Implementing Financial Sector Resolution

CEPS resolution task force

Outline of report

Introduction: the role of resolution

1. Resolution of banks and banking groups

2. Resolution of central counterparties and other financial market infrastructures

3. Resolution of insurers

4. Resolution of asset managers

Conclusion and policy recommendations
Introduction: The role of resolution

Crisis demonstrated the need for better resolution

- Significant contraction in economic activity ("the Great Recession")
- Significant injection of public money to "rescue" or bail out large institutions.
- Pittsburgh summit: submit systemically important institutions to regulation and supervision; end too big to fail

What resolution cannot do

- Cannot stem systemic crisis
- Cannot cure underlying policy faults
  - Excessive promotion of housing ownership via GSEs
  - Monetary union without fiscal constraints (euro)
- Cannot undo forbearance

What resolution can do

- Create basis for orderly exit for individual institutions, akin to bankruptcy for non-financial firms, so that
  - critical economic functions can continue (this limits disruption in financial markets and damage to the real economy); and
  - investors not taxpayers bear the cost of bank failure
- Contribute to the creation of market discipline that will potentially reduce risk of failure and/or restrict forbearance
1. Resolution of banks and banking groups

a. Resolution reform is part iii of total reform agenda enacted since the crisis to

   i. Reduce the probability that banks would fail via
      o strengthening capital and liquidity standards [Basel III as
        implemented in G-20 jurisdictions];
      o strengthening supervision [e.g. SSM]; and
      o requiring banks to develop recovery plans.

   ii. Reduce systemic risk via
      o introducing mandatory clearing (but this shift makes CCPs a
        “single point of failure” (see Chapter 2)
      o introducing macro-prudential supervision

   iii. Reduce the impact that a bank’s failure could have on
      o the economy at large
      o financial markets
      o taxpayers

b. current status of resolution reform

   i. FSB has established standards for resolvability

   ii. Major jurisdictions have
      o Enacted special resolution regimes (in EU BRRD). These
        regimes introduce the bail-in tool.
      o Created resolution authorities (in Eurozone SRM/SRB) to
        ▪ Assess resolvability
        ▪ Create resolution plans on basis of information supplied
          by the banks
      o Collectively created crisis management groups/resolution
        colleges to assure international coordination
      o Identified key remaining issues (see part c)

c. Key remaining issues

   i. Trigger for resolution. This should be at the point of non-viability
      (PONV) so that authorities do not exercise forbearance (e.g. via
provision of ELA via central bank). Where does supervision end and resolution start?

ii. Stabilisation of the failed bank at the “resolution weekend”

- “before Asia opens” Stabilisation must be accomplished within a very short (36-48 hour) time period. This requires:
  - Approvals for resolution plan to be in place
  - Overall agreement/coordination among home and host authorities on overarching resolution strategy for the group (MPE, SPE or some hybrid)
  - Clear and consistent communication to key stakeholders regarding resolution plan as well as progress in its implementation.

- Recapitalisation of the failed bank. This should occur via bail-in (see 1.b.ii above for relevant legislation).
  - TLAC (FSB) and MREL (EU) are intended to assure that there is enough “reserve capital” available to bail-in so that customer/operating liabilities (deposits) need not be bailed in.
  - Discussion to cover pre-positioning, reconciliation of TLAC and MREL, role of senior debt/requirement for TLAC to be subordinated.
  - Discussion also to cover what instrument does the bailed-in investor receive (equity [if so how is conversion determined], receivership certificates, nothing [e.g. write-down bond]).
  - Will SRM decision making work for SSM? How will they interact with ECB?
  - Role of resolution fund and SRF for SSM. What role will DG Comp play?

- Retention of authorisation/licenses for the bank in resolution and/or approval of change in control (to resolution authority).

- Stay on qualified financial contracts (QFCs) so that counterparties cannot terminate/close out and liquidate collateral posted by bank-in-resolution.
o ISDA stay protocol is a start, but only a start.

