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Bank Recovery and Resolution Directive:
Principles for delivering clarity for market participants – 22 November 2013

Introduction

The International Regulatory Strategy Group is a cross-sectoral practitioner body with membership from banking, insurance, asset management, clearing houses and related professional services. The Group remains strongly supportive of the EU's Bank Recovery and Resolution Directive (BRRD) as a critical component of the bank regulatory reform agenda, and an important step towards addressing "Too Big To Fail." We welcome the good progress that has been made in both the European Parliament and the European Council to reach this trilogue stage, and recognise that in some areas compromise was hard fought. Representing both banks and investors in bank credit, the Group combined both perspectives earlier this year to identify a set of principles that will greatly enhance the effective implementation of the Directive. These principles were discussed with Rapporteur Gunnar Hokmark MEP, in March 2013. The Group's central message was to highlight the importance of developing a resolution regime that is clear and predictable, not just for banks and resolution authorities, but also for the providers of bail-in liabilities.

Increased predictability will enhance market stability, improve the market's ability to make risk-aware investment decisions preserving banks' ability to secure funding, and exert discipline on banks. Predictability is especially important in the EU given the healthy diversity of the banking sector, the number of Resolution Authorities and the breadth and complexity of the new powers.

We wish to reinforce some of our key concerns at this critical juncture, reflecting the progress made within the EU and at a global level. In particular we highlight the importance of:

- A clear articulation of resolution objectives, including a clear focus on preserving and maximising value for bank creditors, consistent with no public bail-outs and no contagion;
- A firm commitment to the creditor hierarchy, with discretion on bail-in scope kept to an absolute minimum ("constrained discretion");
- Guidance on how resolution authorities will take resolution decisions, for example through the publication of a Code of Practice by resolution authorities; and
- Greater disclosure of resolution authorities' "presumptive resolution paths" (the presumed baseline resolution strategy) for the resolution of specific institutions.

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Principles for a new regime

We set out below 2 key principles which the IRSG considers should underpin any Bank Recovery and Resolution Regime namely:

1) Improving Predictability for Investors in Banks
2) Developing Presumptive Resolution Paths (PRPs)

Principle 1: Improving Predictability for Investors in Banks

Using the Group's buy-side expertise in particular, we outline a number of areas where the BRRD needs to provide a strong degree of certainty:

1. Clear articulation of resolution objectives, including a clear focus on preserving and maximising value for bank creditors, consistent with no public bail-outs and no contagion;
2. Predictable and clear triggers for early intervention and the point of non-viability/resolution;
3. Clear rules on resolution authority decision mechanics ;
4. Firm commitment to the creditor hierarchy with discretion on bail-in scope kept to an absolute minimum (constrained discretion)
5. Legal certainty around rights for each asset class;
6. The use of the "No Creditor Worse Off in Liquidation" (NCWOL) principle, thus delivering equity and fairness while preserving value for bank creditors;
7. Clear third country agreements and arrangements
8. Greater disclosure by banks themselves of the risks they face, including at legal entity level; and
9. Greater disclosure of resolution authorities' "presumptive paths" for specific institutions, by which we mean a presumed baseline resolution strategy (see Principle 2 below).

Both the Council and the Parliament texts score well on some of these standards, but further progress needs to be made. We highlight some key issues below:

Commitment to Creditor Hierarchy and Constrained Discretion on bail-in scope: both texts have made positive amendments to the Commission proposal to ensure the explicit removal from the scope of bail-in those liabilities whose inclusion in the process would increase run risk and propagate contagion. The Council text, however, also introduces broad national discretion for the resolution authorities to exclude any liability in exceptional circumstances. While we understand the rationale for this provision, it risks introducing uncertainty and divergence. We support tight policing of such discretion to ensure that there is a common approach. In this respect, the safeguards in Article 38 (3) are paramount, and we support the role of the Commission to adopt delegated acts as per Article 38 (5).

Derivatives: if the exclusion of derivatives from the scope of bail-in liabilities is required to achieve the resolution objectives then within this approach we have concerns about the

European Parliament's suggestion that centrally cleared derivatives should be treated as senior to those that are not when applying bail-in. We understand and support the policy objective to significantly increase the proportion of OTC derivative contracts that are centrally cleared, but consider that the European Markets and Infrastructure Regulation and the Capital Requirements Regulation already provide the right framework and capital incentives to meet this objective. Introducing a distinction between centrally cleared and non-centrally cleared derivatives into the BRRD deviates from the creditor hierarchy, creates additional pressure for early close-out, and may increase costs for those counterparties who have been given an exemption from the central clearing obligation (including small businesses in particular).

