



Ambasada Britanică
la Chişinău



The bank recovery and resolution law

Bank recapitalization regime (bail-in) and state guarantee

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*This publication has been funded by the British Embassy in Chisinau, through the Good Governance Fund.
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Why the implementation of the „bank recovery and resolution regime” is crucial for Moldovan banking sector

The banking crisis of the recent period resulting in granting emergency credits of over MDL 14 bn. under Government guarantee and the liquidation of three banks, proved the inefficiency and gaps of the current regulatory framework in ensuring financial stability. At the same time, the financial crisis demonstrated that there is a significant lack of adequate tools at the level of the central bank for managing situations of banks in difficulty efficiently and in due time. This situation also proved to have a significant impact on the destabilization of the entire financial and banking sector. Under these circumstances, there is a need for a strong legal framework in line with the international best practices that could prevent crises in the future and especially one that would include a wide enough range of tools that could be used. Even if at the time being the local financial system seems not to be fully prepared for the application of such tools, the approval of the legal, institutional and regulatory framework on financial stability is one of the major actions aiming to strengthen and reform the financial and banking system of Moldova.

At the same time, this wish derives from the commitments taken by our country in the context of the EU Association Agreement as well, and the bank recovery and resolution regime tends to be in line with the one existing at the EU level accordingly, one providing authorities with a credible set of instruments for sufficient and timely intervention in case of a critical situation a bank might find itself in.

In this regards, the authorities have developed the Bank Recovery and Resolution Law¹, for which the experience of the EU member-states and specifically the provisions of the Directive 2014/59/UE² on establishing a recovery and resolution framework for credit institutions and investment firms was taken into account. According to the authors, the law presents itself as a new state intervention tool, harmonized with the Directive 2014/59/UE and is considered necessary especially in preventing a banking institution from failing. At the same time, when bank failure is inevitable, the law sets to reduce the negative consequences for the population to a minimum, meaning maintaining the main functions of the bank by making it viable if possible, or, case-by-base, by transferring these functions to another entity. Recently, the law was implemented with the *early intervention* procedure applied to BC Moldindconbank.

Among the multitude of new elements, the main instrument taken from the EU practice is the bank recapitalization regime – the bail-in regime, which signals a significant change of strategy on salvaging banks facing collapse. Generally, this is the opposite of the bail-out which implies engaging public money, external to the banking system, in order to ensure the continuation of the functions in failing banks (an “external salvaging” of a bank/system). Through the bail-in, the banks in trouble are salvaged at the creditors’ expense and as a last resort from the money of non-guaranteed deposits (an “internal salvaging” of a bank/system). At the same time, the responsabilization of bank shareholders, as well as managers is attempted³, so that they would take responsibility for the risk they expose themselves to in conducting banking activities and so that these risks are not transferred on the taxpayers.

¹ Bank recovery and resolution law, the Official Gazette No. 329-336 (5762-5769) from 27.09.2015

² Directive 2014/59/UE of the European Parliament and of the Council dated May 15, 2014 on establishing a framework for recovery and resolution of credit institutions and investment firms (BRRD).

³ The bank frauds of the past few years show that often the managers of banking institutions have acted simply as representatives of the shareholders who seek to use bank resources in their personal interests. In this regard, the law provides NBM with new powers related to replacing the management bodies of commercial banks.

The international financial crisis, salvaging banks with public money and the response of regulating authorities

As a result of the severe financial crisis that blew over in 2008, both in the EU and the G20 countries, a large process to consolidate a single regime that would include clear norms and instruments in solving financial crises was launched. This entire process was based on the 2008 experience when after the bankruptcy of the American bank Lehman Brothers, a destabilizing shock was generated affecting the international financial markets. In order to counterweight the expansion of these shocks, Governments from Europe and from all over the world had to inject public money to recover the situation of financial institutions in difficulty. Following this, over the past couple of years an alternative was sought so that in the future spending public money to recapitalize banks that had taken too many risks is prevented, and that shareholders are held accountable in this regard.

