Market spotlight: Q&A on Resolution

Q&A with Gilbey Strub
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In June 2012, the European Commission put forward a proposed bank recovery and resolution directive which detailed a bank resolution framework to allow the authorities to deal with a failing bank to ensure financial stability and to cut reliance on taxpayers’ money in the event of bank failure. Since then there have been a number of consultations issued by various bodies; in light of the number of developments in the area, Gilbey Strub, AFME a Managing Director in the Prudential team, provides an update and outlines the key issues that AFME has raised in contributing to the debate.

Question 1: As a general recap, can you outline what ‘recovery’ and ‘resolution’ mean in the context of crisis management?

Answer: Recovery means actions to stabilise a financial institution and restore its viability after it has come under severe stress (for example, M&A, capital raising, or restructuring). Meanwhile, resolution refers to the processes for authorities to deal with a failing financial institution, while preserving important functions, without causing severe systemic disruption and without exposing taxpayers to loss.

Q2: A lot has been happening in the regulatory field since we last conducted a Q&A on the topic of Resolution. Can you provide us with an update on the current proposals and consultations underway in this area?

A: Back in April 2012, the European Commission issued a discussion paper on a debt writedown tool, and in June, the Commission put forward a proposed bank recovery and resolution directive which outlined a bank resolution framework covering the key parameters needed for resolution: resolution triggers, resolution tools, including bail-in, and resolution of groups. This was followed, in October, with the Commission's launch of a consultation dealing with the resolution of nonbank financial institutions “On a possible framework for the recovery and resolution of nonbank financial institutions”.

At the global level, the Bank Committee and the International Organisation of Securities Commissions (IOSCO), together issued a consultative document on “Recovery and Resolution of Financial Market Infrastructures” in July 2012, which applied the key elements required for resolution regimes (as endorsed by the G20 in November 2011 in the document ‘Key Attributes of Effective Resolution Regimes for Financial Institutions’, also known as the ‘Key Attributes’) to FMIs. AFME responded to this consultation, along with the GFMA in September 2012 (view consultation response) and to the Commission's consultation on a resolution framework for non-bank financial institutions in December (view response). In November 2012, the Financial Stability Board (FSB) issued a consultation on “Recovery and Resolution Planning: Making the Key Attributes Requirements Operational”, seeking to build on the Key Attributes in light of experiences in developing recovery and resolution plans for G-SIFIs. AFME responded to the consultation through GFMA in December 2012 (view consultation response).
In the meantime, the UK (home to a major financial market and an important jurisdiction for many AFME members) undertook its own consultation on the topic: the UK HMT issued, in August 2012, a consultation paper ‘Financial Sector Resolution Broadening the Regime’ in which it focused on broadening its special resolution regime beyond banks (view AFME consultation response). Then, in December, the Bank of England and the FDIC jointly issued a paper, Resolving Globally Active, Systemically Important, Financial Institutions, which dealt with the resolution of G-SIFIs in the UK and the US jurisdictions specifically. Any bilateral agreement between these two jurisdictions could serve as a framework for individual firm specific cross-border cooperation agreements (you can link to a Q&A on the BoE-FDIC consultation here and view comment on the paper here).

Q3: Is AFME in support of the implementation of a resolution framework?

AFME is strongly supportive of effective resolution frameworks. Credible resolution regimes are essential in ending moral hazard and ensuring markets can function efficiently. It is in the interests of the industry to address Too-Big-To-Fail (TBTF) and end the implicit state guarantee that has been evident throughout the crisis. Resolution regimes need to be designed carefully so as not to adversely affect the supply and pricing of debt and equity. For example, creditor hierarchies need to be preserved and creditors should be protected to ensure they are no worse off than they would be in a liquidation.

However, putting in place the mechanics of a resolution regime is only part of the jigsaw. Authorities and politicians have to have the courage to make cross-border resolution a reality, both in preparation and in crisis. It would be a great pity if, in the face of a crisis situation, a resolution authority cannot deal with a failing institution through a resolution process. This could destroy the credibility of resolution regimes and perpetuate moral hazard.

Another building block for fully-functioning resolution regimes in Europe is a more liquid market in financial institution assets. There needs to be a market of sellers and buyers of failed institutions to provide the ‘exit’ for resolution authorities that have stepped in once resolution is triggered. Ultimately such a market will build up over time, though a concerted effort is needed to address any regulatory impediments to such a market and to deal with obviously failed institutions.

Q4: How broad should such a scheme be?

