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EPFSF Briefing

"The Framework for the Recovery and Resolution of Financial Institutions: an effective means for ensuring financial markets stability?"

Introduction

The failure of a financial institution without an effective resolution regime can create considerable instability in the financial markets. Establishing an effective framework for the recovery and resolution of financial institutions is therefore an important foundation for stable financial markets. Failing financial institutions must be dealt with in an orderly way which minimises systemic risk and allocates losses appropriately without resort to the taxpayer. The elimination of moral hazard should also enable financial markets to work more efficiently, appropriately price risk and reduce instability arising out of the failure of a financial institution.

The Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions[1] ("Key Attributes") sought to provide a framework for achieving these aims and the proposed directive on bank recovery and resolution ("BRR") seeks to establish such a framework for banks in the EU. Recovery and resolution of Financial Market Infrastructures (FMIs) and non-bank financial institutions are to be covered by a separate initiative. However, it is important to recognise that a resolution framework is just one element of a programme of measures currently under discussion or in the process of being implemented which are required to promote stable financial markets. Increasing the quality and amount of capital institutions hold and improving supervision are also essential elements although additional capital requirements should be adequately calibrated in recognition of a G-SIFI's progress towards being "resolvable" in the eyes of its regulators. Legal certainty, consistency and predictability are also all important building blocks of financial stability. SIFIs are already progressing in the implementation of their resolvability, and the FSB emphasises the importance of firm-specific cooperation agreements between regulators to help provide this.

The EPFSF briefing paper in September 2012 summarised the BRR directive in detail. To review, the BRR framework provides for the following:

- the designation of resolution authorities in all Member States equipped with appropriate resolution tools (including bail-in whereby debt is converted to equity or written down),
- the preparation and regular assessment of recovery and resolution plans,
- Intervention by the authorities to arrest deterioration,
- Coordination by colleges of resolution authorities for cross-border institutions,
- A principle for allocating losses to shareholders and creditors in accordance with a hierarchy of claims,
- A DGS contribution to the absorption of losses equivalent to the cost that it would have borne in normal insolvency, ranking pari passu with unsecured non-preferred creditors, and
- The establishment of resolution funds to provide temporary support to resolution if necessary (for example to help capitalise a bridge bank or provide a short-term guarantee). The funds would be pre-financed by the industry over time to reach a level of 1% of covered deposits. DGS funds may be used for resolution purposes.

[1] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

Significant progress has been made on these issues. This paper discusses some current issues including the role of the DGS and resolution financing in fostering stability.

How the BRR directive relates to the DGS directive

Resolution is inextricably linked with deposit insurance due to its role in preventing bank runs and its ability to reimburse depositors for losses.
In the recent crisis, as authorities generally lacked power to take resolution actions, DGSs were generally not used out of fear that liquidation would lead to collapse of the financial system and the inability to use the DGS for non-"paybox" functions.[2] Bank runs in the UK and elsewhere led Bank of England Deputy Governor Paul Tucker to note that "the UK has not been alone in learning the hard way that it is not enough simply to have a deposit insurance system. Retail depositors will run from a troubled bank if they are not confident." The general public needs to know about the deposit insurance system, understand it and be able to rely on it, Tucker said.[3]

Arguably, a DGS also needs to be *used* in order to prevent bank runs. Notably, the US has not had a bank run since its introduction of deposit insurance during the Great Depression, nor has any insured depositor ever experienced losses since then. This is in part due to the routine nature with which they close failed banks, in good times and bad.[4]

Several jurisdictions have reacted to the crisis by permitting more flexible use of the DGS in resolution. For example in the UK changes were made to enable more flexible use of the DGS, which was used to fund the transfer of deposits from Bradford & Bingley. In the US, the FDIC has very broad powers to use its deposit insurance fund (DIF) - basically for any purpose provided it is the least cost alternative to the DIF and it does not benefit any insiders of the failed bank. The DIF sits senior in the creditor hierarchy and is pre-funded.

Recognising the limitations of DGSs, in 2010 the Commission presented a proposal to recast the DGS Directive but the negotiations in the Council and Parliament exposed the difficulty of finalising the DGS directive until a fully fledged resolution framework is in place. As proposed by the Commission, the 2010 DGS proposal would:

- require pre-funding with a target level of at least 1.5% of eligible deposits to be reached over 10 years with risk based contributions, and
- allow for the partial use of DGS funds for financing the transfer of deposits to another institution or avoiding a bank failure in early intervention, subject to certain financial limits.

DGS uses and depositor preference

The draft BRR now broadens the circumstances in which a DGS may be used, so it is used to contribute to the absorption of losses when exercising any resolution power, up to the amount that it would have borne in normal insolvency. The BRR proposal ranks the DGS pari passu with other senior unsecured creditors.

