



ICELAND

FINANCIAL SECTOR ASSESSMENT PROGRAM

TECHNICAL NOTE ON FINANCIAL SAFETY NET CRISIS MANAGEMENT

July 2023

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June 21, 2023

TECHNICAL NOTE

FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

Prepared By
**Monetary and Capital Markets
Department**

This Technical Note was prepared by Antonio Carrascosa in the context of a Financial Sector Assessment Program (FSAP) mission for Iceland, led by Etienne B. Yehoue. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

AC	Appraisal Committee
BRRD	European Union Bank Recovery and Resolution Directive (2014/59/EU)
BU	Banking Union
CBI	Central Bank of Iceland
CCP	Central Clearing Counterparties
CMH	Crisis Management Handbook
CRD	IV EU Capital Requirements Directive (2013/36/EU)
CRR	EU Capital Requirements Regulation (Regulation (EU) 575/2013)
DG Comp	Directorate General for Competition of the European Commission
DGS	Deposit Guarantee Scheme
D-SIB	Domestic Systemically Important Bank
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
EIM	Early Intervention Measures
ELA	Emergency Liquidity Assistance
EU	European Union
FME	Financial Supervisory Authority (merged with the CBI)
FMEN	Financial Supervision Committee
FMI	Financial Market Infrastructure
FOLTF	Failing or Likely to Fail
FSA	CBI's Financial Supervisory Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSN	Financial Stability Committee
FX	Foreign Exchange
GDP	Gross Domestic Product
Key Attributes	FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions
MoFEA	Ministry of Finance
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NCWO	No Creditor Worse Off than in liquidation
P&A	Purchase and Assumption
PIA	Public Interest Assessment
RA	Resolution Authority
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
TREA	Total Risk Exposure Amount
TVF	Icelandic Depositors' and Investors' Guarantee Fund

EXECUTIVE SUMMARY

This Note assesses and makes recommendations regarding the different elements of the financial safety net in Iceland. The scope of the assessment includes the institutional arrangements for recovery, resolution, and crisis management; the oversight of banks' recovery plans; the legal regime for bank bankruptcy and resolution; resolution planning by the authorities; the funding mechanism to support resolution; the deposit guarantee scheme; and the government authorities' collective preparedness to deal with financial crises.

As Iceland is a member of the European Economic Area (EEA), the European Union (EU) financial regulation has been mostly adopted. That implies that the country has a relatively sound first layer of the financial safety net's legal framework through the transposition of European Directives—albeit thereby also exposing it to the transitional and structural challenges of the EU's crisis preparedness and management framework.¹ Weaknesses are nonetheless identified in the layer of policies, implementation rules and procedures affecting all the elements of the framework, for instance: (i) escalation triggers in recovery plans; guidance on the adoption of the failing or likely to fail (FOLTF) of a bank; (ii) valuation in resolution; bail-in playbooks for banks; (iii) procedures and systems to ensure quick pay-outs to insured depositors by the Icelandic Depositors' and Investors' Guarantee Fund (TVF), as well as testing them periodically etc.

Recovery planning requirements are comprehensive and well implemented. Recovery planning is reaching maturity in the largest banks. The Financial Supervisory Authority (FSA) in the Central Bank of Iceland (CBI) should promote plan testing as a routine business practice among the largest banks.

The regime for banks that are systemic adheres to the internationally agreed resolution standards (with bail-in as preferred resolution tool). Considering that the Resolution Act was approved just in 2020, further work is needed to operationalize the application of all the resolution tools, to ensure operational continuity and liquidity in resolution, to enable separability, and to identify significant impediments to resolution.

The current institutional framework for crisis management lacks formal involvement of the Ministry of Finance (MoFEA). Given the responsibilities of the MoFEA in relation to resolution decisions that may require fiscal resources, it is necessary that the MoFEA be informed on resolution issues well ahead of the failure of a bank. The FSAP recommends setting up a coordination body involving the MoFEA to strengthen cooperation/coordination to develop a more structured dialogue between the MoFEA and the Resolution Authority (RA) at the CBI, while preserving the independence of the RA.

The legal regime for bankruptcy and liquidation of banks that are not systemic, is sound. There are special proceedings to liquidate a financial undertaking, the FSA has an active role in the

¹ See IMF Country Report No. 18/226 and Appendix I.

process and the liquidator has effective tools to perform the liquidation. Under the current bankruptcy and deposit protection frameworks, the main function of the TVF is to pay out the insured deposits.

The Deposit Guarantee Fund (TVF) should be strengthened in line with EU requirements of the Deposit Guarantee Scheme Directive (DGSD). In particular, and to foster compliance with international standards, the maximum deadline for disbursements should be reduced to seven days from one year in the current framework; and the TVF also needs a legal provision to allow the Fund to have access to adequate backup funding sources. In addition, the authorities should assess the potential introduction of a paybox plus mandate subject to a least cost test. As the actual funding level of the TVF was much higher than the minimum requirement of the DGSD, the resolution fund has been funded with a transfer of excess contributions in the TVF.

Finally, the authorities' collective contingency planning for financial crisis (including testing of plans) should be intensified. The CBI is completing a crisis management handbook (CMH) to specify procedural steps, responsibilities, triggers in the escalation process, etc. in the run up to a bank crisis. This CMH can be a key driver to mitigate the aforementioned weaknesses in policies and procedures. The CBI should extend the CMH to the management of a bank resolution and approve it as soon as possible, as well as testing it in a full crisis-simulation exercise.

Table1. Iceland: Key Recommendations				
#	Recommendations	Authority Responsible for Implementation	Priority¹	Timeframe²
Bank Resolution				
1.	A coordination body on resolution issues involving the MoFEA should be established.	CBI and MoFEA	H	NT
2.	The CBI should hire more staff for the RA or could transfer temporarily some resources to the RA.	CBI	H	NT
3.	The MoFEA should propose that the legal protection of the current and former members and staff of the decision-making bodies of the financial safety net is specified in the law.	MoFEA	M	MT
Bank Insolvency				
4.	The FSA should test the rules and procedures for the winding up of a financial institution through a crisis simulation.	CBI (FSA)	M	MT
5.	The FSA should develop an internal guidance to ease the supervision of the operations of a financial undertaking managed by a winding-up board and its interaction with the District Court.	CBI (FSA)	M	MT
Recovery Planning				
6.	The CBI should develop guidance on escalation triggers in recovery plans.	CBI (FSA)	M	MT
7.	The CBI should develop guidance on the testing of recovery plan implementation.	CBI (FSA)	M	MT
Resolution planning				
8.	The RA should undertake further work in resolution planning, in particular regarding the ability to implement all the resolution tools, to ensure operational continuity and liquidity in resolution, and to enable separability.	CBI (RA)	M	MT
9.	The RA should strengthen necessary dialogue with banks by sending every year an executive summary of the resolution plans and letter to the bank's board spelling out the priorities of the RA.	CBI (RA)	M	MT
10.	The RA should further assess potential impediments to resolution coming from the participation of the State and pension funds in the ownership of banks.	CBI (RA)	M	MT
11.	The RA should elaborate granular and operational guidance on topics such as procedures related to FOLTF, valuation and application of all the resolution tools.	CBI (RA)	H	MT

Table 1. Iceland: Key Recommendations (Concluded)

12.	The RA should provide guidance to the banks to prepare bail-in playbooks.	CBI (RA)	H	NT
13.	The RA should contact the resolution authorities of Ireland and Luxembourg to increase the extraterritorial effectiveness of its bail-in decisions.	CBI (RA)	M	MT
Resolution Fund				
14.	The RA should assess the financial capacity of the resolution fund in different scenarios of bank crisis and the need for a backstop; while introducing greater flexibility through a financial stability exemption for the 8 percent minimum bail-in requirement, subject to strict criteria.	CBI (RA)	M	MT
Emergency Liquidity Assistance				
15.	The CBI should operationalize ELA, including the assessment of collateral eligibility in the context of on-site inspections.	CBI	M	MT
Deposit Insurance				
17.	The MoFEA should introduce a maximum reimbursement timeframe of seven business days and assess the potential introduction of a paybox plus mandate subject to a least cost test.	MoFEA	H	NT
18.	The TVF should be provided with access to adequate backup funding sources (MoFEA or CBI).	MoFEA and CBI	H	NT
19.	TVF should implement procedures and systems to ensure quick pay-outs to insured depositors and it should regularly test its pay-out procedures by performing simulations.	TVF	M	MT
Financial Crisis Preparedness and Cooperation				
20.	The CBI should approve the crisis management handbook as soon as possible, widen its scope to the bank resolution stage, and test it in a full crisis-simulation exercise (CBI).	CBI	H	NT
21.	In the CMH, a communication plan for financial crisis (including specifying the authority in charge of leading that communication) should be drafted and approved.	CBI	M	MT
22.	Icelandic authorities should actively participate in the Nordic-Baltic Stability Group and other European fora. This active participation is also justified by the need of introducing borrowing arrangements with national resolution funds / deposit guarantee schemes.	MoFEA and CBI	M	MT
	1. H: High, M: Medium 2. Near term: < 12 months; Medium term: 12 to 24 months.			

INTRODUCTION

A. Scope of the Note

1. **This Technical Note assesses and makes recommendations for the authorities' consideration regarding bank failure mitigation and resolution regime.** It summarizes the findings of the FSAP mission undertaken during the period November 28-December 9, 2022. The note addresses: (i) the public oversight of recovery plans prepared by banks, (ii) the resolution planning activity by the resolution authorities; (iii) the institutional and legal framework for resolving failed banks and financial safety nets; and (iv) the authorities' preparedness to deal with bank crises. The authorities relevant to this note are the Central Bank of Iceland (CBI), the Ministry of Finance (MoFEA), the Financial Supervisory Authority (FSA) and the Resolution Authority (RA) in the CBI, and the Deposit Guarantee Fund (TVF).
2. **The assessment is based on an analysis of legislation and of documentation relating to policies and procedures, and on discussions with the authorities and the private sector.** The Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), the resolution policies developed by the Single Resolution Board (SRB) and the Core Principles for Effective Deposit Insurance Systems serve also as a frame of reference for certain recommendations proposed in this Note.

