afme/ Finance for Europe

Association for Financial Markets in Europe

Risk adjustment of contributions to resolution funds and DGS

17 March 2014

This note sets out AFME's views on the important issue of the calibration of the risk adjustment of contributions to resolution funds under the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Fund (SRF) under the Single Resolution Mechanism and deposit guarantee schemes (DGS) under the Deposit Guarantee Schemes Directive (DGSD).

The risk adjustment of contributions is the subject of Commission delegated acts under Article 94 of the BRRD and the risk adjustment of contributions to the SRF should be consistent with this. The risk adjustment of contributions to DGS is the subject of EBA guidelines under Article 11 of the DGSD and these should also approach the risk adjustment in a consistent manner.

Key principle

The risk adjustment of contributions to BRRD resolution funds, the SRF and DGS should be focused upon ensuring that **an institution's contributions reflect the risk of loss that it poses to the relevant fund**. This approach would maximise incentives for firms to reduce the risk that they pose to the fund and minimise moral hazard. Contributions based on any other principles are likely to create perverse incentives. For example, absent an appropriate adjustment, raising additional loss absorbing debt which does not class as own funds would increase contributions despite reducing the risk to the fund.

In order to assess the risk of loss to the fund, we propose that this should be calculated based upon an assessment of the following components:

(i) the probability that the institution fails and enters resolution (in respect of resolution funds) or that the DGS is triggered (in respect of DGS); and

(ii) the risk of loss to the fund in such event.

We consider how these factors should be assessed in the context of resolution funds and DGS below.

The risk adjustment should be conducted on an annual basis to ensure that it reflects changes that are made by firms to reduce the risk that they pose and to take account of changes in the market.

A. Risk adjustment of contributions to resolution funds

(i) Probability of entering resolution

The probability of an institution entering resolution should involve an assessment of:

a) the probability of failure of the institution; and

b) the likelihood that in the event of its failure it would be placed into resolution.

We suggest that the probability of failure of an institution should be based upon a supervisory assessment of a range of indicators including its capital adequacy (including leverage), asset quality and liquidity profile because it cannot be determined solely by reference to any particular ratio. This assessment should utilise existing indicators and supervisory processes rather than creating a new risk assessment process and be based upon consistent factors across the EU. The assessment should also take account of actions that could be taken by the group to avoid failure under the institution's recovery plan and avoid measures that would result in unpredictability and pro-cyclicality of contributions.

The assessment of the probability of failure should be given significant weight and provide incentives for banks to take steps to increase capital, conduct less risky business and ensure that they have adequate liquidity available. The risk assessment would therefore reinforce the objectives of prudential regulation.

The probability of entering resolution should reflect whether the particular institution would be placed into resolution under the relevant group resolution plan. For example, where the plan involves only one entity or certain entities in the group being placed into resolution, the fund is less likely to be used for those entities which are not planned to be placed into resolution.

It should also take account of the likely systemic (whether global or domestic) impact of the failure of the firm and whether it falls within the scope of the waivers or simplified obligations in Article 4 of the BRRD. However such assessment should not be limited to the impact of the failure of the institution alone, but should also recognise that the fund could be used for any bank and that the failure of a number of institutions which on their own might have a small impact on the financial system could together have a systemic impact and therefore require resolution. All banks should therefore contribute to the fund as they benefit from its potential use.

(ii) Risk of loss to the resolution fund

The risk of loss to a resolution fund should reflect the likelihood that a resolution of the institution would require the use of the resolution fund. In the vast majority of cases there should be no need for use of the fund to absorb losses, as these would be imposed upon shareholders and creditors of the group in accordance with the resolution framework and the group resolution plan. The risk of loss to the resolution fund should therefore take account of the recovery capability and resolution strategy of the institution and whether, in the event that the institution was placed into resolution, it is likely that the resolution fund would be used.

It should also reflect the resolvability of the institution and its loss absorbing capacity. The best way of assessing this would be based upon the level of liabilities that are not excluded from bail-in relative to the size of the balance sheet and potential losses. This would reflect the fact that the greater the level of "bail-in-able" liabilities, the greater the loss absorbency available and therefore the lower the likelihood that a resolution fund would be used for loss absorption. Use of resolution funds for liquidity purposes should not result in losses to the fund because funding would be provided on a secured basis against the bank's assets.

The risk of loss to the fund in the event of failure should be given significant weight in the risk assessment. This would provide incentives for banks to increase their loss absorbing capacity and improve their resolvability. Absent an appropriate adjustment, banks could be disincentivised from raising additional loss absorbing capacity because they would perversely increase their contributions by issuing loss absorbing debt which does not class as own funds. It is also a key factor in assessing the risk to the fund.

