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Valuation Reports in the Context of Banking Resolution: What are the Challenges?

Banking Union Scrutiny

External authors:

Rosa María Lastra and

Rodrigo Olivares-Caminal

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Valuation Reports in the Context of Banking Resolution: What are the Challenges?

Abstract

This paper discusses from a legal perspective the challenges and difficulties involved in the production of the valuation reports required by the BRRD and considers the option of a moratorium tool for use by the resolution authorities as a possible way forward, which could address the concerns about timing and flexibility in the valuation process.

Given the discretionary powers of the resolution authorities and the need for SRB independence, the paper also considers the wider issues of legitimacy and accountability in the actions and decisions taken by the Single Resolution Board in light of the unique and complex institutional structure of the SRM.

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AUTHORS

Rosa María LASTRA

Rodrigo OLIVARES-CAMINAL

RESPONSIBLE ADMINISTRATOR

Marcel MAGNUS

LINGUISTIC VERSIONS

Original: EN

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To contact Economic Governance Support Unit or to subscribe to its newsletter please write to:

Economic Governance Support Unit

European Parliament

B-1047 Brussels

E-mail: egov@ep.europa.eu

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EXECUTIVE SUMMARY

The concept of valuation in the BRRD is an important part of the resolution process. Indeed, the word 'valuation' is used more than 70 times in the text of the Directive.

The resolution authorities' decision to submit an institution to resolution as well as the choice of the resolution tools are based on the results of a valuation performed by an independent expert (Article 36(1) of the BRRD). In addition, another valuation is required under article 74 that aims at verifying whether the so-called 'no creditor worse off' principle has been correctly applied by submitting the institution to resolution instead of to liquidation. These valuations are defined by the European Banking Authority (EBA) in its Regulatory Technical Standards on valuations, as Valuation 1 (decision on the resolution), Valuation 2 (determination of the tools) and Valuation 3 (adherence to the 'no creditor worse-off' principle) respectively.

A provisional valuation can be carried out by the resolution authorities according to article 36(2) of the BRRD, when an independent valuation under article 36(1) is not possible. A 'provisional valuation' needs to be confirmed by an ex-post definitive valuation, which under Article 36(10) of the BRRD must be done by an independent person as soon as practicable.

The ex-post definitive valuation needs (1) to ensure that any losses on the assets of the institution are fully recognised in the books of accounts; and, (2) to inform a decision to write back creditors' claims or to increase the value of the consideration paid.

The task of preparing highly technical and complex valuation reports is made more difficult by the time constraints that characterise the pre-resolution context, where authorities are required to act quickly to avoid a bank run. Evidence of such difficulties came up during the first stages of the crisis of Banco Popular Español, where the Single Resolution Board (SRB) engaged Deloitte as an independent valuer to perform the valuation under article 36.4 (b), (f) and (g) of the BRRD (so-called valuation 2). In its valuation report, Deloitte pointed out the constraints of preparing a report in an extremely short period of time.

These difficulties and the existence of different valuation processes raises important issues of legitimacy and accountability, which are linked to the complex institutional structure of the SRM.

It is difficult in practice to prepare a valuation and adopt the resolution of a complex-structured institution over a short period of time. In fact, it appears more likely that the overall/technical solution of the crisis is prepared in a longer timeframe and that just the final/formal decision about the scheme to be put in place is made by the institutions over a weekend.

Since technocratic authorities always need a degree of discretion in order to properly perform their mandate it is necessary to set some principles and guidelines to circumscribe the SRB's judgements so as avoid unfettered discretion. Discretion is never unrestricted or absolute. Discretion must be understood within a framework of rules, principles and guidelines ensuring that the goals that have to be reached are clear and properly defined.

The introduction of a moratorium tool could address the issues of timing and flexibility in the valuation process. If one of the main reasons for the urgency of the resolution action is the risk of deposit outflows, a tool allowing for a temporarily liability freezing could enable the parties involved to have more time in preparing the valuations.

1. THE CONCEPT OF 'VALUATION' IN THE BRRD[1]

The valuation of an institution's[2] assets and liabilities is one of the key elements of the Bank Recovery and Resolution Directive (BRRD)[3]. Accordingly, the resolution authorities' decision to submit an institution to resolution as well as the choice of the resolution tool(s) to employ are, in fact, based on the results of a valuation performed by an independent expert (Article 36(1) of the BRRD). In addition, another valuation is required under article 74 that aims at verifying whether the so-called 'no creditor worse off' principle has been correctly applied by submitting the institution to resolution instead of to liquidation. These valuations are defined by the European Banking Authority (EBA) in its Regulatory Technical Standards on valuations, as Valuation 1 (decision on the resolution), Valuation 2 (determination of the tools) and Valuation 3 (adherence to the 'no creditor worse-off' principle), respectively.[4]

Sometimes, a valuation can be required over a very short period of time due to a critical impending situation and, as a consequence, the complete required information for a proper assessment of the assets and liabilities might not be available. In these circumstances, the BRRD contemplates the possibility of conducting a provisional valuation[5] that is subject to an ex-post definitive valuation[6].

A definition of 'valuation' is provided by article 1(1)(a) of the Commission Delegated Regulation (EU) 2018/345, where it is said to be "… the assessment of an entity's assets and liabilities conducted by a valuer … ". The valuation can be provisional or definitive[7]. Also, article 1(1)(b) provides the definition of 'valuer', that is "either the independent valuer[8] … or the resolution authority when conducting a provisional valuation…".

The paramount importance of the valuation of assets in the context of the BRRD is made clear by the fact that in the text of the Directive the word 'valuation' is used more than 70 times.