In October 2009⁴ the main elements of the new harmonized cross-border banking sector crisis management framework were published. These are grounded in the fact that a specific banking crisis resolution framework should give priority to objectives of „public policy”, as well as **financial stability, bank services continuity and maintaining payment systems**. In this regard the Directive 2014/59/UE is the result of the effort to create an efficient financial crisis resolution framework. It is also a fundamental reform of the financial market regulation and supervision aiming to create a single regime to ensure that the institutions involved coordinate their actions efficiently and have all the adequate and rapid intervention instruments in managing the difficulties the financial institutions are facing.

Among these tools, the recapitalization procedure seems to be a revolutionary one that wishes to be a paradigm change for the concept of failing banks recovery. However, this raises heated discussions at European level, especially regarding the contribution of deponents in solving crises. Accordingly, the EU Directive foresees only the principles, mechanisms and tools that need be transposed into the member-states' legislation, a series of technical norms meant to ensure the functionality of the Directive being in discussions and development.

International practice in applying the bail-in procedure

The bail-in procedure is a relatively new one at global level. Actually, according to Directive 2014/59/UE, up until now no European financial institution was salvaged from bankruptcy through bail-in⁵. Considering the complexity of the Directive, the existing contraindications between European governments regarding the bail-in procedure, as well as the extremely strong lobby from international financial groups, certain reluctance in implementing the provisions is present in several European countries. However, the recent history notes the use of bail-in in the Cyprus banking crisis, and more specifically, in the recovery of the financial situation in two financial institutions with systemic impact.

The banking crisis in Cyprus started as early as 2010, being generated by the big exposure of the banks to the Greek economy, which in turn showed the most severe effects of the global financial crisis of 2008-2009. In general outlines, two of the largest banks in Cyprus, Laiki and the Bank of Cyprus, have continued to expand their portfolio of Greek bonds and at the same time to support capital alienations (in 2010/2011 huge dividends were

⁴ An EU Framework for Cross-border Crisis Management in Banking Sector (COM (2009)0561 final), http://ec.europa.eu/finance/bank/crisis_management/archive_en.htm

⁵ The Directive 2014/59/UE entered into force on January 1, 2016

paid to the shareholders). In 2011 the European leaders have reached a new agreement to salvage Greece, which involved restructuring debts, so losses for all bonds holders. During that year the Cyprus banks have registered huge losses due to the Greek debt restructuring. The two banking institutions (Laiki and the Bank of Cyprus) have suddenly found themselves with capital levels under the limit required by the Cyprus authorities, and about 10% of the credits were qualified as non-performing (For comparison, at the end of August 2016, the Moldovan banking sector registers 16% of non-performing credits). The Cyprus government could not cover this amount, consequently, they requested international financial aid. To ensure their external financial aid, in 2013 the Cyprus authorities imposed the taxation of up to 80% of those with deposits over EUR 100.000⁶ at the Laiki bank and of up to 60% for deponents of the Bank of Cyprus. Another condition was the liquidation of Laiki bank, and for the other bank, the Central European Bank and the Cyprus authorities have developed a recovery plan. This plan included an orderly procedure to restructure bank assets implemented with the institution's resources. This was actually the bail-in procedure and salvaging a financial institution with its resources.

The Cyprus banking crisis was different from those in other states, the Cyprus regulators placing the losses incurred by the banks on the creditors. Besides the need to salvage the banking sector, the authorities were also constrained by the need of a program to finance the economy from external partners. At the same time, in the process of restructuring bank assets, the shareholders, investors and deponents have incurred losses in the bankruptcy order. The first ones were the shareholders, then the investments and non-guaranteed deposits. Still, the limit of EUR 100.000 imposed to all EU member-states was not reached, the deposits below that threshold always being secure.

Considering the Cyprus example, we can say that the situation of the Moldovan banking sector is much more delicate. If the Cyprus banking system needed external funds following some very risky commitments/exposures of the managers, then the Moldovan one ended up in the same situation due to a much more severe reason, namely the bank fraud. Often some assets become non-performing following the deterioration of the general macroeconomic framework of an economy (e.g. The Cyprus banks with big exposure to the Greek economy), while in case of the three local banks⁷ the obscure intentions of some managers and shareholders lead to their collapse. Consequently, it is regrettable that the large-scale bank frauds from 2014-2015 were placed on the shoulders of the taxpayers. More than ever, this eloquent example proves the need of a recapitalization mechanism for banking institutions at the level of the national legislative framework, a mechanism that would increase the accountability of managers, shareholders and other creditors for the risks taken. In addition, according to the Cyprus example, the bail-in mechanism should, to some extent, secure the use of public funds to cover the *mistakes* of others⁸.

