the responsibilities of the BCL and the CSSF as provided by their respective laws. Therefore, the CSSF retains ultimate overall responsibility for LSIs and if, for instance, an enforcement action is required in respect of a bank under BCL surveillance, it is the CSSF that will take the action.

**15. The Finance Minister is required by the 2015 Law to approve draft decisions of the Resolution Board which may lead to a call for public support or have systemic consequences.** Also, as noted, the Director of Treasury is a member of the Resolution Board providing a channel of communication to the Finance Minister to be appraised of all possible resolution actions and their potential implications. The MoF also participates in resolution colleges described later in this note as a member though it does not vote for joint decisions in these colleges.

## C. Summary of Recommendations

- **Continue to increase the Resolution Department's staff**
- **Develop structural arrangements to safeguard the autonomous conduct of supervision and deposit guarantee functions**

# RECOVERY PLANNING AND EARLY INTERVENTION

## A. Single Supervisory Mechanism

**16. The establishment of the SSM placed prudential supervision, early intervention, and recovery planning for SIs in the euro area under the exclusive competence of the ECB as of end-2014.** Under the SSM Regulation, the supervision<sup>9</sup> of LSIs is primarily the responsibility of the NCAs.<sup>10</sup> However, the ECB may decide to directly supervise an LSI if deemed necessary to ensure the

<sup>8</sup> Please see the Technical Note on Banking Supervision regarding the recommendation on the formal documentation of this arrangement between the CSSF and the BCL.

<sup>9</sup> The supervision of credit institutions within the SSM and in Luxembourg is relevant for this note from the perspective of recovery planning and early intervention.

<sup>10</sup> EU Regulations 1024/2013 (the "SSM Regulation") and 468/2014 (the "SSM Framework Regulation") establish the division of labor and cooperation arrangements between the ECB and NCAs under the SSM.

consistent application of high supervisory standards.<sup>11</sup> The ECB designates SIs on the basis of consolidated accounts and following the designation of a group as SI, the ECB can exercise its powers with regard to the banking subsidiaries and branches of that group established in Member States participating in the SSM.<sup>12</sup> As of June 30, 2016, 61 of 143 banks in Luxembourg were under the direct supervision of the ECB. The ECB also carries out supplementary supervision of financial conglomerates in relation to banks included in the conglomerate. The ECB is involved in relevant supervisory colleges as home supervisor or host supervisor. While conducting direct supervision, the ECB has the powers conferred on NCAs by EU law. These include the powers in the national legislation transposing EU Directives or, where an EU Regulation explicitly grants Member States options, national legislation exercising this option. In that regard, both SIs and LSIs are supervised under a common legal framework with due regard to the principle of proportionality.

**17. In addition to its direct supervision duties, the ECB is also responsible for indirect supervision of LSIs to ensure the effective and consistent functioning of the SSM.** To carry out this duty, the ECB is empowered to issue regulations, guidelines and general instructions to the NCAs. The NCAs are required to notify the ECB of any material supervisory procedures and draft supervisory decisions as well as institution-specific information on a regular or ad-hoc basis (such as the rapid or significant deterioration of an LSI).

**18. From an operational perspective, supervision of SIs is a joint exercise between the ECB and the NCA.** Joint Supervisory Teams (JSTs) undertake day-to-day supervision including recovery planning and early intervention for each SI within the SSM. As a general principle, JSTs are led by ECB coordinators and include a sub-coordinator and staff from the home NCA as well as staff from other interested NCAs. For specific functions, such as recovery planning, the JST is supported by the horizontal specialized expertise functions of the ECB<sup>13</sup> and NCAs.

## B. Recovery Planning

**19. All banks in the European Union are subject to recovery planning requirements.**

Recovery plans are prepared by banks at the highest level of consolidation<sup>14</sup> and are assessed either by the JSTs in the case of SIs, or by the home NCA in the case of LSIs. LSIs may be allowed to prepare recovery plans under simplified procedures. For banks with operations in the EU outside the BU, the plans are shared with and assessed by the relevant supervisory colleges. Plans are shared with the relevant EU resolution authority (SRB or NRA), which may identify any actions in the

<sup>11</sup> This may occur, for example, in cases where financial assistance has been requested or received from the European Financial Stability Facility or the European Stability Mechanism. (SSM Regulation Article 6(5)(b)).

<sup>12</sup> Recital 38 of SSM Regulation.

<sup>13</sup> The Crisis Management Division within DG MS IV.

<sup>14</sup> The BRRD does not rule out the possibility of individual recovery plans for group entities. Such individual plans for group entities may be decided by a joint decision in the supervisory college or the host NCA may request an entity to prepare an individual plan in the absence of a joint decision in the supervisory college (Article 8(2) and (4) of the BRRD).

recovery plan that could adversely affect the resolvability of the institution and make recommendations to the supervisory authority.

**20. The CSSF began to implement recovery planning requirements in 2013.** Initial recovery plan preparation guidance was issued by the European Banking Authority (EBA) in that year. The CSSF prioritized banks and requested certain of them to submit plans, referring them to the EBA publications for guidance in preparing plans. By year-end, four banks had submitted initial recovery plans. Two other banks submitted initial plans by February 2015. By July 2015, nine additional LSIs had submitted initial plans. An additional 27 LSIs submitted initial plans by the end of 2015. Among these, three banks for which the CSSF is the group level consolidated supervisor had provided group recovery plans.

**21. The ECB became responsible for recovery planning by SIs in 2015. The respective JSTs rely largely on the home NCA and ECB specialists to assess the plans.** The JST provides feedback letters to the banks identifying areas for improvements. As noted, plans for two domestically oriented Luxembourg SIs, had been requested by CSSF in 2013. These plans were reviewed by ECB and feedback letters were provided in 2015. Revised plans for these banks have been submitted. The plan for another bank which was only designated an SI in 2016 was first submitted in 2015 and a feedback letter was sent by CSSF. A revised plan has been submitted. The plan for the fourth SI was first submitted in January of 2015, a feedback letter was sent by ECB, and a revised plan was submitted. Four other Luxembourg D-SIBs are covered by group recovery plans of BU-based G-SIBs. The CSSF is a member of these groups' JSTs and is, in the case of some banks, requesting more explicit and comprehensive coverage of the Luxembourg subsidiaries in the plans.

**22. The CSSF remains responsible for supervising recovery plans of LSIs.** All LSIs have been notified as to whether they are to submit full scope plans<sup>15</sup> or plans prepared under simplified obligations.<sup>16</sup> In general, the top ten banks ranked per each of the mandatory indicators prescribed by the EBA were required to submit full scope plans. LSIs designated as "high priority" (HP LSI) by the ECB are required to submit full scope plans. All subsidiaries where the parent is based in a third country (i.e. outside the EU) are required to submit recovery plans independent of the existence of a group recovery plan. The CSSF required some LSIs to submit full scope plans due to their business model, including the largest custodian banks. All LSIs have now submitted at least their initial plans and feedback letters have been sent.

**23. The ECB along with the CSSF is working to improve recovery plans.** The feedback letters sent by the JSTs and the CSSF communicated recommendations for improvement and/or changes to be made in the plans. Thus far, no "material deficiencies" have been identified in the plans,<sup>17</sup> though,

<sup>15</sup> Full scope plans must adhere to all ECB and EBA requirements, including additional obligations for groups, and must be updated at least annually.

<sup>16</sup> Recovery plans prepared under simplified obligations need to be updated only every two years, unless there are material changes to the legal or organizational structure of the institution, its business or its financial situation.

<sup>17</sup> Where material deficiencies or material impediments to plan implementation are identified, the JST requires the bank to submit within two months, extendable by one month, a revised plan demonstrating how those deficiencies or impediments are addressed.

as the supervisors' standards are clarified, possibly in coordination with resolution authorities, it cannot be precluded that material deficiencies will be identified in future. The main general findings have been documented and are being addressed. However, five LSIs, including one college bank, had not passed the initial quick completeness check when submitting their first (group) recovery plan. Consequently, they were requested to re-submit the recovery plan within the 2-month extendable period.

**24. As a host authority, the CSSF participates in the assessment of group recovery plans of EU banking groups based in non-BU jurisdictions.** The CSSF assesses these recovery plans from the perspective of the Luxembourg subsidiaries of the groups (e.g., U.K. and Sweden based) and contributes to a joint decision on the assessment of the group recovery plan. The assessment at present is largely focused on whether the groups' Luxembourg operations are appropriately identified as material legal entities, core business lines and/or critical functions in the group plan. The recent conversion of some important subsidiaries to branches restricts the involvement of the CSSF in assessing relevant recovery plans. This matter is addressed below in the section on cross-border cooperation in resolution planning.

**25. Additional EU level guidance would be useful to assist in recovery planning.** The main findings by the ECB and CSSF during the review of recovery plans indicate a need to further assess critical functions of the banks. There have been cases where the CSSF did not agree with the criticality assessment made by the banks in relation to their custodian functions. An SRB task force, in which the ECB participates, is developing an assessment template which will be shared with the industry in February 2017. One goal is to help clarify what functions are deemed critical and thus require specific attention in both recovery and resolution plans. This work should be brought to conclusion so that adequate guidance is provided for the assessment of the criticality of custodian functions.<sup>18</sup> Additionally, many Luxembourg subsidiaries have large intragroup claims on their foreign parents and/or affiliated entities that can give rise to highly significant liquidity and capital consequences in times of stress. The ECB and CSSF should define for banks specifically how such claims are to be addressed in recovery planning. Such guidance could complement the improvements that could be made in the supervisory framework and practices regarding intragroup exposures (please see the Technical Note on Banking Supervision for a detailed assessment of intragroup exposure framework in Luxembourg and the relevant recommendations).<sup>19</sup>

<sup>18</sup> This guidance would also address which entities should be deemed "material entities" and which activities should be deemed as "core business lines."

<sup>19</sup> In the context of intragroup exposures, banks in Luxembourg enjoy a waiver of the large exposures limit if they comply with certain conditions. Noting that the underlying risk remains despite several improvements, the Technical Note on Banking Supervision puts forward a suite of recommendations (non-exhaustive) from which the CSSF could apply one or more. These include, *inter alia*, formalizing the approval process and requiring the applicants to await authorization before availing of the use of the waiver, introducing specific limits for maturity and currency transformations, requiring banks to submit specific details on intra-group exposures, and intensifying the policy of applying capital add-ons and seeking collateralization.