1.1. Valuation for the purpose of resolution under article 36 of the BRRD (valuation 1)

Article 36(1) of the BRRD provides that before submitting an institution to resolution, resolution authorities have to obtain a "fair, prudent and realistic valuation of the assets and liabilities of the

[1] The authors would like to thank Dr. Marco Bodellini for his valuable research contribution.
[2] The entities referred to in article 36 BRRD are: (1) 'institutions' that according to art. 1.1(23) BRRD are credit institutions or investment firms; and, (2) other entities such as: (i) financial institutions that are established in the Union when the financial institution is a subsidiary of a credit institution or investment firm, or of a company referred in (ii) and (iii) below, and is covered by the supervision of the parent undertaking on a consolidated basis in accordance with Articles 6 to 17 of Regulation (EU) No 575/2013; (ii) financial holding companies, mixed financial holding companies and mixed-activity holding companies that are established in the Union; and, (iii) parent financial holding companies in a Member State, Union parent financial holding companies, parent mixed financial holding companies in a Member State, Union parent mixed financial holding companies.
[3] Directive 2014/59/EU of 15 May 2014.
[4] See EBA, Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms, 23 May 2017, p. 3.
[5] According to article 36(2) and (9) of the BRRD.
[6] According to article 36(1o) of the BRRD.
[7] According to articles 36(1), 74 and 36(10).
[8] Within the meaning of Article 38 of Commission Delegated Regulation (EU) 2016/1075.

institution"[9]. Such a valuation has to be carried out by a person who must be independent from any public authority, including the resolution authority, as well as by the institution in question.[10]

Such a valuation is meant to provide the authorities with an independent and objective view as to the current situation of the institution with regard to both its financial and assets/liabilities conditions. Its main function, therefore, is to enable the authorities to ascertain whether the institution is failing or likely to fail, while the other two conditions for resolution (namely, if there are alternative measures to avoid resolution and, if not, whether a resolution procedure is necessary in the public interest) fall beyond its scope.[11] In other words, as pointed out by the EBA, this valuation should determine whether the institution is balance-sheet solvent or not.[12]

For these reasons, such valuation should seek to ensure that losses under the appropriate scenario are fully recognised.[13]

1.2. Valuation for the purpose of determining the resolution action (valuation 2)

A further valuation has to be conducted under the same article 36 of the BRRD to allow the authorities to make their strategic choices with regard to the resolution tools to employ, particularly the extent, if any, to which the bail-in tool should be used.

Such a valuation is meant to assess the economic value and not the accounting value of the institution's assets and liabilities.[14] This provision seems to lie on the assumption that the accounting value of both assets and liabilities is no longer correct and therefore has to be amended in light of the changed situation.

Also, in performing this valuation, the valuer is required to assess the impact on the valuation of each resolution action that the resolution authority may adopt.[15] The purpose of the valuation is established in article 36(4) of the BRRD.

[9] The same valuation is required by the Directive also before the authorities exercise the power to write down or convert relevant capital instruments.

[10] With regard to the independence of valuers, article 38 of the Commission Delegated Regulation (EU) 2016/1075 states that "a legal or natural person may be appointed as a valuer. The valuer shall be deemed to be independent from any relevant public authority and the relevant entity where all the following conditions are met: (1) the valuer possesses the qualifications, experience, ability, knowledge and resources required and can carry out the valuation effectively without undue reliance on any relevant public authority or the relevant entity in accordance with Article 39; (2) the valuer is legally separated from the relevant public authorities and the relevant entity in accordance with Article 40; (3) the valuer has no material common or conflicting interest within the meaning of Article 41".

[11] See EBA, Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms, 23 May 2017, p. 7.

[12] Id., p. 5.

[13] See article 7(1) of the Commission Delegated Regulation (EU) 2018/345.

[14] See Recital 7 of the Commission Delegated Regulation (EU) 2018/345. The economic value is a measure of the benefit provided by a good to an economic agent while the accounting (book value) is the value of an asset according to its balance sheet account balance. In other words, the payable price (economic value) v. the original cost of the asset less any depreciation, amortization or impairment costs made against the asset (accounting value).

[15] See article 10(1) of the Commission Delegated Regulation (EU) 2018/345.

1.3. Valuation under article 74 of the BRRD and the 'no creditor worse off' principle (valuation 3)

A different sort of valuation is required by article 74 of the BRRD to be performed after the resolution action has been exercised. This valuation has to be carried out with a view to assessing whether shareholders and creditors of the institution submitted to resolution would have obtained a better treatment had such institution been liquidated on the basis of normal insolvency proceedings.

In other words, the function of this valuation is to verify whether the decision of the authorities to resolve the institution in question has complied with the 'no creditor worse off' principle under which no creditor should incur greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings.

The importance of this valuation lies on the grounds that if it is ascertained that shareholders and creditors have suffered greater losses than the ones they would have borne under normal insolvency proceedings, then they would be entitled to obtain compensation from the resolution financing arrangements according to article 101(1)(e) of the BRRD.

Obviously, such a valuation has to be performed on the basis of the information that was available at the moment in which the institution has been submitted to resolution.[16] Also, it should be conducted on a gone-concern basis.[17]

1.4. Provisional valuation

A definition of 'provisional valuation' is valuation that needs to be confirmed by an ex-post definitive valuation. According to article 1(1)(a) of the Commission Delegated Regulation (EU) 2018/345, "… the provisional valuation [can be] conducted by the resolution authority or the valuer, as the case may be, pursuant respectively to paragraphs (2) and (9) of Article 36 of that Directive".

According to article 36(2) of the BRRD, a provisional valuation can be carried out by the resolution authorities when an independent valuation under article 36(1) is not possible. Additionally, article 36(9) of the BRRD refers to "the urgency in the circumstances of the case" as a justification for a provisional valuation by the resolution authority[18] or an independent valuer, and expands on aspects which if not available sustain the need for a provisional valuation. These are, according to article 36(6) and (8) of the BRRD: (1) information resulting from an updated balance sheet and a report on the financial position; (2) an analysis and an estimate of the accounting value of the assets; (3) the list of outstanding on balance sheet and off balance sheet liabilities; and/or, (4) the subdivision of the creditors in classes in accordance with their priority levels and an estimate of the treatment that each class could have received if the institution had wound up under normal insolvency proceedings.

However, it is worth noting that article 36(9) of the BRRD refers to other situation beyond urgency ("… or paragraph (2) applies…"), therefore it is not strange to consider a situation where urgency is not impending and still there is no possibility of securing an independent valuer.

[16] See article 10(1) of the Commission Delegated Regulation (EU) 2018/344.

[17] See EBA, Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms, 23 May 2017, p. 3.

