Questions and Answers

Questions and Answers
about the Magyar Nemzeti Bank's resolution activities
in connection with the resolution regulation

1. What is resolution?

The concept of resolution refers to the restructuring, out of public interest and through the use of official force, of a distressed financial institution or group due to insolvency, in order to maintain financial stability and ensure the protection of clients.

2. What is the general purpose of resolution and why is it needed?

The general objective of resolution is to provide enhanced protection for depositors, maintain financial stability, ensure the continuous availability of critical functions provided by the financial sector, efficiently manage institutional crises and minimise the use of taxpayer funds for crisis management purposes. To that end, resolution establishes the framework necessary for the administrative restructuring of distressed financial institutions.

In the wake of the financial crisis of 2007-2008, it has become clear that, in the absence of an effective framework for managing the distress of financial institutions, only conventional insolvency proceedings (e.g. liquidation) are available. Under such circumstances, institutional distress may spark other processes that can put financial stability at risk, which can then only be averted at the expense of significant taxpayer-funded bailouts. Given that the latter caused countries' sovereign debt to rise, the costs of distress in the financial sector were paid directly by taxpayers themselves. As an alternative approach to crisis management, resolution serves to prevent these scenarios.

In the field of financial stability and crisis management, the resolution framework represents an international best practice. The pertaining EU Directive — which is also intended to promote the harmonisation of resolution law — was passed in April 2014. Contents of the Hungarian draft bill are aligned to that of the Directive and are aimed at transposing its concepts into Hungarian law.

3. What will be the resolution authority?

Under the Bank Recovery and Resolution Directive (BRRD), member states may appoint one or more resolution authorities. Pursuant to Article 4(8) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, it is the MNB that shall act as the resolution authority, the pertaining tasks of which shall be defined in separate legislation.

This, however, does not mean that other organisations (e.g. the Government, the Ministry for National Economy, the National Deposit Insurance Fund [OBA], the Investor Protection Fund [BEVA]) do not play an important role in mitigating the crisis of financial institutions. Their tasks in resolution will be defined in the Resolution Act that is currently awaiting adoption by Parliament.

4. Do the MNB's microprudential supervisory powers represent any conflict of interest concerning its scope of authority in resolution?

It is a requirement of the European Union that, if a member state assigns the function of resolution to an existing body, adequate separation of functions must be guaranteed in order to avoid any conflict of interest. Microprudential supervision already meets this requirement.

5. Why is it the MNB and not the Government that will have the tools of resolution at its disposal?

When enacting the new Act on the Magyar Nemzeti Bank, the Parliament decided to assign the MNB as the resolution authority. The powers of resolution are contained under Article 4 (8) of said Act. One of the reasons behind this decision was that the MNB's tasks in supervision and financial stability are well suited for the function of resolution. Moreover, the information collected by the MNB in its supervisory and macroprudential role provide for a more effective preparation to resolution as opposed to having a separate authority collect these data from institutions on its own.

Nevertheless, the draft bill still leaves certain powers in the Government's hands. For instance, it is entitled to raise capital in institutions brought under resolution. In addition, all fiscal expenditures (which, given the requirement of fiscal neutrality, can only be of a temporary nature) require Government approval.

6. Under what legislation is the Magyar Nemzeti Bank (MNB) entitled to engage in resolution and from what date?

Pursuant to Article 4(8) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, it is the MNB that shall act as the resolution authority, the pertaining tasks of which shall be defined in separate legislation. This separate legislation is the Resolution Act, which details the purpose and principles of resolution, regulates applicable scopes of authority and related instruments, the Resolution Fund and the measures intended to protect owners and creditors, as well as the options for redress against administrative proceedings.

The Act on resolution is based on the provisions of the Recovery and Resolution Directive (RRD) and, after adaptation, became effective two months thereafter (certain elements took effect after three business days).

7. The option of resolution will be available to what types of financial institutions?

In line with the CRD IV/CRR package, the resolution framework will primarily apply to credit institutions and investment enterprises headquartered in Hungary, as well as to financial undertakings subject to consolidated supervision. Furthermore, the legislation will also apply to financial and mixed holding companies headquartered in Hungary, as well as the Hungarian affiliates of institutions based in a third country.

The European Commission is currently evaluating the prospects of extending the scope of the resolution framework to other types of institutions (e.g. financial infrastructure, insurance companies). Should this become a reality, the list of institutions subject to the Hungarian framework will certainly also be extended.

8. Does Hungary's resolution framework represent a unique local regulation or are there other examples within the EU?Do other countries (e.g. EU member states) have similar regulatory frameworks and mechanisms in place?

The contents of the Resolution Act are of EU origin, and other member states have until 2015 to establish their respective frameworks and harmonise them at EU-level. A number of member states (such as Germany, the United Kingdom, France, Belgium, the Czech Republic, the Netherlands and Spain) as well as third countries outside the EU (e.g. the United States and Japan) already have resolution mechanisms in place.

