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# THE SINGLE RESOLUTION MECHANISM

STOCK TAKE AND LOOKING  
FORWARD



## David Denayer

David Denayer is a senior consultant focusing on risk management and banking prudential regulation. His areas of expertise cover strategic risk and scarce resource management, particularly in the context of banking supervision and resolution in the Banking Union. David has assisted major financial institutions throughout France and the Benelux in coping with regulatory challenges on various topics, incl. IRRBB, capital management and recovery planning. In terms of background, David holds a master's degree in Economics and has developed its expertise in risk management via the FRM certification.



## Jonathan van Malleghem

Jonathan Van Malleghem is a Manager with Advantage Reply (Benelux and France) and specialises in Risk Management and Reporting, Recovery and Resolution. Jonathan has assisted financial institutions in preparing their Recovery Plan and understanding the impact of resolution-related requirements (e.g. MREL, TLAC, SRF contribution, Resolution Strategy). In addition, Jonathan is an experienced project manager and regularly assists financial institutions in implementing projects related to new regulatory requirements (e.g. BCBS 239, Revised Securitisation framework, ICAAP) and the implementation of Enterprise Risk Management and Risk Appetite.



## Rob Konowalchuk

Rob Konowalchuk joined Advantage Reply UK in September 2016 as an associate partner, having spent his career in various advisory roles within financial services risk and regulation. With 16 years of experience in the financial services sector (primarily banking and capital markets), Rob has become an expert in a broad range of issues facing financial services firms, particularly in prudential risk and regulation. With a background in accounting and auditing, Rob applies expertise in governance, controls, systems and data to design and deliver change and remediation programmes, primarily driven by prudential regulation (with a focus on capital and liquidity management, regulatory reporting, capital planning and stress testing, and recovery and resolution planning). Rob has a degree in Business Administration and is qualified as a chartered accountant in the UK and Canada.

### About **Avantage Reply**

Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and Treasury.

Website: [www.avantagereply.com](http://www.avantagereply.com)

# Foreword

Two years ago, Avantage Reply published a White Paper introducing the Bank Recovery and Resolution Directive ('BRRD'). The directive was a milestone in the post-crisis regulatory agenda as it sought to address the disorderly government-led bailouts that took place during the financial crisis in the absence of an adequate crisis management framework. A core objective of the BRRD is that banks have adequate safeguards in place to prevent crises, that authorities have requisite powers to intervene to restore financial stability, and that in the event of failure banks are resolved in an orderly manner without adverse effects on taxpayers or the financial system as a whole.

At the time, our White Paper focused on recovery planning – the first facet of the BRRD. Banks were required to either prepare their first recovery plan or to update what they may already have in place, according to the EBA requirements. Since then, banks have gained experience in articulating how they plan to navigate through and out of troubled times, as well to face supervisory challenges in that regard. While improvements are always on the horizon, in particular the Sisyphean objective to embed all the strategic processes involved<sup>1</sup>, what was a new exercise for many banks is now becoming 'BAU'.

Back to the present, the focus has now shifted to the other side of the BRRD – resolution – particularly in the Banking Union where its institutional framework took shape. As its second pillar, the Single Resolution Mechanism articulates the responsibilities for bank resolution in the eurozone under the aegis of the Single Resolution Board. Mandated with the orderly resolutions of failing banks, with minimum impact on the real economy and the public finances, the SRB is fully operational since the 1st of January 2016.

This White Paper takes stock of the current state of play of the resolution framework in the Banking Union, a little bit over one year after the entry into application of the Single Resolution Mechanism, and contemplates the associated challenges (as well as opportunities) for banks in that context.

<sup>1</sup> Recovery planning, risk appetite framework, ICAAP/ILAAP, strategic and financial planning, stress-testing framework, and so on.

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# SRM: The State of Play

## Genesis

After the 2007-2008 financial crisis, the regulatory agenda focused on reinforcing prudential standards to increase banks' resilience, but also in parallel on putting in place a framework – called resolution – to address bank failures in an orderly manner. To tackle the 'too-big-to-fail' problem, policymakers and regulators developed at the global level under the Financial Stability Board ('FSB') a common approach embodied in the *Key Attributes of Effective Resolution Regimes for Financial Institutions*. Implemented in the EU through the Bank Recovery and Resolution Directive ('BRRD'), the framework rests on the principles that losses should be borne by shareholders and creditors, instead of reverting to taxpayers' money, and that the critical functions that banks provide should be safeguarded in resolution to preserve financial stability and the real economy.

The BRRD requires EU Member States to appoint resolution

authorities and grant them significant resolution powers and tools. In the eurozone, the Single Resolution Mechanism ('SRM') was established as the second pillar of the Banking Union – it consists of a central decision-making body, the Single Resolution Board ('SRB'), and relies on the local expertise of national resolution authorities ('NRAs'). In practice, the SRB is responsible for the resolution of the entities and groups directly supervised by the European Central Bank ('ECB') under the Single Supervisory Mechanism ('SSM') as well as other cross-border groups, while other banks fall under the remit of NRAs. The SRM also includes the Single Resolution Fund ('SRF'), a privately funded vehicle managed by the SRB to support its resolution activities.

## From policy design to implementation

In its last report to the G-20, the FSB pointed out the fact that its *jurisdictions are moving from the design of post-crisis resolution*

reforms to their implementation<sup>2</sup>. Europe is no exception. Since 2012, tremendous efforts have resulted in the elaboration of a European resolution framework around the BRRD and the SRM Regulation. Throughout 2016, the European Commission adopted the majority of technical standards mandated by the BRRD and developed by the EBA. By now, the European regulatory framework around banking resolution is therefore almost complete. The missing piece of the puzzle – the implementation in European law of the total loss-absorbing capacity ('TLAC') requirements and its reconciliation with the minimum requirement for own funds and eligible liabilities ('MREL') – is the objective of legislative proposals set out by the European Commission in November 2016 (amongst a broader reform of banking prudential standards). While other notable elements are not yet finalised, including the European Deposit Insurance Scheme ('EDIS') and the development of a common backstop to the Single Resolution Fund, it is safe to say that the balance has shifted from regulators towards resolution authorities in taking the resolution framework forward.

### **Entry into force of the SRM and resolution planning activities in 2016**

The 1 of January 2016 saw the entry into force of the SRM Regulation, and along with it all the prerogatives of the SRB as a (group-level) resolution authority. In particular, the SRB assumed full responsibilities as the resolution authority for significant institutions and cross-border banking groups in the eurozone. More specifically, its mandate foresees the orderly resolutions of failing banks with minimum impact on the real economy and the public finances of the participating Member States of the Banking Union. Needless to say, fulfilling this mandate is a daunting task, and requires tremendous expertise and infrastructure to support resolution planning and execution. What a journey then, from a mere taskforce established within the Commission in mid-2014 to a fully operational and full-fledged Banking Union authority by 2016. Early on, the SRB faced a

race against the clock to develop the capabilities to carry out its mandate, basically from scratch.