[18] For example, with regard to the resolution of Banco Popular Espanol, such provisional valuation was performed by the Single Resolution Board. See SRB, Valuation Report for the purpose of article 20(5)(a) of Regulation (EU) n. 806/2014, p. 1, available at www.srb.europa.eu.

Needless to say, it is important to stress the provisional nature of this valuation and that based on it (which might not comprise all the required information) the resolution authorities' decision to submit an institution to resolution can be exercised affecting the rights and obligations of both, shareholders/investors and depositors/creditors.

1.5. Ex-post definitive valuation

Although article 36(2) and (9) of the BRRD enables, in some cases, resolution authorities to carry out provisional valuations, still article 36(10) of the BRRD provides that ex-post definitive valuations have to be done by an independent person as soon as practicable.

The ex-post definitive valuation is mainly meant: (1) to ensure that any losses on the assets of the institution are fully recognised in the books of accounts; and, (2) to inform a decision to write back creditors' claims or to increase the value of the consideration paid.[19]

The following table summarizes the main features of the different available valuations and provides a comparison highlighting their purpose, time of performance, performer and legislative grounding.

Table 1: Types of Valuations under the BRRD

TYPES OF VALUATIONS UNDER THE BRRD				
Type	**Purpose**	**Time to be Performed**	**Valuer**	**Legislative Grounding**
Valuation 1	Decide Resolution	Before resolution action, when the authorities perceive a potential crisis situation	Independent Valuer	Art. 36(1) of the BRRD
Valuation 2	Determine the applicable tools	After having ascertained the conditions for resolution are met (also through Valuation 1)	Independent Valuer	Art. 36(1) and 36(4) of the BRRD
Valuation 3	Confirmation that the 'no creditor worse off' principle is observed	After the exercise of the resolution action	Independent Valuer	Art. 74 of the BRRD
Provisional Valuation	Decide Resolution and applicable tools in urgent cases	Before resolution action, when the authorities perceive a potential crisis situation	Resolution authorities	Art. 36(2) of the BRRD
			Resolution Authorities or Independent Valuer	Art 36(9) of the BRRD

[19] According to article 36(10) let. (a) and (b).

Ex-post Definitive Valuation	To confirm provisional valuation	As soon as possible after resolution action has been exercised in cases were a Provisional Valuation has been used	Independent Valuer	Art. 36(10) of the BRRD

1.6. The case of divergence between the provisional valuation and the ex-post definitive valuation

A significant issue can arise in the event of a divergence between the results of a provisional valuation and the ones of the ex-post definitive valuation.[20]

To face such a problem, article 36(11) of the BRRD states that if the definitive valuation's estimate of the net asset value of the institution is higher than the one of the provisional valuation, the resolution authority can: "a) exercise its power to increase the value of the claims of creditors or owners of relevant capital instruments which have been written down under the bail-in tool; b) instruct a bridge institution or asset management vehicle to make a further payment of consideration in respect of the assets, rights, liabilities to the institution under resolution, or as the case may be, in respect of the shares or instruments of ownership to the owners of the shares or other instruments of ownership".

Even if such a provision represents a sort of corrective action to fix the situation, still the risk of litigation when the provisional valuation and the ex-post definitive valuation do not match is rather high. This can be the case when the definitive valuation's estimate of the net asset value is lower than the one resulting from the provisional valuation.[21] In such a scenario, the outcome could be that the extent to which the resolution tools (mainly bail-in) have been applied is not enough to restore the institution and therefore new measures are required.[22] The legislator was aware of such a risk and for this reason

[20] See on this Financial Law Committee and Insolvency Law Committee of the City of London Law Society and the Banking Reform Working Group of the Law Society of England and Wales, Response to the EBA's Consultation on the Draft Regulatory Technical Standards on Valuation under BRRD, p. 1, arguing that "[i]t is not clear what happens if the *ex post* valuation shows that the resolution was either not well founded because it transpires the resolution thresholds were not in fact satisfied or on terms which were inappropriate because they were more extensive than required? Is there any remedy available and if so what is it?"

[21] The importance of performing a fair, prudent and realistic valuation is indeed stressed by Recital 6 of the Commission Delegated Regulation (EU) 2018/345, where it is made clear that its aim is to ensure "that all losses are fully recognised at the moment the resolution tools are applied …".

[22] See Financial Law Committee and Insolvency Law Committee of the City of London Law Society and the Banking Reform Working Group of the Law Society of England and Wales, Response to the EBA's Consultation on the Draft Regulatory Technical Standards on Valuation under BRRD, p. 1, arguing that "[i]t is unclear what happens if because of poor record keeping, processing error or misunderstanding by the valuer, any particular liability or asset (or class of liability or assets) is omitted from the valuation process altogether, is wholly or partially omitted in the assignment of equity to a creditor, or class of creditor, or is under or overvalued. This sort of error could significantly affect the amount of equity issued to a creditor or class of creditor, so treating them unfairly in relation to other creditors whose rights have been correctly valued. This is not a process in which [no creditor worse off] will assist in giving a correct result (e.g. because it may have been determined that the creditor would have received nothing or less in an insolvency than the value of the equity that was actually issued to him, although this is less than the equity that should have been issued to him if his claim had been correctly assessed and valued for the bail-in conversion process). It seems to us that there needs to be a process to enable affected bailed-in creditors to make good their entitlement to a higher amount of the new equity (and for over-entitlements to be clawed back). At present there is no such process and one needs to be provided to prevent the legislation failing to meet basic standards in the protection of property rights. It may be that arbitration

the valuer is required to calculate in the valuation a buffer to use to cover additional losses on assets.[23] In this vein, according to article 13 of the Commission Delegated Regulation (EU) 2018/345, to address the uncertainty of provisional valuations, the valuer should include in the valuation a buffer to reflect facts and circumstances supporting the existence of additional losses of uncertain amount or timing. Such a buffer should help cover probable losses that however the valuer has not been able to properly quantify in the provisional valuation.[24] But still the same problem can occur when this buffer is not sufficient to cover such losses either. Obviously, if this is the case litigation might be unavoidable.