## C. Early Intervention

**26. The 2015 Law strengthened the early intervention framework in Luxembourg.** At the EU level, the CRD IV already included measures to address problems in a bank at an early stage. While these measures were incorporated into Luxembourg law, the SSM Regulation also granted the same powers to the ECB for SIs. To give the authorities stronger capabilities to handle problems in an ailing bank, the BRRD introduced a common set of early intervention measures which were transposed into Luxembourg law with the 2015 Law and can also be used<sup>20</sup> by the ECB. The ECB and CSSF are responsible for the application of early intervention measures to SIs and LSIs respectively, and as noted the ECB has the power to decide to exercise direct supervision of an LSI. The use of intervention powers by the CSSF must be communicated promptly to the ECB.

**27. The triggers for early intervention are adequate.** Intervention is triggered based on failure to comply with existing regulations and, more proactively, likely failure to comply with (risk-based) regulations due, inter alia, to a deteriorating financial condition, including deteriorating liquidity, increased leverage, non-performing loans or concentration of exposures. The CSSF is in the final stages of transposing the EBA May 2015 guidelines on early intervention triggers, which are largely but not exclusively based on the Supervisory Review and Evaluation Process (SREP) for each bank.<sup>21</sup>

**28. The early intervention measures are comprehensive and being employed.** The ECB and the CSSF can require the bank to hold additional capital and liquidity, implement recovery plan measures, draw up an action plan, negotiate debt restructuring with its creditors, and change its business strategy and legal or operational structure. Where these powers are insufficient to reverse the deterioration of a bank's financial situation or to remedy infringements, the ECB or the CSSF may remove management. Finally, if the removal of management is not considered as a credible option, a temporary administrator can be appointed to carry out management functions of the bank.<sup>22</sup> The write down and conversion of capital instruments (i.e. common equity Tier 1, additional Tier 1 or Tier 2 instruments) may also be used as an early intervention measure to prevent the failure of a bank.<sup>23</sup> The CSSF has used its powers under the CRD IV on several occasions to impose business restrictions.

<sup>20</sup> Articles 4 (3) and 9 (2) of the SSM Regulation.

<sup>21</sup> EBA Guidelines identify the following indicators for triggering early intervention measures: i) Overall SREP score and pre-defined combinations of the Overall SREP score and scores for individual SREP elements (e.g., where Overall SREP Score is "4", the competent authority should, without undue delay, take a decision on whether to apply early intervention measures); ii) material changes or anomalies identified in the monitoring of key financial and non-financial indicators under SREP revealing that the conditions for early intervention are met; iii) significant events indicating that the conditions for early intervention are met (e.g., major operational risk such as rogue trading, significant deterioration in the amount of MREL or significant outflow of funds).

<sup>22</sup> While the power to appoint a temporary administrator may have uses in certain scenarios—for instance, in cases of persistent conduct-related violations—the relative risks and benefits in appointing a temporary administrator should be considered carefully, particularly its impact on market confidence.

<sup>23</sup> As set out later in this note, the write down and conversion powers may also be used in combination with a resolution action, where the remaining conditions for entry into resolution have been met.

## D. Summary of Recommendations

- **The ECB, in cooperation with resolution authorities, should provide more guidance on defining critical functions and the treatment of large intragroup claims by subsidiaries on foreign group entities in recovery plans.**

# RESOLUTION REGIME

## A. The Single Resolution Mechanism

**29. As noted, bank resolution within the BU falls under the scope of the SRM.** Under the SRM, the SRB is responsible for resolution planning and resolution decision-making for: (i) all SIs; (ii) any LSI directly supervised by the ECB; (iii) LSIs that are part of cross-border groups<sup>24</sup> operating within the euro area and not falling into first two categories; and (iv) any other LSI where resolution would require the use of the Single Resolution Fund (SRF). The SRM centralizes resolution planning and decision-making at the SRB, while implementation is primarily the responsibility of the NRAs using national law. The NRA also is responsible for resolution planning, decision-making and implementation for LSIs not under the direct remit of the SRB. The SRB has an oversight role regarding decisions taken by NRAs in respect of LSIs. With respect to both SIs and LSIs, the SRB maintains back-up authority to intervene and directly exercise resolution powers if necessary to ensure high resolution standards or to ensure that resolution objectives are being met.<sup>25</sup>

**30. The SRB, formally launched in January 2016, began operations in 2015 and focused initially on resolution planning.** It worked with the NRAs to prepare transitional resolution plans (TRPs) for banks deemed a priority (generally the SIs). In 2016 the NRAs, now under more specific SRB guidance,<sup>26</sup> submitted so-called Phase II plans for most priority banks, as well as TRPs for additional banks. In the course of preparing resolution plans, a number of policy matters were identified. Among them, already in 2016, the SRB worked with NRAs to set initial, standardized group level external MREL targets to help enable bail-in. In 2017, the SRB will further specify the nature of the MREL targets, including with respect to the specific components of MREL as well as the internal distribution of MREL among group entities, an important matter in Luxembourg. The SRB intends to address other key policy issues.<sup>27</sup>

**31. The SRB has made progress in establishing working procedures with relevant authorities.** The SRB and ECB have concluded a Memorandum of Understanding (MoU) providing for representation of each authority as an observer in the other's meetings and cooperation and

<sup>24</sup> Article 7(2)(b) of the SRM Regulation refers to these groups as "other cross-border groups."

<sup>25</sup> As well, NRAs have the authority to ask the SRB to assume such responsibilities.

<sup>26</sup> Mainly in the form of the SRB's Resolution Planning Manual, which provides non-binding guidance to NRAs regarding preparation and assessment of resolution plans, and conducting resolvability assessments.

<sup>27</sup> See Resolution Tools and Implementation section of this note.

exchange of information in early intervention, recovery and resolution planning, and in resolution actions.<sup>28</sup> In addition, the MoU provides that, in a Crisis Management Group (CMG) for a G-SIB, the SRB and ECB will coordinate their work.<sup>29</sup> The EC has established a permanent task force to engage with the SRB.<sup>30</sup> The SRB has developed a framework for cooperation with the NRAs, including establishing IRTs led by SRB staff through which to coordinate activities with respect to individual countries or individual banking groups. While the SRB has rehearsed its procedures for taking resolution decisions, it has not yet carried out a full simulation of the complex arrangements for entry into resolution.

## B. Cross-border Cooperation

**32. The BRRD and SRM Regulation provide for various mechanisms to help achieve a high-level of cooperation and coordination between Member States.** First, NRAs, NCAs, the ECB, and the SRB are under a general obligation to exchange information and closely cooperate with each other. Second, the SRB and the NRAs are required to give due consideration to the potential impact of their decisions in other EU Member States. Third, for banking groups solely operating within the BU, decision making is centralized within the SRB so that the SRB itself may decide the resolution scheme. Fourth, where a cross-border group operates in EU Member States not participating in the BU, or is based in a third country, resolution colleges (RCs) and European resolution colleges (ERCs) facilitate coordination and cooperation among Member States (Box 1). Finally, the implementation of resolution tools and the exercise of resolution powers in an EU Member State is given automatic and mutual recognition and is enforced in all other Member States.<sup>31</sup>

**33. The conversion of several Luxembourg subsidiaries to branches raises questions as to the adequacy of cooperation mechanisms with respect to branches within the EU.**<sup>32</sup> The NCA and NRA of a Member State hosting branches can only be a member of the supervisory and resolution colleges, and participate in JSTs and IRTs, if it hosts a "significant branch."<sup>33</sup> A branch can be designated as "significant" by the consolidating supervisory authority (i.e., ECB or the relevant home NCA) if (i) it holds at least 2 percent of total deposits in the host country; (ii) its closure is likely to impact systemic liquidity and payment and settlement services in the host country; or (iii) it is sizeable and important to the host country due to the number of its clients. One bank designated as

<sup>28</sup> The SRB only participates in ECB Supervisory Board meetings upon invitation, for items related to its tasks and responsibilities (such as deliberations on recovery plans or the deteriorating financial conditions of an institution).

<sup>29</sup> The SRB chairs CMGs, but the ECB will chair CMG topics related to recovery planning.

<sup>30</sup> The EC must validate resolution actions proposed by the SRB. See Box 2.

<sup>31</sup> The use of resolution tools prescribed under the BRRD qualifies as "reorganization measures" within the EU Reorganization and Winding Directive for Credit Institutions ("Winding-Up Directive") (2001/24/EC), and thereby receives mutual recognition and enforcement in other Member States.

<sup>32</sup> This so-called "branchification" issue is not unique to Luxembourg.

<sup>33</sup> This is in contrast with the membership of the NCAs and NRAs of subsidiaries in such colleges, JSTs and IRTs, regardless of the significance of such subsidiaries.

a D-SIB by the CSSF and another bank designated as an SI by the ECB<sup>34</sup> are not considered "significant" following their conversion into branches. The essence of resolution planning (as well as recovery planning) is to ensure the continuity of "critical functions", which is determined by assessing the potential impact of the loss of activities and services deemed important to financial stability. A feature of so-called "branchification" is that branches whose activities and services are deemed "critical functions" by the Luxembourg authorities may not qualify as "significant" within the meaning of CRD IV.<sup>35</sup> The consequence is that the CSSF is not entitled to participate in supervisory and resolution colleges<sup>36</sup> and JSTs, and it does not have automatic access to IRTs established for these banks. Hence, its ability to assess recovery and resolution plans as they relate to critical functions in Luxembourg is constrained.<sup>37</sup>

**34. As the Luxembourg case illustrates, the concept of "significant branch" may not always be appropriately aligned with the cooperation arrangements necessary for recovery and resolution purposes.** There is a need to integrate Member States hosting branches into cooperation mechanisms insofar as these branches' functions are deemed "critical" for the local economy. The ECB and CSSF should advocate at the EU level<sup>38</sup> for a policy change to that end. Until such a change is made, the Luxembourg authorities are encouraged to engage with relevant home authorities in line with the CRD IV, which foresees cooperation between the home and host NCAs for the designation of a branch as "significant branch".

**35. Under its organic law, the CSSF is required to consider the impact of its decisions not only at the EU level but also at the international level.** While requiring Member States to take into account the consequences of their decisions in other Member States, the BRRD and SRM Regulation do not contain an explicit provision requiring resolution authorities to consider the effects of their decisions in third countries. The provision in the CSSF Law is useful in that it allows the CSSF to take into account the consequences of its decisions in third countries without prejudice to its duty of loyalty to other Member States.

<sup>34</sup> On the basis of having assets greater than 20 percent of Luxembourg's GDP.

<sup>35</sup> For instance, CRD IV stipulates a 2 percent deposit threshold for a significant branch designation. The EBA, on the other hand, does not recommend a quantitative threshold for market share when assessing critical functions (<https://www.eba.europa.eu/-/the-eba-advises-on-resolution-procedures-for-eu-banks>). By the same token, a bank may hold more than 2 percent of the deposits in the host country but that does not mean per se its deposit taking activities are "critical".