[2] The original 1994 DGS Directive focused mainly on liquidation: insured depositors were reimbursed by the State only if deposits became "unavailable." Upon payment, the DGS would have a right of subrogation to recover the amount it paid out, vis a vis other creditors, from the liquidated estate (the "paybox" function). The directive was flexible in how DGSs were financed and operated, for example, allowing a paybox function alone or broader powers to pay a healthy bank to assume the deposit liabilities of a failing bank via a transfer power. Where DGSs sit in the creditor hierarchy - pari passu or senior - to other senior unsecured creditors, also was at the Member State's discretion, as well as whether the DGS is pre-funded or post-funded.

[3] "The Role of Deposit Insurance in Building a Safer Financial System," Speech given by Paul Tucker, Deputy Governor Financial Stability, Member of the Monetary Policy Committee and Member of the Financial Policy Committee at the International Association of Deposit Insurers Annual Conference, London, 25 October 2012.

[4] During the 1980's and early 1990's S&L crisis, the FDIC closed a bank every other day, on average, over a 15 year period. More recently, in 2012, closures occurred on a weekly basis.

Some MEP amendments have proposed making the DGSs senior. So-called depositor preference has certain advantages and disadvantages. It already exists in certain Member States, like Portugal, and is being considered in the UK. Depositor preference could have a significant impact on institutions' cost of funding as senior debt would bear losses fully before depositors.[5] It also means that the amount in a DGS could go farther before depleting the fund: it will take greater losses to be incurred before insured deposits are impacted because the DGS will have a higher priority. On the other hand, if the DGS ranking "super senior" protects it from being bailed-in this would restrict the amount of available "bailinable debt" and put a greater strain on banks' financing, especially for deposit-funded banks.

Resolution financing

The BRR establishes a pre-funded fund with broad purposes of financing resolution in addition to the DGS. This "resolution fund" would provide temporary support to resolution if necessary, for example to capitalise a bridge bank or provide a short-term guarantee. Each Member State's resolution fund would be pre-financed by the industry over time to reach a level of 1% of covered deposits, although scope is provided for the use of DGS funds for resolution purposes. Whether resolution financing arrangements are required and if so whether they should be funded ex ante or ex post remains an area of debate.

There is also debate as to whether the purpose of resolution financing under the RRD should extend to recapitalisation and loss absorption, or be solely to provide temporary liquidity. However, a broad resolution fund which could be used for loss absorption could increase moral hazard and undermine the message behind the BRR of shareholders and creditors bearing losses. Any proposal for a resolution fund must be clear on what purposes the resolution fund can be used for.

Triggers for resolution

The Rapporteur has suggested amendments to remove reference to liquidity as a trigger for resolution.

The exclusion of the liquidity trigger for resolution was intended to ensure that resolution is not triggered too early. However, the removal of the liquidity trigger could delay the use of resolution tools, making it more difficult and costly to deal with a failing institution whilst maintaining stability. The impact of the BRR on investors and the need to preserve predictability for the markets is also an important consideration. The provisions on the triggering of a resolution tool, the bank securities affected and the rights of investors need to be clear and allow for sufficient predictability so as to enable market stability and safe investment choices, whilst retaining sufficient flexibility to make them effective.

Government stabilisation powers

The Rapporteur has also suggested the inclusion of government stabilisation powers such as state guarantees, capitalisation and temporary public ownership. These are intended to provide a common EU framework for authorities to intervene using public funds where required to address a systemic crisis. The amendments of some other MEPs suggest some acceptance that in certain circumstances publicly-funded intervention might still be required to address a systemic crisis. However, the counter-argument is that inclusion in the BRR of publicly-funded stabilisation powers could undermine the message to the markets that institutions will not be bailed out and thereby create moral hazard. The Rapporteur has sought to reduce this by making the stabilisation powers a last resort tool, but the question remains as to whether it is necessary or appropriate to provide for them in the BRR.

[5] Note for purposes of this discussion "depositors" means insured depositors (and effectively the DGS which stands in subrogation). Uninsured depositors remain pari passu with other senior creditors.

Cross-border cooperation

Whilst the BRR is a welcome step towards developing a coordinated response to the recovery and resolution of institutions across the EU, financial markets and the largest financial institutions operate globally. Cross-border cooperation is therefore needed across other jurisdictions for the recovery and resolution regime to have credibility. This requires ex ante agreement as to the application of the resolution regime across jurisdictions in a manner which market participants can trust. The Key Attributes provides a valuable international framework and the recent joint paper between the Bank of England and the FDIC on approaches to resolution is a welcome example of cross-border cooperation between authorities, which takes a group-level approach to resolution. Further work is however required to implement a global recovery and resolution framework to encourage stability across global financial markets. Achieving credible cross-border resolution is one of the most significant challenges to financial stability.

Conclusion

The FSB Key Attributes and the BRR provide an important step towards creating a framework for the recovery and resolution of financial institutions. This framework is a significant step forward and provides an important part of the measures aimed at ensuring financial market stability. The issues currently being debated in the context of the BRR will play an important part in its effectiveness at achieving its aims.

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EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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