1.7. Difficulties in obtaining technical valuations

It is already clear how challenging is to draft such valuations, which, by definition, are extremely technical and therefore need a significant amount of time to be properly carried out.[25] This task is made even more difficult by the time constraints characterising the pre-resolution context, where authorities are required to act quickly to avoid a run on the bank and the consequent deposit outflows that can speed up the failure of an institution in crisis.[26]

Evidences of such difficulties clearly came up during the first stages of the crisis of Banco Popular Español, where the Single Resolution Board (SRB) engaged Deloitte as an independent valuer to perform the valuation under article 36.4 (b), (f) and (g) of the BRRD (so-called valuation 2). In its valuation report, Deloitte pointed out that due to the institution's liquidity tension, it was required by the SRB to draft such a valuation in just twelve days, while usually a project of this kind would require at least six weeks.[27]

These difficulties and the existence of different valuation processes raises important issues of legitimacy and accountability, which are linked to the complex institutional structure of the SRM. These issues are assessed in the following section.

2. LEGITIMACY AND ACCOUNTABILITY ISSUES

2.1. The role of the SRB in times of crisis

processes would be cheaper and speedier for resolving such disputes than leaving all issues to be determined by the courts and we consider that thought could usefully be given to setting up such a process".

[23] According to Recital 12 of the Commission Delegated Regulation (EU) 2018/345, the buffer should be aimed "at approximating the amount of additional losses".

[24] See EBA, Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms, 23 May 2017, p. 8.

[25] See Financial Law Committee and Insolvency Law Committee of the City of London Law Society and the Banking Reform Working Group of the Law Society of England and Wales, Response to the EBA's Consultation on Draft Regulatory Technical Standards on Valuation under BRRD, *passim*.

[26] This is precisely what happened with regard to Banco Popular Espanol, where due to a significant liquidity tension, the SRB had to quickly draft a provisional valuation to ascertain whether the bank was failing or likely to fail; see SRB, Valuation Report for the purpose of article 20(5)(a) of Regulation (EU) n. 806/2014, p. 1, available at www.srb.europa.eu.

[27] See Deloitte, Hippocrates Provisional Valuation Report, (Sale of Business Scenario), p. 3, available at www.srb.europa.eu.

Since its creation, the Single Resolution Board (SRB) has played a significant role in bank crisis management. The independence and supranational character of the SRB, the authority at the centre of the Single Resolution Mechanism (SRM), allows it to reduce regulatory capture and to prevent (or mitigate) the risk of forbearance,[28] which is a fundamental rationale of banking union.

The legal basis in primary law for the establishment of the SRB—via Regulation EU 806/2014—is article 114 of TFEU, that allows for the adoption of measures for the correct functioning of the internal market. This has been considered by many an imperfect enabling provision. However, it was a creative solution in the light of the constraints arising from the Meroni doctrine[29] and the lack of any specific primary law provision in the Treaty comparable to Article 127 (6) in the case of supervision (ECB/SSM). Yet it has resulted in a convoluted legal arrangement that involves the Council and the Commission in the SRB's decision-making process—the SRB's decisions are characterized by a discretionary element and have been defined as de facto powers[30]—as well as the ECB and the national resolution authorities (NRAs).[31] The drawback of such a creative solution is the difficulty in coordinating the involvement of different institutions with different backgrounds and different constitutional tasks and structures in the resolution process, considering in particular that a resolution action, to be effective, must be prompt and timely, often over a weekend when markets are closed.

On paper, the resolution process is designed to be completed in no longer than 32 hours, which raises challenges in the valuation process pre-resolution. After the ECB has notified the SRB, the Commission and the relevant NRAs that a bank is failing or likely to fail, the SRB is meant to adopt a resolution scheme, to be defined in consultation with the relevant NRAs.[32] Immediately after its adoption, the SRB has to send the scheme to the Commission that, within the following 24 hours, is expected to analyse it and decide whether to endorse the scheme or to raise objections with regard to its discretionary elements. Also, within 12 hours from its receipt, the Commission can recommend the Council not to endorse the scheme on the assumption that the resolution action is not in the public interest. Alternatively, the Commission can propose to the Council to approve or object to a material modification with regard to the amount of resources provided by the SRF (the Council must act on the modification within 24 hours of the scheme's original transmission). If the Council objects to the scheme on public interest grounds, the bank is wound up in accordance with applicable national law. In relation to SRF's modifications or the Commission's objections to discretionary elements, the SRB has to modify the scheme in accordance with the reasons expressed within eight hours.[33]

It is difficult in practice to prepare and adopt such a decision involving these different institutions over such a short period of time. In fact, it appears more likely that the overall/technical solution of the crisis is prepared in a longer timeframe and that just the final/formal decision about the scheme to be put in place is made by the institutions over a weekend.

There are four cases so far in which the SRB has performed a relevant role, namely, Banco Popular Español, Banca Popolare di Vicenza, Veneto Banca and ABLV Bank.

[28] See N. Moloney, European Banking Union: Assessing its Risks and Resilience, 51 Common Market Law Review, 2014, p. 1638.
[29] See R. Lastra, International Financial and Monetary Law, OUP, Oxford, 2015, p. 367.
[30] See N. Moloney supra note 28, p. 1642. Since EU agencies are not allowed to exercise discretionary powers (such as to make discretionary decisions), then Treaty-regulated Institutions—the Commission and the Council—have to be the final-formal decision-makers.
[31] See K. Alexander, European Banking Union: a Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism, 40 European Law Review, 2015, p. 180.
[32] The SRB maintains the power to declare a bank as failing or likely to fail and therefore to trigger the resolution procedure accordingly, if the ECB does not start the process.
[33] See N. Moloney, supra note 28, p. 1640.

When a bank that is considered 'failing or likely to fail', the SRB must carry out the so-called 'public interest test' in order to ascertain whether the submission of such a bank to resolution is needed or not. In other words, the SRB is requested to foresee whether the liquidation of the bank in crisis (which is the default option) could endanger financial stability (for example due to the interruption of critical functions), and, if this is the case, then the SRB is meant to submit the institution to resolution.[34] Valuations play a key role in the process to determine whether the bank is 'failing or likely to fail'.