<sup>36</sup> The BRRD also requires that EU/EEA consolidating supervisors and group level resolution authorities transmit recovery and resolution plans to the competent authorities and resolution authorities of the jurisdiction where "significant branches" are located (Article 7 and 13 of the BRRD).

<sup>37</sup> It should be noted, however, that in the case of the Luxembourg D-SIB converted into branch, the CSSF still remains in the JSTs and IRTs due to the existence in Luxembourg of another bank subsidiary of the same group.

<sup>38</sup> The EBA recently published a consultation on guidelines regarding the supervision of "significant branches" which are systemically relevant ("significant-plus branches"). These guidelines make reference to "critical functions" and the need to cover such functions of "significant-plus branches" in recovery plans. However, it should be noted that these guidelines are relevant for the branches that are designated as "significant branches". Please see: <https://www.eba.europa.eu/documents/10180/1699755/Consultation+Paper+on+Guidelines+on+supervision+of+significant+branches+%28EBA-CP-2016-24%29.pdf>

**36. Cooperation and coordination with third-country authorities is allowed, albeit under certain conditions.** Information exchange is allowed only if the third-country authorities are under a confidentiality regime equivalent to that applying to the Resolution Board. Also, the handling and transmission of personal data should be compliant with EU and Luxembourg data protection laws. Information exchange and coordination can also take place in RCs or ERCs. Participation in these colleges is subject to the request of the third-country authority and an affirmative decision of the Resolution Board or the SRB, as GLRA. When its request is accepted, the third-country authority can only be granted an "observer" status.

**37. While there are improvements at the EU level, no cooperation arrangements have yet been concluded for resolution purposes by the Resolution Board.** There is no cooperation arrangement concluded by the Resolution Board as a newly established resolution authority. On the other hand, the EBA shared its draft non-binding framework cooperation arrangements (FCA) with selected third country authorities in 2015. The negotiations with the US on the draft FCA have been finalized but the conclusion of the FCA awaits the completion of internal processes on both sides. Nevertheless, the EBA's draft FCAs are high-level arrangements and therefore they do not eliminate the need for the SRB and the Resolution Board to have arrangements to operationalize such cooperation provided that such arrangements are in line with the EBA's FCAs. The SRB has negotiated cooperation arrangements with the US and Swiss authorities, but no MoU has yet been concluded.

**38. The Resolution Board should establish cooperation arrangements with third country authorities and the SRB should continue its efforts in this area.** Enhancing cooperation and coordination with third countries is a priority for the SRB in 2017. One challenge in this area is the need of the Resolution Board to assess the equivalence of the confidentiality regime of third-country resolution authorities. While EBA provides guidance on the equivalence of confidentiality regimes of third-country supervisory authorities, no similar guidance exists regarding third-country resolution authorities.

**39. The recognition and enforcement of third country resolution proceedings in Luxembourg is permitted by the SRM regulation and the 2015 Law.** Following a recommendation by the SRB for the banks or groups under its competence, the Resolution Board will implement this recommendation. Where the bank or group is subject to its own competence (e.g., third country proceeding implicating solely a Luxembourg LSI), the Resolution Board will decide on recognition and enforcement of such proceedings. In any case, however, the Resolution Board may decide not to recognize or enforce third-country proceedings on several grounds, including the adverse effect of such action on financial stability in Luxembourg or another EU Member State.

### Box 1. Configuration of Resolution Colleges

There are range of resolution college configurations in which the CSSF must be involved, including in its capacity as supervisory authority and the authority administering the deposit guarantee scheme.

**Article 88 Resolution Colleges (Art. 88 RCs):** BRRD Article 88 requires that “resolution colleges” be established by Group Level Resolution Authorities (GLRAs) as a framework for cross-border coordination of all resolution activities. In general, the other members of the Art. 88 RCs are NRAs, NCAs, competent ministries, and deposit guarantee scheme authorities of EU member states where subsidiaries or significant branches are located. The SRB replaces the NRAs for groups or entities falling under its direct remit while NRA’s may attend as observers. Non-EU (third) country resolution authorities, at their request, may be invited to participate as observers, but have no voting rights. It is only the resolution authorities in the Art. 88 RCs that make decisions on resolution plans and schemes.

In Luxembourg, there are two classes of Art. 88 RCs. For banks/groups headquartered within the BU, either the SRB or the CSSF serves as the GLRA. SRB serves as the GLRA for 29 groups and the CSSF for three. For banks/groups headquartered within the EU but outside the BU, the relevant NRA serves as GLRA, and SRB and/or CSSF may participate as members. The CSSF typically will send three staff, representing the resolution, supervision and deposit insurance functions. The CSSF have been invited to participate in the Art. 88 RCs for HSBC (UK), SEB and Nordea (SE), Danske Bank (DK); and Clearstream International (DE).

**EU European Resolution Colleges (ERCs):** BRRD Article 89 requires establishment of “European resolution colleges” (ERCs) where a third country bank operates in more than one EU Member State. ERCs can be led by the SRB or the NRAs. At present no ERCs have been set up though the EBA is completing a mapping, focused first on G-SIBs, to determine appropriate ERC membership. The CSSF is in discussions with three other EU NRAs to determine which will lead the ERCs for two LSI groups.

**G-SIB Crisis Management Groups (CMGs):** The Financial Stability Board (FSB) initiated the establishment of Crisis Management Groups (CMGs) for FSB-designated globally systemically important banks (G-SIBs). As CMGs are tasked with addressing both recovery and resolution, both the supervisory and resolution authorities participate in CMGs. For G-SIBs headquartered in the BU, the ECB and SRB function as co-leads, taking precedence depending on the subject matter (recovery or resolution). For G-SIBs headquartered within the EU but outside the BU, and for G-SIBs headquartered in third countries, the ECB and SRB do or will soon participate as members. The CSSF may participate as observer but in practice will not do so going forward.

In Luxembourg, the SRB is co-lead of the CMGs for Société Générale, BNP Paribas and Credit Agricole (FR), Deutsche Bank (DE), ING Bank (NL) and UniCredit (IT). The SRB is a member of the CMG for UBS (CH) and will soon be a member of the CMGs for JP Morgan Chase. The CSSF is member of the CMG State Street (US).

**Third Country Resolution Colleges:** Third country resolution colleges are established by the resolution authorities for banks with significant cross-border operations that are not designated as G-SIBs. In the context of Luxembourg, the relevant college is that established by the Canada Deposit Insurance Corporation for Royal Bank of Canada where SRB participates as a member and the CSSF as an observer.

## C. Resolution Planning

**40. Resolution planning for significant Luxembourg banks is at an early stage.** In December, 2015 the CSSF submitted TRPs<sup>39</sup> to the SRB for the two domestically oriented Luxembourg SIs as well as for a third SI. Most Phase II plans were submitted in December 2016,<sup>40</sup> though the preparation of the Phase II plan for one SI has been postponed until 2017 pending establishment of the ERC (Box 1). A fourth SI was designated as such in 2016 and a TRP only will be completed in 2017. The resolution plans for four other Luxembourg D-SIBs are under development in the FSB CMGs, and Phase II plans for the BU operations of these groups have been submitted to the SRB.<sup>41</sup> Despite its global significance, no resolution plan has been prepared for CBL.<sup>42</sup> Resolution strategies in most but not all cases envision reliance on single point of entry bail-in. Resolution plans in most cases have not yet achieved the eventual goal that they be credible<sup>43</sup> and feasible.<sup>44</sup> Resolution planning should be accelerated to the extent possible.

**41. The Resolution Board is developing initial resolution plans for some LSIs.** As noted (Box 1), it is the GLRA for three groups led by Luxembourg LSIs and operating in other non-BU EU member states. The first organizational RC meetings were held in 2015. Draft resolution plans for two groups will be agreed in early 2017 while the plan for the third group continues to be discussed in the RC. Other LSIs have been prioritized based on the potential implications for financial stability of their failure and initial resolution plans for these will likely be adopted by the CSSF's Resolution Board in early 2017. It is envisioned that the plans for most LSIs will rely on normal<sup>45</sup> insolvency proceedings. As additional staffing resources become available, plans for more LSIs should be prepared.

<sup>39</sup> As noted, transitional resolution plans are those on which preparation by NRAs began prior to the SBR being formally launched in January 2016 or which are the initial submission by an NRA to the SRB after its launch.

<sup>40</sup> Phase II plans are not yet fully developed plans, but provide an indication of the resolution strategy and set out impediments and other issues that need to be addressed to make further progress.

<sup>41</sup> The CMGs' work related to recovery planning is led by the ECB.

<sup>42</sup> Despite being an LSI in Luxembourg, the CSSF does not have responsibility for preparing the resolution plan for CBL. CBL is owned by a German financial holding company via Clearstream International S.A., a Luxembourg company licensed by the CSSF as a "specialized PFS (professionals in the financial sector)" whose main activity is to hold all the shares of CBL and Clearstream Bank Frankfurt. The SRB has indicated that the terms "group" and "cross-border group" have narrow meanings under the SRM Regulation. According to the SRB, Clearstream International S.A. is not a credit institution nor a parent undertaking, holding company, investment firm or other entity referred to in Article 2 (b) and (c) of the SRM Regulation, and there is no "group" and "cross-border group" within the meaning of Article 3 (23) of the SRM Regulation. Therefore, Clearstream group is not subject to the SRB's remit despite its cross-border operations. In fact, it is the German resolution authority, FMSA, that has responsibility for the group resolution plan. FMSA recently established a RC for this purpose in which the CSSF will participate as a member. For the recommendation that the CBL should be under the remit of the SRB, please see the "Detailed Assessment of Observance of the CPSS-IOSCO Principles for Financial Market Infrastructures-Clearstream Banking S.A. Luxembourg."

<sup>43</sup> Credible in the sense that the authorities have the necessary legal and operational capacity to implement the plan.

<sup>44</sup> Feasible in the sense that the plan can be implemented without causing substantial disruption to the financial system.

<sup>45</sup> The 2015 Law uses the term "normal insolvency proceedings" to refer to insolvency procedures provided therein to apply to banks. For consistency purposes, the same term will be used throughout this note.

**42. SRB policy requires that resolution plans not contemplate access to the SRF for any purpose.** The potential consequence is to hamstring resolution planners into preparing plans that are not credible or feasible. For example, key practical constraints to resolution at present may be the lack of adequate bail-inable liabilities and the lack of adequate funding-in-resolution arrangements. While the SRB's attempt to instill discipline on the part of NRAs may be useful, the blanket exclusion of any consideration of access to the SRF for capital or liquidity purposes may undermine the quality of the plans. It also precludes that the possibility that the plans address how the SRF access criteria will be met. The SRB should reconsider this policy.