- Continued access to FMIs (see chapter 2)

- Provision of liquidity to the bank in resolution

  o On the basis of collateral that is
    ▪ Returned by secured lenders electing repayment
    ▪ Unencumbered

  o From private or official sources?
    ▪ If from official sources, such does credit provision provide a bail-out, or is it normal lending (given that the bank-in-resolution has been recapitalised).

  o Use of ELA in EU and SSM, and interaction with SRF.

- International cooperation

  o Will authorities agree, announce and actually implement a presumptive path or will they seek to retain (and then use) discretion? Is the current structure as proposed by the G-20 workable?

iii. Restructuring and the return to the private market

- Power of the resolution authority to act as administrator

- Ability to sell lines of business (link to structural reform and desire to align lines of business with specific legal vehicles)

- Ability to execute solvent wind down of recapitalised business.

- Rights of investors during the restructuring process.

- Legal challenges to resolution authorities

iv. Other issues
• Role of deposit guarantee scheme (taking into account depositor preference), EU proposal for re-insurance

• No creditor worse off than in liquidation. How to implement pari passu treatment of creditors with a ranking of bailinable instruments?

• Valuation

• Accountability of senior management for failure.

v. Summary

SPOE, MPOE or hybrid? Can MPOE effectively work?
Importance of clarity, communications, creating and conforming to expectations.

2. Resolution of central counterparties and other financial market infrastructures

a. Role and importance of financial market infrastructures (FMIs)

i. Types of FMI (payment systems, securities settlement systems, central depositories, central counterparties)

ii. Ownership and corporate form
   • public [including systems operated by the central bank]
   • private
     o mutually owned by participants
     o independent shareholder owned

iii. importance of FMIs

iv. interconnection of FMIs (e.g. payments leg of securities settlement system is conducted via payments system FMI)

v. G-SIFIs are principal participants in each of the major FMIs
   • Failure of a G-SIFI puts all FMIs under pressure simultaneously

b. Risk in FMIs

FMIs differ with respect to the degree and duration of risk that they assume. Where the FMI does assume risk, it tends to mutualise that
risk (up to a limit). However, should that limit be breached, the risk reverts to participants. Thus, from a systemic standpoint, a FMI is a single point of failure.

For this reason, authorities (CPMI-IOSCO) have decreed that FMIs should be able to withstand simultaneous failure of their two largest participants.

Principal risk to which FMIs are exposed is the failure of one of its participants. This is determined by:

i. Exposure at default.
   - This may be zero or quite small by virtue of
     o the function of the FMI (if systems operator only, FMI incurs no counterparty risk on the G-SIFI);
     o frequency of settlement (e.g. real time gross settlement in payment systems); or
     o conditionality of settlement (e.g. delivery versus payment in securities settlement systems).
   - This may be quite large at central counterparties.

ii. Loss given default. This will be reduced, to the extent that the FMI has recourse to margin and/or collateral from the G-SIFI.

c. Interaction between resolution of a G-SIFI and risk to/resolution of the FMI

i. If resolution of the G-SIFI succeeds in stabilising the G-SIFI, the G-SIFI will be in a position to meet its obligations to the FMI. Hence, the FMI should
   - ‘stay its hand’ in initiating creditor-remedies against the G-SIFI in resolution to allow the stabilisation to proceed, but be prepared to execute such remedies if the stabilisation fails to occur;
   - Accord the stabilised G-SIFI continued access to the FMI (subject to possible adjustments in margin, etc.).

ii. If the resolution of the G-SIFI does not succeed in stabilising the FMI, the FMI should initiate its creditor remedies vis-à-vis the failed G-SIFI.
d. Recovery and resolution at central counterparties (CCPs)

i. First loss of CCP covered by margin of failed counterparty (G-SIB)
   - On what basis does close-out by CCP occur?
   - Does close-out by CCP trigger cross-default on other obligations?

ii. If loss exceeds margin of failed counterparty, ‘waterfall’ is initiated
    - Where does CCP’s own capital (‘skin in the game’) come into play, and what should be the size of this contribution?