In practice, the question of putting a bank into resolution arises where early intervention measures, including the activation of the recovery plan, prove ineffective to restore an ailing bank's viability. More specifically, three conditions must be met to enact a bank resolution: a supervisory judgment that the bank is *failing or likely to fail*, the lack of reasonable prospects to rescue the bank with a private solution or supervisory intervention, and a public interest argument. Under such circumstances, the bank enters a resolution phase that entails a fundamental restructuring of the entity, either in the form of a wind-up, break-up or bail-in. While no actual bank resolution took place in 2016, the SRB was not inactive – quite the contrary.

The framework attaches a great focus on preventive measure, including through the preparation of resolution plans in which the resolution authority analyses and identifies a preferred strategy to resolve the banks under its remit given their inherent structure. In this regard, the SRB adopted a gradual approach, foreseeing the development of resolution plans in different phases. In 2016, resolution plans for the main banking groups in the Banking Union were drafted, building on the preparatory works conducted in 2015. This comprised 65 full resolution plans and 30 transitional plans. Banks will be presented with the main conclusion early this year, including indicative MREL targets (at consolidated levels) and first steps towards improving resolvability where needed (e.g. changes in legal, operational and/or financial structure).

Besides resolution planning efforts, the SRB pursued its efforts to structure and strengthen its resolution framework, through the development of a body of documentation (e.g. a resolution planning manual and crisis management manual), the set-up of Internal Resolution Teams ('IRTs')<sup>3</sup> and Resolution Colleges, and a crisis simulation exercise to enhance

<sup>2</sup> FSB, Resilience through resolvability – moving from policy design to implementation, 5th Report to the G20 on progress in resolution, August 2016, p4.

<sup>3</sup> IRTs represent the equivalent of Joint Supervisory Teams (JSTs) in the SSM, bringing together staff from the SRB and NRAs.

resolution readiness. Finally, the SRF was established in early 2016 and transferred the proceeds of the national resolution funds that it supersedes, and a first round of fund raising under the aegis of the SRB took place.

### The banks' perspective

Naturally, the SRB actively involves banks in the preparation of their resolution plan and, if need be, in their actual resolutions. **Box 1** represents for illustrative purposes banks' typical involvement depending on the stage in the resolution process.

In anticipation of a resolution, banks are expected to assist resolution authorities in their resolution planning activities (e.g. through the submission of templates, organisation of workshops with IRTs, etc). As part of ensuring resolvability, banks have to comply with loss-absorbing requirements so as to ensure sufficient capital resources in resolution and may be required to undertake structural reforms (e.g. ring-fencing). Finally, banks are required to make financial contributions to build up the SRF. Resolution planning, loss-absorbing requirements and resolution financing arrangements are the subject of subsequent dedicated sections in this White Paper.

Where all three conditions for resolution are met, the SRM Regulation imposes a stringent timeline for adopting a resolution scheme – the so-called “resolution weekend”. Governance arrangements between the SRB and the Commission (and in certain cases the European Council) on the approval of the scheme are strictly specified to ensure a prompt response in case of an emergency situation. During – or in anticipation of – this resolution weekend, the ailing bank must be valued to give the SRB a clear and up-to-date understanding of its financial position and to inform the most adequate resolution scheme. As an essential pillar of the success of the resolution process, resolution authorities will not moderate their expectations over banks' capacity to support this valuation exercise as well as to determine the point-in-time waterfall of loss allocation to creditors under the (national) insolvency hierarchy. More generally, pressure will be applied on banks' ability to produce detailed and high-quality data in a timely fashion (virtually at the push of a button).

Depending on the resolution action, the bank may be partly/fully wound down or maintained in a going concern. In the latter case, the bank will go through a significant restructuring phase. Practical challenges include regaining the trust of market participants, redefining its business model, potentially coping with a new shareholding structure, etc.

### BOX 1: BANK'S CHALLENGES THROUGHOUT THE RESOLUTION LIFE CYCLE

#### PRE-RESOLUTION



- Resolution planning (reporting, process, ...)
- preparation for resolvability (e.g. ring fencing)
- MREL compliance and balance sheet optimisation
- SRF Contributions

#### RESOLUTION



- Data production to support valuation and restructuring activities

#### POST-RESOLUTION



- Data production to support valuation and restructuring activities

### BOX 2: SRB KEY PRIORITIES IN 2016 AND 2017

2016		2017	
1	<b>ENSURE RESOLUTION READINESS</b> <ul style="list-style-type: none"> <li>Draft full resolution plans for “high priority” banks, including MREL targets on conso level</li> <li>Finalise internal body of knowledge</li> </ul>		<b>ENSURE RESOLUTION READINESS</b> <ul style="list-style-type: none"> <li>Further develop resolution plans, including resolvability assessment and MREL follow-up</li> <li>Further operationalise resolution actions</li> <li>Challenge readiness through crisis simulations</li> </ul>
2	<b>OPERATIONALISING THE SRF</b> <ul style="list-style-type: none"> <li>Set up the fund</li> <li>Transfer the 2015 contributions collected by NRAs</li> <li>Set up SRF management structures</li> <li>Complete the first collection exercise</li> </ul>		<b>SINGLE RESOLUTION FUND</b> <ul style="list-style-type: none"> <li>Develop an IT solution for the SRF contribution mechanism</li> <li>Continue technical work on a common backstop</li> <li>Develop and implement investment strategy for the SRF</li> <li>Further operationalise the role of the SRF in resolution cases</li> </ul>
3	<b>FOSTERING COOPERATION</b> <ul style="list-style-type: none"> <li>Set up cooperation agreements with key stakeholders</li> <li>Develop a culture of cooperation with NRAs</li> <li>Establish Resolution Colleges</li> <li>Dialogue with legislators on regulatory issues</li> </ul>		<b>POLICY AND COOPERATION</b> <ul style="list-style-type: none"> <li>Contribute to TLAC/MREL, EDIS, FMI resolution framework</li> <li>Build the SRB oversight function over LSIs</li> <li>Set up European Resolution Colleges for non-EU G-SIBs</li> <li>Support NRAs’ handbooks to implement resolution tools</li> </ul>
4	<b>CAPACITY BUILDING</b> <ul style="list-style-type: none"> <li>Develop support functions (IT, finance, etc)</li> <li>Relocate headquarters to new premises</li> </ul>		<b>SRB AS AN ORGANISATION</b> <ul style="list-style-type: none"> <li>Develop support functions (IT, finance, etc)</li> <li>Set up an SRM ICT platform for resolution activities</li> <li>Implement a definitive administrative contribution collection process</li> </ul>

### 2017 Outlook

Looking ahead, the SRB will reaffirm its focus on resolution readiness and pursue its journey of ensuring banks are ‘safe-to-fail’ in the Banking Union. The SRB’s 2017 Work Programme essentially points towards continuing the efforts undertaken in 2016 to implement the resolution framework under the SRM. Specifically, it sets out four priorities (see box 2).