**43. The CSSF Resolution Department has prioritized its engagement in the many SRB IRTs relevant to Luxembourg.** In general, the department either participates as a regular member or as a less active member in which case its activities are mainly to receive and provide relevant information and to prepare briefings for the Resolution Board. The department is active in the IRTs for all the Luxembourg SIs and for those relevant to the subsidiaries of G-SIBs which have significant operations in Luxembourg. It is a less active member in other IRTs. Again, additional staffing could facilitate more active engagement in a greater number of IRTs.

**44. In the view of the CSSF, the Luxembourg subsidiaries of groups based in other jurisdiction are not always adequately addressed in the parent resolution plans.** The CSSF assessment of the plans of SIs in other BU jurisdictions is that they often are focused on the top-level institution and do not address adequately the Luxembourg subsidiaries, including how proposed resolution strategies would affect those subsidiaries. Similarly, some G-SIBs in third countries do not provide adequate attention to significant Luxembourg subsidiaries. The CSSF is taking steps to ensure adequate consideration of these subsidiaries in the plans. The CSSF, with the support of the SRB in both its capacity as leader of relevant IRTs and member or future member of relevant CMGs, should continue to pursue these efforts.

**45. The Resolution Board has adequate powers to require changes to enhance resolvability of banks, groups and subsidiaries and branches.** These measures include, inter alia, requiring banks to limit its maximum individual and aggregate exposures, divest specific assets, limit or cease specific activities, change the legal or operational structure of the bank or any entity under its direct and indirect control, set up a financial holding company and issue liabilities to meet MREL requirements. For cross-border banks, these measures may be adopted by a joint decision within the RC at the level of one or several institutions or at group level. In either case, in the absence of joint decision, the Resolution Board can take the measures it deems appropriate.

**46. Resolution planners would benefit from further guidance from the SRB.** Consistent with the priority given to operationalizing bail-in, the SRB's policy focus thus far has been mainly on the amount, quality and location of MREL. Bail-in will likely need to be accompanied by steps to ensure access to adequate funding in resolution for a potentially extended period. Resolution plans are precluded from considering access to central bank ELA as a source of such funding under the BRRD and, as noted, SRB policy precludes consideration of access to the SRF as well. The SRB should provide guidance on how resolution plans should address liquidity funding in resolution. Guidance also should be provided on criteria for determining critical functions, core business lines and

material entities, ensuring access to FMIs in resolution, and on undertaking the various valuations involved in resolution.

## D. Entry into Resolution

**47. For all Luxembourg banks within the SRM, be it under the responsibility of the SRB or the Resolution Board, the same set of triggers apply for entry into resolution.** Three conditions/determinations are needed for resolution: (i) that a bank is failing or likely to fail (FOLTF);<sup>46</sup> (ii) that there are no alternative private solutions, nor supervisory actions (including early intervention measures) or the write down or conversion of relevant capital instruments that could prevent the failure of a bank within a period of time; and (iii) that a resolution action is necessary in the public interest. The FOLTF condition is to be ascertained by the ECB (or CSSF's Executive Board as appropriate) and the second and third conditions are to be determined by the SRB (or Resolution Board where appropriate).

**48. For banks that fall under the authority of the SRB, entry into resolution entails a complex and potentially lengthy process.** In addition to determination as to the existence of resolution conditions by the ECB and SRB, the decisions regarding the initiation of resolution are subject to validation by the EC and European Council according to the SRM Regulation requirements (Box 2). Also, if the resolution scheme adopted by the SRB contemplates the use of the SRF, an EC decision with respect to compliance with state aid rules is required. This complex decision-making structure may impede timely resolution decision-making. Avenues for streamlined and accelerated decision-making for entry into resolution and resolution actions under the SRM Regulation should be explored.

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<sup>46</sup> Article 18(4) of the SRM Regulation. The EBA has issued guidelines regarding the interpretation of the different circumstances when an institution shall be considered to be failing or likely to fail. In general, the EBA Guideline suggest the competent authorities or the resolution authorities, as the case may be, take into account an institution's capital position, liquidity position and compliance with any other requirements for continuing authorization (including governance arrangements and operational capacity). This guideline is formally transposed into Luxembourg law via an internal procedure of the Resolution Department.

### Box 2. Entry into Resolution Under the SRM

The decision-making structure consists of the following steps:

- The ECB, after consultation with the SRB, determines that a SI is failing or likely to fail, and informs the EC and the SRB. The SRB may make that determination if the ECB, within 3 days of having been informed by the SRB of its intention to make that determination, does not do so.
- The SRB, in close cooperation with the ECB, determines that there is no reasonable prospect of alternative private sector solutions, or supervisory actions taken that would prevent failure with a reasonable period of time. The ECB may also inform the SRB that this condition is met.
- The SRB adopts a resolution scheme when it assesses that resolution action is necessary in the public interest, and, immediately after adoption, submits it to the EC.
- The resolution scheme may enter into force only if no objection has been expressed by the Council, or by the EC, within 24 hours after submission. Within this period, the EC either endorses the resolution scheme, or objects to it, with regard to the discretionary aspects of the resolution scheme in the cases not covered below (i.e. Council decisions).
- Also, within 12 hours after submission, the EC can propose to the Council to object to the resolution scheme on the ground that it does not fulfill the public interest criterion. If the Council objects to the resolution scheme on this ground, the entity is orderly wound up in accordance with national insolvency law. The Council provides reasons for its decision.
- Within 12 hours after submission, the EC can also propose that the Council approves or objects to a material modification of the amount of the SRF provided for in the resolution scheme. The Council provides reasons for its decision.
- Within 8 hours, the SRB modifies the resolution scheme in accordance with the reasons expressed by the EC, in its aforementioned objection, or by the Council, in its approval of the modification proposed by the EC.
- Where State aid or the SRF are used to finance resolution measures, the EC must approve this aid. This State aid decision will be prepared in advance and approved before the resolution scheme is approved by the SRB and submitted to the EC for final approval.

**49. There is uncertainty regarding how resolution will be initiated for LSIs that fall under the SRB's remit but that are not directly supervised by the ECB.** For the initiation of resolution, the SRM Regulation requires that the ECB makes the FOLTF determination. Alternatively, if the SRB considers that the FOLTF condition is met, it has to notify the ECB before taking action. In any case, the initiation of resolution is contemplated as a procedure taking place between the ECB and SRB. However, not all banks under the remit of the SRB are supervised directly by the ECB. For instance, a banking group may be an LSI (and thus not subject to direct ECB supervision) but may fall under

the competence of the SRB by virtue of its cross-border operations.<sup>47</sup> Therefore, a question arises as to the involvement of the ECB in initiating resolution for banks or groups that it does not directly supervise.<sup>48</sup> One may justify the involvement of the ECB for such banks or groups on the basis of consistency within the SRM in the implementation of FOLTF condition. However, this may also lead to concerns as to timely initiation of resolution since the ECB would be tasked to make a determination for a bank or group that is not under its direct supervision. Currently, the ECB plans to approach the EC for clarification regarding the role of the ECB in triggering resolution for LSIs under the remit of the SRB. Uncertainties with respect to the ECB's role for such banks should be removed.

**50. Resolution can be initiated if a resolution action is necessary in the public interest, but applying this test in a cross-border context may be a complex one.** When assessing whether a resolution action is necessary in the public interest, the SRM Regulation requires that the SRB take into account the extent to which liquidation could achieve resolution objectives. However, bank liquidation procedures within the Member States are not harmonized, and thus the ability of such procedures to achieve resolution objectives may differ in each jurisdiction. It may therefore prove difficult for the SRB to apply the "public interest" test with respect to a group established in two or more Member States.

## E. Resolution Tools and Implementation

**51. The BRRD resolution tools have been transposed into Luxembourg law.** The 2015 Law introduced four principal resolution tools:

- *Bail-in tool.* In addition to the power to write down or convert capital instruments both during early intervention and in resolution, the BRRD introduces a bail-in tool which allows for the write down of certain liabilities of the bank and/or their conversion into equity. This tool is most likely to be relevant where the aim is to recapitalize the bank and restructure its operations. However, the bail-in tool may also be used to support other resolution tools—for example, to generate capital for a bridge bank that would acquire certain good assets and critical operations of a failing bank (e.g., its deposit book) before winding down the rest of its operations.
- *Sale of business tool.* This tool allows for the sale of the shares of the failing bank, or its assets, rights and liabilities, to a private sector purchaser. As with all the resolution tools prescribed by the BRRD, the consent of shareholders or third parties is not required to execute the sale.
- *Bridge institution tool.* Like the sale of business tool, the bridge institution tool allows for the sale of the shares of the failing bank, or some or all its assets, rights and liabilities; however, the

<sup>47</sup> As of June 2016, there are 15 banking groups falling under the SRB's remit solely by virtue of their cross-border activities. Among them, 5 banking groups have subsidiaries in Luxembourg. Furthermore, the SRM Regulation allows the SRB to exercise its powers directly to an LSI on its own initiative or upon a decision by the relevant Member State. As being LSIs, these groups or entities are not directly supervised by the ECB either.

<sup>48</sup> While the literal reading of the SRM Regulation confers the responsibility to determine FOLTF condition for such groups to the ECB, there is a counterargument that the SRM Regulation should be read in conjunction with the SSM Regulation and thus the NCAs should make the FOLTF determination for such groups as the supervisory authority.

acquirer will be a government-sponsored and possibly government-owned temporary bridge institution rather than a private sector purchaser.

- *Asset separation tool.* This tool allows for the transfer of assets, rights and liabilities from the failing bank to a separate asset management vehicle under the direction of the resolution authority. The asset management vehicle must manage or liquidate the assets with a view to maximizing their value. The asset separation tool may only be used in combination with other resolution tools to minimize implications under the State aid framework.

In addition to these principal tools, the 2015 Law allows the Resolution Board to exercise its power to write down and convert capital instruments outside of resolution thus guaranteeing that losses are first borne by shareholders and then by holders of capital instruments before the use of resolution tools. The 2015 Law also introduced supporting powers, such as the ability to appoint a special manager or impose stays on rights to terminate contracts or execute collateral.