iii. If ‘waterfall’ runs dry, and default fund is depleted,
    - What are procedures and timing for replenishment?
      - Are there limits on the amount that participants are liable to contribute, or are they expected to be ‘good to the last drop’?
      - Can replenishment occur immediately?
        - If not, can the CCP reopen?
If not, CCP moves to resolution

- Access to CB liquidity

iv. If CCP resolution is initiated,

- CCP is closed to new transactions
  - How do market participants transact/fulfil mandatory clearing obligation?
- Book of existing transactions can be handled via haircuts, tear-ups and/or return of transactions to participants.
  - But such methods have significant adverse effects on participants, undermining financial stability.

v. Authorities in charge of CCPs

- In the EU, a diversity of authorities is in charge of supervision of CCPs. Is the current structure of colleges sufficient? Will cooperation work, above all in stress?
- Cooperation at global level
- Need for separate resolution authority for CCPs, with same powers as bank resolution authorities?

vi. Summary

Do extremely adverse consequences of CCP resolution point toward importance of being able to replenish default fund immediately, if it becomes depleted?

3. Resolution of insurers

a. Insurance differs from banking
   i. Insurance companies rarely fail due to lack of liquidity
   ii. Failure results from determination that technical reserve/capital is inadequate to cover future liabilities to policyholders

b. Resolution in insurance differs from resolution in banking. Pure insurance already has well-established resolution procedures, including
   i. Run-off (solvent and insolvent)
   ii. Schemes of arrangement
c. However, insurance groups may engage in banking-type activities
   i. Guaranteed investment contracts
   ii. Writing credit derivatives

d. Bancassurance
   i. Deposit-taking banks that distribute insurance should be resolved as banks
   ii. Groups that contain banks that take deposits and insurance entities that underwrite insurance require separate “conglomerate” approach.

4. Resolution of asset managers

a. The business model structure of asset management
   i. The fund manager.
   ii. The fund itself.
   iii. One or more of the entities from which the asset manager draws critical services (e.g. bank that is custodian for the fund).

b. What requires resolution?
   i. The fund itself?
      
      • Unlevered, unsupported without liquidity guarantees (implied or explicit), where investors in fund have equity in the fund: no need for resolution, as fund value declines so does value of fund units. Investors in fund suffer losses but fund itself does not require resolution.

      • Levered fund (fund has borrowed on security of fund assets). Fund cannot meet payments on loans; lender liquidates collateral to repay loan. Losses accrue to investors in the fund (and possibly to the lender to the fund, if proceeds from the liquidation of the collateral were insufficient to repay the loan).

      • Fund with liquidity commitment (e.g. money market mutual fund with fixed NAV). The fund sponsor/asset manager has explicitly or implicitly promised investors in the fund the ability to redeem on demand/at short notice at NAV (possibly fixed), even though the assets in the
fund may be illiquid. If redemption requests surge beyond expected levels, the fund may find it difficult to meet the liquidity commitment, so that it has to:

- Turn to the sponsor for support (which it may be unable or unwilling to give);
- “break the buck” (in the case of fixed NAV); and/or
- Restrict redemptions from the fund.

If such funds are large, system-wide repercussions can result from the failure of one fund to meet the expectations of investors regarding liquidity.

ii. Bank dealing with the fund as

- Lender, where the fund has pledged its assets as security for the loan and allowed the bank to re-hypothecate the assets.
- Custodian (impact depends on degree to which fund’s assets were segregated).
- Counterparty or borrower.

iii. Asset manager/fund sponsor

- If the asset manager or fund sponsor fails, can this be handled under normal bankruptcy law, with the board of the fund responsible for shifting responsibility for managing the fund to a new manager?

- How do the following practices affect the answer to the previous question?

  - Provision of implied or explicit liquidity commitments to one or more of the funds under management;
  - Transacting in sponsor name, with subsequent allocation to specific funds by the sponsor;
  - Allowing lenders to re-hypothecate assets pledged by the fund to secure borrowings;
Failure to segregate assets (sponsor assets from fund assets; assets of each fund managed by the sponsor).

Conclusions and policy recommendations

This section will draw together conclusions and make recommendations for industry and the authorities (with emphasis on EU and Eurozone institutions).