(iii) Intra-group liabilities

It is also necessary to ensure that the assessment of contributions based upon the liabilities of each institution in a group does not result in double-counting of intra-group liabilities.

For example, if parent institution A issues €100m debt externally, it creates liabilities of €100m which would be included in A's contribution to the resolution fund. If A then lends this to its subsidiary B, it creates a liability of B to A of €100m. The intra-group liability of B to A would be reflected in the contribution of B to its resolution fund, resulting in the group paying twice for what on a consolidated basis would be a single liability of €100m.

We suggest that this is addressed by deducting intra-group liabilities from the assessment base of total liabilities less own funds and covered deposits.

B. Risk adjustment of contributions to DGS

(i) Probability that the DGS is triggered

The probability that the DGS is triggered should be based upon the probability that deposits become unavailable, which is the trigger for payout by the DGS. This should be based on the probability of failure of the institution, assessed in the same manner as considered above in respect of resolution funds, i.e. based on a supervisory assessment of the institution's capital adequacy (including leverage), asset quality and liquidity profile and adjusted to take account of actions that could be taken by the group to avoid failure under its recovery plan.

(ii) Risk of loss to the DGS

The risk of loss to the DGS should be based upon the proportion of liabilities that are subordinated to covered deposits, reflecting the seniority provided to covered deposits under the BRRD and that the DGS would not suffer any losses unless the institution incurred losses in excess of all such subordinate liabilities.

The risk assessment should reflect, as a secondary aspect, the fact that covered deposits are highly unlikely to become unavailable if the institution is placed into resolution, as a key objective of resolution is to maintain access to covered deposits. In this case, if the institution does not have a significant amount of liabilities subordinated to covered deposits, the DGS may be required to make a contribution under Article 99 of the BRRD based on the losses that covered depositors would have suffered. The value of the contribution is likely to be lower than the losses that the DGS would suffer in a liquidation of the institution and therefore if an institution is likely to be placed into resolution in the event of its failure, the risk of loss to the DGS should be lower.

Accordingly, the probability of entering resolution in the event of failure should also be reflected in the risk assessment of DGS contributions such that the greater the likelihood of being placed into resolution in the event of failure, the lower the risk of loss to the DGS. The probability of entering resolution in the event of failure should be assessed in the same manner as discussed above in respect of contributions to resolution funds.

C. Summary of proposed approach

The following tables summarise the approach suggested above. We suggest that these factors could helpfully be set out in a "scorecard" similar to the approach taken to the risk adjustment of contributions to the Deposit Insurance Fund in the US.[1]

1. Risk adjustment of contributions to resolution funds

Risk adjustment component	Method of assessment
Probability of failure	Supervisory scoring of: • Capital adequacy (including leverage); • Asset quality/risk; and • Liquidity assessment. It should also reflect the feasibility of recovery actions that could be implemented to avoid failure.
Probability of entering resolution in the event of failure	Assessment of: • the likely systemic (global or domestic) impact of the failure of the firm or a number of similar institutions; • whether or not the firm comes within the scope of waivers or simplified obligations under Article 4 of the BRRD; and • whether the institution would be placed into resolution under the group resolution plan.
Risk of loss to the fund	Assessment of: • the likelihood that, in the event that the institution was placed into resolution, it would require the use of the resolution fund, taking account of the recovery capability, loss absorbing capacity and resolution strategy of the institution; and • the level of liabilities that are not excluded from bail-in relative to the size of the balance sheet and potential losses.
Adjustment to remove double-counting of intra-group liabilities	Adjustment of the assessment base to remove intra-group liabilities.

[1] A summary of the FDIC approach is available here: http://www.fdic.gov/news/news/financial/2011/fil11008.pdf

2. Risk adjustment of contributions to DGS

Risk adjustment component	Method of assessment
Probability of failure	Supervisory scoring of: • Capital adequacy (including leverage); • Asset quality/risk; and • Liquidity assessment. It should also reflect the feasibility of recovery actions that could be implemented to avoid failure.
Risk of loss to the fund	• The ratio of (i) liabilities that are subordinated to covered deposits to (ii) total liabilities. • Adjustment to reduce the risk of loss where the probability of entering resolution in the event of failure is higher, assessed on the basis of: o the likely systemic (global or domestic) impact of the failure of the firm or a number of similar institutions; o whether or not the firm comes within the scope of waivers or simplified obligations under Article 4 of the BRRD; and o whether the institution would be placed into resolution under the group resolution plan.

AFME

17 March 2014