**52. The SRB and the CSSF need to further develop their preferred strategies for managing failing banks.** Consistent with the spirit of the BRRD and with SRB guidance, the CSSF envisions that normal insolvency proceedings with a payout of covered depositors would be employed for most LSIs under the CSSF's remit,<sup>49</sup> as they would likely not meet the public interest test for use of resolution tools (Box 2). For banks engaged substantially in what are deemed to be critical functions, bail-in may be the preferred strategy, with losses in subsidiaries passed up to the parent, accompanied by restructuring that may require the use of other resolution tools. For some groups with multiple subsidiaries in Luxembourg, a combination of normal insolvency proceedings and the use of resolution tools may be appropriate. The CSSF at present is not prioritizing the use of a bridge bank.

**53. As further described below, the Resolution Board (and SRB) face a range of practical challenges to implement the resolution tools and are working to overcome them.** Some efforts may require support at the European level.

### **Bail-in tool**

**54. As noted, work on resolution plans at present is mainly focused on operationalizing the bail-in tool and setting MREL requirements.** The authorities see bail-in as offering the best opportunity to achieve credible and feasible resolution plans in the near term. In principle, the effectiveness of bail-in will depend in part on banks that might be placed into resolution having in place sufficient bail-inable liabilities, which at the BU and Luxembourg levels is the goal of ongoing efforts to establish MREL requirements. The MREL requirement comprises (i) a loss absorption component (to bring capital to zero); (ii) a recapitalization component (to meet the regulatory capital requirement); and (iii) a market confidence component (to restore access to market funding). In 2016 the SRB applied a standardized approach in calculating the amount of each component

<sup>49</sup> As will be described later in this note, the ability to execute an asset and liability (e.g., covered deposit) transfer as an alternative to payout is currently not explicit in law.

applicable to all BU parent banks based on each bank's risk-weighted assets irrespective of the tentative resolution strategy. This yielded an "informative" external MREL target.<sup>50</sup> In 2017, it is envisioned that elements of the resolution strategy may be factored into setting the external MREL target, that the "quality" of MREL (the nature of subordination and proportion of the instruments that comprise MREL) will be further specified, and that the distribution of MREL instruments within group entities (internal MREL) will be defined. Given that many Luxembourg banks are subsidiaries of foreign banks headquartered in the BU, the specification of the nature and amount of internal MREL is a critical matter, as this establishes the capacity by which the subsidiaries can upstream losses and, potentially, recapitalize.

**55. The SRB, in consultation with ECB, is working to achieve a common approach to MREL and operationalizing bail-in.** As noted, the MREL specification is to be transitioned in 2017 from a standardized approach to one tailored to the situation of each bank/group. Incorporating institution-specific factors will require ensuring that MREL is sufficient in amount (i) to absorb losses identified in the level one valuation;<sup>51</sup> (ii) to recapitalize the bank to supervisory standards; (iii) to provide for an additional recapitalization amount to help instill market confidence; and (iv) to provide a confidence margin to be able to absorb losses not identified in the level one valuation that may be brought to light in resolution as well as those that may be inherent in post-bail-in bank restructuring as contemplated in the resolution scheme.<sup>52</sup> The SRB and the CSSF should ensure that MREL determinations in individual banks and groups address each of these components.

**56. The significant intragroup claims of many Luxembourg subsidiaries on their foreign parent and affiliated group entities must also be considered in setting internal MREL targets in those subsidiaries.** In principle, these claims are subject to bail-in if the parent or affiliate is subject to resolution. In, for example, an unanticipated failure of a parent,<sup>53</sup> write-off losses on these claims may well dwarf the subsidiary's regulatory capital and internal MREL issued to the parent, thus rendering the subsidiary insolvent.<sup>54</sup> It is unclear how the SRB and the CSSF will agree to address this risk.<sup>55</sup> The CSSF and SRB should provide clarity for banks to be able to meet their MREL requirements as soon as possible.

**57. The feasibility and credibility of the bail-in tool can be constrained by compensation claims that can arise when departing from pari passu treatment of creditors.** In bail-in, the BRRD and Luxembourg law permits resolution authorities to depart from pari passu treatment of

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<sup>50</sup> This formerly was referred to as an "indicative" target.

<sup>51</sup> The valuation necessary to support the FOLTF determination. See Box 2.

<sup>52</sup> The restructuring envisioned in the resolution strategy might imply downsizing that could also influence the MREL determination.

<sup>53</sup> Where the CSSF has not had time to exercise its discretion to require the subsidiary to reduce the exposures.

<sup>54</sup> Conversion of these claims would give rise to a shareholding in the parent by the subsidiary.

<sup>55</sup> One option being considered by the CSSF is to require that these intragroup claims be collateralized.

creditors in the same class under certain circumstances.<sup>56</sup> Under the Luxembourg creditor hierarchy, some senior claims that might be excluded from bail-in, such as uncovered UCITS deposits, rank *pari passu* with other unsecured deposits and senior unsecured bonds. As in the BRRD, the 2015 Law provides the safeguard that no creditor shall be left worse off in a resolution action than they would have been under normal insolvency proceedings (the No-Creditor-Worse-Off, or NCWO, provisions). Excluding claims such as uncovered UCITS deposits from the scope of bail-in could give rise to potentially significant NCWO claims in the case, for example, of the resolution by bail-in of a Luxembourg bank engaged in custodian functions (and thus holding UCITS deposits) and wealth management services in a single legal entity.<sup>57</sup> NCWO claims must be paid by the SRF and the SRF access criteria give rise to yet additional challenges that must be taken into consideration.<sup>58</sup> (See Resolution Funding later in this section.)

**58. Irrespective of the policy and transitional issues presently associated with bail-in, the CSSF envisions bail-in as only one tool that would have to be used in resolution.** In addition to the policy issues cited above, for some banks there will be a transitional period before the amounts and location of MREL needed to support a bail-in are in place, and in the interim use of other resolution tools needs to be contemplated. CSSF resolution planners also anticipate that post-bail-in restructuring of banks in resolution will usually be required, highlighting the importance of being able to operationalize the sale of business and bridge bank tools in case of need.

### Sale of business tool

**59. The lack of flexibility to depart from the *pari passu* principle may constrain the effective implementation of sale of business (and bridge bank) tools.** The BRRD and Luxembourg legislation explicitly allow for departures from the principle of *pari passu* for the bail-in tool.<sup>59</sup> As recommended by international good practices, however, the ability to depart from the *pari passu* treatment of creditors in a class should also be explicitly available for the application of the sale of business tool and the bridge bank tool. For example, this may be necessary to allow for the transfer of certain liabilities (e.g., uncovered corporate deposit liabilities) but not the other liabilities within the same ranking (e.g., senior unsecured bonds). While it may be possible to read such flexibility into the relevant legislation, the lack of express authority may give rise to legal challenges. Moreover, to minimize the risk that a transfer involving the departure from the *pari passu* principle

<sup>56</sup> For instance, for operational practicality or financial stability reasons, or to maximize value for all creditors.

<sup>57</sup> In the case that UCITS deposits are discretionally excluded from the scope of bail-in whereas the wealth management clients' deposits are bailed-in to absorb losses and recapitalize the bank.

<sup>58</sup> The authorities believe, however, that departing from the *pari passu* treatment of creditors is probably not an issue in the case of a bail-in for the vast majority of banks.

<sup>59</sup> The FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions Resolution recommend that while, in principle, the hierarchy of claims is to be respected, resolution authorities should have the flexibility to depart from the *pari passu* principle if necessary to contain the potential systemic impact of a firm's failure or to maximize the value for the benefit of all creditors.

would not be automatically recognized and enforced in other Member States, changes to this effect should be considered at the BRRD level.<sup>60</sup>

**60. The CSSF faces challenges in being able to execute sales of certain critical businesses.**

As noted, there are four major business lines undertaken by the Luxembourg banking system: domestic retail and commercial banking, investor services, private wealth management, and intragroup treasury services. Of these, domestic retail and commercial banking may be deemed as critical functions, and custodian functions may well be deemed as a critical function the largest banks engaged in investor services. There are limited number of banks engaged in retail functions in Luxembourg and thus a limited market for the sale of retail business lines.<sup>61</sup> For a variety of reasons custodian functions are time-consuming to transfer from one legal entity to another, with most market transactions of this nature requiring at least three months and potentially up to nine.<sup>62</sup> The authorities should factor these issues into resolution planning and develop policies to tackle them.

**Bridge bank tool**

**61. The use of a bridge bank can serve as an effective fallback solution where a suitable arrangement with a private sector acquirer under a sale of business tool transaction cannot be achieved.**

Where the authorities are unable to conclude a private sale within the required timeframe or on acceptable terms, critical functions may be transferred to a bridge bank and subsequently sold to the private sector. Existing law provides a clear basis to establish a bridge bank. The bridge bank is to be controlled by the Resolution Board, and there are a range of options for its ownership. As noted, the emphasis in resolution plans is currently on bail-in,<sup>63</sup> and no consideration is being given to operationalizing the bridge bank tool. As a contingency, the CSSF should consider how it might use and operate a bridge bank, including ownership, governance and funding arrangements. To facilitate this, the SRB should provide clarity on its expectations regarding the terms and conditions under which the bridge bank tool can be employed.

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<sup>60</sup>Recent court cases demonstrated the uncertainty as to whether the actions taken by an NRA that do not precisely match the terms of the BRRD will be given effect in another Member State. See *Goldman Sachs International v Novo Banco*, *Guardians of New Zealand Superannuation Fund v Novo Banco*, and *Bayerische Landesbank v Heta Asset Resolution*. Clarification at the EU level would minimize the risks that a transfer involving the departure from the principle of *pari passu* treatment would not be subject to automatic recognition and enforcement by other EU Member States.

<sup>61</sup> The authorities note, however, that retail banking has generated robust earnings during periods of market turmoil, making it an attractive activity for investors or banks not yet established in Luxembourg.

<sup>62</sup> The sale of custodian functions also gives rise to potentially significant NCWO claims as discussed above in the context of bail-in.

<sup>63</sup> For subsidiaries, as noted this would involve writing off equity and converting debt instruments issued to the parent (to the extent that issuing such debt instruments is eventually required—see discussion of policy issues associated with setting MREL, above) so as to recapitalize the subsidiary outside of resolution, with bail-in at parent level if so required.

## Resolution Funding

**62. There are constraints on access to the SRF,<sup>64</sup> the main funding mechanism available to support resolution.** The SRF can support the implementation of resolution actions by providing new capital to facilitate loss absorption and recapitalization, and by providing liquidity support during resolution. In addition, the SRF is to be used to pay successful NCWO compensation claims arising from the departure from pari passu treatment of creditors in the same class when implementing resolution actions. In all cases, a prerequisite for access to the SRF is that shareholders and creditors have collectively first absorbed losses of at least 8 percent of total liabilities and own funds of the bank.<sup>65</sup> This may impede the implementation of any resolution tool necessitating the use of SRF, where there are insufficient bail-inable liabilities to meet 8 percent rule due, for example, to statutory or discretionary exclusions from bail-in.<sup>66</sup> This may be a resolution impediment particularly during the transitional period to meeting MREL requirements.