9. Is resolution ultimately aimed at the termination or rescue of a given financial institution? Or is neither of the two statements accurate?

Resolution measures are aimed at maintaining financial stability and ensuring the continuous operation of critical functions (e.g. uninterrupted access to bank deposits) of the financial system. Neither the rescue nor the termination of a given institution can be considered a priority, as the main objective is to provide the possible highest level of protection for secured depositors while keeping market functions operational and maintaining financial stability. Depending on the circumstances, these objectives might call for the complete or partial sale of a distressed institution and, in many cases, for the liquidation of whatever units remain.

10. Can a successful resolution proceeding help restore the operations of a financial institution, and, if done without success, can it lead to liquidation?

Both outcomes are indeed possible as there is no guarantee for the success of resolution. However, it is generally accepted that resolution ensures the continuity of critical (essential) functions for a troubled institution (it is not the institution itself that takes priority but the availability of core services it offers).

11. What options do financial institutions — whether headquartered in or outside the EU — have when it comes to the resolution of their Hungarian affiliates?

As a general rule, the Hungarian affiliates of financial institutions headquartered in a third country are subject to resolution proceedings that are imposed in the given third country. However, under certain circumstances there is a legal opportunity for the MNB to have such affiliates subjected to Hungarian resolution law, even if resolution of the institution at hand has already commenced or in the third country, whether prior to or concurrently with the Hungarian proceeding.

12. Under what specific conditions is the MNB entitled to engage in the resolution of a financial institution?

Resolution may commence if all of the following three conditions are met:

a) actual or foreseeable insolvency,

b) no other means are available to restore solvency,

c) it is of public interest.

13. In what ways do resolution proceedings differ from supervisory action that the MNB already has in its toolkit (e.g. delegation of a supervisory commissioner), from the revocation of the supervisory licence or the instigation of a liquidation/dissolution proceeding?

Supervisory crisis management only entails the assignment of management rights (with the delegation of a supervisory commissioner); meanwhile ownership rights continue to remain with the owners of the distressed institution. Crisis management by way of resolution provides the authority with more powers than supervision itself: not only can managerial rights be revoked but the owners' power of disposal may also be suspended and their decisions are made by the resolution authority during the procedure.

Previously, if supervisory crisis management ended without success and the owners of the distressed institution could not restore its solvency, the only alternative left was to revoke its licence and initiate, whether directly or indirectly, winding-up proceedings. This latter is a lengthy procedure that typically takes years and does not ensure the continuity of critical functions. With the introduction of resolution, the range of options available for crisis management is now expanded, allowing for its use at certain types of institutions if supervisory crisis management ends in vain. This way, the MNB can guarantee that critical functions remain unaffected (for instance, deposits remain available and do not get ‘frozen’, thus warding off the need for indemnification by the OBA).

14. Is it true that the Hungarian Financial Supervisory Authority (HFSA), MNB’s legal predecessor in the matter, had no concrete tools by which to effectively proceed with a distressed but not yet insolvent financial provider in case its owners refused to cooperate?

Yes, that was an apparent problem. Before resolution was introduced, the success of crisis management had greatly depended on the owners’ willingness to cooperate. The function of resolution can now enable the MNB to also proceed in cases where the owners of apparently or predictably insolvent institutions are unable or not willing to maintain or restore solvency. Furthermore, in its new scope of competence, the MNB may — in the protection of depositors and to safeguard financial stability — make certain decisions instead and on behalf of the owners themselves.

15. What are the main types of measures the MNB is entitled to adopt under resolution?What is the intended purpose of these actions and based on what aspects does the MNB decide which one to apply in a particular case?

The MNB has the competence to adopt a wide variety of measures, during ‘peacetime’ and in situations of crisis alike.Measures available in the preparatory period (e.g. obligatory removal of obstacles to resolvability) pave the way for an effective resolution proceeding; meanwhile those that can be adopted in an actual event of distress are intended to address the crisis that emerges because insolvency is imminent (e.g. dismissal of executives, use of resolution tools such as asset transfers, write down or conversion of capital instruments, intervention in contractual relationships). In the course of its resolution activities, the MNB primarily relies on actions that can be reasonably expected to help achieve the resolution objectives.

16. What does creditor bail-in refer to?

It is a resolution tool whereby a troubled financial institution that is on the brinks of bankruptcy can be recapitalised without having to resort to taxpayer funds. Instead, uninsured creditors and bond holders agree to bear, after shareholders have been divested of their shares, the remaining burdens and to having their claims cancelled or converted into equity (and therefore becoming owners themselves). As a result, the institute will most likely be saved from dissolution or liquidation and can safely resume normal operations and serve its clients.

