Implementing Financial Sector Resolution

*Issues for the Task Force, 1st meeting - 23 June 2015*

The aim of the post-crisis resolution framework is to make sure that large banks (G-SIBs) are no longer too big to fail, that they can be resolved in an orderly way, without calling upon public money. The framework was debated at length, and is now more or less in place. There are however many implementation issues to be discussed. In addition, orderly resolution of other systemically important financial institutions is now also on the agenda, and proposals are expected on Central Counterparties (CCPs) and (re)insurers.

There were cases of bank (or insurance) company failures pre-crisis, some of which were liquidated, such as Herstatt, Banco Ambrosiano or BCCI. In most cases, they were resolved through public money, and gave raise, in the EU, to state aid procedures. This was the general rule during the financial and sovereign crisis.

The list below list the main pending issues on resolution in the financial sector, focusing mainly on the implementation of resolution of banks. This document further provides a quick overview of the relevant legislation, terminology, and links to some useful documents in the context of the task force.

**Issues**

- **Will the new regulatory framework work in a crisis?** Will it allow to be applied flexibly and avoid a formal insolvency procedure?

- **Where does supervision end and resolution start?** The resolution authorities should, according to BRRD, at all times set a robust MREL. But will this be compatible with supervisors’ Tier 1 ratio? Will MREL eventually overtake Tier 1 as benchmark? To what extent can resolution authorities intervene in sound banks and require a certain structure of the balance sheet, and bail-in-able debt in particular? How is the EU banking system prepared for this? Will the bank structure proposal account for resolvability?

- **The role of resolution authorities vs EU competition policy authorities (state aid) in resolution.** Under the BRRD, State aid rules apply as soon as resolution authorities come in. How will both authorities interact? Both can impose restructuring plans, will they be coordinated?

- **How will resolution work across borders, in the EU and internationally?** Resolution authorities should ensure that loss-absorbing capacity within a group is distributed across the group in accordance with the level of risk in the different entities (‘top down’ approach). The minimum requirement necessary for each individual subsidiary should be separately assessed. The BRRD...
framework is fairly weak to enforce a coordinated approach in the EU, but the SRB creates a single body.

- **Single point of entry (SPOE) vs multiple point of entry (MPOE) in resolution**: can both be combined in a resolution framework? Will MPOE not prevail, and lead to further ‘subsidiarisation’, ring fencing, and a fragmented approach?

- **MREL vs TLAC**: how to ensure consistency of approaches internationally?

- **Functioning of the bail-in tool in practice**: Will banks have sufficient liabilities that can be bailed-in? What will be effect on banks with limited amounts bail-in-able securities? What will be the impact of a bail-in on capital markets? Does pricing of subordinated-debt give any indication of the default probability?

- **Use of DGS in resolution**: Can it be determined in a weekend how much a DGS would have to contribute in an insolvency? Can this be agreed upon and coordinated on a cross-border basis?

- **Use of resolution funds, and Single Resolution Fund, in resolution?**

- **Resolution tools across institutions and infrastructures**: Comparison of the resolution mechanism of banks and non-bank financial institutions (e.g. CCPs and (re-)insurers) and implications for policy and resolution tools. Can design of the banking sector be followed? Can resolution of a bank and its position in a CCP be kept separate? Should resolution authorities become overall in charge?

Some terminology

**Structured early intervention and resolution (SEIR)**: as capital ratios decline the regulator is allowed or obliged to impose corrective measures, which become progressively more pervasive with falling capital ratios. Reorganisation and liquidation are mandatory when capital falls below critical thresholds.

**Prompt corrective action (PCA)**: introduced in the US Federal Deposit Insurance Corporation Improvement Act (1991): a system of Prompt Corrective Action (PCA) for insured depository institutions was created to “resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund”. Corrective measures are in part compulsory, in part left to the authorities’ discretion, and include a broad range of requirements and restrictions.