Resolution planning activities will be extended to all the banking groups under the remit of the SRB and appropriate follow-up will be pursued on resolvability assessment. Consolidating and capitalising on what has been done, the SRB will conduct horizontal benchmarking to foster consistency and identify best practices. With regards to resolution readiness, the SRB plans to identify and address weaknesses in its operational capacity to deal with and resolve ailing banks. The Crisis Management Manual and Resolution Planning Manual will be enhanced and augmented to move them from conceptual to more operational. This, when combined with planned dry-run exercise, will prepare the SRB to execute an orderly bank resolution along with key stakeholders (NRAs, ECB, etc.).

As it develops and matures, the SRB is set to take a bigger role in the Single Resolution Mechanism – either directly on its scope with bigger involvement in IRTs or indirectly with NRAs through oversight and guidelines.

### A first false start?

Everything, however, is not clear and bright on the horizon. Recent events in Italy demonstrated that the path towards the end of the era of public bailouts remains full of obstacles. High levels of non-performing loans have prompted the public authorities to ready an intervention package under the so-called *precautionary recapitalisation* mechanism foreseen in the BRRD. An exception to the principle that public support should lead to resolution, this mechanism entails extraordinary public support in the form of capital injections to solvent banks and on a temporary basis, where capital shortfalls have been established as part of supervisory stress tests. The state rescue funds approved by the Italian authorities may plow as much as €20 billion into the Italian banking system, although any public recapitalisations would remain subject to the scrutiny of the European Commission under the State Aid framework (which entails in any case burden-sharing requirements from the bank’s creditors).

This sequence of events may feel like a disappointment for the Single Resolution Mechanism – a framework put in place to avoid bailouts, protect taxpayers and sever the link between banks and their governments. In any case, it serves as a wake-up call that bank failures remain prominently political events and that many challenges exist between transposing and actually implementing the new framework.



# Resolution Planning: An Overview

As a forward-looking institution, much of the SRB's day-to-day operations consist in actively preparing for an eventual bank resolution. This entails the development of resolution plans, as well as developing the operational capacity to proceed with the application of resolution tools and powers. Developed in close cooperation with the competent authorities (typically the ECB/SSM) resolutions plans describe how resolution authorities would deal with a bank reaching the point of non-viability. By nature, such information is forward looking and subject to considerable uncertainty regarding the particular circumstances of the bank's difficulties. To mitigate this obsolescence risk, resolution plans are updated annually or in case of significant changes, such as mergers and acquisitions or other structural or business model change.

In September 2016, the SRB released a public version of its Resolution Planning Manual. This 'playbook' contains a wealth of information on the agency's approach to resolution planning. This section focuses on the main building blocks<sup>4</sup> within this approach to provide a high-level overview of resolution planning activities, highlighting challenges that may arise for banks in practice.

## BOX 3: MAIN BUILDING BLOCKS OF RESOLUTION PLANNING



<sup>4</sup> Elements not covered in this section include notably the internal/external communication strategy to adopt in case of resolution.



### STRATEGIC ANALYSIS

The starting point of resolution planning is a deep dive into the bank's structure and organisation. This exercise, termed the strategic analysis, consists of a detailed and wide-ranging study covering the following elements:

- Legal, ownership and governance structures;
- Financial position, including balance sheet analysis, assessment of liquidity and capital positions;
- Business model and business lines, including the identification of critical functions and core business lines;
- Internal and external interdependencies; and
- Identification of the services essential or critical to the continuity of critical functions, including internal services, IT systems and access to FMs.

The objective of the strategic analysis is to provide a deeper understanding of the bank and inform the determination of the preferred resolution strategy and resolvability assessment. To some extent, it has many similarities with the strategic analysis performed by the banks themselves as part of their recovery plan. For this reason, the resolution authorities will leverage and process this input, subject to the critical eye of the IRTs.

Additional information will be expected from institutions, in accordance with the ITS developed by the EBA and adopted in July 2016 by the Commission (the "resolution templates"), new templates regarding critical functions and FMs unveiled during the 5<sup>th</sup> Industry Dialogue in January 2017 or other reporting requested on an ad-hoc basis. In parallel, the SRB cooperates with the SSM on topics such as the business model analysis conducted as part of the Supervisory Review and Evaluation Process ("SREP").

The strategic analysis represents the groundwork of resolution planning. For banks, it entails a lot of pedagogy with respect to their business model and operating model, but also a lot of reporting.

In this regard, the publication by the SRB of a new set of templates (Liability Data, Critical Functions and FMs) illustrates a strong trend towards the use of standardised reporting templates and the industrialisation of those data collections.

### PREFERRED RESOLUTION STRATEGY

Building on the strategic analysis, the resolution authorities then consider the best approach to wind down the bank in an orderly manner. Given that in the BRRD framework, resolution represents a last resort solution, the credibility and feasibility of liquidation under normal insolvency proceedings are assessed first – although this is not expected to be verified for the largest systemic banks. Where resolution proves the most appropriate path, resolution authorities establish and articulate a preferred resolution strategy.

The BRRD outlines four (non-mutually exclusive) resolution tools to deal with failing banks: sale of business(es), bridge institution, asset separation and bail-in. The preferred resolution strategy will reflect the most appropriate combination of tools in the light of the bank's separability (feasibility/credibility of a break-up) and loss-absorption capacity (amount/composition of funding instruments subject to bail-in). Accordingly, the resolution authorities will rather opt for a business or financial restructuring strategy.

When it comes to banking groups, the level of application of resolution tools is an essential part of the preferred resolution strategy. Depending on the group structure (in particular the degree of integration/entrenchment), resolution is applied at the parent company (single point of entry, or 'SPE') or at lower, subsidiary or sub-group level (multiple points of entry, or 'MPE'). Recent regulatory initiatives (see next section) make this distinction by proposing formal definitions for the notions of *resolution entity* and *resolution groups* – enshrining the identification of the entities to be resolved, versus the subsidiaries that belong to them.