B. The Financial Sector in Iceland

3. **In Iceland eleven credit institutions are operating under the remit of the RA, including four commercial banks and five savings banks.** There are no foreign banks operating in the country². At year-end 2021, total assets in the financial system amounted to roughly 450 percent of Iceland's Gross Domestic Product (GDP). In 2007, a year before the financial crisis, that percentage was around 900 percent. Pension funds have the largest share, 170 percent of the GDP and about 45 percent of financial system assets. The combined assets of commercial banks amounted to about 150 percent of GDP.
4. **Pension funds play a very significant role in the Icelandic financial sector³, holding 18 percent of the mortgage market and 25 percent of bank shares.** They are also key players in the funding for non-financial corporates and the foreign exchange market. The interlinkages with banks are increasingly larger and pension funds account for about 13 percent of total bank liabilities. This includes deposits with commercial banks (accounting for 3.5 percent of bank liabilities), holding of bank bonds (accounting for 7.25 percent of bank liabilities) and holding of bank equity (accounting for 1.75 percent of bank liabilities). Pension funds account for a sizable portion of banks' non-deposit funding: about a half of domestic bonds issued by banks are held by pension funds.

² See Central Bank of Iceland: "Economy of Iceland 2022", October 2022.

³ See International Monetary Fund: "Iceland. Staff Report for the 2022 Article IV Consultations", June 3, 2022.

5. The three largest banks (Landsbankinn, Íslandsbanki and Arion banki), represent 95 percent of the banking sector and are classified as domestic systemically important banks (D-SIB) by the Financial Stability Committee (FSN). There are five savings banks with a negligible market share (less than 1 percent of total assets of the banking sector). The majority of the D-SIBs' funding is in the form of deposits and marketable bonds. At year-end 2021, deposits comprised about half of their funding. Most of the deposits (96 percent) were held by Icelandic residents. The banks' market funding has increased in recent years, comprising 28 percent of total funding at year-end 2021. At the end of 2021, the holding of foreign-denominated bonds by commercial banks was below 2 percent of their total assets. None of the debt of three largest banks is issued to parent or other group entities and there are no other significant intra-group funding arrangements and guarantees.

6. The State and pension funds are major shareholders in the three largest banks. The State holds 98.2 percent of shares in the largest commercial bank, Landsbankinn hf, and 42.5 percent of shares in Íslandsbanki hf following the sale of 57.5 percent of its stake in the beginning of 2021. The third large commercial bank, Arion Banki hf, is wholly owned by private investors. Some pension funds also hold large stakes in banks, although they are not usually very active investors. Seven funds have 25.38 percent of Íslandsbanki's capital. Arion bank has also a very significant participation of seven pension funds (41.63 percent) in its capital.

7. The D-SIBs comfortably meet minimum capital requirements and leverage ratios. These entities must meet the Central Bank's minimum capital requirement, which ranged between 17.8 percent and 18.9 percent as of year-end 2021. The D-SIBs' capital ratios were 5-8 percent above the required level, after adjusting for dividend payments planned for 2022. The D-SIBs' leverage ratio, a measure of equity relative to total non-risk-adjusted assets, was among the highest in Europe, 13.8 percent at year-end 2021.

8. The overall economic situation worsened in the wake of the pandemic, but the effects varied from one sector to another. The banks supported businesses and households affected by the pandemic by offering payment moratoria and loan freezes to all who requested them. In some instances, borrowers had the option of restructuring or refinancing their debt. Banks' profitability has improved since pandemic restrictions ended, reflecting lower required provisions, increase in fees and commissions, and a declining cost-to-asset ratio. The ratio of non-performing loans was, at year-end 2021, lower than before the pandemic. At that time, 13 percent of corporate loans and 2 percent of household loans were classified as forborne. A majority of customers with forborne loans have begun to make full or partial payments on them.

9. Overvalued house prices combined with household debt burden could result in systemic risks. By end-2021, household credit growth reached 10 percent, raising household debt to 84 percent of the GDP. The combination of high house prices and household indebtedness may trigger a negative spiral between the financial system and the economy in the event of a house price correction. The spiral might be amplified further by the large share of indexed and variable rate

loans⁴ and the interconnectedness of the pension funds with the banks and their systemic importance. Nevertheless, banks' capital position is considerably above the minimum capital requirement, which provides strong buffer⁵.

C. General Institutional Framework

10. The Financial Stability Council is a formal high level cooperation venue for public authorities in the field of financial stability. This Council is chaired by the Minister of Finance and the Governor is one of its members. The main tasks of the Council are⁶ to formulate official financial stability policy; to monitor economic imbalances, financial system risks and undesirable incentives that can jeopardize financial stability; and to evaluate the effectiveness of macroprudential tools. The Council relies primarily on proposals and analyses from the CBI.

11. The CBI, in its role of ensuring financial stability, focuses on assessing risks facing systemically important financial institutions, identifying macro-financial imbalances, and securing a safe and sound operation of payment and securities settlement systems. The CBI regularly analyses risks and threats to the stability of the Icelandic financial system in order to detect vulnerabilities that could undermine financial stability. In order to enable it to achieve its macroprudential objectives, the CBI is equipped with adequate macroprudential instruments. Decisions on the application of the CBI's financial stability policy instruments shall be taken by the Financial Stability Committee (FSN).

12. The FSN coordinates the public response to threats to financial stability or to events, that could potentially cause significant contagion effect or damage in the financial system. The FSN is chaired by the Governor of the CBI and its members include: the Deputy Governor for financial stability, the Deputy Governor for monetary policy, the Deputy Governor for financial supervision and three external members appointed by the Minister. An appointed official from the MoFEA shall also participate in the meetings as a non-voting member with the right to address the meeting and present proposals. One of the tasks of this Committee is to decide which supervised entities, infrastructures, and markets shall be considered systemically important and of a nature such that their activities could affect financial stability. The FSN also has an advisory role involving the assessment of developments and prospects for the financial system, systemic risk, and financial stability; and comments to proposals in this area prepared by governmental authorities.

13. The Financial Supervisory Committee (FMEN) was founded to increase oversight and cooperation in the financial sector. With the merger of the Central Bank and the former Financial Supervisory Authority (FME) in 2020, the Committee's role was amended but it still serves as the coordinating unit of the authorities in a financial crisis. The FMEN is composed by the Deputy Governor for Financial Supervision, the Deputy Governor for Financial Stability, and three experts in

⁴ This is a factor that can impair borrowers' debt service capacity.

⁵ S&P Global Ratings: "Icelandic Bank Ratings Affirmed as Risks Shift Amid High House Prices And Rising Rates; Outlooks Stable", July 13, 2022.

⁶ Act 66/2014, on the Financial Stability Council.

financial market affairs who are appointed by the MoFEA, for a term of five years. The Governor takes a seat on the FMEN as its Chairman when the Committee takes decisions concerning systemically important financial institutions' equity, liquidity, and funding.

14. The FSA (inside the CBI) is responsible for overseeing the recovery planning activity done by banks and for the application of early intervention measures (EIM). Since 2018 the FSA has been receiving recovery plans from Icelandic D-SIBs. Other credit institutions started this process later (2020). EIM can be applied if the bank does not comply with legal and regulatory provisions or if the CBI considers it likely that the bank will not be able to comply them as a consequence of a weak liquidity position, increased hedging, increased defaults by borrowers or a concentration of exposures. Decisions on providing funding to credit undertakings experiencing liquidity problems (emergency liquidity assistance, ELA) are centralized in the CBI.

15. The RA has been set in the CBI and has adequate functional independence. In the organigram, the RA reports directly to the Governor of the CBI but works closely with the Financial Stability Division. The RA has full access to information from the financial supervisory department and other departments of the CBI⁷. Information is shared through processes that are separate from the processes of other tasks of the Bank. The financing of the RA is done by charging the credit institutions under its remit. The annual charge is based on the size of the balance sheet of the credit institution, except for small institutions that have a minimum yearly fee of ISK 250,000.

16. Icelandic Depositors' and Investors' Guarantee Fund (TVF) is a private non-profit institution. It operates on the basis of Act 98/1999 on Deposit Guarantees and Investor Compensation Scheme, and subsequent amendments. The main task of the TVF is to reimburse covered deposits in a bank bankruptcy (pay-box function). TVF operates with three independent divisions: the deposit division, the securities division and the resolution fund and is overseen by the CBI.

17. In Iceland there is no agency responsible for the resolution of non-bank financial institutions. Insurance companies, central clearing counterparties (CCP), pension funds or other non-bank financial institutions are not subject to the resolution framework. As such, these institutions (excluding pension funds) would be wound up through insolvency proceedings and with the oversight of the CBI in its capacity of financial supervisor. In case of CCPs, the recent European resolution regulation will be implemented in Iceland in coming years.

D. Some Consequences of the 2008 Financial Crisis

18. Since the financial crisis of 2008, there has been a complete overhaul in the prudential legal framework, largely led by legal amendments in the European Union that have been transposed in Iceland law⁸. The most significant effect is that there are greater demands for bank

⁷ Article 5 in Rule 1733/2021, on the Practice of the RA of the CBI.

⁸ Directive 2013/36/EU (CRD), Regulation (EU) 575/2013 (CRR), and Directive 2014/59/EU (BRRD), with subsequent changes, that have been incorporated (or will be done soon) into the Icelandic legal system

capital in terms of quantity and quality to meet the capital adequacy ratio and a leverage ratio. Rules on liquidity and funding have been tightened to make financial institutions better prepared to meet their obligations at any time. The banks are now subject to the Supervisory Review and Evaluation Process (SREP) that allows the supervisor to make specific demands on financial institutions, including special capital demands. Rules on risk management of financial institutions have been also revamped, e.g., increasing the independence of the risk unit vis-à-vis other units of the institution. Additionally, financial supervision has been overhauled. The supervisory authority has been strengthened with additional staff and technical resources. It has more powers, for example, to restrict certain activities of financial institutions, to revoke licenses, and to assess and oversight qualified holders.