The provisions of the bank recovery and resolution Law

The term of ***“bank resolution”*** describes the process of restructuring a banking institution by a resolution authority, in our case NBM, using certain specific instruments. Its main goal is to ensure the continuity of basic functions of the bank (e.g. deposits, accounts, payments). When possible, the intention is to restore its viability, fully, and if not, the

⁶ 100.000 is the minimal threshold guaranteed by the Directive 2014/49/UE on schemes of deposits guarantees, which impose a single deposits guarantee system in all EU member-states.

⁷ C.B. „Banca de Economii”, C.B. Unibank and C.B. „Banca Socială”

⁸ Basically salvaging banks with public money is contrary to the principles of capitalist economy, and collective responsibility for individual mistakes is more of a socialist principle. Consequently, the bail-in procedure come to fix a fault of the global financial system.

compromised assets are liquidated and only the good ones are kept. The new banking crisis management framework, as it was conceived by the authors, is structured on three pillars: (i) preparation, (ii) early intervention and (iii) bank resolution, triggering conditions, involved authorities, competencies and tools that can be applied, as well as their implementation method being established for each pillar.

1. Preparation – the first stage when the need to recover the situation of a bank arises. Each commercial bank develops and periodically updates a recovery plan, and in case of major difficulties, NBM establishes a resolution plan.

2. Early intervention – in this stage, NBM is authorized to take certain measures with respect to a bank if it is breaking the regulatory rules of bank activity. These measures refer to a series of actions that can be imposed on a commercial bank, among which: replacing management bodies, implementing the recovery plan, modifying the business strategy, modifying the legal or operational structure.

3. Resolution – it implies the state authorities' intervention in a bank, in order to restructure it to achieve the objectives of the resolution. The main objectives refer to avoiding negative effects on financial stability, protecting the deponents falling under the Deposits guarantee law⁹, protecting other funds and assets to the extent possible.

When a commercial bank meets all requirements for imposing a resolution, NBM can apply a series of **resolution instruments**. The law does not expressly provide the terms for using one instrument or the other, still, when NBM applies resolution tools, it takes the resolution objectives into account and selects the instruments that allow the most rapid and less costly recovery of the situation.

The resolution instruments that can be applied are:

- **Selling the business** – implies that NBM transfers the shares or other property instruments issued, as well as assets, rights or bonds to a potential viable buyer;
- **Bridge-bank** – implies operating similar transfers to a bank specially created to receive and hold some or all shares, assets, rights and bonds of one or several banks under resolution. This is done to maintain the essential bank functions and further sell the bank. The social capital of the bridge-bank is fully owned by the Ministry of Finance.
- **Asset separation tools** – implies transferring the rights and liabilities of a bank or bridge-bank to an asset management entity. Such an entity is a legal entity with a social capital fully or partially owned by the state, and it is created to receive the assets of the bank under resolution;
- **Recapitalization measures(bail-in)** – within this instrument NBM has more powers in terms of the amount payable for the remaining liabilities of a bank under resolution. These will be redirected toward the recapitalization of the bank under resolution at the expense of certain categories of its creditors¹⁰. Essentially, unlike the *bail-out* mechanism, the losses shall not be covered at the expense of the taxpayer, but by the shareholders and other creditors of the bank.

⁹ Law Nr.575 din 26.12.2003 on individual deposits guarantee in the banking system

¹⁰ The creditors of the bank under resolution sustain losses after the shareholders according to the receivables order of priority within the forced liquidation procedure. Considering that the deponents are creditors of the bank, they fall under the law provisions, except for the deposits falling under the deposits guarantee law.

General findings

The major banking crisis demonstrates that Moldova needs a regulatory framework regarding bank resolution. Once approved, it is in line with international practices and European mechanisms, and it comes to respond to the challenges posed by the defrauding of several local banks, but also by the last international financial crisis. The table below summarizes the results of the new measures of intervention against bank failure, accordingly, the third column showcases the hypothetical results of the law. At the same time, the table presents the impact of bail-out (solution initially admitted for the three liquidated banks which were granted emergency credits under government guarantee) as opposed to the newly proposed solution – the bail-in. Thus, through the bail-in procedure, the taxpayer will be exempt from incurring more costs following frauds committed with the involvement of bank's shareholders and management, as it happened with the approximately MDL 14,8 bn. granted to the three liquidated banks. (The Government has assumed the responsibility on the law on issuing state bonds is currently discussed in the Parliament¹¹).