At the heart of resolution planning lays the establishment of resolution strategy. It is necessarily a multi-dimensional piece of work, based on inputs ranging from the group's structure and business model to issues of coordination between resolution authorities of different jurisdictions.

Though taking into account banks' existing structure and business model, significant efforts may be required to ensure a successful execution of the preferred resolution strategy which may impact how banking groups structure their activities and allocate resources and responsibilities.



### FINANCIAL AND OPERATIONAL CONTINUITY

Ensuring the continuity of critical functions in resolution is key to the whole resolution paradigm. As such, the resolution plan will include arrangements to ensure that necessary operational and financial resources are in place to sustain the critical functions throughout the resolution process. In particular, resolution authorities aim to make sure the preferred resolution strategy does not threaten the continuous provision of critical functions.

Resolution authorities must evaluate and ensure an adequate level of operational resilience with respect to internal services, IT systems, outsourcing and access to FMs to support critical functions in resolution. This may include staff retention/substitution arrangements and the implementation of service level agreements (SLAs).

While, in principle, the bail-in tool should provide sufficient capital post-resolution (see next section), there is no such mechanism to support funding continuity. Despite the recapitalisation, the resolved entity might find it difficult to refinance itself on the market. Resolution authorities will therefore develop a resolution funding plan as part of resolution planning, setting out the uses and sources of funding, including resources available internally, potential market issuance and, as a last resort, access to the SRF. Assistance from central banks, e.g. through the provision of Emergency Liquidity Assistance ('ELA'), cannot be assumed but is not excluded as such (inventory of eligible collateral).

The extent of contingency planning required to ensure continuity of critical functions in resolution is difficult to overstate. Unsurprisingly, this topic is a key area of focus. The FSB published guidance on operational continuity, financial continuity and access to FMs in 2016.

Institutions with streamlined organisations and well-documented processes will find it easier to meet their resolution authorities' expectations. Others will be confronted with challenges and incentives to rethink their operating model.

### RESOLVABILITY ASSESSMENT

The last building block of resolution planning deals with the bank's resolvability. This means that it is both feasible and credible for the resolution authority to either liquidate it under normal insolvency proceedings or to resolve it by applying its various resolution tools and powers. The resolvability assessment aims to identify any material impediments and subsequently initiate a credible remediation plan.

Findings will be communicated to banks, which will then have four months to present the SRB with suggested measures addressing the identified impediments. If those are considered insufficient, the resolution authority is entitled to require the implementation of alternative measures prescribed by the BRRD. In subsequent guidelines, the EBA classified such measures and the type of impediments they address as structural, financial or information-related, described as follows:

- Structural impediments relate to the structuration of a bank from a legal, operational and financial perspective;
- Financial impediments relate to the bank's business activities and its balance sheet composition;
- Information impediments relate to the (in)ability of the bank to produce timely and quality reporting.

While the SRB is bound to impose measures that are necessary and proportionate, the range of options set out in the BRRD is high-impact and far-reaching, particularly as they relate to the core processes of the bank.

Notwithstanding the safeguards put in place, the path to resolvability is expected to be extremely challenging. It is however notable that this ought to be the area where banks have the greatest opportunity to take the initiative and make themselves heard in the resolution planning process. Performing self-assessment is a useful way to devise an effective remediation plan and maintain a constructive dialogue with its resolution authorities.



### **Resolution planning challenges**

The resolution planning process is challenging. From undoubtedly putting banks' reporting systems under pressure, to prepping up for thematic workshops with IRTs, and so on. That being said, the bulk of the impact really lays in what it leads to, particularly in the continuous efforts to achieve and sustain resolvability.

Key to a bank's resolvability is the resilience of its operations. This implies the implementation of credible arrangements to provide for essential staff, infrastructure, funding, liquidity and capital to support and maintain the core business lines and critical operations in resolution. In this respect, many banks have adapted their operating models in anticipation of regulatory expectations (e.g. through the set-up of service company or of SLAs). In that context, resilience relates to specific contractual (that is, valid and enforceable in resolution) provisions, access arrangements and governance structures.

Recent guidance from the SRB on operational continuity distinguishes three different service delivery models banks can adopt for the provision of operational services; whether by a division within a regulated legal entity, by an intra-group service company or by a third party service provider. While the guidance remains neutral towards the respective models, the SRB may favor the one the more in phase with its preferred resolution strategy. Such scrutiny could force the banks to reconsider what it considers to be its right level of entrenchment given its business objectives.

More generally, the necessity to achieve and maintain resolvability puts banks' business model and strategy under the pressure. It represents

additional intrusive scrutiny in complement to the regular supervisory oversight that focuses on a going-concern approach. The SRB may, for instance, require banks to limit or cease specific existing or proposed activities.

Last but not least, the impact on data, system and reporting is daunting. Banks' information systems should be in a position to provide all data needed to develop and implement the resolution strategy in a timely manner. This may entail the production of various reports, from comprehensive mapping of critical functions, shared services and legal entities, to granular data supporting the valuation exercises underlying the entry in resolution to identifying unencumbered, high-quality collateral to inform the potential access to liquidity in resolution, and so on.

Finally, it is worthwhile to mention the intricacy of resolution planning with regular supervision, notably under the SREP. Among its supervisory priorities for 2017, the ECB outlined a focus on business model analysis and outsourced activities. Banks may find it opportune to address the associated thematic reviews keeping in mind the potential ramifications for resolution planning.

### IMPACT ON RECOVERY PLANNING

Recovery and resolution plans, although fundamentally different in many respects, are necessarily intertwined. Therefore, the launch of resolution planning will impact banks' preparation and update of their recovery plans.

The SRM regulation foresees the intervention of the SRB in the assessment of recovery plans, in particular "with a view to identifying any actions in the recovery plan which may adversely impact the resolvability of the institution or group"<sup>5</sup>. One can think for instance of recovery options altering the funding (potential impact on bail-in capacity) or cost (potential impact on operational continuity) structure. Another area is the identification of critical functions and shared services, where we expect challenges coming from the resolution authority given the prominent role of this exercise in resolution planning.

This heightened level of scrutiny will reflect the different priorities of the competent and resolution authorities; the former based on the recoverability and the latter on the impact on resolvability. With the competent and the resolution authorities cross-assessing the recovery and resolution plans, their effective cooperation should lead to some form of convergence over time. Such a change of supervisory regime seems already underway, as some banks have received recommendations from the SRB to adjust their recovery strategy. In this context, a necessary alignment between the recovery and the resolution plan is expected to take place; although on an iterative basis. Beyond EBA requirements, banks should keep in mind SRB's expectations when preparing and updating their recovery plans.



