APRC International Conference

Session 2: Resolving Financial Crisis through Bank Restructuring Program

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Content of presentation

- Context – Challenges in resolving systemic banks
- Institutional responsibility
- Resolution powers and safeguards
- Resolution options for systemic banks
- Resolution toolkits
- Resolution funding
- Coordination

Challenges in resolving systemic banks

- The global financial crisis and other banking crises over the years have demonstrated the complexities of resolving large banks, especially systemic banks
- Unlike smaller banks, the resolution of a large or systemic bank cannot be resolved by closure and payout of insured depositors or standard purchase and assumption
- It requires the application of more complex solutions
- The objectives of resolution emphasize the need to preserve continuity of systemic functions, avoiding contagion, minimizing adverse economic impacts and minimizing fiscal risk and moral hazard

Challenges in resolving systemic banks

- **Resolution of a systemic bank involves many elements:**
  - Clearly defined institutional responsibilities for resolution and other functions
  - Comprehensive resolution powers
  - Resolution strategies to maintain continuity of critical functions and services
  - The capacity to implement a resolution with no or minimal public funding – and therefore other forms of loss absorption and funding for capitalization
  - Group resolution – domestic and cross-border
  - The need to prevent contagion through liquidity and credit channels
  - The need for close domestic coordination and cross-border coordination

Challenges in resolving systemic banks

- It is especially challenging for deposit insurance agencies if they are the resolution authority
- It requires the development of a new capacity for systemic bank resolution – including developing resolution strategies, resolution options and implementation guidance, and resolution planning
- It requires a clear delineation of institutional responsibility between the key agencies
- It requires a clear delineation between the use of deposit insurance funds and systemic resolution funds
- And it requires the ability to determine the maximum contribution to resolution from a deposit insurance fund, based on a well-defined least-cost test and associated methodology to calculate least-cost

Institutional responsibilities

- **Specifying institutional responsibilities is essential, together with well defined objectives, transparency and accountability arrangements**

- **This will include the agency responsibilities for:**
  - **Determining non-viability and triggering resolution – the supervision authority**
  - **Assessing the systemic importance of a bank – all agencies, but led by the supervision authority and central bank**
  - **Resolution plans, resolvability assessments and resolution – the resolution authority**
  - **Deposit insurance functions – the deposit insurance agency (which might also be the resolution authority)**
  - **Systemic resolution funding agency – likely the deposit insurance agency, but via a separate fund from deposit insurance**
  - **Provider of emergency liquidity support – the central bank**
  - **Advising the government on public funding, guarantees and indemnities if required – the finance ministry**

Resolution powers

- Resolution of large or systemic banks requires comprehensive legal powers, with a clear trigger for entry into resolution – based on non-viability
- Resolution powers need to apply to banks and entities within the banking group
- Potentially, there might be a need to extend powers to financial conglomerates – e.g. where a large bank is part of a wider financial services group
- Safeguards are crucial – especially the protection of 'no party worse off' than under conventional winding up

Resolution powers

- **Powers are needed for:**
  - Assuming control of the bank and group
  - Maintaining critical functions and services
  - Bail-in – both to enforce contractual bail-in and to bail-in other liabilities ('statutory bail-in')
  - Capital issuance and restructuring
  - Business transfer
  - Bridge bank
  - Asset management companies
  - Implementation of cross-border resolution

Resolution strategies

- **Resolution strategies are needed for resolving large and systemic banks, as well as the criteria for selecting resolution options and implementation guidance**

- **The main resolution options are:**
  - **Recapitalization of the bank and group**
  - **Transfer of critical functions and services (and possibly other business) to another bank – subject to market dominance and systemic concentration risk issues**
  - **Transfer of critical functions and services (and possibly other business) to a bridge bank**

Resolution strategies

- **Recapitalization of a bank or capitalization of a bridge bank can be achieved in a number of ways**

- **These include:**
  - **Conversion of all contractual bail-in debt to CET1 capital (if not already done prior to resolution)**
  - **Bail-in of other liabilities, other than insured deposits, secured liabilities and liabilities where bail-in would cause significant disruption to the financial system (e.g. derivatives)**
  - **Capital injection by an acquiring entity after all losses have first been absorbed by existing shareholders and creditors**
  - **Capital injection funded from a resolution fund (under the same preconditions as above)**
  - **Capital injection funded from public finance – subject to robust safeguards**
  - **Any combination of the above**

Resolution strategies

- **Each option has distinct benefits and costs, which need to be pre-identified by category of bank and then via resolution plans for each individual bank**

- **The resolution options need to be supported by detailed guidance on implementation**

- **This requires the development of a comprehensive resolution toolkit that sets out the criteria for selecting resolution options, the implementation steps for each option, the actions required of each relevant agency and the coordination required between agencies**