19. The banking sector, 14 years after the financial crisis, has come back to basics with moderate loan to deposit ratios, simple structures of assets and liabilities, traditional business models and a relatively small refinancing risk in foreign currency (FX). The easy access of banks to international capital markets was one of the main factors explaining the huge relative size of banks in the economy of Iceland and the share of foreign assets and liabilities on the total banks' balance sheet (more than 60 percent). Easy and cheap funding of banks fueled a very strong increase in domestic credit, and consequently higher economic growth. But it also provoked significant vulnerabilities, especially when international funding markets dried up. At that time, the refinancing risk peaked, leading to a systemic banking crisis. The restructuring of the banks' asset portfolios, after the crisis of 2008, was largely completed in 2017, and since then the banks have mostly relied on core financial operations.

WHEN BANKS ARE FAILING

A. Bank Resolution

Institutional Arrangements

20. The current staff of the RA consists of two individuals, which—notwithstanding their qualifications—is insufficient to achieve the required tasks. The initial budget included three full-time equivalent staff. The staff needs of the RA reflects features of the banking system: simple and similar business model across the three D-SIBs and small-sized banks, etc. Some of these features ease the drafting of the resolution plans. Nevertheless, the need for policies and of more granularity in the resolution plans, as well as the experience of other relatively small jurisdictions in Europe (for example, Cyprus, Malta, Latvia, Lithuania and Estonia), suggests that the CBI should hire more staff for the RA.

21. Since March 2022, all major decisions related to resolution matters, both ex-ante and ex-post decisions, are taken by the Governor of the CBI. This includes approving resolvability assessments, resolution plans, minimum requirement for own funds and eligible liabilities (MREL) and execution of resolution actions following a failing or likely to fail (FOLTF) decision taken by the FMEN, after a previous consultation with the RA.

22. The MoFEA has some specific roles under the Icelandic resolution framework: the Minister has to approve the application of financial stabilization tools and resolution decisions that can have a direct effect on the Treasury or systemic effects. This competence of the MoFEA when there are systemic effects must be linked to the use of public funds in those circumstances. The Minister must also approve decisions by the RA to borrow funds from or lend funds to a similar financing entity in one or more countries of the EEA. The MoFEA attends, in an observatory capacity, the meetings of the FSN, as financial stability and the supervision of financial markets are ultimately an administrative responsibility of the Ministry.

23. Establishing an interagency committee or a board focused on resolution issues would be useful. Such arrangements are relatively common in Europe for example, France, Belgium and Spain. It would facilitate coordination and help to develop a more structured dialogue between various agencies, including the CBI and the MoFEA. The setting up of this committee does not mean a change of the responsibilities on the resolution decisions. The need for coordination and the required specialization on the subject matter of its members justify the existence of that committee. As the resolution of a bank could require the use of the resolution fund, some public money, and even the deposit guarantee fund, the participation of the institutions that would be involved to facilitate the implementation of such actions, especially the CBI and the MoFEA, in the meetings of that committee or board, in a regular basis, is required. The securities market authority also participates in this board in the three mentioned countries.

24. A recent judgement of the European Court of Justice helps us to understand the relevance of getting an adequate involvement of the authority that has a final say in the implementation process in a resolution. A claim filed against the European authorities in the Banco Popular case sought the nullity of the decision because the few hours that elapsed between the Single Resolution Board's (SRB) decision and the support given by the College of Commissioners could mean a blank cheque for the SRB. The Court rejected the claim saying that it is clear that the key role of the European Commission lies in the participation of its representative, as a permanent observer, in the meetings of the Executive Session and the Plenary Session of the SRB, as well as in the right of that representative to participate in the discussions and to have access to all documents relating to the resolution. In this way, the EC was involved in the different phases of the decision process and became aware of the drafts of the resolution decision, thus participating in its final drafting.⁹

25. Another way to strengthen the cooperation on resolution between the MoFEA and the CBI could be to set an operational guidance for request by the MoFEA of regular information to the RA within CBI regarding resolution activities foreseen. Such a guidance could be put in a law as needed. Although the MoFEA is informed now on key areas regarding the resolvability assessments and resolution plans of the systemically important banks, a more structured

⁹ See Appendix II for further details.

information sharing is needed. In the operational guidance, some templates could be included, as well as clear information reporting lines.

Some Legal Features

26. The legal safeguards for shareholders and creditors set out in the Key Attributes are in place in Iceland. For example, shareholders and creditors are protected from incurring losses in resolution greater than they would have incurred under bankruptcy proceedings (the NCWO principle). If left financially worse off, they are entitled to compensation from the resolution fund. Another safeguard is that, in principle, the resolution powers should respect the hierarchy of claims set out in the law. A deviation from "pari passu" treatment of creditors under specifically defined and limited circumstances is in place when using the bail-in tool. That deviation should be allowed for the other tools. Nevertheless, in practice, this possibility is negligible considering the super preference of deposits.

27. The involvement of courts in resolution decisions does not pose special challenges. No ex-ante judicial approval or review of interventions is required or prescribed in the Resolution Act; decisions made by the RA cannot be suspended or reverted by Courts¹⁰. According to Article 6 of the Resolution Act, decisions made by the RA are final at an administrative level and no possibilities to appeal decisions to other administrative authorities. Ex-post judicial review is not restricted to the legitimacy of intervention measures and resolution actions, according to Article 6 of Resolution Act, but resolution decisions taken by the RA in good faith cannot be overturned or suspended. More concretely, Article 33 deals with the merits of resolution actions, and specifically with valuation in resolution. A resolution action could depend exceptionally on a court decision in some particular situations: if a bank has sought moratoria or a claim for winding-up proceedings has been put forth, a court would have to decide to reject the claim. Also, the RA can request that court proceedings against a bank in resolution be postponed, arguing that this would be necessary for the adopted resolution measures.

28. The legal protection for civil servants should be explicitly included in legislation. In Iceland, there is a well-established "rule of employers' liability" based on case law by the Icelandic Supreme Court in the mid-1930s. The rule provides that an employer can be liable for damage caused by his employee's negligent action in the course of the employment. Article 23 of Act No. 50/1993 says that employer's claim for recourse for damages paid as a result of the employee's negligent conduct is limited to what is considered reasonable taking account of the employee's position and degree of negligence, based upon the circumstances of the case. The same rule applies for claims against an employee for loss caused by him in the course of his employment. The rule of employer's liability for the employees' negligence can be applied to the public sector as well as the private sector. It covers liability for loss or damage caused by negligent conduct of employees of the State, municipalities and public institutions in the course of their employment. It is recommendable to specify in the law the legal protection of the current and former members of decision-making

¹⁰ If shares of banks, its assets, liabilities or rights have been sold during resolution, if the buyer acted in good faith, a financial compensation by the resolution fund is the only form of remedy.

bodies and staff (including current and former agents and advisors). This provision should apply to all the institutions in the financial safety net of Iceland.

29. Recommendations

- The CBI should hire more staff for the RA. Its current staff seems insufficient to achieve the required tasks, especially for the drafting of many policies and for getting more granularity in the drafting of resolution plans. The experience of other small jurisdictions in Europe supports this recommendation.
- Establishing a committee or a board focused on resolution issues would be useful to facilitate coordination and help to develop a more structured dialogue between various agencies, including the CBI and the MoFEA, while preserving the independence of the RA.
- The legal protection for civil servants should be explicitly included in legislation and should specify the protection of the current and former members of decision-making bodies and staff (including current and former agents and advisors). This provision should apply to all the institutions in the financial safety net of Iceland.

B. Bank Insolvency

Winding Up of a Financial Undertaking

30. The estate of a financial undertaking cannot be liquidated according to general rules¹¹ and it must be wound up mainly at the demand of the FSA if it has revoked the undertaking's operating license. Alternatively, liquidation can occur at the demand of the undertaking's board of directors if it can no longer meet all obligations to creditors when their claims fall due, and it is considered unlikely that the undertaking's payment difficulties will be alleviated in the short term. Therefore, a financial undertaking can be wound up at the demand of the FSA and the court decides whether it shall be wound up. A petition for the winding-up shall be directed to the District Court where civil proceedings could be brought against the undertaking where it is headquartered. Once a court has ordered that a financial undertaking shall be wound up, a District Court judge will appoint a winding-up board, consisting of up to five people. Upon its appointment, the board shall assume the rights and obligations held by the undertaking's board of directors and shareholders' meeting or meeting of guaranteed capital owners. The persons appointed to the winding up board must fulfil the same eligibility requirements as the board of directors and the managing director of a financial institution. The liquidator has the power to sell assets and transfer liabilities to another institution (P&A).

31. If a credit institution has its head office in Iceland, liquidation shall mean granting a moratorium. If a court in Iceland grants a credit institution a moratorium, such authorization shall automatically apply to all branches which the credit institution operates in another EU Member

¹¹ Article 101 of Act 161/2002.

State. The Resolution Act and Bankruptcy Act do not differentiate between depositors/creditors from Iceland and from foreign countries.