<sup>5</sup> Regulation (EU) No 806/2014 ("SRM Regulation"), Art 10.2.

# Bail-In and Loss-Absorbing Capacity

“  
***Going forward,  
bail-in rather than  
bail-out will be the  
rule of the game.***

- ELKE KÖNIG, CHAIR OF THE SRB

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Among the resolution tools available to the resolution authorities under the BRRD, the bail-in tool stands out. Basically, it intends to make sure that it is the bank's shareholders and creditors and not taxpayers that foot the bill in case of failure (that is, bail-in instead of bail-out). In practice, it consists of a two-step financial restructuring of the bank, as follows:

1. Absorption of losses by own funds and beyond if necessary through the write-down of certain liabilities (respecting the creditor hierarchy); and
2. Conversion of all or part of the remaining eligible liabilities into equity in order to recapitalise the bank.

What is key is that the bail-in tool enables the resolution authority to allocate losses outside of an insolvency process, so that the bank may continue to perform its critical economic functions. Its application nonetheless is subject to safeguards, including that creditors should not incur losses greater than would have been incurred under normal insolvency proceedings ('no-creditor-worse-off' principle), and the assurance of a reasonable prospect that the bank's financial soundness and long-term viability will be restored. As part of this assessment, the bank is required to submit a business reorganisation plan to present its strategy to restore its long-term viability following the implementation of the bail-in.

When it comes to the effectiveness and credibility of the bail-in tool, the availability of sufficient loss-absorbing capacity in resolution is essential. While all liabilities can in principle be bailed-in, the regulator foresees two types of exclusion: some mandatory such as covered deposits or covered bonds; and some deemed necessary by the resolution authority (e.g. over fears of contagion to other parts of the financial system). In that context, and with the aim of preventing any shortfalls from arising in resolution, two prudential standards have been developed in parallel at the European level as part of the BRRD (minimum requirement of own funds and eligible liabilities, or 'MREL') and at the international level by the FSB (total loss-absorbing capacity, or 'TLAC'). Both require banks to maintain a minimum amount of own funds and eligible liabilities (that consist of highly loss-absorbing ('bail-in-able') instruments) and aim to ensure that banks adopt a funding structure that is able to provide sufficient capital resources to absorb shocks and recapitalise the bank post-resolution.

#### ***MREL in 2016: the SRB's approach***

Pursuant to the BRRD, the MREL standards entered into force in 2016. In the current regime, MREL is set as a percentage of total liabilities and own funds, and is assigned on a case-by-case basis by the resolution authority, after consulting with the competent authority.

The BRRD set out a range of assessment criteria the resolution authority must take into account; first and foremost that the bank must be resolvable. The adoption of the Regulatory Technical Standards (RTS) further specifying those criteria was delayed until May 2016 following disagreements between the Commission and the EBA; mainly over the implementation of a binding floor of 8%. This provision, eventually removed, was designed keeping in mind that the SRF may only contribute if losses totalling not less than 8% of total liabilities and own funds have already been absorbed. The final

RTS set out a framework detailing the composition and calibration of the MREL, which comprises of a loss-absorption amount (LAA) and a recapitalisation amount (RCA). While the calibration is based on own funds requirements (including the prudential buffers), the framework includes significant discretion for resolution authorities to depart from such standard charge.

Throughout 2016, the SRB took the first steps to develop its MREL approach. In a particular context, amid looming regulatory changes (see below) and the early stage of resolution planning, it adopted a gradual approach in developing its MREL framework.

In early 2016, banks were required to submit a liability data template ('LDT') containing granular data on their liability structure – this provided the SRB with a first set of detailed information to assess loss-absorbing capacity, inform the calibration of MREL and operationalise the bail-in tool. As a new exercise, the reporting was to be completed on a best efforts basis. In a second phase, the SRB held thematic workshops with banks over MREL calculation and subsequently fine-tuned its approach. The latter was unveiled as part of the 4<sup>th</sup> Industry Dialogue in November 2016. The underlying methodology is rather mechanical as it makes little use of the discretion available in the RTS (e.g. it disregards banks' preferred strategy or the nature of their eligible liabilities). Regarding the debated issue of the 8% benchmark, the SRB underlined that it should generally, but not necessarily, be required. Since the setting of MREL is an integral part of the resolution planning process, targets were assigned (at consolidated level) to the 65 banking groups for which full resolution plans were drafted. Targets were communicated on an informative basis, enabling those banks to prepare for their future MREL requirements.



### Next steps in 2017




In line with the gradual approach adopted, the SRB will raise the bar in 2017. This includes improving the methodology, moving from a mechanical approach to a richer setting defined as an essential and integrated part of the resolution planning process. Informative targets at consolidated level will be refined accordingly and turned into binding requirements, based on transition periods to be decided on a case-by-case basis. Finally, the SRB will zoom in on banking groups' structure to look at the quality and location of loss absorbing capacity. In this process, the SRB will assign MREL targets to the material entities of the banking groups under its remit.

To support these ambitions, the annual data collection has been stepped up. Early this year, the SRB published a recast of the Liability Data Template, including notably revisions in terms of format (XBRL), scope (extended to cover intra-group instruments) and quality expectations (removal of references to data provision on a priority or best efforts basis). This data will help the SRB develop MREL at entity level and start to explore the quality and location of MREL within banking groups.

“  
**As TLAC and MREL pursue the same objective of ensuring that institutions have sufficient loss absorbing capacity, the two requirements are complementary elements of a common framework.**  
”