**63. The ability to meet the conditions for access to the SRF may also present challenges in the context of a systemic crisis involving the failure of multiple LSIs.** As noted, the preferred means for dealing with failures of most LSIs is via normal insolvency proceedings. Since there is no need to recapitalize such banks in resolution, their MREL requirement might be equivalent to their regulatory capital requirement. However, in a systemic crisis, the resolution authorities may have good reason to be reluctant to use normal insolvency proceedings for such banks. Yet, lacking an MREL buffer above regulatory capital that can be written off to help meet the eight percent threshold access to the SRF for any resolution funding purpose would be precluded. The potential inability to access the SRF in such circumstances highlights the importance of putting in place explicit asset and liability transfer powers under liquidation (normal insolvency proceedings). See Insolvency Regime, below in this Section.

**64. The ability to ensure adequate post-resolution liquidity funding is a significant challenge for resolution planners, particularly in the context of bail-in.** The implementation of bail-in may give rise to a market reaction that leads initially to a significant withdrawal of funding. There is little experience in calibrating the amount of capital additional to regulatory requirements that will be sufficient to maintain or reestablish market confidence in these circumstances. If plans for ensuring post-resolution liquidity funding prove insufficient, resolution authorities may need to take additional resolution actions. This indicates the need for the SRB and CSSF to have fallback plans in place. See Section on Financial Safety Nets and Funding in Resolution, below.

<sup>64</sup> See Financial Safety Nets and Funding in Resolution section, below, for a description of the SRF.

<sup>65</sup> A second constraint is that the amount provided by the SRF is limited to the lesser of five percent of the bank's total liabilities and own funds or the means available to the SRF plus any amounts that could be raised through ex post contributions in the following three years.

<sup>66</sup> For example, where the resolution authorities wish to exclude from bail-in UCITS deposits and thus there are insufficient other liabilities to absorb losses to meet the 8 percent threshold.

## Role of Courts

**65. While the judicial review regime in Luxembourg strikes a balance between the rights of interested parties and financial stability concerns, the implications of the EU specific judicial review regime have yet to be seen.** As noted, the SRM centralizes decision making but relies for implementation by the NRAs. As a result, judicial review may take place both at the national and EU levels. In Luxembourg, where the courts find the resolution decisions of the Resolution Board illegal, acquisitions by third parties of the shares, assets, rights or liabilities of the bank under resolution are protected. In such cases, the remedy is limited to compensation for the loss suffered as a result of the wrongful decision or act. The SRB's resolution decisions, on the other hand, are subject to ex post judicial review by the European Court of Justice (ECJ).<sup>67</sup> In reviewing such decisions, the ECJ will only review the legality of the decision taken (and not the substance of the decision)<sup>68</sup>. There appears, however, to be no limitation on the nature of the actions that could be taken by the ECJ. The ECJ may declare the decisions of the SRB void, order the suspension of the implementation of the SRB decision, or reverse the resolution action. This would likely have implications for actions taken at the national level. If, for example, the SRB's decision/instruction to the CSSF was declared void, there would be no legal authority for the CSSF to act (unless the ECJ's decision were to provide otherwise).

## F. Insolvency Regime

**66. The SRM Regulation and the BRRD do not replace the insolvency laws applying to credit institutions.** The BRRD contemplates that the existing insolvency procedures for banks would remain applicable as an alternative<sup>69</sup> to resolution when the criteria for entry into resolution have not been met with respect to a failing bank and/or alongside resolution where the residual parts of a bank will be wound down. Insolvency regime applying to banks also remains relevant in the implementation of resolution (for example, with respect to the hierarchy of claims). While the 2015 Law introduced new resolution tools and powers in accordance with the BRRD, it maintained intact the existing court-based insolvency proceedings (i.e. the suspension of payments and winding-up).

**67. The merits of the suspension of payments procedure under the 2015 Law as a reorganization measure needs to be reconsidered.** Upon an application by the CSSF or the bank concerned, the court can grant an order for the suspension of payments to impose a general moratorium where the bank faces liquidity problems. Additionally, it can be imposed as an interim measure after the license withdrawal where this decision is still not final.<sup>70</sup> This procedure was used during the Icelandic banking crisis as a reorganization measure through a broader interpretation of

<sup>67</sup> Article 86 of the SRM Regulation.

<sup>68</sup> Under the 2015 Law, administrative courts in Luxembourg are also required to take into account the complex economic assessments made by the authorities.

<sup>69</sup> Article 8(5) of the SRM Regulation, Article 32(5) of the BRRD. Please also see recital 45 of the BRRD. During the resolution planning stage, the resolution authorities are required to take into account the feasibility and credibility of insolvency procedures to achieve the resolution objectives (please see Article 10 of the SRM Regulation and Commission Delegated Regulation 2016/75 on the content of resolution plans).

<sup>70</sup> Under the LFS, the license revocation decision can be referred to the court within one month.

the law by the courts. However, several features of this procedure render it inconvenient for reorganization purposes. It requires creditor consent for reorganization, triggers insured deposit payouts within 7 days and allows the bank's counterparties to exercise termination or modification rights. Therefore, it may easily destabilize the situation for the bank. To the extent that the authorities consider that the suspension of payments as a reorganization procedure is a useful instrument under the insolvency framework applicable to banks, the authorities could assess how it could be modified to ensure an orderly restructuring.

**68. The winding-up of banks can only be initiated by courts upon the CSSF's or the State Prosecutor's application.** Such application can be made where the suspension of payments does not rectify the situation at hand, the bank is no longer able to comply with its commitments, or the withdrawal of its license has become final.<sup>71</sup> The grounds for the withdrawal of license provided in the Law on Financial Sector include, *inter alia*, failure to meet prudential requirements on capital, liquidity or large exposures. This allows the authorities to initiate winding-up where they do not see any public interest in using resolution tools and powers upon the bank's failure and before the balance sheet or liquidity insolvency of the bank.

**69. The availability of asset and liability transfer powers under the winding-up procedure needs to be set out explicitly.** The 2015 Law gives significant discretion to the court in determining the winding up method and the general bankruptcy provisions that will apply to the liquidation. In the BCCI and Landsbanki cases, however, the general bankruptcy rules applied by the court did not allow transferring assets and liabilities to a third party. Although the 2015 Law refers to the use of FGDL's funds to transfer assets and liabilities including deposit book transfer,<sup>72</sup> no explicit<sup>73</sup> power is granted either to the liquidator or the CSSF to conduct such a transfer.<sup>74</sup> Given the fact that a winding-up order triggers a deposit payout in 7 days, the legal framework should explicitly provide the authorities the necessary power to conduct such a business transfer in a short notice without creditor consent to ensure orderly wind down of a bank. This would potentially allow retaining some franchise value associated with the bank's business lines and could reduce the costs for the FGDL

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<sup>71</sup> Under Articles 11 and 63-2(1) of the LFS. It should be noted that under the SSM, irrespective of the status of the bank, be it an SI or LSI, the power to withdraw the license is to be exercised by the ECB.

<sup>72</sup> Article 181(3) of the 2015 Law.

<sup>73</sup> It is recommended in the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions that resolution authorities have the power to transfer insured deposits during liquidation to ensure orderly wind down of a bank. As noted in the Key Attributes Assessment Methodology for the Banking Sector, the legal framework should clearly set out such powers.

<sup>74</sup> The authorities consider that the court in its winding-up order can decide the implementation of the provisions of the company law permitting the transfer of the business of a company that is under liquidation. However, this is subject to the discretion of the court. Therefore, there is an ambiguity for the authorities before the winding-up as to whether these transfer powers are readily available during liquidation. Additionally, the conduct of such transfers through the company law provisions raises the question to what extent these provisions are compatible with the objective of orderly wind-down of a bank. For instance, it is not clear whether such transactions will be subject to creditors' consent. Also, prior notice requirements under the company law (at least 1 month in advance of the transaction) may run contrary to the expediency of the situation in the case of a bank. Finally, under the relevant company law provisions, consideration can in principle be in the form of shares in the acquiring company. This is likely to dissuade a willing bank since the transaction would result in a change in its ownership structure.

relative to a deposit payout. As noted before, the availability of transfer powers could also increase the authorities' capacity to handle multiple bank failures through the winding-up procedure (please see paragraph 63 above). Such changes would require revisiting the roles and responsibilities of the CSSF and FGDL during the insolvency proceedings.

#### **70. The creditor hierarchy rules need to support the implementation of resolution tools.**

The creditor hierarchy under the winding-up procedure plays a vital role in resolution as it is a yardstick used to allocate losses to creditors and to determine any compensation to be paid under the NCWO principle. In that regard, clarity and transparency are needed both for resolution planners and also for creditors. The hierarchy of claims in Luxembourg in the winding-up of banks is determined by a variety of laws (e.g, Civil Code, securities law, financial collateral law and the new 2015 Law). This seems to give rise interpretation difficulties<sup>75</sup> regarding the ranking of preferred claims. Also, there exist no precedent clarifying the creditor hierarchy based on the current laws. The MoF has initiated a project to assess the state of the clarity of the creditor hierarchy. The recent EC proposal on developing a harmonized approach for the subordination of senior unsecured bonds in the creditor hierarchy of banks presents an opportunity for the authorities to further clarify the creditor hierarchy rules in Luxembourg.