Given the discretionary nature of such 'public interest test' and the many actors involved in the process (with the danger of politicisation and forbearance in the workings of the NRAs), the SRB's decisions so far have led to different outcomes, some more controversial than others. With regard to the two Italian banks[35] and ABLV Bank, the SRB determined that there was no reason to start a resolution procedure, while in the case of Banco Popular Español, the 'public interest test 'led to a 'positive' outcome and consequently the bank was submitted to resolution. On 23 May 2017, the SRB requested Deloitte to perform an economic valuation under article 20 of the SRM Regulation of Banco Popular Español and then submitted the institution to resolution on 7 June 2017, confirming that the resolution of a significant bank requires more time than just a weekend.[36]

Indeed, these cases provide evidence that the SRB's actions—whichever form they take—are usually prepared in advance and only the final decision process, involving the Commission and the Council, takes place over a short period of time.

2.2. The case for discretion (balance between absolute discretion and relative discretion)

The four cases above mentioned are useful to understand the nature and limitations of the SRB's discretionary powers.

The SRB is charged with the task of drawing up resolution plans. In doing so, the SRB has the discretionary power to determine which resolution tools are to be employed if the bank will be submitted to resolution. Afterwards, the SRB is also empowered to trigger the resolution procedure if it deems that the resolution conditions are met, for which a valuation is required. Additionally, when the ECB determines that a bank is failing or likely to fail, the SRB is supposed to ascertain, in light of the 'public interest test' which solution is to be taken, choosing from either the submission of the institution to normal insolvency proceedings or to resolution. All these choices are discretionary but have to rely on a valuation report.

Moving from the assumption that technocratic authorities always need a degree of discretion in order to properly perform their mandate (and on the assumption that one-size-fits-all do not work in resolution matters), it is necessary to set some principles and guidelines to circumscribe the SRB's judgements so as avoid unfettered discretion. An example of guidelines that can lead resolution authorities in forecasting whether a bank's crisis can impact financial stability is represented by the threshold set out by the EBA to distinguish between the so-called other systemically important

[34] See M. Bodellini, To Bail-In or To Bail-Out, That is the Question, 19 European Business Organization Law Review, 2018, *passim*.

[35] See M. Bodellini, Greek and Italian 'Lessons' on Bank Restructuring: Is Precautionary Recapitalization the Way Forward? 19 Cambridge Yearbook of European Legal Studies, 2017, p. 161.

[36] See Single Resolution Board, Decision of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Español S.A., available at www.srb.europa.eu.

institutions (O-SIIs) and institutions that are not.[37] Such guidelines provide the resolution authorities with some standard and predefined criteria which should be able to circumscribe somehow their discretion. This lies on the rational assumption that the failure of bank that qualifies as O-SII on paper could endanger financial stability more than the crisis of a bank that is below such a threshold. A clear and transparent explanation of the reasons that justify the SRB's discretionary choices is also an effective means to limit arbitrary and unreasonable decisions.

Discretion is never unrestricted or absolute. Discretion must be understood within a framework of rules, principles and guidelines ensuring that the goals that have to be reached are clear and properly defined.[38]

One of the most important principles that enshrines a discretionary decision is the exercise of effective legitimacy and accountability. This entails the need to provide every stakeholder in the resolution process with a comprehensive and well-founded explanation of the legal and economic rationale behind each discretionary decision.

Given that the SRB has the very relevant task of ascertaining if the crisis of a bank under its remit and its consequent submission to normal insolvency proceedings, according to the law of its jurisdiction, can negatively affect the public interest, mainly by generating instability, the design of adequate accountability mechanisms is of paramount importance.

In relation to both Veneto Banca and Banca Popolare di Vicenza, once the ECB concluded that the two banks were failing or likely to fail, the SRB claimed that neither alternative private measures nor supervisory actions could have prevented their failure within a reasonable timeframe.[39] Such conclusion was reached on the basis of the banks' inability to raise private capital, the weaknesses and lack of credibility of their business plans and the ineffectiveness of the application of the power to write down or convert the capital instruments.[40] The assessment of a business plan that is considered weak and not credible is necessarily based on some discretionary assumptions. This raises important queries as regards the legitimacy of the process.

In the same vein, in relation to the public interest test, the SRB concluded that due to the particular characteristics of the two Italian banks and their financial and economic situation, the resolution procedure was not necessary in the public interest.[41] The reasons for this conclusion, were that: (1) the functions performed, i.e. deposit-taking, lending activities and payment services, were not 'critical' since they were provided to a limited number of third parties and could be replaced in an acceptable manner and within a reasonable timeframe; (2) their failure was not likely to result in significant adverse effects on financial stability taking into account, in particular, the low financial and operational interconnections with other financial institutions; and, (3) normal Italian insolvency proceedings would have achieved the resolution objectives to the same extent as resolution, since such proceedings

[37] See EBA, Guidelines in the criteria to determine the conditions of application of article 131(3) of Directive 2013/36/EU CRD IV in relation to the assessment of other systemically important institutions (O-SIIs), 16 December 2014, *passim*.
[38] See C. Goodhart and R. Lastra, Populism and Central Bank Independence, Open Economies Review, 2017, p. 59.
[39] See Single Resolution Board, Decision of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A., available at www.srb.europa.eu; see Single Resolution Board, Decision of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A., available at www.srb.europa.eu.
[40] Id.
[41] Id.

would also have ensured a comparable degree of protection for depositors, investors, other customers, clients' funds and assets.[42]

The reasons that have been used as the basis to deny the need for a resolution action in order to safeguard the public interest are based on some discretionary considerations as well. In particular, the SRB concluded that the functions performed by the two banks were not critical since they only involved a limited number of counterparties and could be somehow replaced.[43] Obviously the determination that such activities were provided to a limited number of third parties lies on discretionary valuations since the concept of 'limited number of third parties' is a relative one and it is not defined by the rules. Therefore, its meaning has been defined by the SRB itself, on a discretionary basis. Likewise, the assumption that these functions could be replaced in an acceptable manner and within a reasonable timeframe is a determination based on SRB's own discretionary considerations.