- CRR 2 RECITAL 15

### BOX 4: LOSS ABSORBING CAPACITY REQUIREMENTS – OVERVIEW OF AS-IS VERSUS AS-PROPOSED

	 <b>MREL</b> BRRD (May 2014)	 <b>TLAC</b> Term sheet (Nov. 2015)	 <b>MREL</b> CRR II & BRRD II (Proposal, Nov. 2016)	
			<b>PILLAR 1</b>	<b>PILLAR 2</b>
<b>REQUIREMENT</b>	<b>Objective</b>	Ensure sufficient loss-absorbing (bail-in-able) capacity		
	<b>Specification</b>	Eligible liabilities divided by total liabilities and own funds	Eligible liabilities divided by total risk exposure amount or leverage exposure	
	<b>Nature</b>	Bank-specific requirement ("Pillar 2")	Standardised requirement ("Pillar 1")	Bank-specific requirement ("Pillar 2") Split into a requirement and a guidance
	<b>Entry into force and phase-in</b>	Applicable since 1 January 2016 Phase-in to be agreed with the RA	Dependency on legislative process Phase-in to be agreed with the RA	2019 (16% TREA/6% LRE) until 2022 (18% TREA/6.75% LRE)
	<b>Scope and level of application</b>	All EU credit institutions Solo and consolidated requirements	G-SIBs -Resolution entities (external TLAC) -Material sub-groups (internal TLAC)	All EU credit institutions -Resolution entities (external MREL) -Subsidiaries of RE (internal MREL)
	<b>Interaction with capital buffers</b>	Buffers included in MREL calibration	Buffers sit 'on top' of MREL	
	<b>Disclosure</b>	No guidance	Required	
<b>ELIGIBLE LIABILITIES</b>	<b>Eligibility criteria</b>	Unsecured long-term liabilities <sup>6</sup>	Unsecured long-term liabilities <sup>6</sup>	
	<b>Subordination</b>	Not mandatory (may be required)	Mandatory (limited exclusions) – Accompanied by a proposed reform of bank insolvency creditor hierarchy –	Not mandatory (may be required)
	<b>Deduction</b>	No deduction of cross-holdings	Deduction of cross-holdings	
	<b>Composition</b>	No particular requirement or expectation	No particular requirement or expectation	

<sup>6</sup> Subject to some variations with respect to eligibility and exclusion (e.g. structured notes).

### A new regulatory framework in sight

As mentioned, the MREL was developed in parallel of international standards developed under the aegis of the FSB, the total loss-absorbing capacity ('TLAC'). While, in many respects, both standards bear similarities and in any case retain the same policy objectives – namely to ensure banks maintain a sufficient amount of bail-in-able instruments, fundamental differences exist in their design and scope – **see box 4**. Mandated to both implement TLAC in the EU and review the MREL framework by the end of 2016, the European Commission achieved both in November when it released a comprehensive package of legislative proposals. Termed the *EU Banking Reform*, the package amends the rules on capital requirements and on bank recovery and resolution; it sets out a comprehensive revision of the loss-absorbing requirements including the implementation of TLAC in EU law, the associated recast of the MREL framework and a common approach to bank creditors' ranking in insolvency.

### Highlights of the proposals

The package introduces TLAC in EU law as a minimum, 'one-size-fits-all', requirement only applicable to G-SIIs (sort of "MREL Pillar 1"). It faithfully transposes the FSB Term Sheet. EU G-SIIs will be required to hold a sufficient amount of own funds and eligible liabilities to cover 16% of RWAs or 6% of their leverage exposure (whichever the highest) from 2019 (before rising to 18% and 6.75% by 2022). MREL as we know it, would remain a bank-specific requirement ("MREL Pillar 2"), applicable to all banks<sup>7</sup>, however it is significantly reformed to ensure coherence with the global standards. The Commission's proposals point to a number of areas of alignment in order to minimise compliance costs and achieve a coherent, two-leg, MREL framework.

First and foremost, the proposals rebase the current measurement of MREL in terms of RWA or leverage exposure. While the criteria underlying

the calibration remain identical, the capital buffers are removed from the calculation, as per the FSB Term Sheet (see below). Also, the proposals restrict the discretion of resolution authorities by de facto capping the setting of MREL.

In terms of eligibility criteria, the package closely aligns the existing modalities to the FSB Term Sheet and transfers them from the BRRD to the CRR in order to level the playing field across Member States. CRR2 defines eligible liabilities in the continuity of regulatory capital by extending certain provisions (e.g. prior supervisory approval for buy-backs, EBA mandate to monitor market practices, etc.). In line with the FSB standards, the proposals requires subordination for G-SIIs, meaning eligible liabilities should be subordinated to excluded liabilities (mitigating NCWO risks), but leaves the discretion to resolution authorities when setting institution-specific requirements.

On a related topic, the Commission put forward a common approach to reforming bank creditors' ranking in insolvency to level the playing field amid diverging initiatives by Member States. It calls for amendments to national bankruptcy codes to introduce a "senior non-preferred" instrument (sitting below unsecured senior debt but above subordinated debt). The new sub-class of debt would help banks cope with the subordination requirement while potentially mitigating impact on funding costs; it essentially mirrors the French approach, although it enables Member States to grant preferences to certain types of deposits (as undertaken by Italy and Germany).

The package clarifies the treatment of breaches of MREL, and notably the interaction with capital rules. As mentioned, capital buffers are excluded from the MREL calibration but instead sit above in the stacking order. It means that failing to meet both its MREL and buffers leads to restrictions on distributions (under the MDA mechanism). A waiver may be applied where the bank is temporarily unable

<sup>7</sup> This means EU G-SIIs may be imposed an add-on under Pillar 2 on top of their Pillar 1 requirement when deemed necessary and duly justified by the resolution authority.



to issue eligible instruments (e.g. in difficult market conditions) for a maximum duration of six months and subject to the submission of a remediation plan by the bank. Furthermore, the proposals extend the powers of resolution authorities in cases of breach (e.g. to require from banks to modify the maturity profiles of their eligible instruments). To increase flexibility, and drawing from similar reforms in capital rules, the concept of MREL guidance is introduced in the form of two non-binding buffer requirements: an add-on to the LAA to cover potential additional losses and an add-on to the RCA to foster market confidence post-resolution.

In terms of level of application, the reforms onboard the concepts of resolution entity and resolution group and may as such apply in relation to different resolution strategies. MREL will apply on a consolidated basis at the level of the resolution group (“external MREL”). For subsidiaries within such resolution groups, MREL applies on a solo basis with eligible instruments issued to the resolution entity (or third parties to the extent it would not jeopardize the bank’s ownership structure). This “internal MREL” may be, subject to certain criteria, substituted by collateralised guarantees.

#### ***Implications and next steps***

While still at an early stage in the legislative process, pending review by the European Parliament and Council, The proposals already go a long way towards clarifying the way forward for loss absorbing requirements, following months of regulatory uncertainty. Certain elements, however, are likely to be further debated along the legislative process. Among them, the scope of Pillar 1 requirement, limited to G-SIIs, while both the EBA and the SRB have called for including O-SIIs as well. The internal MREL framework, while a useful introduction, is also likely to be reworded due to issues of consistency, articulation with the Banking Union framework and gold-plating versus internal TLAC.

While an ever-changing regulatory framework is always challenging for banks when managing their balance sheets and funding mix, many elements of the proposals are positive. For instance, the reform of creditors' insolvency hierarchy is welcome as it increases flexibility over managing its funding structure, while contributing to develop a broad (bank) debt market in the spirit of the Single Market.