### **G. Summary of Recommendations**

- **SRB and CSSF should accelerate resolution planning in the most significant banks**
- **SRB should reconsider its policy of a blanket preclusion of the use of the SRF in resolution plans**
- **CSSF and the SRB should continue to work to ensure adequate consideration of significant Luxembourg subsidiaries in group resolution plans in other BU jurisdictions and in third countries**
- **The SRB should provide policy guidance on how resolution plans should address liquidity funding in resolution, criteria for determining critical functions, core business lines and material entities, and on the various valuations involved in resolution.**
- **SRB (and CSSF) should develop any required policy guidance on the treatment of intragroup exposures in setting internal MREL requirements**
- **Streamline SRB decision-making to ensure timely resolution and clarify the ECB's role in initiating resolution for banks/groups not supervised by the ECB**

<sup>75</sup> For instance, the SRM Regulation Article 22(6)(b) provides that the SRB may recover its expenses from the institution under resolution as a "preferred creditor." Luxembourg insolvency law is unclear as to the precise ranking of the SRB's claims among different levels of preferential claims. The ECB has also raised its concerns that the ranking of BCL's claims vis-à-vis other creditors needs further clarification ([https://www.ecb.europa.eu/ecb/legal/pdf/en\\_con\\_2005\\_12\\_f\\_sign.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2005_12_f_sign.pdf))

- **The CSSF and SRB need to address NCWO and operational challenges in implementing the sale of business tool (e.g., in the case of critical retail and custodian functions)**
- **Clarify that the ability to depart from pari passu treatment of creditors in a class are available under all resolution tools**
- **Contemplate fallback strategies, including the potential use of the bridge bank tool**
- **The SRB should provide clarity on its expectations regarding the terms and conditions under which the bridge bank tool can be employed and funded.**
- **The SRB should continue and the CSSF should seek establishing cooperation arrangements with third country authorities.**
- **The ECB and CSSF should advocate at EU level the integration of host Member States into cooperation mechanisms for recovery and resolution planning insofar as these plans relate to the branches providing critical functions to the host country.**
- **Explicitly allow the transfer of assets and liabilities during the winding-up process**
- **Ensure the clarity of creditor hierarchy, including the BCL's lien right and the ranking of SRB's preferential claims**

## FINANCIAL SAFETY NETS AND FUNDING IN RESOLUTION

### A. The Single Resolution Fund

**71. As noted, the SRM Regulation establishes a SRF.** It is owned and administered by the SRB and funded by regular ex ante and, potentially, extraordinary ex post contributions by banks. The SRF will be built up over eight years to a target amount currently estimated to be at least €55 billion (at least 1 percent of covered deposits of all banks within the member states participating in the SRM). The SRF consists of national compartments which can be used to fund resolution measures for banks in the contributing jurisdiction. The use of the national compartments is being progressively mutualized over a period of eight years. The mutualized parts of the compartments in the SRF are available to fund resolution measures in any SRM jurisdiction after a certain percentage of the jurisdiction's national compartment is used.<sup>76</sup> The SRF is a potentially important source of resolution funding. It may fund the losses, recapitalization costs, liquidity needs and other costs and

<sup>76</sup> The prescribed sequencing of use of the national compartments and mutualized financial means varies over the transitional period to complete mutualization, with a declining portion of the national compartment having to be drawn prior to access to the mutualized financial means, after which the remainder of the national compartment can be drawn.

expenses associated with resolution measures only to the extent necessary in order to ensure the effective application of the resolution tools, specifically:

- To guarantee the assets or the liabilities of, or make loans to, an institution under resolution, a bridge institution, or asset management vehicle;
- To purchase assets of the institution under resolution;
- To make capital contributions to a bridge institution and an asset management vehicle;
- To make loans to the institution under resolution, a bridge institution or an asset management vehicle;
- To pay compensation to shareholders or creditors who suffered greater losses than they would have if the bank had been wound up under normal insolvency proceedings (NCWO claims); and
- To make contributions to the institution under resolution in lieu of the write-down or conversion of certain liabilities and/or creditors under exceptional circumstances and subject to certain conditions.<sup>77</sup>

**72. The amount of SRF funding potentially available for resolution measures with respect to Luxembourg banks is roughly € 5.5 billion as of the end of 2016.** This is comprised of the funded amount of the Luxembourg compartment of €105 million, €4.3 billion from the mutualized compartments, and a €1.1 billion bridge financing arrangement in the form of a Loan Facility Agreement (LFA) from the Luxembourg state<sup>78</sup> for the unfunded portion of the Luxembourg compartment. In the case that the Luxembourg compartment and mutualized compartment are not available in sufficient amount, the SRB can first seek ex post contributions from the Luxembourg banks (up to an annual limit currently of around €0.2 billion),<sup>79</sup> and secondly can seek to borrow from the market. If timely access to market financing on reasonable terms and/or in sufficient amount are not available, the SRB can access the Luxembourg LFA. The current level of funding available for Luxembourg compares to the € 3.5 billion in fiscal cost incurred during the 2008/09 crisis.

**73. There is no permanent, common public back-stop funding arrangements for the SRF.** While BU participating states have committed to negotiate arrangements for a common backstop at least by the time the SRF is fully mutualized in 2024, there remains a risk in the interim that the SRF will prove insufficient in amount. This could undermine the efficient functioning of the SRF and its

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<sup>77</sup> SRMR Articles 27 and 76, and BRRD Article 44.

<sup>78</sup> The LFA is the standard bridge financing agreement entered into by most BU participating states. It allows the SRB to draw the funds without any further authorization or agreement of the Luxembourg government or legislature.

<sup>79</sup> The limit is three times the annual ex ante contribution. Due to the way banks in various jurisdictions' premiums are calculated, the annual premiums of Luxembourg banks are set to rise substantially each year, as will thus the limit on potential ex post contributions.

ability to deal with future bank failures. A common backstop could take the form of a credit line from the European Stability Mechanism<sup>80</sup> (or from participating states collectively) and this is the MOF's preferred approach.<sup>81</sup> Any borrowings against the credit line would be reimbursed from extraordinary ex post levies on banks in the medium term.

## B. Deposit Insurance

**74. The Deposit Guarantee Scheme Directive created a common EU framework.** The DGSD introduced harmonized coverage of deposits at €100,000, a requirement for faster payout, and ex ante funding arrangements. The DGSD requires that premiums be risk-based and that by July 3, 2024, each scheme shall reach a target level of at least 0.8 percent of covered deposits.

**75. The Luxembourg Fonds de garantie des dépôts Luxembourg (FGDL) was established in late 2015 with the transposition of the DGSD.**<sup>82</sup> The FGDL covers eligible deposits made in banks in Luxembourg and their branches in the EU. The FGDL does not cover deposits in Luxembourg bank branches outside the EU (i.e. third countries), deposits of other banks or investment firms, deposits by undertakings for collective investment, nor most deposits by pension and retirement funds.<sup>83</sup> Covered deposits as of December 31, 2015, were €28.7 billion. This represents roughly 6 percent of the roughly €490 billion in total deposits. This low proportion of covered deposits is attributable to the sizeable deposits of investment funds and wealth management clients in Luxembourg banks. The funds are kept in a BCL account. The CSSF is empowered to determine when the FGDL is triggered. The FGDL is already subject to a requirement to payout deposits within seven days,<sup>84</sup> though the operational capacity to do so in medium-sized and larger banks is still being put in place.<sup>85</sup>

**76. The FGDL is financed through ex-ante contributions imposed on banks and targets an eventual balance of 1.6 percent of covered deposits.** The risk-based premiums are determined by CPDI. The first contributions were made in Q2 2016. Relative to the EU DGSD's target level of 0.8 percent of covered deposits which needs to be reached in 2024, the FGDL has a target level of twice that, comprised of two fund compartments with target levels of 0.8 percent each. The first

<sup>80</sup> The European Stability Mechanism based in Luxembourg is a crisis resolution mechanism for euro area countries. The European Stability Mechanism can finance recapitalizations of financial institutions via loans to member governments and under very limited circumstances can directly recapitalize financial institutions.

<sup>81</sup> This is a recommendation of the Five Presidents' Report: [https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf)

<sup>82</sup> The FGDL took over functions exercised in the past by the private non-profit Deposit Guarantee Association Luxembourg.

<sup>83</sup> Deposits held by personal pension schemes and occupational pension schemes of small or medium-sized enterprises are covered.

<sup>84</sup> The DGSD requires all DGSs to achieve this no later than 2024.

<sup>85</sup> This involves progressive implementation the required IT platform at FGDL and work by banks to be able to deliver required information to FGDL on a timely basis. FDGL will test all banks' capacity to do so in the second half of 2017.

compartment is to be fully funded at around €230 million by the end of 2018,<sup>86</sup> while the second compartment is to be fully funded by 2026. The CPDI can require banks to make extraordinary contributions in an amount of up to 0.5 percent of covered deposits each year in case the resources in the FGDL are insufficient. The CPDI may enter into agreements with third parties to obtain financing in case the extraordinary contributions from the participating institutions are not available immediately or are insufficient in amount. It is exploring a line of credit with a consortium of banks. The CPDI should pursue these efforts to ensure backstop funding arrangements are in place. As a last resort, however, public funding in compliance with the state aid rules could be necessary.

**77. The authorities have transposed the BRRD requirements regarding the ranking of depositors and the status of FGDL claims in the creditor hierarchy.** As such, covered deposits are senior to uncovered FGDL-eligible deposits of natural persons and SMEs, which in turn are senior to other deposits and ordinary unsecured non-preferred creditors. In the case of a covered deposit payout, FGDL assumes the rights and obligations of the depositor in liquidation.<sup>87</sup>

**78. In addition to paying out covered deposits in the context of normal insolvency proceedings, the FGDL can fund resolution actions in certain cases.** Specifically, in the context of bail-in, FGDL is liable for the amount by which covered deposits would have been written down to absorb the losses in the bank, had covered deposits been included within the scope of a bail-in and been written down to the same extent as creditors with the same level of priority.<sup>88</sup> FGDL is not required to make any contribution for recapitalizing the bank or a bridge bank into which its operations are transferred. In case resolution tools other than bail-in are employed, the FGDL is liable for the amount of losses that covered depositors would have suffered in proportion to the losses suffered by creditors with the same level of priority. In any case, the FGDL's liability cannot exceed losses that would result under normal insolvency proceedings.

**79. The interpretation of the BRRD with respect to deposit insurers', and thus the FGDL's, liability in resolution remains to be clarified.** Article 109 of the BRRD states that "in all cases the liability of the deposit guarantee shall not be greater than the amount of losses that it would have had to bear had the institution been wound up under normal insolvency proceedings." The term "liability" in this provision can be interpreted to mean that the FGDL may not provide gross, upfront support greater than its estimated cost (net of recoveries in liquidation) without taking recoveries from resolution into account.<sup>89</sup> Under this narrow interpretation and given the super preference

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<sup>86</sup> As of September 30, 2016, the balance of the first compartment was €76 million, representing one-third its target level.

<sup>87</sup> The FGDL generally ranks only below the costs of the bankruptcy administration and tax authority and certain employee claims.

<sup>88</sup> BRRD Art. 109.