Hierarchy of Creditor Claims

32. The tiered depositor preference is in place in Iceland, that is, all deposits rank higher than ordinary claims. By ensuring the tiered preference of all deposits, the risk of breaching the NCWO principle in resolution has been greatly reduced. There is a possibility that holders of senior preferred bonds could be subjected to bail-in, but some creditors ranking "pari passu" would not. This could be for instance derivative holders or holders of commercial debt. However, considering how small derivatives and "other liabilities" are in comparison to issued debt and borrowed funds, the risk of using the bail-in tool would be considered very low. In 2021, Iceland implemented the new category of senior non-preferred debt instruments. So far, banks have not issued any of this instrument. See table below for the complete ranking of claims:

Table 2. Iceland: Hierarchy of Creditor Claims

Rank	Label of the claims	Legal Basis	Comments
1	Priority Claims	Insolvency Act 21/1991, Art. 109-110.	
2	Secured Claims	Insolvency Act 21/1991, Art. 111.	
3	Covered Deposits, TIF Claims and Other Preferred Claims	Insolvency Act 21/1991, Art. 112. Resolution Act 70/2020, Art. 85a.1.a.	
4	Eligible deposits above EUR 100,000 held by natural persons and micro, small and medium sized enterprises	Resolution Act 70/2020, Art. 85a.1.b.	
5	Eligible deposits above EUR 100,000 held by large sized enterprises	Resolution Act 70/2020, Art. 85a.1.c.	
6	Other deposits	Resolution Act 70/2020, Art. 85a.1.d.	
7	Other ordinary claims - including Senior preferred bonds	Insolvency Act 21/1991, Art. 113. Resolution Act 70/2020, Art. 85a.2.	
8	Senior Non Preferred	Resolution Act 70/2020, Art. 85a.3.	Issued debt with the following characteristics: The original contractual maturity of the debt instrument is of at least one year; The debt instruments contain no derivatives and are not derivatives themselves; and The relevant contractual documentation and, where applicable, the prospectus of the issuance explicitly acknowledge its lower ranking. Based on Article 2 of Directive (EU) 2017/2399.
9	Residual Claims	Insolvency Act 21/1991, Art. 114, 1-3. Resolution Act 70/2020, Art. 85a.4.	Interest and other costs related to claims
10	Other subordinated debt	Resolution Act 70/2020, Art. 85a.5.	
11	Tier 2 Instruments	Resolution Act 70/2020, Art. 85a.6.	
12	Additional Tier 1 Instruments	Resolution Act 70/2020, Art. 85a.7.	
13	Common Equity Tier 1	Resolution Act 70/2020, Art. 85a.8.	

33. The FSA should test the rules and procedures for the winding up of a financial institution through a crisis simulation. Although the framework seems effective, it has not been tested yet. It is also recommendable to approve an internal guidance to ease the supervision of the operations of a financial undertaking managed by a winding-up board and its interaction with the District Court.

PLANNING FOR BANK FAILURES

A. Recovery Planning

34. The authority distinguishes between the submission of full recovery plans and simplified ones, applying the principle of proportionality in the scope, frequency and intensity of supervisory engagement and dialogue with an institution. The three D-SIBs—Arion banki hf., Íslandsbanki hf. and Landsbankinn hf.—have been required to prepare a full plan since 2018, while other credit institutions and investment firms are allowed to prepare a simplified one (these entities started this process in 2020). The FSA requires that a recovery plan covers at a minimum of all the items listed in art. 2 of Regulation 780/2021¹². Recovery plans are updated regularly and on an ad hoc basis, in particular following changes with potential material impact on the plans or where material deficiencies have been identified. The last revision of the recovery plans was completed in spring 2022. The FSA considers that the recovery plans have sufficient quality, although they communicate to banks deficiencies or impediments¹³. The findings of the FSA's reviews of the plans are available to the RA upon request, as well as all other available information the RA may require as a part of their work.

35. Icelandic banks have liquidity and capital contingency plans with thresholds for triggering management escalation well above regulatory requirements. Once banks trigger any corrective measure of those contingency plans, they also start the interaction with the FSA. The execution of the recovery plan will be the second stage.

36. Recommendations

- **The FSA should set thresholds to facilitate the decision-making process of banks on the implementation of recovery actions.** The thresholds should be set at a level sufficiently above the point of likely supervisory intervention. The calibration of the recovery plan should be

¹² That national Regulation adopts Annex 1 of the BRRD.

¹³ After reviewing the recovery plans of banks, the FSA has found some material deficiencies. Most common were: weak or unclear governance structure that could hinder successful implementation of the plan; lack of integration into the risk management framework; lack of satisfactory process to identify core and critical business lines and material entities; lack of effective recovery indicators and unclear escalation procedures; unsatisfactory description and analysis of recovery options; unrealistic assumptions of the recovery scenarios; doubts on the effectiveness of recovery triggers; and unsatisfactory communication and disclosure plan. Banks are working satisfactorily on these issues.

consistent and aligned with the risk management framework and liquidity contingency plan of the institution. Escalation triggers in recovery plans needs also further work by the FSA and discussion with banks.

- **The FSA should develop guidance on the testing of recovery plan implementation (e.g., via dry runs).** Banks should institutionalize these tests as a routine business practice. Authority should expect banks to ensure they have sufficient credible options to restore their capital and liquidity positions¹⁴ to appropriate levels in, or following, a stress. In assessing the capacity of these options, firms should take into account the likely actions of peers in a stress.

B. Resolution Planning

37. The RA has already approved the first version (April 2022) and an update (September 2022) of resolution plans for the three D-SIBs. The RA will work on the resolution plan and the resolvability assessment of Kvika Bank in 2023. In the first part of 2023, the RA plans to finalize resolution plans for the five savings banks. Subsequently, the RA will work on resolution plans for SaltPay, Indo Savings Bank and Fossar Markets Investment Bank (both licensed in 2022). The RA has decided to draft simplified resolution plans, based on Article 11 of the Resolution Act that gives the RA power to adopt simplified resolution plans for credit institutions considered less significant or non-critical for the Icelandic financial system¹⁵. The minimum content of resolution plans prepared thus far follows EU rules¹⁶.

38. Resolution plans are prepared on the basis of information that the RA obtains from the institutions themselves¹⁷. A list of information which the RA shall consider when making resolution plans is included in a national regulation¹⁸. This list of information replicates the information included in the European regulation (in particular, EBA's templates). Moreover, the RA has indirect access to all data from banks via the supervisory and financial stability departments in the CBI, without any restriction. On the other hand, the RA does not share the resolution plans with the concerned banks.

¹⁴ Liquidity indicators include available central bank eligible unencumbered assets (recent experience with crisis situations has highlighted the usefulness of asset encumbrance as a liquidity indicator). This indicator plays an important role in assessing the institution's ability to withstand funding stress using eligible and available collateral to access standard central bank facilities.

¹⁵ When considering these simplified resolution plans, the RA bases its assessment on the second paragraph of Article 1 of Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016, supplementing the BRRD.

¹⁶ More concretely, Article 22 of Commission Delegated Regulation (EU) 2016/1075. The CBI has approved rules which implement this European regulation into Icelandic legislation.

¹⁷ Commission Implementing Regulation 2018/1624/EU of 23 October 2018.

¹⁸ Regulation 780/2021, based on Article 12 of the Resolution Act.

39. Recommendations

- **The RA should share a summary of the key findings of the resolution plans with the concerned banks.** That summary and, especially, a letter to the bank's board with the priorities of the RA every year, are good tools to strengthen the existing dialogue with banks.

C. Resolvability Assessment

40. For the three systemically important banks in Iceland, the resolution plans do not yet identify any material impediments to preferred resolution strategies. This is a preliminary conclusion, because the resolution planning activity has just started. If impediments do exist and the institution in question cannot remove them, the RA is obliged to request the institution to take some actions: to review intra-group support agreements; to prepare service agreements with intra-group or third parties in order to guarantee continuity of critical functions; to set up limits to its individual and aggregate exposures; to provide with additional information relevant to the resolution process; to divest specific assets; to limit or cease specific existing or proposed activities; etc.

41. Some elements of the statutory creditor hierarchy favor the resolvability of banks. In particular, senior preferred debt is ranked below all deposits. This helps resolvability, because the RA could also use senior preferred debt to recapitalize a resolved bank, without affecting confidence-sensitive and systemically important liabilities like any deposit classes. Accordingly, the RA has stated that senior preferred debt qualifies as MREL until, at least, 2024. This decision will be reviewed after the implementation of BRRD II.

42. While the RA does not consider the public participation in the ownership of banks to give rise to impediments to resolution, the experience in many countries suggests otherwise¹⁹. In a bail-in, the State could be wiped out and lose the stake in the bank (with private holders of subordinated and senior debt becoming shareholders), so the RA could face legal obstacles and political pressures impeding a fast and effective bank resolution. A crisis of a public bank could also negatively affect the sovereign's creditworthiness.

43. The RA has argued that no impediments are foreseen in the resolvability of banks as a consequence of the significant participation of pension funds in their capital and other liabilities. A bank crisis should not trigger significant problems to the pension fund sector as shareholders of banks, bondholders and depositors, considering the total net worth of the sector with regards to its stake in those banks. Nevertheless, this crisis could provoke negative secondary effects, through the deterioration of the macroeconomic indicators. Therefore, further work is needed to fully understand what would be the impact of a crisis on pension funds, with a particular focus on potential impediments to the successful execution of resolution strategies.

¹⁹ See Mark Adams, Hanife Yesim Aydin, Hee Kyong Chon, Anastasiia Morozova and Ebru Sonbul Iskender: "Regulating, Supervising and Handling Distress in Public Banks", IMF, DP/2022/010, May 2022.

Resolution Tools

44. On the preferred resolution strategy, the RA has identified three different categories of banks:

- (i) Institutions whose business model, activities, risk profile, and funding model assume that simple bail-in will be the preferred and only resolution tool to be applied.
- (ii) Institutions for which a mixed approach to resolution is possible, e.g. part or all of the institution's assets could be disposed in addition to using the bail-in tool (only the part where critical functions take place will be recapitalized).
- (iii) Institutions that do not satisfy the conditions for resolution.