17. What liabilities can be written down or converted as part of a creditor bail-in procedure?

In line with the EU Directive, creditor bail-in will primarily extend to the distressed institution's unsecured and uncollateralised liabilities. It will therefore not apply to deposits insured by the OBA, investments backed by the BEVA, liabilities with an original maturity of less than 7 days, liabilities owed to non-group member institutions or arising from participation in designated payment and settlement systems and owed to such systems or participants in such systems, client assets, as well as wages payable to the institution's employees, taxpayer liabilities and liabilities arising from service contracts.

During the resolution process the MNB may, under special circumstances, decide to have additional liabilities excluded, if necessary for sustaining the institution's critical functions and key business lines or when such exclusion may help avert a negative spillover effect, and when creditor bail-in for a given liability is not possible within an adequate time frame.

18. Would the MNB also resort to depositors' assets in recapitalising an institution under resolution?

Up to the designated coverage limit that currently stands at EUR 100,000, deposits at the institution are fully protected and their holders therefore need not participate in bearing any losses. On the contrary, their protection gets reinforced, because resolution can often render the OBA's indemnification proceedings unnecessary as access to retail deposits remains uninterrupted.

19. Can creditor bail-ins put household savings at risk?

On the contrary: one of the key objectives of resolution is to prevent savings from being affected in any way. Creditor bail-in helps to ensure that creditors ineligible for protection (typically outside corporate and retail circles), rather than the Government (taxpayers), meet the costs of the failure. During the resolution proceeding, it is shareholder equity that is written down first, after which the authority may convert some of the savings of creditors or major depositors into shares, thereby ensuring that the costs of such failure are borne by shareholders and creditors, and that the institution can continue to operate in safety.

20. How does creditor bail-in affect deposits below EUR 100,000?

Those insured by the OBA are not affected in any way.

21. And what if someone has more than EUR 100,000 in savings?

Up to the coverage limit of EUR 100,000 (approx. HUF 30 million), deposits are not affected by creditor bail-in. To the extent necessary, amounts in excess of this limit might be resorted to in a bail-in regime. In such cases, affected major depositors are compensated with the shares of a restored and fully operational bank, and can continue to have access to their remaining funds once the bank's restructuring is complete.

22. In what sequence do the various liabilities get bailed-in?

Liabilities get bailed-in in the same order as if the institution were to be delisted under normal liquidation. Correspondingly, equity claims of the original owners are forfeited before other creditors are brought in to absorb losses. Once shares and other similar equity instruments are written down, subordinated loans get bailed-in and only then come creditors and bond-holders. Deposits and investments, whether unsecured or exceeding the insurance limit, are only used as a last resort and to the extent necessary.

23. In a resolution scenario, can the MNB acquire ownership rights and make decisions in the name, on behalf and without consent of the hitherto owners of the financial institution at hand?Would not that be interpreted as nationalisation?

As a resolution authority the MNB is entitled — with the enforcement of resolution objectives in mind — to exercise ownership rights over an institution under resolution, that is, to decide in matters that would otherwise fall within the owners' jurisdiction. Such authorisation may be used out of public interest, under strict guarantee rules.

Exercising ownership rights is not synonymous with nationalisation, as it does not entail the actual transfer of such rights to the State; it merely represents their interim takeover. As far as these rights are concerned, the person of the owner remains unchanged — it is only the rights of disposal over assets that get restricted or suspended for a temporary basis, in line with pertaining EU regulations.

24. Do the MNB's resolution proceedings violate the EU's prohibition on monetary financing?

Absolutely not. The MNB itself does not provide financing during the resolution process: that will always come from a newly established Resolution Fund, a proposed pool of contributions by market participants. Unlike the practices at the OBA, the MNB may not engage in lending to the Resolution Fund, not even when backed with a state guarantee.

25. In a resolution scenario, which parties get to absorb the losses of the affected financial institution and in what order?Who gets to bear the costs of resolution?

The losses of an institution under resolution are borne primarily by its owners (original owners and subordinate creditors who, in the event that capital instruments are converted and written down, become owners themselves). As a guarantee rule, the owners' losses must not exceed what they would face were the institution under resolution liquidated.

The costs of resolution are covered by the Resolution Fund, which in turn becomes a creditor to the institution under resolution. Non-recoverable expenses of the Resolution Fund are registered as losses and reduce the assets at the Fund's disposal. Market participants are responsible for financing the Resolution Fund; it is therefore credit institutions and investment enterprises — the primary beneficiaries of stability in the financial markets — that ultimately pick up the tab.

26. What new institutions must be established for the resolution framework?Who will be assigned the bridge institution and asset separation tools (a private or public institution)?Who will have oversight over the Resolution Fund?