**Recovery**: a plan providing for measures to be taken by the institution to restore its financial position following a significant deterioration of its financial situation. Recovery plans shall be considered to be a governance arrangement. They should be authorised by the authorities. Early intervention, in the BRRD (Art. 27), is part of the recovery. It can comprise management and strategy changes, and go as far as the removal of the management of the group.

**Resolution**: application of resolution tools to: (a) to ensure the continuity of critical functions; (b) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors and client funds (BRRD).

**Resolution tools**: (a) the sale of business; (b) the bridge institution tool; (c) the asset separation tool; (d) the bail-in tool. Resolution authorities may apply the resolution tools individually or in any combination.

**Triggers**: ratios that trigger intervention by management or authorities. Basis is own funds requirement plus 1.5 percentage points (Art. 27 BRRD).
**Bail-in**: a contribution by a financial institution to loss absorption and recapitalisation equal to an amount not less than 8% of total liabilities (or, where applicable, of 20% of risk-weighted assets) including own funds. ‘Pari passu’ treatment of creditors should be respected. Resolution authorities should be able to exclude or partially exclude certain liabilities.

**MREL**: minimum requirement for own funds and eligible liabilities. The resolution authorities should, at all times, set a robust MREL so as to avoid the risk of contagion or a bank run. For groups, the minimum requirement is set by the group-level resolution authority, decided upon in cooperation with host countries, with EBA mediating if no decision has been reached between national authorities (Art. 45.9). A proposal shall be made on a harmonised application of the MREL by the EU Commission before the end of 2016, on the basis of a report of EBA, (Art. 45).

**TLAC**: minimum standard for Total Loss-Absorbing Capacity, TLAC in conjunction with other measures should act to remove the implicit public subsidy from which G-SIBs currently benefit when they issue debt and incentivise creditors to better monitor G-SIBs’ risk-taking. Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement.

**MPOE vs SPOE**: single point of entry (SPOE) and the multiple point of entry (MPOE) approaches in resolution. In SPOE, the home authority applies resolution powers at the top parent company level, ideally the holding company, through the absorption of losses by the parent. In MPOE, resolution powers may be applied differently to different parts of the group, and may be more adapted to banks with separately capitalised subsidiaries.

**Link with deposit guarantee schemes (DGS)**: DGS funds can be used for resolution, as for example the DGS directive allows. It however may render cross-border resolution coordination even more difficult, as it should be done equally across countries, which in an EU context.

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**EU framework**

**BRRD**: Minimum harmonisation directive establishing procedures for recovery and resolution of all banks in the EU 28, and the other EEA countries.

**SRB**: Regulation establishing single mechanism, the board, with the authority to draw-up resolution plans for the significant banks within the SSM (in cooperation with the national authorities), and setting the MREL, in cooperation with national authorities.

**SRF**: Resolution Fund for SRB concluded through an intergovernmental agreement endowed with adequate financing means with a target level of 1% of covered deposits.

**DGS**: Deposit guarantee schemes directive (1994), with latest amendment, establishing minimum level of pre-funding (of 0.8% of covered deposits) and minimum pay-out period in case of bank failure.

**State aid rules**: EU Treaty pronounces a general prohibition of state aid. The EU Commission has the sole competence to decide when state aid can be permitted. The EU Treaty provides that all new aid measures must be notified and approved by the European Commission prior to their implementation, if not, the aid is invalid. Financial stability considerations can precede in exceptional circumstances (Art 107.3b TFEU).
Useful documents

Official docs


IMF (2012), From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions, IMF Staff Discussion Note

IMF (2014), Cross-Border Bank Resolution: Recent Developments

Other


Garcia, Gillian G.H., Rosa M. Lastra, María J. Nieto (2009), Bankruptcy and reorganization procedures for cross-border banks in the EU: Towards an integrated approach to the reform of the EU safety net.

Thomas Huertas (2014), Safe to Fail, Palgrave

Hupkes, Eva (2009), “Form follows function” – A new architecture for regulating and resolving global financial institutions