45. The three largest banks are in the first category. Banks in the second category, in general, will have lower MREL requirements than the first category of institutions. In the third case, the recapitalization amount in the MREL target will be zero (that means that there will be no MREL requirements over and above the ordinary own funds requirements for such institutions). **Although current resolution plans for the D-SIBs only envisage the use of bail-in as preferred tool, it is necessary to develop operational guidance on the other tools (sale of business, bridge bank and asset segregation).** Given the prevailing circumstances at the time of failure, the preferred resolution strategy may not be feasible or may need to be applied together with other tools. On asset segregation and bridge bank tools, there is only a reference in Article 3 of the Resolution Act, which states that a bridge bank or an asset management company (AMC) would be at least partially owned by public institutions or the resolution fund, and Articles 45 and 50, which state that the RA can establish a bridge bank or an AMC, respectively. Work on separability is needed to operationalize transfer strategies (sale of business, bridge bank and segregation of assets). A separability analysis would include the identification of the proposed transfer perimeter; a separability assessment, including the interconnections between the preliminary transfer perimeter and the rest of the institution (identifying obstacles and costs to implement the transfer); an assessment of the market interest and capacity; and a description of bank's capabilities to provide accurate and timely information on the transfer.

46. **In addition, further efforts are needed to ensure the preparation of bail-in playbooks by the banks.** Such playbooks expected to address all internal and external actions that must be undertaken by the banks to effectively apply that tool. In particular, the playbook is expected to cover: governance and horizontal issues, including the identification and description of communication arrangements, disclosure obligations and the process for the elaboration of a business reorganization plan after the bail-in; processes and timelines for the identification of the perimeter of bail-enable instruments (this perimeter should increase gradually) and the generation of data to be used in the drafting of the resolution scheme and in the bail-in execution; a detailed description of the procedural steps for the execution of the bail-in inside and outside the bank for every type of instrument covered by the playbook; and a description of the management

information systems that support the different processes. These playbooks are expected to be validated by the senior management of the bank and should be updated at least annually, taking into account the feedback from the RA.

47. The RA also needs an internal playbook to set the steps and procedures to be followed executing a bail-in. For example, only in the preparatory stage, this playbook should deal with requests for information to support valuation 1, 2 and 3 (templates with the required information and rules to organize on-site visits -if needed-); appointment of an external valuer (list of pre-selected firms and draft contracts are recommendable); preparation of the bail-in execution (based on an updated liabilities report, additional required data and compulsory exclusions of bail-in) with the goals of determining the instruments to be bailed-in, identifying key stakeholders, and determining (after an adequate analysis) discretionary exclusions based on the regulation; and preparation of drafts for all the decisions and communications.

48. The D-SIBs have issued bonds in those countries and the prospectuses include bail-in-ability clauses. The RA needs to find the suitable contact persons in those authorities, to facilitate a transparent and expedited recognition process and prepare for the documentary needs of those resolution authorities while implementing bail-in. If needed, banks could provide a legal assessment of those potential impediments.

49. The application of any resolution tool requires a robust valuation framework. Rule 666/2021 of the CBI implements European regulations on the different aspects of that valuation (the independence of the valuer, the methodology for valuing the assets and liabilities of a bank, the approach in preliminary valuations and so on) into Icelandic legislation.

50. Recommendations

- Further work is needed to assess the impact on resolvability of the participation of pension funds and the State in the capital of large banks.
- It is necessary to develop an operational guidance for all the resolution tools. This guidance should include steps, procedures, templates and drafts to help the authority in the application of those tools. Banks should also prepare their bail-in playbooks.
- The RA should closely collaborate with the RA of Ireland and Luxembourg to increase the extraterritorial effectiveness of its bail-in decisions.
- The RA should develop a practical set of rules on valuation in resolution, following documents published by the EBA and the SRB²⁰.

²⁰ European Banking Authority: "Handbook on Valuation for Purposes of Resolution", 22 February 2019 and Single Resolution Board: "Framework for Valuation", February 2019.

Cross-Border Cooperation

51. At the moment, there are no foreign financial entities or branches of foreign financial entities in Iceland and the systemically important banks in Iceland have virtually no entities or branches in foreign countries, neither within the EU/EEA nor in third countries. That means the CBI, including the RA, is not part of any cross-border supervisory or resolution colleges²¹.

RESOLUTION FUNDING

A. Banks' Loss-Absorbing Capacity

52. The CBI recently approved the second version of resolution plans for the three D-SIBs and, concurrently, issued MREL targets for the three banks. The banks were required to fulfil the MREL requirements from the outset. The two publicly listed D-SIBs disclosed their first MREL requirements, and Islandsbanki disclosed the updated MREL as well. While the banks have until January 2024 to meet regulatory loss-absorbing capacity requirements, their existing capital and liability stacks meet those requirements today. The RA does not expect the banks to build additional loss-absorbing capacity buffers sufficient to meaningfully lower default risk on senior preferred debt, at least in the near term. Subordination requirements will be introduced in H1 2023, after the implementation of BRRD II. Transitional periods and interim targets will likely be introduced.

53. The Icelandic resolution authority has some flexibility in determining MREL requirements. It can take into account:

- (i) The preferred resolution strategy.
- (ii) The risk profile, funding model, and business model of each institution.
- (iii) The loss absorption amount and recapitalization amount (including the market confidence charge) and their interaction with capital buffer values and additional capital requirements made by the FSA (Pillar II).
- (iv) Subordination and the determination of which liabilities can be included with MREL.
- (v) Deadlines for satisfaction of MREL requirements.

54. The resolution authority has left the default required recapitalization amount unchanged (i.e., equal to the minimum own funds requirement). On the market confidence charge, the resolution authority's position is that there is no need at this time to levy it on Icelandic banks. On adjustments of the recapitalization amount, the authority can set, in every specific case, a reduction of total risk exposure amount (based on the probable balance sheet size position of the

²¹ If needed, these arrangements would be done in accordance with the relevant parts of the Resolution Act and Chapter VI of Commission Delegated Regulation (EU) 2016/1075.

financial institution that is FOLTF) that should never exceed 10 percent of total assets. These adjustments are welcomed by banks as an example of proportionality (the D-SIBs would be small banks in many European jurisdictions and all the small banks face obstacles accessing funding markets to raise loss absorbing capacity).

55. As subordination requirements relating to MREL were not harmonized under BRRD I, the RA can determine subordination requirements on an institution-specific basis. The subordination requirements under BRRD II will require that banks in Iceland decide whether to continue issuing senior preferred securities or shift to senior non-preferred issuance. The RA thinks that senior preferred securities can be used to satisfy MREL at least until the deadline to comply with MREL requirements under BRRD II. For EEA-EFTA countries like Norway, Liechtenstein and Iceland, this deadline will be three years after the incorporation of BRRD II into the EEA Agreement. Most likely this deadline will be mid-year 2026.

56. Currently, the CBI is working with the MoFEA in implementing BRRD II into Icelandic law, which will require updating the MREL policy. This process is scheduled to be finalized in Q2 2023. To meet the new subordination requirements, the RA will be able to extend deadlines for individual institutions and allow the inclusion of senior preferred securities in MREL²². Icelandic institutions currently comply with the requirements to apply the 3.5 percent. Also excluded liabilities of equal rank do not constitute more than 5 percent of the institution's own funds and eligible liabilities.

B. Emergency Liquidity Assistance

57. The eligible parties to ELA are domestic financial undertakings (credit institutions) that have been granted an operating license²³. To be eligible for ELA they must be solvent according to a predefined criterion; be temporarily illiquid; be unable to meet their liquidity needs from an alternative source; have sufficient collateral for ELA according to predefined minimum requirements standards; and present a recapitalization program that the CBI considers to be sufficient. The specific arrangement of ELA would depend on the characteristics of the emergency materializing.

58. Some key features characterize the ELA. These include: (i) the liquidity support should be as short-term as possible; (ii) the extension of ELA to a credit institution may not collide with the general ban on financing public sector projects; (iii) the currency of ELA is the Icelandic króna; (iv) the interest rates applied to loan under ELA should be set above prevailing market rates in normal times (to incentivize the replacement of the ELA); and (v) the solvency criteria for ELA is the European Central Bank's criterion²⁴.

59. The main elements of the minimum standard requirements for ELA's collateral are: legal certainty (there should be no doubt about the ability and legal right of the CBI to seize and

²² Based on Articles 72(3) and (4) of CRR II.

²³ Article 19 of the Act 92/2019, on the Central Bank of Iceland.

²⁴ The criterion of the ECB is the rule 4.1 of the "Agreement on emergency liquidity assistance" of 9 November 2020.

liquidate the collateral after a counterparty default); credit quality (the collateral should fulfil internal minimum credit quality standards and credit quality should be reflected in the haircuts); simplicity (plain vanilla electronically listed bonds should be favored); market transparency and price availability (the non-availability of true market prices means that the value of assets needs to be approximated which generally increases overall credit risk); and market liquidity (collateral with real and active market making should be favored). On government guarantees, as a rule, the CBI would not request that the government issues a guaranty in relation to ELA. However, special circumstances could in some cases trigger government guarantees. If special circumstances apply, a government guarantee would increase the value of poor-quality collateral.

60. The CBI favors constructive ambiguity regarding the requirements of the collateral to be used in an ELA. This approach gives more flexibility to a central bank because the circumstances of the liquidity stress of a bank are unpredictable. Moreover, moral hazard is minimized if the central bank conveys the idea that granting ELA is not guaranteed, even when complying with some explicit collateral requirements. Banks have a different perspective: accepting the unpredictability of circumstances of the next crisis, they would appreciate some clarity on those requirements to manage liquidity in a critical situation. Some central banks, in the context of on-site inspections, check the eligibility of the available collateral of the financial institution in a crisis simulation, that is, they are working further on the operationalization of ELA.

61. Other requirements of ELA include the same risk controls as applied in normal times, such as closeout-netting provisions, single agreement clauses, etc. Additional risk control measures could be included on a case-by-case basis. Some examples of these additional measures are: a detailed recapitalization plan evaluated by the CBI; increased surveillance of the ELA-recipient and the assets provided as collateral; and conditions that ensure that all loss due to ELA falls on the credit institution's shareholders. Finally, any ELA granted should remain confidential and secret for 1-2 years after ELA has been repaid in full. All decision to extend ELA should be made public after the confidentiality period.