Table 1. Bail-in vs. Using public money or bank failure

Consequences of actions undertaken	Bank recovery methods		
	Bank failure	External recapitalization (with public money)	Bail-in
Vital bank functions are continued	NO	YES	YES
Financial stability is maintained	No, in case of a systemic bank	YES	YES
The taxpayer is exempted from having to incur costs	YES	NO	YES
Guaranteed deposits are safe	YES	YES	YES
Non-guaranteed deposits are safe	NO	YES	NO
Guaranteed bonds are recovered within the limit of the guarantee	YES	YES	YES
Non-guaranteed bonds are recovered	NO	YES	NO

Source: *Bail-in – preferred alternative to bank failure or using public money*, Bogdan Olteanu, National Bank of Romania 2016, Expert-Grup compilation.

Each selected solution for bank recovery implies certain consequences, namely:

1. In the hypothesis that a bank goes bankrupt, all clients and partners of the bank are affected – debtors, creditors and users of payment services. The only categories that suffer less are the holders of deposits and bonds guaranteed by certain types of contracts with adequate protection. In addition, there will be no direct costs for the taxpayer, and the financial stability will be affected if the bank going bankrupt is a systemic one
2. In case of external recapitalization – internationally known as a bail-out, this procedure will ensure the continuity of vital bank functions (cards, accounts, etc.) Guaranteed deposits will remain safe, covered by the guarantee scheme, and the non-guaranteed bonds will depend on those who will cover the costs from public resources, hence the Government. This system was applied most recently in case of the three banks plundered that were not granted resources from NBM reserves under Government guarantee, in exchange, cost is to be incurred by the taxpayer, through an issue of state bonds.

¹¹ Draft law on state bonds issue by the Ministry of Finance for enforcement of payment obligations derived from state guarantees nr.807 dated 17.11.2014 and nr.101 dated 01.04.2015, currently examined in the parliamentary committees under number 257. <http://parlament.md/ProcesulLegislativ/Proiectedeactelegislative/tabid/61/LegislativId/3278/language/ro-RO/Default.aspx>

3. Recapitalization – the bail-in process, will ensure the continuity of essential bank functions (payments, cards, accounts, etc.) The guaranteed deposits will remain safe, covered by the guarantee mechanism, and the guaranteed bonds will be legally covered within the limit of the guarantee. No with respect to the non-guaranteed deposits and the other non-guaranteed payables, they will be managed by the resolution authority in order to recover the recapitalization money. Conversely, there will be no more costs incurred by the taxpayers (*Annex 1 schematically shows the application of the bail-in procedure*).

An important element of the law is the legal guarantee provided to the creditors that in the bank recovery and resolution process they shall not lose more than more than in the bankruptcy alternative. However, the maximum amount guaranteed by the Deposits Guarantee Fund is of just MDL 6 000, which is extremely small in comparison with the limit imposed to the EU member states (EUR 100 000). At the same time, the deposits guarantee scheme does not cover legal entities. Thus, from the perspective of maintaining the deponents' confidence in the banking system, but also of the development of the domestic financial sector, the deposits guarantee scheme needs to be redesigned, and the guarantee ceiling needs to be increased up to the level of current economic realities

Final conclusions and recommendations

Considering the political and economic context our country found itself in, as well as the pressure the authorities are under regarding unblocking the financial international support, the process of drafting the Bank recovery and resolution law was started in the spring of 2016. The process was a rather short one, the authorities being guided by the timeframe established in the *Roadmap on the priority reforms agenda*¹² and the stringent need of a Financing Agreement with the International Monetary Fund.

The bank resolution foreseen by the law is an alternative to the usual insolvency procedures, that allows the situation of a bank in difficulty to be treated efficiently taking the general public interest into account. Considering that the bank recovery and resolution law foresees that the resolution authority has to prepare resolution plans for each bank (the actions to be taken should resolution become necessary), NBM as well as other involved institutions should not limit themselves to adopting this law, but should transpose the secondary legislation and mandatory technical standards on the main aspects of recovery and resolution developed by the European Bank Authority (EBA)¹³.