It is worth noting that the revised rulebook would blur the lines between capital and funding instruments; in the light of potential MDA repercussions, treasury functions will be incentivised to develop an holistic approach to capital and funding management. This intricacy should prompt banks to integrate and embed both processes in activities such as business planning and forecasting, funds transfer pricing, and stress testing<sup>8</sup>. Within banking groups, the revised standards contribute to the ongoing debate over the allocation of scarce resources between parent and subsidiary companies and 'ring-fencing' practices by host countries.

<sup>8</sup> Actually, the EBA (Draft) Guidelines on stress testing and supervisory stress testing refer to a MREL impact assessment in an adverse scenario as part of the ICAAP.



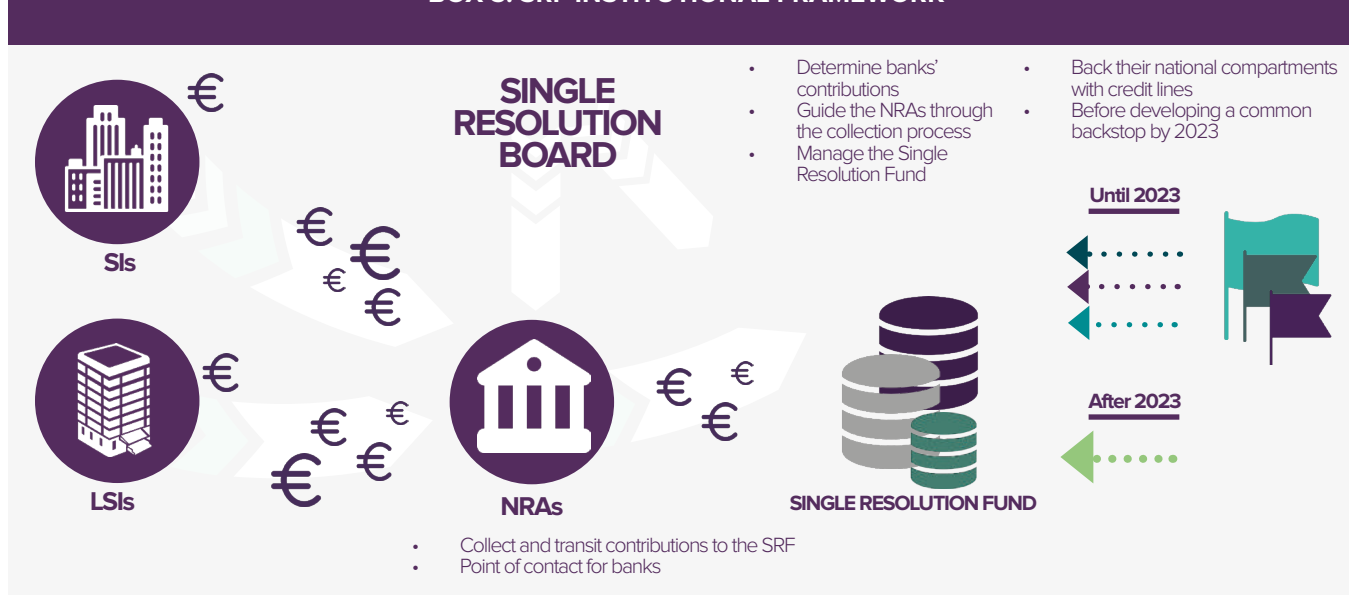
# Single Resolution Fund

## Introducing the Single Resolution Fund

Along with the SRB, the SRM Regulation established the SRF to mutualise the national resolution financing arrangements called for in the BRRD. Managed by the SRB, the SRF represents the financial arm of the SRM, intending to ensure the efficient application of the resolution tools. But its purpose is neither to absorb losses in resolution nor to be a recapitalisation mechanism. Essentially, the SRF is a last-resort backstop to ensure financial continuity in resolution. Any use of the fund must be documented as part of the resolution scheme and approved by the Commission under the state-aid rules.

The SRF will be funded through ex-ante contributions and will represent 1% of all covered deposits by 31 December 2023 – estimated when drafting the rules to amount to €55 billion. To build up the fund, the resolution authority levies mandatory ex-ante annual contributions from institutions. If those contributions are insufficient to cope with the SRF's objectives, the SRB can raise additional funds through extraordinary ex-post contributions, alternative funding sources (e.g. directly tapping the market) or borrowing from financing arrangements of non-participating Member States.

### BOX 5: SRF INSTITUTIONAL FRAMEWORK



### **An incomplete construct**

Formally, the SRF was set-up in late 2015, following the ratification of an Inter-Governmental Agreement ('IGA') by participating Member States on the transfer and mutualisation of national resolution funds. This process is gradual however, as the SRF comprises national compartments that will be progressively phased-out by 2023, as per the Banking Union rationale of de-linking banks and their sovereigns.

As required in the IGA, the SRF was transferred the proceeds of the 2015 fundraising by national resolution funds – that is, €4.3 billion – in January 2016. From then, the contribution cycles are governed by the SRM regulation. As depicted in **Box 5**, the SRB now determines the contributions, which are then collected by the NRAs who then transfer them to the SRF. The second iteration in 2016 increased the capacity of the Fund to €10.8 billion.

During the transitional phase, and as the SRF builds up, bridge-financing arrangements were adopted in order to cover any temporary financing shortfalls: each participating Member State entered a harmonised loan facility agreement ("LFAs") with the SRB to back its national compartment. Those national credit lines are to be used as a last resort, upon exhaustion of all the other financing sources available under the SRM regulation, and ought to be fiscally neutral over the medium term (i.e. recouped by ex-post levies). By 2023, when the SRF will be fully homogeneous, European institutions have to work out a common fiscal backstop to remove the bank-sovereign nexus and complete the second pillar of the Banking Union.

### **Determining banks' contributions: a black box?**

As mentioned, banks are required to make contributions to build up the SRF. However, the industry has voiced concerns about the opacity of the contribution calculation. While the methodology used to compute those is publicly set out<sup>9</sup>, some elements weaken the transparency of the process and, as such, impede the transparency of its output. Unfortunately this may get worse looking ahead.

The first step of this process, outlined in **Box 6**<sup>10</sup>, consists of setting the annual amount to be raised in a given year. This assessment is performed by the SRB, considering the regulatory target to reach by 2023. Not only is the target uncertain and can only be estimated, its own measurement is put into question and subject to review. As mandated by the BRRD, the EBA assessed last year the appropriateness of the target level basis, currently set in terms of covered deposits, versus alternatives. Different options were considered with a final set of preferences for total liabilities, excluding own funds and/or covered deposits on consistency grounds over the regulatory framework and contributions methodology. Such a revision may increase the volatility of contributions and hinder stable and predictable change year-on-year. This recommendation is now in discussion at the European Commission as to whether to take it forward, determine the target level percentage and whether to apply the reform to the SRF as well.