62. If a credit institution applying for ELA is FOLTF, then the credit institution would not qualify for ELA. Not until a bail-in decision is made by the Resolution Authority shall the bank be regarded as solvent and may then, if necessary, be granted ELA. If a bridge institution/bank is wholly or partially owned by one or more public authorities, it is more likely that the CBI would require a government guarantee in relation to ELA to the bridge institution. A decision to extend ELA to a bridge institution would exclusively be taken on a case-by-case basis. The granting and reviewing of ELA to a credit institution in resolution would need to be taken in close co-operation with the RA and relevant government authorities. Special care must be taken, if the CBI extends ELA to a credit institution in resolution, not to go against the general ban on the CBI's financing of public sector activity. The CBI has to work further on liquidity after resolution. In principle, ELA could be granted, but the requirements, especially on the need of a public guarantee are not completely defined.

63. Recommendations

- It makes sense to consider, in the eligibility criteria for ELA, the request of a liquidity restoration plan, complementing the other requirements.
- The CBI should work further on the operationalization of ELA. In the context of on-site inspections, it should check the eligibility of the available collateral of the financial institution in a crisis simulation.
- The CBI should set clearer rules on liquidity after resolution. In principle, ELA could be granted, but the requirements, especially on the need of a public guarantee are not completely defined.

C. The Resolution Fund

64. The resolution fund has been established as a separate department within the TVF²⁵.

The fund had 28.7 billion ISK under management at year end 2022 (around 2.50 percent of total covered deposits—1,139 billion ISK). As the minimum target of the resolution fund is 1 percent of insured deposits by year-end 2027, Iceland's resolution fund is already fully funded, thanks to a transfer made by the TVF. In accordance with Act no. 70/2020, the RA takes decisions on payments from the resolution fund. The permanent arrangement for funding the resolution fund was laid down with the passage of Act no. 48/2022.

65. If the financial resources of the resolution fund are not sufficient to cover losses, costs or other expenses in resolution²⁶, the RA is authorized to require banks a special additional contribution. That contribution can amount to up to three times the annual contribution. The RA can decide that a special subsequent contribution will be postponed in part or in whole for up to six months if the contribution can have a significant negative effect on the liquidity or solvency of a bank²⁷. The RA, with the prior approval of the MoFEA, can decide that the resolution fund borrows from one or more similar financing arrangements in another member state of the EEA, if the funds that are available, including those that can be raised with a special bank contribution, are not sufficient. Doubts are more likely on the sufficiency of the Icelandic resolution fund than on the financial capacity of the TVF (as the latter will intervene in a liquidation of a very small bank and the former in the resolution of D-SIBs).

²⁵ An Act has modified Act 98/1999 and Act 70/2020 and has allowed the setting up of the fund.

²⁶ The wording of the Resolution Act mirrors Article 71.1 of the SRMR ("Where the available financial means are not sufficient to cover the losses, costs or other expenses incurred by the use of the Fund in resolution actions ..."), so the safeguard to avoid moral hazard is the same than in the EU: the 8% bail-in requirement.

²⁷ It is necessary a MoFEA's policy specifying the circumstances and conditions for a temporary suspension of a special supplementary contribution.

66. Recommendations

- **A robust backstop for the resolution fund is needed, considering that gross outlays of the fund may be relatively large.** A credit line by the government would offer greater (and more timely) assurances than exceptional industry contributions and/or borrowing from EEA resolution funds. Nevertheless, the MoFEA and the CBI should negotiate financing arrangements with other resolution funds of the EEA.

D. Public Recapitalization

67. Article 79 of the Resolution Act allows a public recapitalization of a bank (as a financial stabilization tool) in extraordinary circumstances. However, this requires a previous burden sharing from shareholders and holders of other eligible bail-in instruments of at least 8 percent of its total obligations (including own resources). There is another piece of regulation allowing a public recapitalization²⁸. It sets out that under unusual and extraordinary circumstances on the financial market (specified in the Act), the MoFEA is authorized to disburse funds in order to establish a new financial undertaking or take over a financial undertaking or its bankrupt estate, either wholly or in part.

68. Before making the decision to recapitalise a bank, the minister would have to consult with the parliamentary committee which manages the State's budget. The MoFEA would have to receive financial authorisation through a supplementary budget law that goes through three debates in the Parliament.

The Management and Sale of Public Stakes in Banks

69. Icelandic State Financial Investments (ISFI) is a state body with an independent Board of Directors which reports to the Minister of Finance. ISFI was established with Act 88/2009, which came into effect in August 2009. The main activities of ISFI are:

- (i) To manage the State's holdings in companies and undertakings.
- (ii) To administer the State's communication with financial undertakings.
- (iii) To oversee the execution of the State's ownership policy.
- (iv) To exercise the Treasury's voting rights at shareholders' meetings of financial undertakings.
- (v) To conclude agreements with boards of directors of financial undertakings with regard to, for example, equity contributions.

²⁸ Act 125/2008, on the Authority for Treasury disbursements due to unusual financial market circumstances.

- (vi) To make proposals to the Minister regarding additional funding of financial undertakings.
- (vii) To assess and establish conditions for the restructuring and mergers of financial undertakings.
- (viii) To make proposals to the Minister as to whether and when specific holdings in financial undertakings should be offered for public sale.

Box 1. Iceland: The Financial Capacity of the Icelandic Resolution Fund

The resolution fund will have 28.7 billion ISK at year end 2022 (around 2.50 % of total covered deposits). The minimum target in the Banking Union is 1 % of covered deposits, so, in principle, that amount should be enough. Let us assess two different scenarios.

Suppose that a bank faces an idiosyncratic crisis. How to fund that resolution? First, with the loss absorbing capacity of the bank (minimum bail-in of 8 % of total liabilities of the bank); second, with the resolution fund (up to 5 % of total liabilities of the bank); and third, more bail-in or public money. What happens if the resolution fund cannot meet that 5 %? First, the RA is authorized to require banks a special additional contribution. That contribution can amount to up to three times the annual contribution. Second, the RA is permitted, with the prior approval of the minister, to decide that the resolution fund borrows from one or more similar financing arrangements in another member State of the EEA.

If the crisis is systemic, the standard resolution framework is difficult to apply. In this scenario, authorities could follow Article 79 of the Resolution Act, implementing the so-called government financial stabilization tools. The problem is that this public recapitalization requires, in line with the BRRD (Articles 37 and 56-58), a previous burden sharing from shareholders and holders of other eligible instruments of at least 8 % of its total obligations (including own resources). It seems contradictory to use an extraordinary tool to preserve financial stability and to require that minimum burden sharing that could provoke financial instability. Another feature of this tool is that the resolution fund (that is, banks) does not participate in this funding. If the government stabilization tool is not applied, the funding shortage of the resolution fund will be significantly higher.

70. ISFI makes proposals on the sale of the State's holding in a bank and the Minister decides on all the relevant elements of the operation. When the Minister has accepted the proposal of ISFI regarding a sale, he prepares a memorandum and submits it to the Budget Committee and the Economic Affairs and Trade Committee of the Parliament. The Minister shall also consult the Central Bank of Iceland on the suitability of bidders, the probable impact of a sale on the foreign exchange market, foreign exchange reserves and liquidity in circulation. The memorandum shall, inter alia, contain information on the main objectives of the sale of the holding, which method of sale will be deployed and how a sale process will be arranged in other respects.

71. Recommendations

- Article 79 of the Resolution Act should define with more detail the extraordinary circumstances in financial markets to justify the use of the government financial stabilization tool. It is also necessary to assess the compatibility of that article of the Resolution Act and Act 125/2008, on the Authority for Treasury disbursements due to unusual financial market circumstances. The MoFEA could merge the two Acts while observing EEA requirements. In any case, a financial stability exemption to the 8 percent requirement, subject to strict criteria, should be introduced to ensure sufficient flexibility (as also recommended by the 2018 Euro Area FSAP).²⁹
- Clear criteria on possible investors in the sale of state-owned banks should aim to mitigate potential reputational risks for the State (especially after the last sale to professional investors in an accelerated bookbuild in Islandsbanki). It is crucial to comply with market practices and standards, taking into account the peculiarities of the Icelandic market (especially its size).

DEPOSIT INSURANCE

A. Institutional Arrangements

72. As Directive 2014/49/EU on Deposit Guarantee Schemes has not yet been adopted into the EEA Agreement, Iceland is not obliged to transpose it into Icelandic law. The current legislation is, for most parts, based on Directive 1994/19/EU, although some amendments have been made which align certain elements of Act 98/1999 with the legislation in other European countries: for example, the increase of coverage up to the equivalent of EUR 100,000 in Icelandic ISK.

73. The governance structure of TVF is laid out in Act 98/1999. The provisions on Board appointment and composition were recently amended, to ensure more independence of the Board from banks. Under the current legislation, the Board of Directors shall consist of four directors appointed by the MoFEA. Two directors are directly appointed by the Minister, one director is proposed by the CBI and one director is nominated by Finance Iceland, an association of Icelandic financial institutions. Four alternate directors are appointed in the same manner as the directors. The Board of Directors is permitted to hire a managing director for the fund.

B. Funding

74. The minimum target of TVF's deposit division is 0.8 percent of the insured deposits of all licensed credit institutions³⁰. In practice, the current TVF's funds represents 1.6 percent of covered deposits (before the transfer of ISK 28.7 billion to the resolution fund this year, the actual resources held by the TVF has reached 4.2 percent). That means that there is a minimum target, but not a predefined actual target. As the actual target of the TVF is not determined and in 2022 the

²⁹ See "[Euro Area Policies: Financial System Stability Assessment](#)", published in July 2018.