The same holds true for the two remaining SRB's assumptions; particularly, the statement that their failure was not likely to result in significant adverse effects on financial stability necessarily presupposes discretionary valuations that different resolution authorities might not agree on. Even though, at the same time, it is worth noting that the EBA's guidelines on the determination of O-SIIs have been used to reach that conclusion. In particular, the SRB mentioned that both banks were far below the 350 basis points threshold that is taken into account to qualify an institution as an O-SII.[44] Likewise, the fact that normal Italian insolvency proceedings are said to be able to achieve the resolution objectives to the same extent as resolution, since such proceedings would also ensure a comparable degree of protection for depositors, investors, other customers, clients' funds and assets is a discretionary consideration, that also contrasts with the assumption that usually they are not apt to provide third parties with the same level of protection as resolution.[45]

Further evidence of the fact that the SRB's activity is discretionary can be found in the fact that the resolution plans, adopted in 2015, provided for both banks' resolution action on the grounds of their ability to impact the system's stability in case of failure.[46] However, due to their loss of significance over the preceding two years, with regard to both their size and interconnectedness, the SRB determined that resolution was no longer necessary to protect public interest and reach the resolution objectives.[47] This determination is clearly discretionary, too.

Discretionary elements also explain the SRB's decision not to submit ABLV Bank to resolution. In this case, the SRB decided that resolution action was not in the public interest since the functions that the bank was performing were not critical.[48] The reason is that their discontinuance could not lead to the disruption of services essential to the Latvian and Luxembourgish real economies nor to the generation of financial instability. [49] Once again, the SRB's decision rests on discretionary assumptions.

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[42] Id.
[43] Id.
[44] Id.
[45] See M. Bodellini, To Bail-In or To Bail-Out, That is the Question, 19 European Business Organization Law Review, 2018, *passim*.
[46] See Single Resolution Board, Decision of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A., available at www.srb.europa.eu; see Single Resolution Board, Decision of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A., available at www.srb.europa.eu.
[47] Id.
[48] See Single Resolution Board, Notice Summarising the Decision taken in respect of ABLV Bank, AS available at www.srb.europa.eu; see Single Resolution Board, Notice Summarising the Decision taken in respect of ABLV Bank Luxembourg S.A. available at www.srb.europa.eu.
[49] Id.

As stated earlier, Banco Popular Español was submitted to resolution by the SRB on 7 June 2017 mainly on the grounds of the insolvency proceedings' inability to achieve the resolution objectives. Resolution was considered necessary to ensure the continuity of critical functions and to avoid significant adverse effects on financial stability such as contagion.[50] The SRB determined that discontinuing critical functions such as deposit taking, lending to SMEs and payment and cash services could have led to the disruption of services that are essential to the Spanish real economy and to disruption of financial stability in the country.[51] These arguments lie again on discretionary assumptions made by the SRB that have been used as the logical foundations for the decision of resolving the bank. However, it is also important to notice that to reach such a conclusion the SRB took into account the EBA's guidelines to assess other systemically important institutions underlining that Banco Popular Español was far above the threshold (i.e. 402 basis points).[52]

It is also worth noting that the resolution plan drawn by the SRB provided, in case of crisis, the submission to resolution of the Spanish bank and the application of the bail-in tool.[53] By contrast, the SRB eventually decided to apply the sale of business tool after the write down and conversion of capital instruments.[54] This shift with regard to the resolution action/tool to adopt was motivated by the fact that the crisis of the bank was mainly due to a lack of liquidity, originated by significant deposit outflows. As a consequence, bail-in was no longer the most appropriate resolution tool to revert the liquidity crisis of the institution. This circumstance, however, shows once again that resolution authorities need to benefit from some amount of discretion also in order to change previously taken decisions, since the conditions of banks (that are lively institutions in a moving environment) can change over very short periods of time.

2.3. Legitimacy and accountability in the SRB

Legitimacy pre-exists and is a requisite of accountability. There are two aspects to legitimacy: formal and societal.[55] According to the former, the creation of an entity such as the SRB must be the fruit of a democratic act: an act of the legislator, a constitutional decision or a treaty provision. The latter refers to the support by the public and can be fickle since public acceptance is also influenced by politics, the media, current events, change in circumstances, sentiment, and others factors. In any case, when societal legitimacy weakens or is no longer present, the law is bound to change.[56]

Accountability can been defined as "an obligation owed by one person (the accountable) to another (the accountee) according to which the former must give account of, explain and justify his actions or decisions against criteria of some kind, and take responsibility for any fault or damage".[57] It is possible to distinguish between 'explanatory accountability', where the obligation consists in answering

[50] See Single Resolution Board, Decision of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Español S.A., available at www.srb.europa.eu.
[51] Id.
[52] Id.
[53] Id.
[54] Id.
[55] See R. Lastra, above note 29, at pp. 84-85, and A. Verhoeven, *The European Union in Search of a Democratic and Constitutional Theory* (The Hague: Kluwer Law International, 2002) 10–11 and 364.
[56] See C. Goodhart and R. Lastra, Central Bank Accountability and Judicial Review, SUERF Policy Note no. 32, May 2018, p. 2.
[57] See R. Lastra and H. Shams, Public Accountability in the Financial Sector, in E. Ferran and C. Goodhart (Eds.), *Regulating Financial Services and Markets in the 21st Century*, Hart Publishing, Oxford, 2001, p. 167; drawing on D. Oliver, Law, Politics and Public Accountability: The Search for a New Equilibrium, *Public Law*, 1994, p. 228.

questions and providing explanations about the actions taken and 'amendatory accountability', where the obligation amounts to making amends of the actions performed.[58] Accountability in relation to SRB actions can exist only if there is transparency with regard to the information on such actions. Therefore, the provision of information is a component of accountability.[59]

According to this accountability definition, the resolution authorities, such as the SRB, are 'the accountable' entity. The European parliament is an important 'accountee' and there are other mechanisms of accountability at the national and EU levels (administrative review and judicial review notable) whilst a number of stakeholders are impacted by the SRB's decisions. In terms of the 'content of the obligation' the resolution authority must give account, explain and justify its actions or resolution decisions, and take responsibility for any fault or damage.[60] This could be the case of inaccurate provisional valuations by the resolution authorities leading to damages.