<sup>89</sup> For example, if a failed bank were to be liquidated and insured deposits paid out the FGDL estimates its net cost would be €10. The alternative is to transfer insured deposits of €60 along with €40 of the failed bank's assets and €20 in cash from FGDL to an acquirer. The FGDL estimates that it would recover €15 of the €20 via its claim on the bankruptcy estate, resulting in a net cost of €5. Interpreting FGDL's liability as its net cost in liquidation (€10) would prevent it from pursuing the least cost alternative.

given to covered deposits, the ability of the FGDL to support resolution powers (e.g., by injecting cash to back a deposit transfer under a sale of business resolution) may be constrained. If this is the case, it should be reconsidered to allow the FGDL to disburse greater funds upfront in a resolution if its estimated final cost, net of recoveries, would be lower. Without such flexibility the transfer powers may not work, especially in unanticipated failure when due diligence is curtailed, or during a crisis when banking assets may not easily be sold, and cash needs to be injected instead to back deposits.

**80. Discussions are ongoing on the missing pillar of the BU—a common euro area deposit insurance scheme.** The EC announced in 2015 a proposal to implement a European Deposit Insurance Scheme (EDIS) for BU members by 2024.<sup>90</sup> The MOF supports the EDIS initiative.

### C. Emergency Liquidity Assistance

**81. In the BU the provision of ELA is the responsibility of the national central banks, subject to potential objection by the ECB.**<sup>91</sup> Luxembourg banks have access to the Eurosystem's single monetary policy credit operations. Collateral requirements are established under the Eurosystem framework. A bank's eligibility for single monetary policy credit is decided by the ECB's Governing Council according to criteria that include the financial soundness of the bank, which generally requires compliance with minimum regulatory capital requirements, as assessed in the first instance by the CSSF with input from the ECB where relevant.<sup>92</sup> In contrast to the provision of liquidity under the single monetary policy, the provision of ELA to Luxembourg banks is a discretionary decision for the BCL, which bears the risk of any loss.

**82. In practice BCL ELA would involve either lending to a solvent bank whose eligibility requirements for accessing monetary policy are not fulfilled, and/or lending against collateral falling outside the established Eurosystem framework.** The BCL's organic law allows it, in exceptional circumstances, to "grant short-term loans to its counterparts while respecting its independence and the provisions prohibiting monetary financing. It shall grant loans on the basis of adequate collateral which may consist of a State guarantee under the conditions previously agreed between the State and the Central Bank." The ECB's Governing Council can object to the provision of ELA by the BCL if it finds that the actual or proposed ELA conflicts with the objectives and tasks of the ESCB or constitutes monetary financing of bank support, and there are established procedures for ex post and ex ante notification of ELA to the Governing Council by national central banks. Any ELA outstanding is reviewed by the Governing Council regularly. No ELA has been provided to a Luxembourg bank since the last FSAP in 2011. A communication between BCL and the MOF regarding a possible state guarantee as provided for in BCL's organic law were initiated but no decisions have been taken. This matter should be brought to conclusion.

<sup>90</sup> See [http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index\\_en.htm](http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm)

<sup>91</sup> The ECB is referred to in this section in its monetary policy authority capacity.

<sup>92</sup> For example, for credit to SIs.

**83. The BCL has policies in place to guide ELA decisions.** In line with the established Eurosystem ELA framework, it will make its own solvency determination based on input from the relevant supervisors (CSSF, ECB) and will use its discretion in this regard. It is taking steps to be able to value, set haircuts for, and perfect liens on the various forms of collateral it deems acceptable. The BCL may wish to consider formulating a policy on the circumstances and conditions under which it might provide ELA in line with the established Eurosystem ELA framework to a bank being resolved under, for example, a resolution strategy and plan. Such a policy could address, for example, situations where the solvency of the counterpart is unclear at present, but where prospective solvency is reasonably assured.

**84. The BCL has limited capacity to provide ELA in FX.** While the BCL does have access to FX from market sources and the BIS, it has no bilateral FX swap arrangements in place with relevant central banks. It should continue to pursue additional contingent FX funding arrangements, possibly by collaborating with the ECB.<sup>93</sup>

**85. BCL's policies and procedural requirements have not been communicated to the banks or to the resolution authorities (Resolution Board and SBR).** Not providing relevant information to the resolution authorities may impede the comprehensiveness and effectiveness of resolution planning. BCL should consider means by which to communicate to resolution planners information about its ELA policies and procedures.

**86. As noted in the previous FSAP, BCL has a special lien right over all the assets of a credit institution for claims arising from monetary and exchange policies, as well from ELA.** The 2011 FSAP recommendation as to the clarification of the scope and triggers for this lien right remains relevant. Given the significant changes in the resolution framework, the interaction of this lien right with the implementation of resolution tools and powers also need to be explored.

## D. Additional Resolution Funding Support

**87. The BRRD's government financial stabilization tools (i.e. temporary public ownership and public equity support) are not included in the SRM Regulation and were therefore not transposed in the 2015 Law, but this does not preclude state involvement as a last resort.** Should SRF and ELA funding not be available or prove insufficient in amount, the Luxembourg state may be able to bring financial resources to bear, subject to state aid rules,<sup>94</sup> to support an effective resolution. In the event of having to do so, the arrangement put in place by the state should also address the recovery of the resources it commits to the full extent possible. This objective should be addressed in relevant contingency planning. See next Section.

<sup>93</sup> For example, BCL could explore whether it could avail itself of swap lines entered into by the ECB.

<sup>94</sup> EC approval required under the state aid rule is subject to 8 percent loss absorption rule.

## E. Summary of Recommendations

- **The MOF should continue to contribute to deliberations on adoption of a BU-wide backstop funding arrangements for the SRF and a common BU-wide deposit insurance scheme**
- **The CSSF should arrange for backstop funding for FGDL**
- **Clarify the interpretation of the FGDL's liability in resolution, and its potential to fund an insured deposit and asset transfer as a less expensive and disruptive alternative to payout**
- **A potential state guarantee of BCL ELA should be discussed between the BCL and the MOF**
- **The BCL should continue to pursue additional contingent FX funding arrangements,**
- **The BCL may wish to consider formulating a policy on the circumstances and conditions under which it would provide ELA in line with the established ELA framework to a bank being resolved under a resolution strategy and plan**
- **The BCL should consider to communicate to resolution authorities information regarding its ELA policies and procedures to enable better resolution planning**
- **Clarify the scope and triggers for the BCL's lien right as well as its impact on resolution tools**

# SYSTEMIC CRISIS MANAGEMENT

## A. Overview

**88. The institutional architecture for the BU largely is designed with supervision and resolution of individual banks and banking groups in mind.** For example, the interactions between the competent (supervisory) authority and the resolution authority on preparing a resolution plan, and between the SRB, the EC, and the Council on the adoption of a resolution scheme, all contemplate the failure of an individual institution or group. However, the simultaneous failure or potential failure of multiple banks in a single or in multiple BU states may require a more comprehensive strategy. At present, there can be ambiguity as to which authorities would be responsible for the design, implementation, and public communication under such a strategy and how the various authorities would coordinate their activities.

**89. The MOF should ensure the preparedness of the authorities to manage a system-wide financial crisis in Luxembourg.** It should seek to achieve clarity and agreement on the respective roles and responsibilities of the ECB and the SRB in planning for and managing such a crisis relative the roles of the domestic authorities. The MOF should pursue adoption of a formal coordination framework among all relevant parties, perhaps first domestically and then with the ECB and the SRB.

The domestic authorities, at least eventually with the involvement of the ECB and the SRB, should develop Luxembourg-specific contingency plans for the management of a system-wide crisis. These plans might necessarily contemplate as a last resort the use of extraordinary financial support from the state, and should address measures that would ensure the state adheres to state aid rules and recovers any resources it commits to the full extent possible. These contingency plans should be periodically tested and enhanced, perhaps initially by the domestic authorities, but at some stage together with the SRB and ECB.

## **B. Summary of Recommendations**

- **MOF should seek to achieve clarity and agreement on the roles and responsibilities of the domestic authorities, and eventually the ECB and the SRB, in dealing with a system-wide crisis**
- **The domestic authorities initially, and with ECB and SRB involvement eventually, should develop Luxembourg-specific contingency plans for the management of a system-wide crisis**
- **Contingency plans should be tested and enhanced via simulation exercises**

## Annex I. Implementation Status of Key 2011 FSAP Recommendations on Safety Net, Bank Resolution, and Crisis Management Framework

Recommendations	Status
<ul style="list-style-type: none"> <li>• Strengthen the deposit insurance scheme through ex ante funding, speedier and automatic payments, the use of funds for bank restructuring, and improved governance.</li> </ul>	<ul style="list-style-type: none"> <li>• The national transposition of the DGSD transformed the private ex post financed deposit guarantee scheme into a public ex ante financed scheme. The Luxembourg DGS has a final target level of 1.6 percent of covered deposits, twice the level required in the DGSD. The first 0.8 percent are to be collected by end 2018, ahead of the 2024 DGSD deadline. Luxembourg already requires a covered deposit payout within 7 working days, which is the 2024 DGSD target payout period.</li> </ul>
<ul style="list-style-type: none"> <li>• Strengthen the bank resolution framework, including by providing for earlier control of problem banks and enhanced resolution tools.</li> </ul>	<ul style="list-style-type: none"> <li>• The provisions of the BRRD involving a new range of resolution tools were transposed into domestic law. The requirements for recovery planning provide the authorities additional mechanisms by which to intervene in problem banks.</li> </ul>
<ul style="list-style-type: none"> <li>• Seek pragmatic solutions in the area of cross-border resolution, such as introducing mechanisms for the mutual recognition of insolvency or reorganization measures or having explicit duties to cooperate among authorities.</li> </ul>	<ul style="list-style-type: none"> <li>• The SRM regulation and the 2015 Law provide for strong cooperation mechanisms with the EU authorities and other Member States. While resolution actions in a Member State are given automatic recognition, third-country resolution proceedings can be recognized and enforced by the Resolution Board. Currently there is no cooperation arrangement signed by the CSSF's Resolution Board with third countries.</li> </ul>
<ul style="list-style-type: none"> <li>• Set up a structured and effective framework for crisis preparedness and management.</li> </ul>	<ul style="list-style-type: none"> <li>• The 2015 Law provide for the roles and responsibilities of the authorities with respect to individual bank failures. No formal and structured mechanisms exist for interagency cooperation and communication for crisis preparedness and management.</li> </ul>

Recommendations	Status
<ul style="list-style-type: none"> <li>Formalize a multipartite domestic framework providing for specific operational procedures to facilitate crisis prevention and decisive, quick and early intervention.</li> </ul>	<ul style="list-style-type: none"> <li>A Systemic Risk Board was established in April 2015. Its composition ensures close cooperation between its members (i.e. the Government, the BCL, the CSSF, and the CAA). Its aim is to help safeguard the stability of the Luxembourg financial system by strengthening the resilience of the financial system and decreasing the build-up of systemic risks.</li> </ul>