<sup>9</sup> Commission Delegated Regulation (EU) 2015/63.

<sup>10</sup> It is to be noted that small institutions will contribute to a lesser extent, at a fixed price or lower than proportionate contribution.

### BOX 6 : DETERMINATION OF BANKS' CONTRIBUTIONS TO THE FUND



Another source of complexity is that, while the accumulation path towards the target is supposed to be linear, the BRRD includes a provision to deviate from this principle based on cyclical considerations<sup>11</sup> (i.e. increase / decrease contributions in economic upturn / downturn).

The second step allocates this annual amount to be raised to the banks in scope based on their size and risk profile. The former considers total liabilities excluding own funds and covered deposits whereas the latter is driven by a set of pre-defined risk indicators including capital, liquidity, systemic importance, etc. By definition, the relative nature of this process is challenging. A thorough analysis of the drivers is virtually impossible as all the data involved are typically not available for the whole sample. Also, the set of risk indicators is not yet stabilised due to availability reasons (MREL, for instance), which may increase the volatility of the risk adjustment as the still missing indicators are gradually incorporated.

In those circumstances, the lack of stability in the computation process will remain challenging for banks, be it from a budgeting or reporting perspective. Recently, the SRB signalled more transparency and harmonisation for future exercises. Information regarding the 2016 collection was published on its website and this trend should continue in 2017. As mentioned in the introductory section, the SRF was set as a priority area. This entails the improvement of the contribution mechanism, through the set-up of the Contribution Collection System (“CCS”) Portal and ex-post audit of the data collection.

<sup>11</sup> The Commission was scheduled to release late last year a delegated act specifying how such adjustments should be conceived.







# Key Takeways

## ***SRM at 1 year: mixed feelings?***

With the entry into force of the bail-in tool and the SRM, 2016 was a pivotal year for European post-crisis regulation in establishing a robust banking crisis management framework. Tremendous results were achieved in a relatively short amount of time, ranging from political agreement over the legislative rules to the set-up of the commensurate capacity to implement those. Outside the banking industry, it is worth noting the beginnings of similar frameworks for other financial institutions<sup>12</sup>.

This progress on the banking crisis management framework notwithstanding, its effectiveness remains largely untested. Recent events in Italy have casted doubts over the stated objectives of addressing the ‘too-big-to-fail’ problem and ending the era of public bailouts. In addition, recent studies commissioned by the European Parliament on the resolvability of banking groups highlighted significant disparities with respect to legal and operational structures. The path towards a resolvable banking system in the eurozone remains difficult.

## ***Banks’ perspective: adapting to the new normal***

Resolution is here to stay. While there is no escaping the challenges, change also brings opportunity. Resolution requires a deep and holistic review of banks’ own organisations – laying the groundwork to further optimise business models, capital and balance sheet management, operating models, IT systems, data management, outsourcing activities and overall efficiency, and so on.

Resolution is a game changer. As banks continue to adapt their business models to the new economic and regulatory environment – characterised by heightened regulatory and supervisory standards, low interest rates, new market entrants – achieving (and sustaining) resolvability is poised to become a key driver of strategic planning in the coming years.

<sup>12</sup> The European Commission proposed a regulation on resolution and recovery of CCPs in November 2016 whereas EIOPA released a consultative paper in December 2016 paving the way towards a European recovery and resolution framework for Insurers.

### HOW AVANTAGE REPLY CAN HELP

Avantage Reply is a pan-European specialised management consultancy delivering change initiatives in risk, compliance, finance (capital management and regulatory reporting), treasury and operations within the financial services industry. Building on these broad capabilities, Avantage Reply is in an ideal position to assist banks throughout the resolution planning process. Our service offering includes:

- Development or review of recovery and resolution plans;
- Support in performing resolvability self-assessment and change management support in areas such as data management, systems infrastructure, process and controls, governance;
- MREL/TLAC impact/gap analysis and support in programmes around balance sheet optimisation, capital management, intra-group capital allocation, etc;
- Methodological support and implementation of crisis simulation exercises, with a view of identifying weakness and draft a remediation plan; and
- Provision of training and technical assistance (amid continuous dialogue with the resolution authorities).

Also, we believe a robust and sound recovery plan already goes a long way towards addressing resolution challenges. In this context, we can help with designing and delivering remediation programmes, based on internal initiatives or in response to regulatory feedback.

## Avantage Reply (Amsterdam)

The Atrium | Strawinskylaan 3051  
1077 ZX Amsterdam  
Netherlands  
Tel: +31 (0) 20 301 2123  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

## Avantage Reply (Brussels)

5, rue du Congrès/Congresstraat  
1000 Brussels  
Belgium  
Tel: +32 (0) 2 88 00 32 0  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

## Avantage Reply (London)

38 Grosvenor Gardens  
London SW1W 0EB  
United Kingdom  
Tel: +44 (0) 207 730 6000  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

## Avantage Reply (Luxembourg)

46A, avenue J.F. Kennedy  
1855 Luxembourg  
Luxembourg  
Tel: +352 26 00 52 64  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

## Avantage Reply (Milan)

Via Castellanza, 11  
20151 Milano  
Italy  
Tel: +39 02 535761  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

## Avantage Reply (Paris)

Rue du Faubourg Sainte Honoré, 3  
75008 Paris  
France  
Tel: +33 (0) 1 71 24 12 25  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

## Avantage Reply (Rome)

Via Regina Margherita, 8  
00198 Roma  
Italy  
Tel: +39 06 844341  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

## Avantage Reply (Turin)

Via Cardinale Massaia, 83  
10147 Torino  
Italy  
Tel: +39 011 29101  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

## Avantage Reply (Lisbon)

Avenida da Liberdade, 110  
1269-046 Lisbon  
Portugal  
Tel: +351 21 340 4500  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

## Xuccess Reply (Frankfurt)

Hahnstrasse 68-70  
60528 Frankfurt am Main  
Germany  
Tel: +49 (0) 69 669 643-25  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)

---

## Xuccess Reply (Hamburg)

Brook 1  
20457 Hamburg  
Germany  
Tel: +49 (40) 890 0988-0  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)

---

## Xuccess Reply (Munich)

Arnulfstrasse 27  
80335 München  
Germany  
Tel: +49 (0) 89 - 411142-0  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)