A more fundamental aspect to be considered is what happens if the ex-post definitive valuation demonstrates that the entity should have not been put to resolution in the first place. Although this might seem an unlike situation, if it materialises, the losses faced by the shareholders/investors and creditors could be considerable. This opens a dilemma as to how to proceed with provisional valuations. If provisional valuations are inaccurate, an ex-post adjustment based on a definitive valuation is desired for reasons of transparency and credibility and the natural consequence on a system of accountability. However, if there is an error in deciding to put an entity into resolution that should have not been resolved, that can seriously tarnish the credibility and reputation of the resolution authority and other provisional valuations. Accordingly, the ex-post definitive valuation should only focus on assessing whether an adjustment is required and, if so, of which nature, bearing in mind that a resolution action, to be effective, must be prompt and timely, and often must be taken over a short period of time.

Under article 45 of the Single Resolution Mechanism Regulation, the SRB is accountable to the Commission, to the Council and to the European Parliament. What seems to be peculiar in this context is the fact that, due to the Meroni doctrine constraints, the SRB is not the real-formal decision-maker in respect of the measures to put in place in the face of bank failing or likely to fail. Even if the choice to resolve a bank, instead of submitting it to liquidation, (or vice versa), is technically prepared by the SRB, from a formal viewpoint, such a decision is effectively made by the Commission. This shift in the decision-making process can have an impact even on accountability, leading to possibly argue that the one to be deemed accountable for the decision adopted should be the Commission.

From a practical perspective it is clear that the powers of resolution authorities are significant. They must also be proportionate. Indeed, the authorities that are given such powers have the obligation to give account of their decisions and actions. There are procedural elements that determine the legality of an administrative act, such as the competence of the entity that issues the act or the procedure to prepare and approve such act, and the existence of a public interest. This is particularly the case when decisions are discretionary and the authority is put in front of different alternative choices to make. It also follows that where errors are proved or harm inflicted, the accountable authority is responsible and has to take measures of amendments.[61]

[58] See Turpin, Ministerial Responsibility, in Jowell and Oliver (Eds.), The Changing Constitution, 2nd edn., Oxford, Clarendon, 1994, p. 112, quoted by Lastra and Shams, ibid, p. 168.

[59] See R. Lastra and H. Shams, supra note 57, p. 172.

[60] See R. Lastra, Central Banking and Banking Regulation, Financial Markets Group London School of Economics and Political Science, London, 1996, p. 49, who, with regard to central banks, argues that accountability requires that such authorities explain and justify their actions and give account for the decisions they make in performing their mandate.

[61] R. Lastra and H. Shams, above note, p. 168.

This poses challenges for the SRB, which is supposed to give account and justify its discretionary decisions, mainly the choice of resolution over liquidation (or vice versa), being based on the impact of the bank's crisis on the public interest, *i.e.* on discretionary elements (and even probably on the basis of a provisional valuation as provided by article 36(2) and (9) of the BRRD.

It is also worth noting that SRB's decisions may be challenged either before the so-called Appeal Panel of the SRB or before the Court of Justice of the European Union. The judicial review of administrative actions to prevent an arbitrary and unreasonable exercise of discretionary authority is an important element of the rule of law.[62] But of course such judicial review has to be done taking into account the discretion that resolution authorities need to employ in order to effectively perform their tasks. In such a context, discretion can be seen as the freedom to act within the legal framework.[63] It follows that judicial review should not extend to the content of the decision since the aim of the Court is not to supplant or replace the decision taken. On the opposite, such a judicial review should focus on the parameters and legal framework surrounding the decision in question in order to determine whether or not the resolution authority mandate has been exceeded.[64]

3. MORATORIUM—A WAY FORWARD?

In this final section of the paper we explore a mechanism that could address the main issue, i.e. the lack of time to produce a definitive valuation. The aim in overcoming this difficulty is that the involved parties will not have to rely on a provisional valuation. This should result in a more efficient and reliable process, reducing issues of accountability and a possible reputational cost for the resolution authority. A possible solution in this vein is the establishment of a corporate insolvency-style moratorium.

A 'moratorium', is "a temporary prohibition of an activity", of late Latin moratorius 'delaying', from Latin morat 'delayed', from the verb morari, from mora 'delay'.[65] In the legal context, in particular, it is "a legal authorisation to debtors to postpone payment".[66]

The German BaFin has pointed out that 'moratorium' is a term used in the case of a package of measures stipulated by the domestic banking act allowing the authority to prohibit an institution that is about to become insolvent from making payments (such as disbursing deposits or committed loans) or disposing of assets.[67] The rationale of this 'moratorium' is to protect the assets entrusted to the bank by its customers and to ensure that the afflicted creditors are satisfied equally in case of compensation.[68]

A mention to the term 'moratorium' has been also done by the Chair of the ECB's Supervisory Board, in a letter dated 2 October 2015.[69] In this letter, answering a question on whether the ECB had sufficient

[62] See C. Goodhart and R. Lastra, supra 56 p. 4.
[63] C. Goodhart and R. Lastra, Populism and Central Bank Independence, Open Economies Review, 2017, p. 60, underlining that discretion should not mean arbitrariness.
[64] These theories have been developed with regard to central banks by C. Goodhart and R. Lastra, Central Bank Accountability and Judicial Review, SUERF Policy Note no. 32, May 2018, p. 4.
[65] See Oxford Dictionary online.
[66] *Ibid.*
[67] See BaFin, Federal Financial Supervisory Authority, Supervision, Moratorium, available at https://www.bafin.de/EN/Aufsicht/BankenFinanzdienstleister/Massnahmen/Moratorium/moratorium_artikel_en.html.
[68] Id., also stating that "If a bank begins to experience difficulties, this should not represent the starting signal for a race between the fastest creditors who are satisfied in full, and the slower ones who leave empty-handed".
[69] See ECB, Banking Supervision, Letter sent by Danièle Nouy to Sven Giegold, 2 October 2015, available at www.ecb.europa.eu.

legal instruments in order to enact moratoria on banks to stop the outflow of bail-inable capital, it was pointed out that "while the term 'moratorium' is not defined in the Union banking legislation, it can be generally understood as a measure by which the relevant authority suspends or restricts payments by a credit institution. This is an instrument granted to the resolution authority"[70] under article 69 of the BRRD.

