Implementing Financial Sector Resolution

Report on second meeting

25 September 2015

The second meeting of the CEPS Task Force was held at the Commerzbank Headquarters in Frankfurt, exploring various issues regarding resolution in the financial sector. In particular, the issues regarding the implementation of the bank recovery and resolution mechanism and the design of the recovery and resolution frameworks for CCPs and insurers were discussed. By the beginning of 2016 the group, chaired by Thomas Huertas, should arrive at a series of policy recommendations, focusing on the implications of the resolution and recovery regime for EU banks and its adaptation to insurers, asset managers and CCPs.
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From supervision to resolution

Speaker:
Eleni Angelopoulou, Head of Division, Crisis Management, ECB

The European Central Bank (ECB) perceives cooperation between the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB), the trigger for resolution and who decides, the valuation, the control of forbearance the critical issues/factors that will determine whether the recovery and resolution mechanism will succeed or fail.

Early intervention is essential. The ECB is currently building a database with the early intervention triggers (Tier 1 based) as well as early warning indicators. Although the supervisory and monetary policy responsibilities are separated within the ECB, in crisis situations the monetary side will get access to information on the situation of the bank, which is essential to provide emergency liquidity assistance (ELA).

- Smooth transmission of monetary policy measures requires a less fragmented banking system that breaks the fatale link between banks and sovereigns. The banking union is an important step to accomplish this.
- The banking union has three pillars of which two are being put in place: the single supervisory mechanism and the single resolution mechanism. The third pillar, a single deposit insurance scheme, has been proposed at various occasions, including in the five presidents report, but policy makers still need to agree on a proposal.
- The single resolution mechanism that is currently being implemented faces several challenges. Some key challenges:
  - Operationalizing resolution;
  - Obtaining the required information from supervisors and banks;
  - Getting the inter-institutional agreements to work.
- Within the recovery and resolution framework the ECB has formal responsibilities regarding bank recovery. The supervisor has indicated that it will follow the European Banking Authority's (EBA) guidelines for the application of early intervention and recovery measures (applying early intervention measures in a proportional manner), though withholds the possibility to use its discretionary competencies in case the situation asks for it.
- Both the ECB and SRB can call for resolution based on the available data.
- ECB and SRB will need to work very closely for withdrawing bank license, granting new licenses for bridge bank, and ensuring that the bank is sufficiently capitalised after bail-in.
- The ECB has set-up internal task force for communication with the SRB. In case of disagreement, the ECB governing council has the ultimate responsibility.
- ECB, SRB, Single Resolution Authorities (SRAs) are supposed to cooperate closely together. For this inter-institutional agreements are made. The ECB and the SRB have signed a memorandum of understanding (MoU), which will be applicable from 2016 onward. The MoU sets out the rights and obligations of the institutions when dealing with the recovery/resolution of significant institutions. But just paper is insufficient; a culture of cooperation needs to be created to work effective.
- Within the ECB there is a separation between supervision and monetary policy-tasks, but this does not mean that there is no information exchange in crisis situations. In case of crisis, the monetary part of the central bank can obtain information from the supervisory part to assess to what in extend banks need to be supported. In this context Emergency Liquidity Assistance (ELA) can support the bank for a short time.
- After the implementation of the recovery and resolution framework, ELA should become less common. Hence, the recovery and resolution should lead to earlier
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Interventions, which should limit the liquidity shortages and thus also require less or even no ELA. During the financial crisis ELA was often used to extend the life of banks.

- However, the availability of liquidity tools with sufficient firepower remains essential to stabilise the banking sector.

Several issues remain unclear:

- What will, for example, be the consequence of a difference in banks directly supervised by the ECB and the banks potentially resolved by the SRB? The less significant banks under SRB are for instance excluded from the MoU that both institutions signed (SRB covers all banks, whereas the ECB only the significant banks);
- The Bank Recovery and Resolution Directive (BRRD) is not being implemented in the same way in all the Member States leading to different practices in different countries.

- The new resolution mechanism is likely to work in case a single bank fails. But it might not be able to deal with a systemic crisis. The current Greek crisis, for example, shows that bail-in is difficult if there is de facto no subordinate debt left to bail-in.

- In early intervention the resolution authority has the right to get all the information required for resolution. This also includes information required to prepare the valuation exercise, which will be undertaken by external valuers assigned by the SRB. Moreover, in case of early intervention the ECB will form teams that may have to decide on early intervention measures.