Predictable Triggers: we welcome the steps taken in the EP text to increase the transparency of triggers, notably the requirement in Article 27 for resolution authorities to publish guidance on the way in which they will judge resolution trigger conditions. A predictable trigger for resolution is critical, and PONV should closely approximate the default probability point, as recently highlighted by ESMA in their recent Risk Review[1]. We also support the EP's proposal to move the Special Manager function to Resolution.

Rules or guidance on resolution authority decision mechanics: many of the resolution authorities' decision mechanics remain opaque, which will complicate any analysis of potential losses by creditors and could lead to divergences in bank funding costs across the EU. This could be addressed by resolution authorities publishing a Code of Practice that outlined their approach to resolution and the available tools, as supported in recent FSB Guidance[2].

Use of Government Stabilisation Powers: we continue to oppose the introduction of such powers in the BRRD on the grounds that they run counter to the underlying policy objective to significantly reduce the future likelihood that taxpayers will have to pay the costs of bank resolution. However, if these powers are to remain in the final compromise then we would support the strong constraints in the Council text stipulating that all unsecured and non-preferred non-deposit liabilities have to be written-down or converted first. Without appropriate constraints, resolution authorities will enjoy broad discretion that could lead to ambiguity, an unlevel playing field and reduced market discipline.

Use of resolution funds: We continue to question the rationale of the proposed resolution fund and fear it will risk moral hazard. The EP text in Article 92 provides for Resolution Funds to be deployed in connection with the use of the resolution tools only if shareholders and, "where appropriate," creditors have borne losses. The Council text introduces a loss imposition threshold of 8% of Own Funds plus Eligible Liabilities before losses can be absorbed by the resolution fund[3], and then only up to a further 5%. A fixed rule similar to the Council's proposal

[1] Trends, Risks and Vulnerabilities, ESMA, September 2013
[2] "[ ] it is important that authorities communicate their possible approaches to resolving cross-border banks [ ] to help inform market expectations." FSB Guidance on Developing Effective Resolution Strategies.
[3] There is also a provision restricting the contribution of the fund to 5% of Total Assets of the institution in resolution.

provides greater clarity, and reduces the moral hazard risk of resolution funds being used to mutualise solvency risk among survivor banks

Choice of resolution tools: both co-legislators have spent significant time refining the scope and operation of the new bail-in powers. However, we would welcome greater predictability on the choice of the most suitable resolution tool for a specific bank. This could be reflected in a Presumptive Resolution Path (see Principle 2 below).

Promoting Cross-border resolution: for cross-border banks, effective cooperation between Home and Host resolution authorities is critical. It is important that recovery and resolution frameworks reflect the diversity of business and funding structures in international financial groups, notably the two stylised models for resolution that have been recognised by regulators at the international level: the Single Point of Entry (SPE) model, where capital, liquidity and funding are managed centrally within a banking group, requiring a "top down" approach to bail-in, and the Multiple Point of Entry (MPE) model, where separately capitalised and funded subsidiaries operate under common corporate strategy, branding and ownership but are resolved locally. Uncoordinated local host resolution actions (e.g. ring-fencing of capital or liquidity, or uncoordinated bail-in) will undermine the group as a whole. Stringent rules to minimise unnecessary uncoordinated actions, as outlined in the Council text Article 83a (4), are welcome.

The FSB's recent guidance on Developing Effective Resolution Strategies requires institution-specific Cooperation Agreements, but this does not seem to be included in the BRRD, at least not beyond the EU.

Furthermore, the FSB's September report, *Progress and Next Steps Toward Ending "Too-Big-To-Fail",* underlines the necessity to remove obstacles to cross-border resolution through legislative initiatives. We see an opportunity for the BRRD to address some of these obstacles, for example by empowering authorities to avoid the early termination of financial contracts in a resolution setting across jurisdictions. We therefore would hope that Article 85 (4d) of the Council text will be retained in the final BRRD.

Valuations for bail-in: we note the role for the EBA to develop technical standards for valuation. In doing so, we recommend care is taken to ensure that the standards are seen as both credible and practical. The bail-in process will be characterised by a number of different valuation exercises undertaken at different times, for different purposes and to different levels of materiality. Therefore the standards governing these will need to take account of the objectives and constraints of each different valuation exercise. While a number of these valuations may necessarily and appropriately be undertaken on a basis that is not compliant with IFRS, the ability to rationalise formal valuations back to an IFRS recognition basis will be important. We recommend the EBA give careful consideration to this and consult with the industry and appropriate accounting experts before finalising any rules.