Accordingly, article 69(1) of the BRRD states that "Member States shall ensure that resolution authorities have the power to suspend any payment or delivery obligations pursuant to any contract to which an institution under resolution is a party from the publication of a notice of the suspension in accordance with Article 83(4) until midnight in the Member State of the resolution authority of the institution under resolution at the end of the business day following that publication".

What needs to be stressed is the fact that the power under article 69 of the BRRD can be exercised by resolution authorities only with regard to institutions that have been already submitted to resolution and the arising suspension of payments can last no more than two business days. Additionally, this power does not include within its scope eligible deposits, obligations owed to payment and settlement systems, central counterparties, central banks, or eligible claims under investor-compensation schemes.

It is also worth noting that some EU jurisdictions allow for the use of a similar tool also outside a resolution scenario. This is the case of Latvia, where on 19 February 2018, the ECB instructed the Latvian Financial and Capital Market Commission (FCMC) to impose a moratorium on ABLV Bank prohibiting all payments of its financial liabilities and without providing a termination date.[71]

Looking at its *modus operandi*, a moratorium could be an effective instrument to provide both resolution authorities and independent valuers with the required time to properly perform the valuations under article 36(1) of the BRRD. However, this needs to be assessed vis-à-vis the continuity of the basic payments system to guarantee the coverage of the essential needs of depositors. A moratorium can be imposed on withdrawals or payments in excess of the deposit guarantee scheme over a given period of time. Depositors could still have the freedom to dispose of their deposits up to the statutory guaranteed amount and be assured that their basic needs are covered.

If one of the main reasons for the urgency of the resolution action is the risk of deposit outflows, a tool allowing for a temporarily liability freezing could enable the parties involved to have more time in preparing the valuations.

But in order to have such a tool in place, a legislative reform is needed.

Moving away from such considerations, in November 2016, the Commission presented a proposal to amend the BRRD also by introducing a moratorium.[72] In the Commission's view, such a tool should allow for freezing the flow of payments for a short period of time (up to five days), thereby facilitating the quantification of available assets and liabilities. Accordingly, this tool could be very useful both in a pre-resolution context (and more specifically in the context of early intervention) and during

[70] *Ibid.*
[71] See ECB, Banking Supervision, ECB instructs national supervisor to impose moratorium on ABLV Bank, Press release, 18 February 2018, available at www.bankingsupervision.europa.eu.
[72] See European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC.

resolution.[73] Its scope should be broader than the one of the tool under current article 69 of the BRRD possibly impacting every liability apart from covered deposits. The five-day period will not, however, solve the issue of the required time to obtain a definitive valuation. As previously noted, in the case of Banco Popular de España, six weeks would have been required to properly do the valuation.[74]

Notwithstanding the clear usefulness of the tool in question, it is also worth noting that some of associations have clearly expressed their concern about the possibility to introduce this new instrument in the EU legal framework.[75] The main reasons for their concern are: "(i) the compatibility of the powers with an effective recovery and resolution framework and the resolution objectives; (ii) the impact on incentives, contagion and financial stability; (iii) the capital required to be held by counterparties; and (iv) global consistency and the interaction with the progress made in ensuring contractual recognition of resolution stays".[76]

The most significant concern seems to be the one relating to the potential impact of moratorium on financial stability. In particular, it has been argued that "the imposition of a stay on payment and delivery obligations will impact on counterparties of the institution which may be reliant on payment and/or delivery for their own liquidity and risk management. The application or existence of a stay power is also likely to make markets more sensitive to stress as counterparties could be impacted at an earlier stage, potentially destabilising other banks".[77] This argument certainly deserves careful attention, however, it can also be argued exactly the opposite, namely that no intervention to freeze the flow of payments for a short period of time with regard to a bank that is experiencing liquidity problems can generate contagion and thereby financial instability.

CONCLUSIONS

This paper has discussed the difficulties and challenges involved in the production of the valuation reports required by the BRRD. The very essence of having a prompt and speedy resolution process (often over 32 hours) to prevent a bank run goes against one of the principles of accurate valuation: sufficient time. The need to produce highly technical reports (which would typically require six weeks) in a very short period of time is a major challenge in the resolution process under the BRRD. Given the litigious nature of some resolution actions and the different interests at stake, this is a fundamental issue for the credibility of the SRM.

We analysed the various types of valuations under BRRD following the classification conducted by the European Banking Authority (EBA) in its Regulatory Technical Standards: Valuation 1 (decision on the resolution), Valuation 2 (determination of the tools) and Valuation 3 (adherence to the 'no creditor worse-off' principle). We also examined the concept of provisional and ex-post definitive valuations.

In the light of the difficulties inherent in the production of accurate valuation reports under a tight timeframe and the different actors involved in the resolution process under the SRM, we considered the issues of legitimacy and accountability. The use of discretionary powers by technocratic

[73] Id.

[74] See supra 27.

[75] See *ex pluribus* International Securities Lending Association, Proposed moratorium powers under Bank Recovery and Resolution Directive (BRRD), October 2017, *passim*, available at www.isla.co.uk. Also, the International Swaps and Derivatives Association, Proposed moratoria under the BRRD: a step backwards in efforts to end 'too big to fail', September 2017, *passim*, available at www.isda.org.

[76] See Association for Financial Markets in Europe, Moratorium tools in the Risk Reduction Measures package, June 2017, p. 3, available at www.afme.eu.

[77] See Association for Financial Markets in Europe, Need for reconsideration of the proposed introduction of new moratoria tools, 4 October 2017, p. 2, available at www.afme.eu.

independent authorities (as the SRB's judgments are) need to be circumscribed within a framework of normative principles and guidelines so as avoid unfettered discretion. Discretion, lest we forget, is never unrestricted or absolute. Administrative discretion must always be understood within a set of rules to ensure adequate legitimacy and accountability.

Finally, in the context of mitigating actions we evaluated the possible introduction of a moratorium tool that could address the issues of timing and flexibility in the valuation process. If one of the main reasons for the urgency of the resolution action is the risk of deposit outflows, a tool allowing for a temporarily liability freezing could enable the parties involved to have more time in preparing the valuations.

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