- Resolution plans will be prepared at group level. For groups with their ‘home’ outside the banking union it is up to the colleges. The ECB has started cooperation in crisis management groups. It has started close cooperation within these groups, in which supervisors and resolution authorities are represented, in various countries including the UK and the US.

- Whether the banks need to hold extra capital after a bail-in highly depends on the uncertainty about the valuation, and the contractual recognition of bail-in. Whether a capital buffer is required will be decided on a case-by-case basis. The Cypriot banks, for example, required higher capital ratios because of high NPLs.

- In systemic crisis micro tools will need to be supplemented by macro ones.

- The ECB will have more data on the European banking sector than any supervisor before. This will allow it to develop early warning indicators to detect banks in need for recovery/resolution.

- Agreeing before events occur and following standardised guidelines by the EBA must prevent that conflicts of interest can influence the call for resolution.

- Given the sequence of events, investors might prefer to wait instead of investing during the recovery phase, knowing that the bank is at the brink of being bailed-in.

### Banks, bail-ins and capital markets

**Speakers:**

**Karl-Heinz Raschutitis,** Corporate Finance Dep., Commerzbank

**Marcus Schluechter,** Deputy Head of Division of the Credit Risk Department, Public and Financial Institutions, EIB

Many questions remain on how a bail-in will work in practice. What are the probabilities of resolution (PR) and the loss given resolution (LGR)? Will Tier II creditors become shareholders before a bail-in, and at what price? Markets have already priced in differences in the PR and LGR for different types of capital instruments.

- Bail-in will be a gone concern, while MREL will become a going concern requirement. For G-SIBs there will with TLAC be another going concern requirement. MREL and
TLAC are not per se compatible. MREL is expressed as share of total liabilities, while TLAC is a share of RWA.

- The new instruments will shift the equilibrium between investors, issuers (banks), and regulators. What volumes will be issued? And what will be the spreads?

- The issuers will need to find their new optimal capital structure complying with the regulatory (Pillar I), supervisory (Pillar II), market (e.g. rating agencies and investors) and own demands (management decision on buffers). It is still uncertain what the impact on the cost of capital will be. Moreover, will investors be able to make a distinction between legal, contractual or structural subordination. And will banks be allowed to invest in each other’s debt instruments.

- Investors will need to get an understanding of the hierarchy of the different debt and capital instruments.

- Transparency on the recovery and resolution plans will be crucial for investors to determine the probability of resolution (PR, replacing possibility of default) and loss given resolution (LGR, replacing loss given default). The more different resolution tools are included in the plans, the more uncertainty for investors.
  - Market prices seem primarily been based on the probability of an event to happen. While at the moment that an event occurs investors’ attention shifts to loss given event.
  - Is a Basel-like pillar III for more transparency on resolution required? More transparency has pros and cons. Better information for investors, but might also limit the flexibility of supervisors/resolution authorities. The FSB principles are considered to guide regulators and supervisors in this.

- One of the uncertainties is for instance the treatment of Tier II capital instruments. The value given resolution will largely depend on whether it is converted into ordinary share capital before or at bail-in.

- The resolution mechanism is a comprehensive medicine cabinet for financial sector: Some measures are diagnostic and preventive, while others are more reactive.

- BRRD provides uniform rules for resolution; no creditor worse off. The introduction of BRRD leads to difference in pricing of securities, unsecured securities become relatively more expensive.

- Spreads have increased in the markets and ratings have been adjusted since the adoption of the BRRD (both downgrades and upgrades).

- Recently the issuance of covered bonds has increased, enhancing the asset encumbrance. If this trend continues an issue could erupt on the bail-in-ability of liabilities.

- HETA: was a resolution of a bad bank, why so much time to resolve it? You cannot keep these legal uncertainties, was between Bavarian (Germany) and Austrian authorities. Is not a good example for the future.

- The condition of the Greek banks does currently not allow applying the resolution framework as envisaged, with limited bail-in-able funds available. How will investors come back? In case of a precautionary measure, a resolution is not a foregone conclusion. What if some of these banks are now declared insolvent in the context of the stress test?

- What will be crucial in the future in the implementation of the resolution mechanism?
  - Timing of measures as well as preparation of both recovery and resolution plans.
    - The banks might for instance be urged to use the tier 2 already in the recovery phase, making them parri-passu with other shareholders in case of bail-in/resolution.
  - Valuation of assets in case of resolution (see EBA standards).
    - Art. 36 is the basis: Is there positive net asset valuation? Then you see how much equity there is (see also Art. 47).
    - How will subordination work?
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- No creditors’ worse off principle: German interpretation of BRRD: tradable instruments are not part of no creditor worse off criterion.
- How will this be communicated to the markets? Should resolution strategy be disclosed?