Resolvability assessment and resolution planning

- Once a generic resolution toolkit has been developed, the resolution authority is then able to undertake resolvability assessments and develop resolution plans

- Resolvability assessments and resolution plans should be undertaken for all systemic banks and other large banks that could potentially be systemic depending on the situation

- Resolution plans need to include comprehensive information on the structure of the banking group, the functions performed by each entity, the critical functions and services, and the specific implementation details for each applicable resolution option

Critical functions

- **The critical functions will typically include functions relating to:**
  - Deposit-taking
  - Transactions capacity
  - Wholesale funding
  - Payments and settlements
  - Correspondent banking
  - Treasury
  - Derivatives servicing
  - Provision of credit under committed credit facilities
  - Loan servicing
  - Provision of risk hedges to customers

Critical functions

- **The resolvability assessment and resolution plan need to identify, for each critical function:**
  - the details of the functions provided, including scale, scope, nature of clients, etc
  - the FMIs in which the bank or an entity in its group participates
  - the legal entities performing the functions
  - the systems used to perform the functions
  - the jurisdiction in which the entities are located
  - the inter-dependencies (legal, financial and operational) of these entities required for them to continue to maintain these functions

Critical services

- **The resolvability assessment and resolution plan need to identify all critical services, drawing on the guidance developed by the FSB**

- **The critical services will include systems, data and other functionality required to:**

  – **perform critical functions**
  – **maintain customer accounts**
  – **maintain financial records**
  – **identify, measure, monitor and manage risks**
  – **comply with prudential requirements**
  – **comply with other legal requirements**

Critical services

- **As with critical functions, the resolvability assessment and resolution plan need to identify the relevant details for critical services**

- **These will include:**

  - **the details of the services provided, including scale, scope, etc**
  - **the legal entities performing the services**
  - **the systems used to perform the services**
  - **the jurisdiction in which the entities are located**
  - **the inter-dependencies (legal, financial and operational) of these entities required for them to continue to maintain these services**

IADI International Association of Deposit Insurers

LEMBAGA PENJAMIN SIMPANAN Indonesia Deposit Insurance Corporation

Assessing resolvability

- For each resolution option, the resolvability assessment should identify and assess:
  - how the resolution option would be implemented
  - the obstacles to particular resolution options and the means by which those obstacles can be reduced or removed
  - the content required for resolution plans and the pre-positioning required of banks to achieve a least-cost resolution that meets resolution objectives
- This analysis will require the resolution authority to develop comprehensive, detailed information on D-SIBs and their groups, including a ‘mapping’ of all relevant functions and services by legal entity and jurisdiction

Resolution plans

- **Comprehensive resolution plans should be prepared, covering:**
  - **Details of legal entities within a group, their functions and inter-dependencies**
  - **Identification of all critical functions and services, the legal entity performing them, and the jurisdiction in which each entity is located**
  - **Implementation details for the feasible resolution options, including business that would be subject to continuity requirements, business suitable for transfer to a bridge entity or another bank, bail-in-able debt and capitalization instruments**
- **Resolution plans should be reviewed regularly and periodically tested by the resolution authority**

Group resolution

- For any large bank it is likely that resolution will apply not just to the bank but also the group
- This includes cross-border operations – subsidiaries and branches
- Resolution plans need to provide comprehensive information on the group structure, entity functions and inter-entity financial and operational dependencies
- Resolution plans also need to identify how ‘Single Point of Entry’ (SPE) resolution and ‘Multiple Points of Entry’ (MPE) could be implemented, and the benefits and costs of each

SPE resolution

- Under SPE resolution, the subsidiaries relevant for critical functions and services are capitalized via the parent entity
- This has the merit of keeping the group intact, reducing the need for separation arrangements and probably lowering the overall capitalization requirement relative to MPE and group break-up
- But it involves the need to ensure that the parent entity can be capitalized sufficiently to fund the recapitalization of all relevant subsidiaries
- This can be done in various ways

SPE resolution

- One option is to apply bail-in at the parent entity sufficient to meet group capital needs – but this is likely to require compensation for creditors of the parent entity who effectively subsidize creditors in the subsidiaries

- Another option is to bail-in liabilities in the relevant subsidiaries for the capital required in the subsidiaries by converting liabilities to CET1 capital in the parent and then cascading capital from the parent to the subsidiary – which avoids compensation issues if done correctly

SPE resolution

- This suggests the need for careful consideration of the entity location of bail-in debt

- In cross-border situations, if public funding or resolution funding is used, then this raises the likely need for a burden-sharing agreement, ex ante if possible, between the parent and host authorities

