

**Sunk in the Atlantic—  
Going concern and  
franchise value in [out]  
EU bank resolution**



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# 1. EU legislation, soft law, and case-law

BRD/BRR/Delegated Regulations	FSB's KA/EBA's Tech Standards	ECJ case law
<p>1. Resolution is aimed to ensure the <b>continuation of banks' critical functions</b> and to protect <b>financial stability</b></p> <p>2. Bank resolution is <b>superior to bankruptcy</b>, as the latter <b>destroys value</b> and fosters its <b>contagion</b> throughout the sector</p>	<p>1. Resolution must be triggered <b>before</b> the concerned bank is <b>balance-sheet insolvent</b></p> <p>2. <b>Fire sale liquidation</b> of assets must be avoided at all times to <b>reduce the amount of additional resources required</b> by the operation</p>	<p>1. A bank can be put in resolution <b>whether or not it is balance-sheet insolvent</b>, providing the authority deems it <b>not viable</b></p> <p>2. The resolution authority is empowered with <b>wide discretion</b> to decide what resolution tools are suitable and expedient</p>
<p>3. Regarding the <b>valuation</b> of the affected entity, it must be considered <b>gone concern</b>, and <b>no franchise value</b> shall be taken into account</p> <p>4. This is in force for both <b>pre</b> (1-FOLTF &amp; 2-RTools) and <b>post-resolution</b> (3-NCWO) Valuations</p>	<p>3. Legislation must envisage clear rules for entities' valuation and ensure the <b>independence of the valuers</b> in charge</p> <p>4. Franchise value must not be enforced as <b>the entity in resolution is considered out of business</b></p>	<p>3. Valuers' independence shall be analyzed just in terms of potential <b>conflict of interest between the valuer and the resolution authority</b>, setting aside other stakeholders (eg, the acquirer)</p> <p>4. The resolution decision <b>renders impossible by itself</b> any going concern criterium for the entity's valuation</p>

## 2. Zero-sum or positive-sum game? (1)

ASSETS	LIABILITIES
100 Other assets	Equity 100
150 Loans	Long-Term Debt (subordinated) 50
50 NPLs	Long-Term Debt (senior) 40
	Sort-Term Debt (repos&derivatives) 30
	Deposits 80
300	300

1. Once the losses stemming from NPLs (50) are wiped out against existing Equity (100) and the conversion of LTD (subordinated) (50) into equity bail-in is enforced, but the entity needs **regulatory capital**, and more than probably **liquidity**.
2. If a gone concern/fire sale valuation method is applied, NPLs should be greater, and the rest of the loan portfolio value will drop heavily, so that **more capital and liquidity would be required**.
3. Wounding up and/or converting senior LTD (40), not to mention STD (repos&derivatives) (30), would be **disastrous and panic fostering**.
4. Conclusions: (i) **value preservation is a pre-requisite** in bank resolution, (ii) a receiver is required for **gaining time, preserving value, fresh resources addition**, and **taylor-made P&A** fashioning.

## 2. Zero-sum or positive-sum game? (2)

1. A deeper restructuring of the entity is done, normally when the liquidity stress and losses are larger. The P&A operation consists of **splitting the troubled entity in a dual 'bad'/'bridge' structure** (for the sake of simplicity, we use here the same figures):

**'Bad' Bank**

ASSETS	LIABILITIES
50 NPLs	Equity 100
50 Shares of the 'bridge' bank	
<b>100</b>	<b>100</b>

**'Bridge' Bank**

ASSETS	LIABILITIES
100 Other assets	Equity 100
150 Loans	Long-Term Debt (senior) 40
	Short-Term Debt (repos&derivatives) 30
	Deposits 80
<b>250</b>	<b>250</b>

2. Up-front losses are imposed to bail-inable liability holders as explained in former step 1 (previous slide), but **some recovery is feasible (partially)** via dividends from the 'bridge' bank to the 'bad' one and/or the results of the purchase of the 'bridge' by a potential acquirer in the future. **Shareholders' and bondholders' property rights are respected.**

3. In a normal scenario, the **addition of fresh resources** is required to restore the 'bridge' bank's solvency and liquidity levels. The receiver (the Deposit Insurance Facility/Resolution Fund) is in charge of it, via own funds (levied from the industry) and/or indebtedment.

4. When 3 happens, a new liability layer (preferred equity and/or super-senior debt) is created (with its accounting counterpart in cash and/or liquid assets on the assets side) in the 'bridge' bank, which is managed by the receiver in a **'debtor-in-possession'** manner.

### 3. Bank resolution and insolvency law: coincidences and divergences

FEATURE	INSOLVENCY	RESOLUTION
1. Value preservation	For the sake of <b>creditors' satisfaction</b>	To contain the contribution of <b>additional/external resources</b>
2. Goin/gone concern	Neither functions, nor entities	Continuation of <b>functions</b> , not entities
3. Spill-over effects (externalities)	None, reallocation of economic resources by <b>market discipline</b>	Money supply by <b>cheaper credit</b> and <b>financial stability</b>
4. Resources involved	The ones inside the <b>entity's balance-sheet</b>	The ones inside the entity's balance-sheet, industry's <b>pooled funds</b> , and <b>fiscal backstop</b>
5. Incentives' fashioning	Liabilities' hierarchy mirrors the degree of diligence demanded to creditors to <b>monitor the performance of the entity</b>	Apart from <b>regulators and entity's directors</b> , the exit/loyalty choice is the tight leeway for stakeholders, shareholders included
6. Property rights protection	In full, according to the <b>sacrality of contracts</b> and <b>statutory provisions</b> ( <b>bilateral justice</b> )	Distribution by <b>administrative collective action</b> to deal with systemic risk ( <b>multilateral equity</b> )

# 4. Conclusions and policy proposals

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1. Value preservation must be deemed a **driven principle in bank resolution** that conducts: *(i)* early intervention measures, *(ii)* the resolution trigger, *(iii)* resolution tools' fashioning, *(iv)* the market re-entry of the resulting entity, partially or overall, last but not least *(v)* the valuation of the entity for any purpose and at all stages.
2. A forthcoming **EU Common Deposit Insurance Facility** must act as receiver to: *(i)* avoid the *tit-for-tat* strategy embedded in the current bail-in reliant resolution regime, *(ii)* administer the entire resolution scheme at the EU level, in coordination with the SSM, the SRM, the ECB and member States' bodies, *(iii)* collect ex-ante and ex-post levies from the industry to cover the addition of funds for resolution operations, *(iv)* obtain public guarantees for debt issuance, *(v)* ushers the fiscal backstop in case of systemic disruption.
3. **Going concern** and **franchise value** are the valuation criteria consistent with the continuation of the entity's critical functions, no matter the outcome, conservative, asset-stripping, or a combination of both.
4. Beyond than bail-in, the sound **respect of stakeholders' property rights** keeps banks inside the financial market, channels discipline and permits the smooth operation of administrative collective action institutions, like resolution.