We believe that resolution regimes should be put into place for all systemically important financial institutions (banks and non-banks), all banks, and for Financial Market Infrastructures (FMIs) (as outlined by the Financial Stability Board in ‘Key Attributes for Effective Resolution Regimes,’ endorsed by the G20). With this in mind, we note the benefits of the broad scope of the Dodd-Frank Act which allows the US to use stabilisation powers over any financial institution if, among other things, its failure under insolvency law would have a serious adverse impact on financial stability. We believe that all Financial Market Infrastructures (whether they be credit holding or not) should be included. However, the inclusion of FMIs that are not central counterparties (non-CCP FMIs) should be considered on a case by case basis because the rules/the structure determined to be suited to a central counterparty (CP) cannot be applied to, for example, a central securities depositary (CSD).

Q5: Does intervention by authorities raise any particular concern(s)?

We believe that recovery should be the initial port of call for an institution that is suffering difficulty, but the conditions on which authorities determine that an institution is failing must be stringent and in line with global measures in order to keep the harmonised structure of safety. We emphasise here the need for more transparency setting out how the authorities would accomplish consistency and based on what criteria they would act. It is important to enhance the level of certainty for investors about how they will be treated in order to avoid unnecessarily increasing funding costs.

Q6: At the international level, do the Principles for Financial Market Infrastructures set out by CPSS-
IOSCO capture all the eventualities?

We are in agreement with the overall principles as outlined by the CPSS-IOSCO (which cover general organisation, credit and liquidity risk management, central securities depositaries and exchange of value settlement systems, default management, general business and operational risk management, access, efficiency, transparency and responsibilities, but we believe that there need to be additional considerations made. These include, among others, the interconnectedness of FMIs and cooperation across multiple jurisdictions - you can access more detail on these points in the joint trade associations’ consultation response from the GFMA [here](#).

Q7: So, considering that the CPSS-IOSCO initiatives are taking place alongside the European Commission’s and the UK HMT’s consultations – does having numerous forms of legislation create any problems?

We believe that the new resolution regimes suggested and being developed at this stage by CPSS-IOSCO will be an international regime which can be built upon if it is needed. Indeed, it is paramount that regulation be consistent at the global, regional (European) and national level. At the present time, with the EU regulations and the CPSS-IOSCO regulation being determined, there is a lot of resolution and recovery regulation that is being proposed to be implemented. We therefore believe that any potentially new resolution regimes being put forward in the UK should be in line with these other more advanced (at this stage) proposed regulations. Each FMI must be looked at on an individual basis and should not be excluded dependant on its ‘importance’ but rather be included because of its systemic and operational value. All FMIs should be considered in all of the currently proposed regulations.

Q8: In September 2012, the European Commission set out proposals for a single supervisory mechanism, led by the ECB, as part of the plan to establish a banking union. What issues arise from this development with regards resolution?

Under the Commission proposals, the ECB will ensure compliance by banks under its supervision by applying capital buffers and carrying out intervention measures if a bank is breaching (or close to doing so) capital requirements. The commission proposes to co-ordinate such intervention with the existing resolution authorities (currently the national authorities). AFME is concerned about this proposed separation of the jurisdictional scope of supervisory and resolution arrangements: a single resolution mechanism that complements the single supervisory mechanism (SSM) under the ECB needs to be put into place promptly so to avoid significant misalignments and systemic weakness. Another issue that needs to be addressed is the operation of the Recovery and Resolution Directive (RRD) cooperation mandate in light of the new structural arrangements. Clarification will be also be required regarding the interaction, if any, between those powers that are conferred on the ECB under the SSM and the resolution triggers in the RRD framework.

Q9: The Commission’s HLEG consultation on industry structure also touched on the subject of resolution. What are the implications of this?

The HLEG consultation, as part of its objective in seeking to reduce risks in the banking system, touches on improving the resolvability of banks. While we agree with the HLEG’s focus on the need for institutions to have effective and realistic recovery and resolution plans (RRPs), we believe that resolution authorities must be able to develop, in consultation with banks, a top-down resolution strategy to complement the bottom-up analysis contained in these RRPs. It is paramount that authorities assess resolution plans in terms of resolvability (considering both cost and complexity on a bank-by-bank basis); the principle of resolution planning should not start with the question of whether separation is required. It should not be necessary to separate retail and trading activities for the purposes of resolving an institution.

And while we strongly support bail-in as a tool for resolution, we do not agree with the HLEG’s suggestion that bail-in be applied only to a specific class of instruments - this effectively amounts to a new capital requirement
and could serve to increase uncertainty of the creditor hierarchy. And while we agree with the HLEG’s call for clarity to enable investors to anticipate how their instruments will be treated in the event of resolution, we think that this could be better achieved with a requirement for resolution authorities to publish a detailed statement which sets out the general approach to the application of resolution tools to institutions and groups within their jurisdictions. Clarity could also be increased through the creation of guidelines by the EBA for the circumstances where it would be necessary and appropriate to include derivatives in a bail-in and the RRD itself could furthermore be modified to ensure the protection of creditor hierarchy.

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