⇒ BBRD prepared for failure of single bank, but for entire banking system it becomes more difficult.
⇒ The US supervisors have the option to ring-fence the assets of US subsidiaries as well as branches of foreign banks, which gives them the option to put the bank in resolution independent from the home-country supervisors. This might jeopardise the resolution in the EU. This is a fundamental problem of the geographical approach to resolution. It might also lead to further ‘forced’ subsidiarisation.

Resolution of critical infrastructures

Speakers:
Christoph Emsbach, Policy Officer, DG FISMA, EU Commission
Fiona van Echelpoel, Head of Oversight Division, ECB
Angela Armakola, PhD Candidate, Université Paris I
Maja Augustyn, Senior Advisor Public Affairs, BNP Paribas
Teo Floor, Vice President, CCP Risk Management, Eurex Clearing

The resolution framework for critical financial market infrastructure is initiated at global level (G20 and CPMI/IOSCO). It entails Central Counterparties (CCPs) but also other financial market infrastructure like payment systems and Central Securities Depositary (CSD). There are big questions regarding the interconnectedness between CCPs and large clearing banks, which is currently being analysed. Will a CCP in stress situations be kept alive because of the negative impact of a default on the financial system?

⇒ In the past few years there has been some work on financial market infrastructures done. The G20 Pittsburgh summit in 2009 has pushed more derivative trading contracts from over the counter to exchanges/electronic trading platforms, which require clearing through CCPs. CPMI/IOSCO has come-up with principles for financial market infrastructures (PFMI - April 2012) and guidance on resolution plans for financial market infrastructures (October 2014). Around the same time the Financial Stability Board (FSB) published an overview of key attributes of effective resolution regimes.
⇒ The CPMI/IOSCO reports lay the primary responsibility for recovery plans with the CCPs itself. The authorities need to assess the recovery plans and oversee the implementation. The list of recovery tools leaves a lot of discretion.
⇒ The FSB report identifies that global consistency of measures as well as ending the too-big-to-fail notion will be required. Moreover, that the financial services have been national in crisis and that the national legal system are inadequate to wind-down financial institutions in a way that preserves financial stability and protects taxpayers’ money.
⇒ There is more work underway on the resilience, recovery and resolvability of CCPs, analysis of interdependencies (FSB, CPMI/IOSCO, BCBS). The results should be delivered in mid- to end-2016.
⇒ Many elements of the recovery and resolution of CCPs will be similar for banks (e.g. maintain financial stability through ensuring continuity of critical functions), but there might be a need for more flexibility and a debate about who should pay (i.e. CCPs, clearing members, clients, minimise costs for taxpayers through burden sharing and avoid disorderly insolvency).
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- CCPs (as well as payment systems and CSD) essential for functioning of capital markets as well as the financial system in general.
- Focus on resilience, which is the most important stage in the lifecycle (resilience, recovery, resolution), e.g. risk-management and stress testing. Hence, the EMIR-review is more important than a regime for recovery and resolution of CCPs.
- CCPs are considered super-systemic. Interdependencies substantial, especially with small number of banks primarily active in trading across the globe.
- In resolution several options, including transferring entire business lines to other CCPs.
- Bail-in likely to be applied to shareholders, clearing members or end-clients. Considering several options, including initial margin haircutting. Some consider it as not being a good solution, because it would leave the CCPs exposed to higher risks for some period. Though, EMIR makes initial margins untouchable for loss-sharing in case of resolution, contractual changes might be a solution, but clearing members should not bear all costs for the risks they take for their clients.
- The basic idea should be that the defaulter pays, which should make sure that incentives are aligned. The incentives can be improved by increasing the skin (capital) in the game. While some see more capital as no real solution, because it will never be enough. There is already quite some absorption capacity in the system. Eurex has, for example, initial margin from the members, capital contribution and parental backing to cover losses.
  - Prefunded fund EUR 3.5 billion;
  - EUR 50 billion initial margin.
- If things would nevertheless go wrong, market based solution would be a possibility, pro-rata loss sharing. In addition there is a need to enhance transparency on priority of creditors’ positions. An alternative option to decrease the risks of failure of a CCP would be to increase the position of derivatives on the creditors’ ladder.
- Regulation is in the making. UK’s special resolution regime already includes CCPs.
- Some CCPs already have access to central bank liquidity, contrary to the US. But the ECB wants to prevent that it becomes the lender of first resort.
- The credit quality of the clearing members differs across CCPs. In total, there are 13 CCPs in the EU and US controlled by five distinct financial groups. The credit quality of the members varies across the CCPs. Simulations show that in stress situations some might get into financial difficulties if their members get problems. The criteria to become clearing member might have to be tightened and the regulatory capital ratios for CCPs to be increased.
- The past has shown that problems with clearing members do not necessarily need to cause problems with CCPs. There are several examples of banking groups that were declared bankrupt, but nevertheless paid their CCP initial margins as well as variation margins (Lehman Brothers, BES). Although the legal status changed, the obligations were met, and the banks thus remained clearing members.
- Traditionally the CCP dealt with the default of a clearing member through disconnecting it from the clearing and winding-down the positions using the margins.
- Main issue might come from several CCPs trading same asset classes, creating potentially a systemic issue. The resolution authorities will therefore need to make sure that the obligations of the bank to the CCP are met.
Resolution of insurance companies