³⁰ As at 30 June 2022, there were a total of ISK 2,467 billion in deposits, with ISK 1,139 billion being covered deposits (approx. 46% of all deposits in the system).

available funds exceeded the minimum target of 0.8 %, an amendment to Act 98/1999, which came into effect in July 2022, established that members of TVF do not have to pay more contributions to the fund. If it would be necessary to raise contributions from the members again, an amendment to the said Act is needed. To approve or amend a Law to require more contributions or to stop them is not very effective, especially when those contributions depend on objective elements: the evolution of covered deposits, the use of TVF's funds, etc. The Law should specify the target level and what to do when that target is reached without needing a new Law to raise new contributions or to stop them.

75. The credibility of TVF could be strengthened by providing for backup funding arrangements. This could help to tackle temporary liquidity shortfalls of TVF facing a bank crisis. This liquidity gap could be more likely if the deadline for reimbursements is reduced to seven days. The exact modalities of the arrangements will need to be explored further: while the authorities have noted that a public backstop is rejected by the government and the public opinion, borrowing arrangements involving insured institutions would not be sufficient as sole source of funding.³¹ On the financial capacity to reimburse covered deposits, there are less doubts. At the end of September 2022, the non-systemic Icelandic banks deposits covered by the deposit insurance scheme amounted to ISK 71.6 billion whereas TVF's assets amounted to ISK 18.8 billion, that is a ratio of 26 percent. End last year, before the transfer to the resolution fund, that ratio was around 95 percent. It is key to remember that the TVF should be used basically in the bankruptcy of the smallest banks in Iceland. A more challenging situation could face the resolution fund if there is a serious banking crisis, because it should be ready to support the resolution of the largest banks. Considering the impact of the 2008 crisis on the TVF, the MoFEA and the CBI could explore some alternatives to avoid excessive liabilities subject to the TVF, especially with a more intense cross-border activity of Icelandic banks.

76. The investment policy of TVF takes into account the rules on restrictions on investments set out in the provisions of the EU Directive 2014/49/EU, although the Directive has not yet been transposed into Icelandic law. The Directive calls for the assets to be invested "in a low-risk and sufficiently diversified manner". Investment instruments are expected to be of a liquid nature, as, for example, cash and deposits and sovereign bonds and treasury bills. The investment policy of TVF states essentially that the proportion of domestic governments bonds shall be between 52-72 percent, 20-42 percent in government bonds issued by states with AA- credit rating (or better) and 0-20 percent in government bonds issued by states with BBB- credit rating (or better). At least 72 percent of the funds shall be invested in securities guaranteed by the Treasury of Iceland or foreign states.

C. Pay-Box Function

77. TVF's deposit division becomes liable for repayment of covered deposits to depositors in three situations: if a member institution is, in the opinion of the CBI, unable to repay the

³¹ See IADI Core Principle 9.

deposits upon demand or in their due term; if a member institution's estate is subject to bankruptcy proceedings; and, in the context of resolution of a member institution under Act 70/2020, to avoid losses to covered depositors. If the RA takes action on an institution in financial distress and deposits are affected, TVF shall pay a contribution to the RA from TVF's deposit division (with a cap set by the Law). Where it is determined by a valuation that TVF's contribution to the resolution was greater than the net losses it would have incurred had the institution in question been wound up under normal insolvency proceedings, TVF shall be entitled to the payment of the difference by the RA. Finally, some deposits are not protected: deposits owned by financial undertakings and related companies; deposits relating to cases where there has been a conviction for money laundering; deposits of a company in which a financial undertaking is the majority owner; deposits of the State, municipalities, their institutions and companies in large part owned by public entities; deposits of operating companies of mutual funds and other funds on joint investment; deposits not registered by name; and deposits of pension funds other than the client's share in the account of the depositor's pension savings account deposited with a deposit institution.

78. The TVF has no role or responsibility in the event of a voluntary liquidation initiated by one of its members. Under Act 2/1995, on Public Companies, which applies to the members of TVF, in order to initiate a voluntary winding-up process, the assets of a company must exceed its liabilities. Under such circumstances, where a bank initiates a voluntary dissolution process and, consequently, its assets exceed its liabilities, the requirement for TVF's protection under Act 98/1999 is not satisfied, as TVF is only obliged to pay a depositor of a bank in case the relevant bank is unable to make payments to the depositor.

79. Deadlines for TVF's disbursements are too long compared to international standards and even the timeframe required in the EU framework (seven days). Pursuant to regulation 120/2000, with subsequent amendments, if the deposit division is required to make repayments to depositors of a member institution, TVF's Board of Directors and the CBI shall decide the timeframe within which the customers of that institution shall have to lodge claims against the fund. The timeframe shall not exceed two months. Repayments shall be made to depositors within 3 months from the CBI's opinion that an institution is unable to repay deposits to its customers. The repayment period can be extended three times, for three months at a time, so the period cannot exceed 12 months.

80. A pay box plus mandate, subject to a least cost test, can be an effective way to resolve a bank. That means the use of TVF's funds for resolution of member institutions up to the net cost it would have incurred if the bank had been liquidated³². In practice, this would typically entail the transfer of deposits and good assets to a healthy bank, with the deposit insurance fund providing the necessary resources (subject to safeguards such as a 'least cost' test) to cover the gap between the two. By transferring assets at higher "going-concern" values, the deposit insurance fund would incur lower costs; while depositors effectively retain continuous access to their funds as time-

³² See Oana Croitoru, Marc Dobler, and Johan Molin: "Resolution Funding: Who Pays When Financial Institutions Fail?", IMF, Monetary and Capital Markets Department, June 2018.

consuming reimbursement procedures are omitted. The transposition of Directive 2014/49/EU, and especially the development of its Article 11.6, would facilitate the introduction of that function.

81. Public awareness of the deposit insurance system in Iceland has not been measured.

All member companies of TVF are required, under Article 16 of Act 98/1999, to publish, on their websites, information on their membership of TVF, the scope of coverage, information on which liabilities are excluded from coverage and how depositors can make claim for repayments. In many jurisdictions, advertising that protection is attractive for depositors, but this is not the case in Iceland, as a consequence of the 2008 crisis. This negative image makes very difficult the implementation of any governmental support measure to the TVF.

82. Recommendations

- Authorities should introduce a maximum reimbursement timeframe of seven business days, in line with international best practices³³, and work on internal processes and systems to make that target achievable, while improving public awareness of the deposit insurance. The transposition of Directive 2014/49/EU will ease that work. So far, TVF has not implemented these procedures and systems (for example, IT system's capacity and procedural requirements to get regular information from banks on accountholders, including the use of single-customer view) and has not tested periodically its pay-out procedures by performing simulations. These technical and procedural changes should enable payouts within a much shorter timeframe.
- The MoFEA and the TVF should set an actual funding target to be reached, considering total covered deposits of small and medium banks. That target could be modified with the evolution of those deposits. Implementing this approach does not require the modification of a Law as it happens now.
- The credibility of TVF should be strengthened by allowing access to backup funding sources. Credible backup funding sources would include credit facilities from the MoFEA, the CBI, or borrowing arrangements with EU deposit insurance systems; sole reliance on market borrowing would not be sufficient. This could help to tackle temporary liquidity shortfalls of TVF facing a bank crisis, which are more likely if the deadline to reimbursements is reduced to seven days.
- The MoFEA should assess the potential introduction of a paybox plus mandate subject to a least cost test. The transposition of Directive 2014/49/EU, and especially the development of its Article 11.6, would facilitate the introduction of that function.
- An assessment by an independent third party of the TVF's compliance with the IADI Core Principles for Effective Deposit Insurance Systems should be carried out. Although the management of the TVF is well aware of the Core Principles, no formal assessment of the fund's compliance with them has been carried out by a third party.

³³ See IADI Core Principle 15.

FINANCIAL CRISIS PREPAREDNESS AND COOPERATION

83. The CBI is working on the implementation of a comprehensive contingency plan for crises in the financial system. The final draft of the Crisis Management Handbook (CMH) has to be approved by the Governor of the CBI. This plan covers all the elements in the scope of this technical note: crisis indicators (related to solvency, liquidity markets and supervision); triggers and criteria for escalating the response level; communication plan; contingency management (including participating members and communication issues); the regular liquidity window for the CBI's transactions with counterparties for monetary policy and financial stability (for example, quality requirements for collateral); early intervention measures and recovery (application of recovery plan or other measures and special supervision of recovery actions); ELA (definition, information gathering, decision process and disclosure); determination of the FOLTF of a bank (criteria, information gathering, decision process and communication plan); and maintenance program for the contingency plan (review frequency, responsible parties, simulations and rehearsals). The CMH should be expanded as soon as possible to the phase of bank resolution.

84. The CMH will define guidelines and internal processes for responding to all the symptoms of a crisis. For example, it will set the response to liquidity and solvency problems of credit institutions; set the CBI's response to crises, ranging from short-term liquidity needs to a request of ELA, and to early intervention measures; tackle issues such as collateral requirements for the CBI provision of liquidity, management of stigma, definition of stages and triggers; etc. On communication, no formal national or system-wide financial crisis communication plan has been announced. It is necessary to appoint an authority to draft that plan and to lead the communication in a crisis. As the Financial Stability Council is responsible for formulating official policy on financial stability, the MoFEA should participate in those decisions. The plan should distinguish between potential events (such as resolution, liquidations, TVF's pay-outs or ELA) and provide tailored guidance on communication for these events. The CMH, in its first version, will end with a description of the main decisions at the bank resolution stage. It will provide further guidance on when an institution is considered FOLTF and the procedure relating to such decision. This document should also include an internal guidance to assess the FOLTF decision sent to the resolution authority by the supervisory one.

85. The CMH will include new provisions on ELA. In the CMH-draft, it is assumed that a special data dashboard, with all the mentioned key indicators, will be designed for an easy one-point access to the early warning / horizon scanning. The draft also assumes that the department of Market Operations will be involved together with the FSA and the Financial Stability department, in the process of monitoring emerging liquidity problems among financial institutions that qualify for ELA. On collaterals, it is proposed that the CBI will require banks to maintain a comprehensive and updated list of assets most likely to be used as potential collateral for ELA. Finally, ELA in FX will suppose a higher haircut on collateral to account for increased risks for the CBI, according to the CMH-draft.