Of course, it is very unlikely that the entire banking system fails at the same time, regardless of the laws adopted by the Parliament. However, in the context of transposing the EU Directive on establishing a framework for recovery and resolution of crediting institutions and investment firms into the national legislation and establishing 01.01.2018 as target date when the bail-in tool enters into force, the legal framework related to deposits guarantee in the banking sector which cannot provide a solution in banking crises needs to be modified.

Considering the above mentioned, as well as in order to ensure solid and logical reforms in the financial and banking sector for the following period we consider the following recommendations need to be implemented:

The European regulatory framework on solving banking crises is not reduced to the Directive 2014/59/UE, but goes on with mandatory technical standards regarding the main aspects of recovery and resolution developed by EBA

¹² Roadmap on priority reforms agenda, http://gov.md/sites/default/files/foaie_de_parcuri_privind_agenda_de_reforme_prioritare_.pdf

¹³ The EBA orientation regarding types of tests, examinations or exercises that can lead to support measures within the Directive on recovery and resolution of banking institutions <http://www.eba.europa.eu/documents/10180/821335/EBA-GL-2014-09+%28Guidelines+on+Public+Support+Measures%29.pdf>

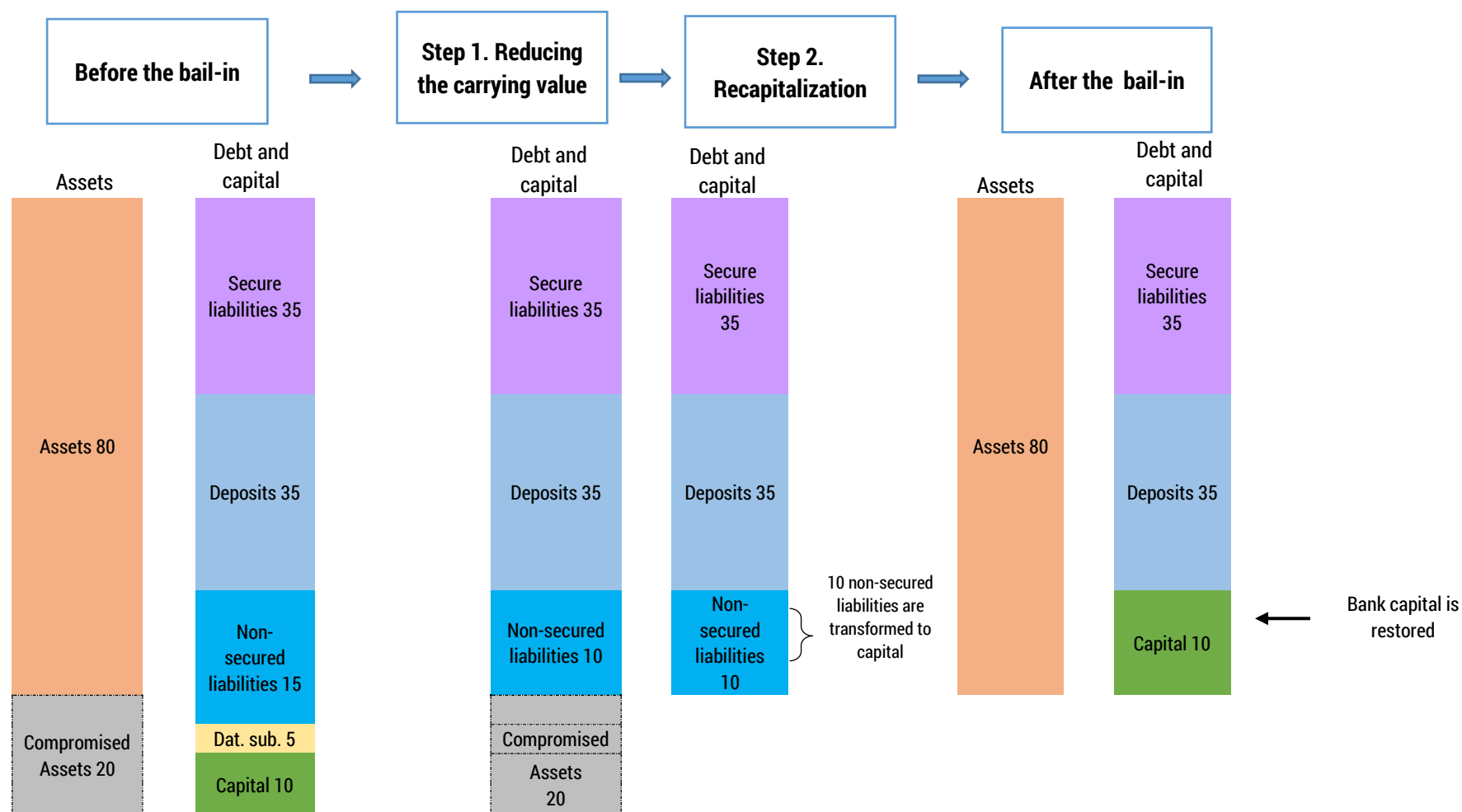
which need to directly be transposed into the NBM regulatory documents;