The proposed resolution framework calls for the establishment of a number of new institutions:

a) resolution fund,

b) asset separation entity (if necessary),

c) bridge institution (if necessary).

<u>Resolution Fund:</u> Financed ex-ante by contributions from market participants, this fund is considered a separate legal entity and is handled by its own board of directors and the OBA's working organisation. The target funding level defined in the Directive must be reached in a period no longer than 10 years. Where ex-ante contributions are not sufficient for financing the resolution objectives (e.g. during the initial period), extraordinary ex-post contributions may be ordered. Additionally, the Resolution Fund may also raise external funds (e.g. through a bond issue). Public financing made available to the Resolution Fund may only be of a temporary "bridging" nature, which market participants are required to repay to the Government with statutory interest (*principle of fiscal neutrality*).

<u>Asset separation entity:</u> As a resolution tool, asset separation allows for the separation of performing assets of the institution under resolution from its under-performing or impaired assets, with the latter being transferred to an asset separation entity. As a requirement under the Directive, the asset separation entity must be in majority state ownership or control. However, whether to assign these tasks to an existing or a newly established institution already falls within member state competence.

<u>The bridge institution tool:</u> It is a resolution tool in majority state ownership that is created for the purpose of carrying out, as an interim solution, the critical functions and holding the assets of one or more institution under resolution, if such temporary transfer or sale to a private-sector purchaser is not feasible or possible. A bridge institution could be a bridge bank or bridge investment enterprise, depending on the type of the institution under resolution whose critical functions, assets, liabilities, rights and responsibilities have been transferred to the bridge institution.

27. Does the creation of an institutional framework for the resolution of banks represent additional government red tape, or is it actually the most economical solution possible?

The institutional framework of resolution does not add to state bureaucracy: most functions get established within already operating organisations and the costs of newly created institutions are overshadowed by the positive implications of resolution (more efficient crisis management that is financed from the market rather than from public funds, reinforcing financial stability).

28. Who will be called in to contribute to the Resolution Fund?What is the target level of and the applicable time frame for building up the Resolution Fund?Will contributions to the Resolution Fund be registered as yet another 'tax' imposed on financial institutions?

Under the directive, the Resolution Fund will have to be built up to reach a target level of at least 1 per cent of covered deposits, in a transition period of no more than 10 years. While contributions to the Resolution Fund indeed represent payment obligations above the current taxes and dues, market participants will be making these payments 'for their own sake', as the Fun will only be available for resolution purposes. Intended to help finance the resolution of distressed institutions, the Fund is a tool for strengthening financial stability and market participants therefore have a vested interest in building it up within the possible earliest time frame. It must also be noted that imposing these contributions is an obligation equally applicable under the Directive to each EU member state.

29. Can the assets thus far accumulated in the National Deposit Insurance Fund be re-allocated for resolution purposes and the other way round: would the Resolution Fund be available for deposit insurance purposes as well?If necessary, would the Government or consumers be asked to share additional burdens in the resolution process?

Under applicable EU regulations, assets in the OBA may be used for resolution purposes up to a maximum of 0.4 per cent of covered deposits, provided that continuous access to deposits is maintained during resolution (that is, no indemnification is paid), and to the extent the OBA would be liable for in a possible indemnification (in other words the OBA may not provide co-financing to the resolution of an institution excess of what it would have to pay out as indemnification were the institution under resolution be subject to normal liquidation proceedings). The option of co-financing only goes one way as the Resolution Fund cannot be used to finance the OBA's deposit insurance activities.

If, during the transition period of building up the Resolution Fund, a payment obligation arises for which sufficient funds have not (yet) been accumulated, and extraordinary contributions cannot be ordered due to their procyclical effect or other reason, it might be necessary on a temporary basis to provide the necessary funding from the Government budget. These public funds, made available in the form of a loan, will have to be repaid by the Fund, together with applicable interest, from market participants' ex-post contributions. Therefore, while budgetary resources may indeed be relied upon to a significant degree, this will only be temporary in nature — the Government, in line with EU regulations, can only provide bridge financing (fiscal neutrality principle).

30. Will the Resolution Act provide any options for redress, as well as provisions intended to protect the interests of owners and creditors?

Yes. Petitions for redress against resolution measures may be filed with the court. Such petitions cannot be aimed at getting resolution measures suspended from execution, but those having suffered damages as a result of an unlawful administrative decision may indeed be eligible for indemnification.

Owners and creditors will see their interests being safeguarded by additional guarantee rules, the most important of which is the so-called 'no worse off principle', ensuring that no owners and creditors should be left worse off than they would have been had the institution under resolution gone into full liquidation. This means that owners and creditors of an insolvent institution can only benefit from resolution, as even in a worst-case-scenario they can still expect a minimum return they would be eligible for under liquidation.

MAGYAR NEMZETI BANK