Speakers:
Dimitris Zafeiris, Head of Financial Stability Unit, EIOPA
Henning Schult, Senior Manager Regulatory Affairs, Allianz

In comparison to banking and infrastructures, the discussions on a recovery a resolution framework for insurance companies are still in a very elementary phase. The discussions focus on whether and in case which activities/insurers are systemic and whether there are any critical functions that should be ‘protected’ in case of resolution. One of the main priorities within insurance seems to be to harmonise and pool the insurance guarantee schemes.

- Recovery and resolution scheme has not progressed as much as banking and CCPs. A potential recovery and resolution system for non-banks will have to take the specificities of insurance companies into account.
- Is insurance creating systemic risk? Problems in an insurance company are unlikely to become systemic since there is more time to act, there are no immediate liabilities. In insurance you always have a slow burning crisis. The low interest environment might give rise to this. There are much less critical functions than in the case of banks, for example assets can just be transferred.
- Recovery plans are included in Solvency II. But the orientation is different. Hence, the plans are not ex-ante but ex-post (after breaching solvency requirements).
- Need to look at products and activities to identify the systemic parts of insurance companies. There are for example large difference between life and non-life insurance. Life insurance is a very long-term affair and can have a material impact on the savings of the community. Moreover, contagion between non-insurance and insurance activities might for example be a risk for some insurers (e.g. bank-assurance model).
  - AIG and monoline insurers of securities, which are often used by banks, making it systemic;
  - What would be the consequence if a large car insurance company with millions of insured cars would fail?
  - Group interconnectivity.
- Need for more harmonisation to make the rights and obligations similar across the EU (e.g. Insurance guarantee schemes). Albeit there is a lack of willingness to share risks across countries.

Outline of Task Force Report

Speakers:
Thomas Huertas, Partner, EY & Chair of the Task Force
Karel Lannoo, CEO, CEPS

At this stage only the outline of the report is discussed. This means that comments on the structure and the topics covered by the report are welcome. These can be sent to Karel Lannoo and Thomas Huertas until October 9th. Thereafter the writing of the report will start. The objective is to have the draft report ready before the third meeting.

Initial comments on the outline:
- The report should emphasise more the importance of single vs. multiple point of entry, which deserves more fundamental thinking.
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✔ The report could make the point that recovery and resolution is becoming part of the banks’ day-to-day business.
✔ CCP can fail due to a problem with several members, but there are also other possibilities that might require different kinds of approaches to resolution.
✔ Resolving a CCP is unlikely to lead to closure, transfer to bridge-facility etc. might be more likely.
✔ Need to express the importance on high quality granular data to allow authorities to get grip on what is happening in the financial institutions.
✔ Emphasis the impact on the link between the resolution and capital markets (e.g. valuation, demand, cross-holdings, etc.).
✔ Might need to focus to make sure that the key messages come across:
  o Banking: Identify implementation issues;
  o Others: Design of the framework. The non-bank resolution part might focus on CCPs, (re)insurance companies, and asset managers. Payment systems etc. might be left aside since many are operated by central banks.

Third meeting
The third meeting of the task force will be held on 11 December 2015 at the CEPS premises in Brussels. The agenda will be communicated in due course. During the meeting the recovery and resolution mechanism for (re)insurance companies and asset managers will be discussed as well as the draft report.