- With the adoption of the law, the implications of the new provisions and tools on other elements of the financial system have to be taken into account, such as the maximum ceiling for deposits guarantee, the its limit of MDL 6000 not corresponding to the current economic realities anymore;
- The banking crisis and the urgent need to reform the sector lead to certain negligence in observing the commitments taken by signing the EU Association Agreement. Thus, a calendar plan needs to be developed for the harmonization of the legislation on financial services according to the Georgian and Ukrainian model;
- Although the law provides the establishment of the National Macroprudential Authority, there were no clear actions taken in this sense so far. At the end of March, the German Economic Team in Moldova and the “Expert-Grup” Independent Think-tank, based on the international best practice have presented the reasons and how this forum should be reformed to the Government¹⁴. Thus, we recommend the acceleration of the process to establish the National Macroprudential Authority according to the international model and good practices in the field, namely a smaller number of members with a reduced political exposure and strict relevance in view of financial stability.
- This law is one of the most complex legislative documents Moldova can have. In addition, the text of the law is quite technical and not understood by the vast majority of the population, which is actually targeted by the provisions of the law in light of their relationships with the banking institutions. In this respect, we encourage the initiation of NBM coordinated public debates/presentations on the Law, that would bring additional clarity on its provisions.
- In the context of several contradictions at the level of European states regarding the constitutionality of provisions limiting the property right of certain creditors over their receivables, we recommend that the Government require the exposure of Constitutional court on the possibility of violating Article 46 of the Constitution “The right to private property and its protection” early on. More than once Moldova was drawn in costly disputes in international arbitration courts for violating the property right. We have a recent example when several shareholders from the banking sector have initiated a dispute against Moldova regarding the NBM decision to sell shares held for three months.
- Once the bail-in procedure is introduced, the correct information of the population correlated with the lack of an adequate system for bank deposits protection could make the deponents move their money from the domestic bank accounts to accounts in banks from more protected jurisdictions. Consequently, in the context of the recent developments in the banking sector a migration of the capital can aggravate the already fragile stability of the sector. We consider it is essential to maintain an adequate supervision by NBM, together with promoting policies in order to maintain a sufficient level of capital internally.
- If for natural persons the relationships with the banks are not mandatory (creating bank deposits is an optional action of each person, independently and on their own risk), then a large part of the companies, due to the specific of their activity are bound by law to conduct their activity running their money through commercial banks¹⁵. Under these circumstances, all involved institutions (especially the NBM, NCFM, DGFBS, NCFS) should come up quickly with risk adequate protection solutions or clarifications if necessary.

¹⁴ “National Committee for Financial Stability. Why and how it should be reformed”, The German Economic Team in Moldova and the “Expert-Grup” Independent Think-tank, 2016 <http://www.expert-grup.org/ro/biblioteca/item/1249-reformare-cnsm>

¹⁵ For example insurance companies hold huge amounts of money in the commercial banks accounts

Simplified example of loss absorption and recapitalization in a bail-in procedure



* 10 Capital + 5 Subordinated debt + 5 Non-secured liabilities for covering 20 Compromised assets. The remaining 10 Non-secured liabilities are converted to 10 Capital for ensuring the further functioning of the bank. In this case, it did not get to charging deposits, although in case of some larger compromised assets or classes of smaller inferior liabilities, charging the deposits would be inevitable.