MPE resolution

- **Under MPE resolution, each relevant subsidiary is capitalized at subsidiary level and not via the parent**
- **This reduces the complexities of cross-border burden-sharing and potential compensation issues for bail-in, but has potential disadvantages**
- **It is likely to increase the capitalization required for subsidiaries (e.g. foreign bank subsidiaries) to the extent that it involves breaking up the group. A stand-alone bank, separated from the parent, is likely to require greater capital than a subsidiary retained in the group, all else being equal**
- **It also requires group entities to have strong separation arrangements, especially for critical functions and services, which will increase operational costs for the banks, and creates a risk of disruption to critical functions and services in a failure situation**

MPE resolution

- MPE resolution also risks a greater potential need for government guarantees of new liabilities raised by a bank separated from the parent group, due to possible lack of market confidence in what is, in effect, a stand-alone bank
- Liquidity support for a separated subsidiary is also more likely to be needed than for a subsidiary retained in the parent group
- Cross-border arrangements are also complex in a MPE resolution – arguably more so than for SPE
- The feasibility, costs and benefits of SPE and MPE need to be carefully assessed as part of resolvability assessments and resolution planning

Bail-in

- Bail-in is another aspect of resolution that requires careful consideration in resolvability assessments and resolution planning
- Bail-in of TLAC and other contractually bail-in-able debt is reasonably clear cut, as long as the triggers are well specified – but still requires consideration of the relative benefits of write-down versus conversion to CET1 capital, and if the latter, the form of capital instrument
- Bail-in of other liabilities is much more complex – especially wholesale deposits, where the big risk is a pre-emptive run
- Bail-in also creates a major risk of contagion in a system-wide banking crisis – i.e. wholesale depositors and others are likely to run on other banks if bail-in is applied to those types of liabilities in one or more banks

Bail-in

- It is therefore essential that the risks associated with ‘statutory’ bail-in are carefully assessed and incorporated into resolution strategies and resolution plans

- The assessment of bail-in risks needs to be made not just by the resolution authority, but also by the other key agencies, especially given the potential systemic impacts, ELA implications and possibility of government guarantees

Bail-in

- **Resolution plans for banks need to identify which liabilities would be targets for bail-in (and in which order of priority, based on the ranking of claims) and which would be exempted**

- **The greater the exemptions of liabilities from bail-in, the more the need there is for compensation to creditors who are bailed in more deeply, or alternatively, the greater is the need for resolution funding to cover the gap from exempted liabilities**

Resolution funding

- Resolution funding is a major element in the resolution of systemic banks
- There will be a need for resolution funding in almost all situations
- Funding will be required for several purposes, including potentially for loss absorption and capitalization (depending on the scope for bail-in), compensation for creditors rendered worse off as a result of the resolution, and potentially guarantees and indemnities

Resolution funding

- **Resolution funding should not come from the deposit insurance fund beyond the ‘least cost’ amount – which requires methodology for calculating this**

- **It needs to be sourced from either:**

  - **a resolution fund established for the purpose, funded by levies on banks, supplemented by government funding which can be recovered ex post via bank levies, or**

  - **an ex post funding structure, with initial funding from the government, recovered from ex post levies on banks**

- **There are different costs and benefits of each, which need to be carefully assessed**

Resolution funding

- The preconditions, purposes and conditionality of resolution funding need to be well defined – including a requirement for shareholders and at least subordinated creditors to first bear losses to the full extent of their legal liability

- If public funding is to be available – as an alternative or supplement to a resolution fund – then it is essential that the preconditions, purposes and conditionality be specified, and that there is the legal capacity and operational arrangements to recover funding outlays from the resolved bank and banking industry in full NPV terms

Resolution funding

- **Resolution plans need to identify for each bank the likely need for resolution funding, after taking into account bail-in capacity**
- **Separately, there is a need to specify the ELA arrangements in the central bank for liquidity funding of a bank in resolution, subject to a program of recapitalization or bridge bank capitalization, and possibly government indemnities**

Domestic coordination

- Coordination between the agencies at a domestic level is crucial for resolving systemic banks
- As noted earlier, the responsibilities of each agency need to be well specified
- The action points for each agency, and consultation requirements, need to be clearly identified
- A financial stability council comprising each agency is an important vehicle for coordination, supported by a standing sub-committee of senior staff dedicated to crisis resolution arrangements

Domestic coordination

- **Bilateral MOUs and a multilateral MOU between all relevant agencies – focused on crisis resolution – are essential**
- **The MOUs should specify the responsibilities of each agency and points of coordination**
- **In addition, it is important that the agencies develop a coordinated resolution toolkit setting out guidance of resolution options and guidance on which options to select**

Cross-border coordination

- Cross-border coordination is essential for banks with substantial cross-border operations, especially where these have systemic importance in home or host countries
- Bilateral MOUs are important, but a multilateral MOU between the relevant agencies in both (or more than two) countries is more effective and efficient for setting out the coordination arrangements comprehensively
- MOUs need to be backed up by more detailed coordination of cross-border resolution strategies and resolution plans – SPE and MPE
- Periodic cross-border crisis exercises are important for capacity building

Thank you