Principle 2: Developing Presumptive Resolution Paths (PRPs)

A balance needs to be struck between giving investors more certainty and, ensuring that resolution authorities retain a degree of flexibility to address unforeseen events and prevailing market conditions. We think that additional disclosure can be provided by both banks and resolution authorities to set out the most plausible resolution strategy, without making any irrevocable commitments and without compromising a degree of flexibility for the resolution authorities. More predictability should lead to better market discipline and, by directly linking resolution plan preparations with the policy objective, it would also help to ensure that regulators' efforts to maximise resolvability in the pre-resolution phase are both targeted and proportional.

The development and disclosure of Presumptive Resolution Paths tailored to specific institutions and specific legal regimes would meet the objective of giving the market information which would enable investors to better value bank funding instruments (without having to price to worst case) and bring more clarity to counterparties. Such PRPs would result in better pricing and increased market discipline, both contributing to improved financial stability.

Some Principles for the development of Presumptive Resolution Paths could include:

a. Purpose: provide market participants with the presumed baseline resolution strategy of a particular bank with the objective of:

i. increasing market stability through a concrete demonstration of resolvability;

ii. providing the clarity necessary on bank resolution mechanics to enable bank investors to make risk-aware decisions and price bank funding instruments accurately;

iii. facilitating the removal of obstacles to resolvability by narrowing down presumed resolution strategies; and

iv. improving the market's ability to exert influence on a bank in pre-resolution.

b. Bank / resolution authority cooperation: development of the PRP path should be based on close and iterative dialogue between the bank and the relevant authorities, and between those relevant authorities themselves.

c. Ownership by Home Resolution Authorities: for the PRP to have maximum credibility it would need to be owned by the group home resolution authority and approved by the crisis management college.

d. **Content**: subject to resolution of the issues on disclosure and liability outlined above, the PRP should contain information on the triggers for resolution, and the baseline strategy the resolution authority would seek to execute. That strategy should include the likely resolution tools to be employed and the mechanics of execution (including legal certainty), including details of third country agreements or arrangements, and how public liquidity support would be provided, if necessary. The Presumptive Resolution Path may include more than one baseline resolution strategy, but the emphasis should be on a small number of most likely paths.

FSB Guidance

The above principles are consistent with the recent FSB paper entitled "*Guidance on Developing Effective Resolution Strategies*" [4], which stated that

"*a description of the resolution tools available and of how the tools work, or the disclosure of a preferred resolution strategy will increase predictability for the market."*

However the FSB paper recognised that resolution authorities need to retain some flexibility, and did not go as far as to make disclosure mandatory:

> *"Authorities should not, however, give or appear to give complete or irrevocable commitments to implement any particular preferred resolution strategy. To do so could limit the flexibility that is necessary for authorities to act, in line with their statutory responsibilities and functions, in a manner that is most likely to maintain financial stability in the prevailing market and economic circumstances at the point of failure of the firm.*

EBA Guidelines

The evolving debate on Single or Multiple Point of Entry bail-in, combined with the near-finalisation of the EU's BRRD has already led to parts of the market inferring potential resolution strategies for each type of bank. Furthermore, for large US and large Swiss banks and for UK banks, the resolution authorities' preferred resolution strategies are becoming clearer. To avoid the market inferring a multitude of potentially confusing resolution paths, this issue requires attention. The BRRD should address it by providing the EBA with a role to develop guidelines, in light of international developments, concerning the communication by resolution authorities of the presumed resolution strategy to the market. In many instances significant structural, operational and legal changes may have to be implemented to redesign legal entity structures to fit the chosen resolution strategies, and meet the pre-conditions laid out by the FSB in its recent guidance. This underlines the need for a sensible phase-in for market communication, but also emphasises its importance.

Conclusions

The BRRD introduces a much improved resolution toolkit, and is long overdue. However, the effective introduction of this enhanced toolkit requires more transparency and predictability. A resolvable banking system requires large amounts of cost-effective Loss Absorbing Capacity, and funding will only be available if endgames are clear, predictable and efficient. If designed appropriately, the BRRD will not only reduce the frequency and impact of disorderly bank failure, but will also ensure banks preserve their ability to secure market funding at reasonable cost so as to continue to play their role in support of economic growth and job creation.

[4] Section 4, Disclosure of the resolution strategy, in Guidance on Developing Effective Resolution Strategies, July 2013