86. The CBI has implemented a business continuity plan approved by the Governor. The plan deals with alert levels, crisis management team, meeting places and teleconference directions; protection of Bank's critical services; communication plan; specialized plans (pandemic, security of information, IT operations and physical security); contact persons inside the Bank and with other institutions; etc. Parts of the business continuity plan have recently been tested at a cyber security exercise led by the CBI. The scenario for the exercise was a widespread ransomware attack, which spread across key parts of the financial system. The scenario evolved until ATMs, core banking systems, payment systems and cash distribution centers were inoperable. The exercise put parts of the contingency plan in to practice, mostly in relation to coordination between financial market participants (systemically Important banks, the critical data center, and the CBI), coordination of different plans and groups within the Central bank and secure communication pathways. From the CBI's perspective, the exercise showed that the plans provided are fully operational.

87. The MoFEA and the CBI are members of the Nordic-Baltic Stability Group. The Group meets regularly to exchange information relevant to cross-border financial stability in the region and holds simulation exercises to test members' preparedness for financial crises. Members include financial supervisors, finance ministries and resolution authorities in the Nordic-Baltic Region. Participation of Icelandic authorities in this forum should be very active, because it is a way to share policies and guidance in which the largest countries should be more advanced. This recommendation could be extended to the participation of Icelandic authorities in all the European fora (European System of Financial Supervision through the EEA agreement by participating in the work of the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

88. The MoFEA, the FME and the CBI participated in the Nordic Baltic Stability Group joint financial crisis simulation exercise in 2019. The scope of the exercise was to test the crisis preparedness of all the participating authorities, simulating a financial crisis that affected all countries and took place over two simulated weeks—which were two days in real life. The scenario was broadly that there was an abrupt and sizeable repricing of risk premia which leads to tighter credit conditions. Property prices fell sharply, and banks faced funding difficulties. Following this exercise, a special working group on communication and collaboration tools was set up to create a mutual understanding and framework for communication and collaboration between authorities. This included setting up specific e-mail protocols, agreeing on a video-conferencing solution, discussion levels of secrecy/security for information etc. Another working group has been set up to analyze the legal framework for cross-border information sharing amongst the agencies involved. Simulation exercises of the Nordic-Baltic Stability Group are supposed to take place regularly and at least every 5 years so another exercise can be expected in the next couple of years.

89. Recommendations

- In the next iteration, the CMH should provide further details on the resolution phase in order to be more prepared tackling a bank failure.
- An authority should draft the comprehensive contingency plan for crisis and lead the communication in a crisis. In the CMH there will be a communication plan for financial crisis, but it has not been drafted yet. The plan should distinguish between potential events (such as resolution, liquidations, TVF's pay-outs or ELA) and provide tailored guidance on communication for these events.
- Participation of Icelandic authorities in the North Baltic Stability Group forum should be very active, because it is a way to benefit from policy guidance from the larger countries. Participation is also justified by the need of introducing borrowing arrangements with national resolution funds / deposit guarantee schemes. This recommendation could be extended to the participation of Icelandic authorities in all the European fora.

Appendix I. 2018 Euro Area FSAP Findings on Crisis Management

In July 2018, the IMF concluded its first Euro Area FSAP, praising the Euro Area authorities for establishing a considerably strengthened bank resolution framework at the EU-level, while highlighting room for further improvement.

- **The banking union needs a more effective deposit insurance system (DIS).** Many national DISs are underfunded and lack effective backup funding. A common deposit insurance system for the Euro Area is missing. Greater risk pooling would help avoid disruptions that may overwhelm countries' individual capacities and would help address hosts' risk-sharing concerns.
- **A financial stability exemption is needed to help mitigate critical constraints in the framework.** The SRMR requires bailing in a minimum of 8 percent of total liabilities and own funds prior to access to the Single Resolution Fund or national public funds for loss absorption. Building loss-absorbing capacity and recapitalization capacity beyond capital requirements will take time, and is generally not required for smaller banks expected to be liquidated. Many banks may therefore have no access to funds, even in a system-wide crisis. A financial-stability exception—to be used only in times of Euro Area-wide or country-wide crisis—subject to strict conditions and appropriate governance arrangements—would bring much-needed flexibility.
- **Despite the establishment of the SSM and the SRM, fragmentation along national lines persists.** In the EU, resolution requires an assessment against potential outcomes under significantly heterogeneous national insolvency regimes. This is exacerbated by diverging national supervisory powers and securities regulation practices, various national discretions in the directives for bank resolution and deposit insurance, and SRB decisions being executed by national resolution authorities under diverging national laws (e.g., administrative and labor laws). Heterogeneous national (bank) insolvency regimes, with more generous public-funding options and less stringent loss-sharing requirements under EU state aid rules than in the SRM, deliver substantially different outcomes for bank creditors, and strongly incentivize national solutions
- **Many banking union countries have not availed themselves of essential powers available under EU directives.** For example, most countries have not established powers for public equity support and temporary public ownership (i.e., "government stabilization tools"); almost two-thirds of the countries have not authorized the use of deposit insurance funds in liquidation proceedings, preventing the use of time-tested and cost-effective purchase and assumption ("sale of business") transactions in liquidations.
- **A more unified resolution framework for small and large banks should include an administrative bank liquidation tool.** This would allow the National Resolution Authority (NRA) to appoint a liquidator and commence proceedings.

- The NRA would be authorized to apply this tool to all banks within its remit—irrespective of whether the public interest test is met. A liquidation tool would help reduce destruction of value, level the playing field for creditors, and reduce the risk of member states “gaming” the system.

Appendix II. Two Key Decisions of the Court of Justice of the European Union (CJEU) on Bank Resolution

1. First, the CJEU has ruled last June on the resolution decision of Banco Popular (BP) adopted on June 7, 2017, by the Single Resolution Board. What can we learn from that judgement?
2. The CJEU validates the elimination of important fundamental rights, such as the right to be heard of shareholders and other creditors of a failing bank before the adoption of the resolution scheme and the right to property (the decision implied to write down the value of shares and subordinated debt) in the interest of protecting the public interest of financial stability.
3. On the requirements to resolve a bank, the CJEU confirms that the failure of a bank is not necessarily linked to its insolvency. The judgement also recalls that the provision of liquidity by the single resolution fund to a failing bank can be made only to achieve the effective application of the resolution tools.
4. The CJEU supports the extraordinary process of sale of BP. Facing an exceptional situation (such as the one experienced at the time), the national authority that executes the SRB's decision can contact only specific potential buyers and not trigger an open auction, provided that none of the potential buyers is unduly favored or discriminated against.
5. On the valuations of BP carried out before its resolution, the CJEU considers that the valuation carried out by experts of the SRB that sought to determine the unviability of the bank (valuation 1), loses relevance at the moment that the European Central Bank formally communicates to the SRB the failure of BP; and a final valuation 2 was not necessary, because in the implementation of the sale of business tool, the only goal of that valuation is to inform the resolution decision, not to determine the losses for that BP's shareholders and subordinated creditors.
6. Finally, the governance of the European resolution framework is also strengthened by the ruling. It is clear that the key role of the European Commission lies in the participation of its representative, as a permanent observer, in the meetings of the Executive Session of the SRB, as well as in the right of that representative to participate in the discussions and to have access to all documents related to the resolution.
7. Another relevant judgement was issued by the CJEU last May. This case began, in March 2018, with a claim filed against BP by investors who, as a result of the resolution of the entity agreed by the SRB on June 7, 2017, had lost their shares acquired in the capital increase carried out by the entity in May 2016. The application sought the nullity of the share subscription contract, due to an error invalidating the consent, since it was signed on the basis of a prospectus that contained incomplete and inaccurate accounting and patrimonial information, or alternatively, by fraud, by having deliberately falsified and concealed the bank's financial solvency

8. What does the European bank resolution framework represent? It is an exception to the general regime of insolvency proceedings, which is applicable only in exceptional circumstances: when it is not possible to liquidate a credit institution without destabilizing the financial system. The exceptional nature of this regime means that the application of other provisions of EU law may be ruled out where they may render ineffective or hinder the application of the resolution procedure (e.g. voting at shareholders' meetings on capital increases or reductions; the protection of creditors in the event of a capital reduction; the obligation to launch a public takeover bid in the event of acquiring a certain percentage of shares; the obligation to publish a prospectus for relisting shares in a bail-in; etc.).

9. For the CJEU, as these claims require that the credit institution subject to resolution (or its successor) compensates former shareholders for losses suffered as a result of the resolution decision, such actions would frustrate the resolution procedure itself and the objectives pursued by the BRRD. Therefore, although there is a public interest in ensuring strong investor protection throughout the Union, for the CJEU, that interest does not take precedence over the public interest in ensuring the stability of the financial system.

10. As a shareholder whose shares have been cancelled by the resolution authority loses his status as a shareholder, the CJEU concludes that he cannot initiate a judicial action for damages on account of an incorrect or inaccurate prospectus. Does this conclusion imply a lack of effective judicial protection for investors? For the CJEU, no, since the amortized shareholders can exercise two actions with compensatory effect: to urge the annulment of the resolution decision of the SRB and to request compensation from the Single Resolution Fund for having incurred more losses in resolution than in a possible liquidation

11. There are two significant effects of this judgement on the resolution framework: first, the sale of the shares of a bank in resolution is clarified and favored by this judgment, since it is clear that the awarding entity of that bank does not have to assume losses in the future due to the materialization of legal contingencies such as those described in this case. This also avoids possible future guarantees issued from the resolution fund to facilitate a bank sale. Second, on the public interest in a resolution, the general rule should be liquidation following normal insolvency proceedings and the exception, the application of the bank resolution framework. Therefore, it seems to follow from the judgment that, if we want agile and efficient liquidations of medium and small banks, the emphasis must be on the reform of these ordinary insolvency procedures, not on progressively expanding the scope of application of the resolution regime.