

Recovery and Resolution

First experience, challenges and obstacles

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- Efforts to end „too big to fail“
- Enhance financial stability, reduce moral hazard, protect depositors
- Ensure continuity of critical functions post resolution
- Allocate losses to firm owners (shareholders) and unsecured and uninsured creditors
- Avoid exposing taxpayer funds to risk
- Promote home-host cooperation (to avoid ring-fencing)
- Enhance market discipline
- Transparency about creditor hierarchy
- Avoid contagion within the banking system

Financial Stability Board (FSB):

- „Key Attributes of Effective Resolution Regimes for Financial Institutions“, 2011

European Union:

- BRRD („Bank Recovery and Resolution Directive“), 2014
- SRM (Single Resolution Mechanism), 2014

European Banking Authority (EBA):

- ca. 40 RTS / BTS on recovery and resolution - planning

Germany:

- Restructuring Act, 2011; Separation & RRP Act, 2013
- BRRD implementation through the Act on Recovery and Resolution of Credit Institutions (SAG) 2015; Draft Law for SRM implementation, 2015

BaFin:

- Draft Circular on recovery planning (MaSan), 2012
- Final Circular on recovery planning (MaSan), 2014

Experience, Challenges and Obstacles

Part 1: Assessing recovery plans

Part 2: Resolution planning

Experience in assessing recovery plans

BaFin Restructuring Group



Policy

Recovery Planning

Resolution Planning

Early Intervention

Separation Act

G-SII/O-SII Regulation

International Standards

Cross Sector/Benchmarking

Experience in assessing recovery plans

Regulatory Framework – History



BaFin and Deutsche Bundesbank

- Request for recovery plans from systemically important banks and subsidiaries of G-SIB which are PSI in Germany on the basis of Draft Circular on recovery planning (MaSan) in 2012
 - Workshops with systemically relevant banks
 - Consultation
 - Review process of recovery plans initiated early ahead of BRRD
 - Final publication 2014
- Implementation of regulatory requirements for recovery and resolution planning in advance of BRRD (Separation & RRP Act 2013)
- BaFin/Deutsche Bundesbank contributed to EBA's work on the BTS and SSH Module
- Implementation of BRRD through the Act on Recovery and Resolution of Credit Institutions (SAG) 2015

Experience in assessing recovery plans

Regulatory Framework – SAG/MaSan



- **SAG** closely implemented BRRD

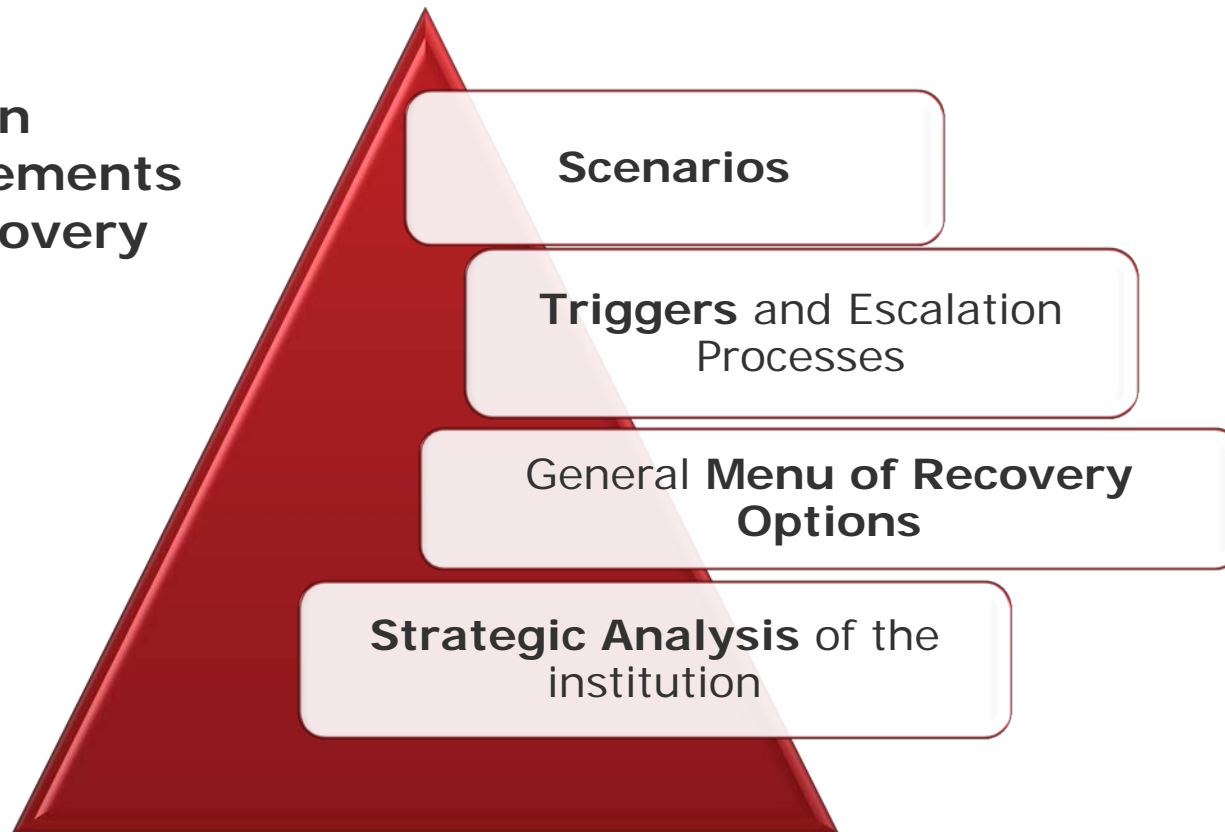
Deviations:

- 6 months submission period may be extended on request
 - Recovery plan for German subsidiary of foreign group must include its domestic and foreign subsidiaries
 - German Banking Act requires auditor review of recovery plan
- **MaSan** largely consistent with EBA Standards and BRRD
 - Even stricter (6 versus 4 scenarios)
 - Little need for adjustment of MaSan or recovery plans

Experience in assessing recovery plans

MaSan – Recovery Plan Structure

German requirements for recovery plans:



Regulatory Framework

MaSan – Interplay within the SSM

- MaSan ceased to be applicable to SSM Banks
- Regulation applicable to SSM Banks:
 - SAG
 - EBA Technical Standard on Content of Recovery Plans
 - EBA Guidelines on the range of scenarios to be used in recovery plans (Implementation by ECB)
 - EBA Guidelines on Recovery Plans indicators (Implementation by ECB)
- **MaSanVO “under construction”, aims at combining the new regulatory standards**

- Strategic Analysis
- Recovery Options
- Triggers: Recovery indicators and thresholds
- Stress Test Scenarios
- Governance and communication
- Cross comparison and benchmarking

Experience in assessing recovery plans

Strategic Analysis

Requirements

Article 6 para 1 - 3 EBA RTS on the Contents of Recovery Plans:

- Description of the entity (including business and risk strategy, critical functions and core business lines)
- Mapping of core business lines and critical functions
- Detailed description of internal and external interconnectedness
- Starting point of the „red thread“

Positive

- (Most) formal requirements were met
- Most recovery plans aim at providing a full picture of the bank

Deficiencies

- Missing data (esp. for subsidiaries or branches abroad)
- Considerations (e.g. on business model, risk profile or markets) not sufficiently focussed
- Incomplete derivation of findings (e.g. identification of core business lines or critical functions)
- Data on internal / external interconnectedness often incomplete

Experience in assessing recovery plans

Recovery Options

Requirements

- Article 6 (4) and (5) of the EBA RTS on the Contents of Recovery Plans:
- range of recovery options expected to contribute to maintaining or restoring the entity's financial position
- impact and feasibility analysis
- „normal“ and extraordinary measures

Positive

- Banks (critically) question their options in a crisis scenario
- Focus on capital, liquidity and risk

Deficiencies

- Tendency to include (too) many options, even if not relevant / applicable
- Description of options: (too) superficial
- Alleged option effects: not deductible / questionable
- Implementation obstacles: not identified or too imprecise
- Sustainability: questionable

Experience in assessing recovery plans

Indicators and Thresholds

New Requirements

- Article 5 (d) of the EBA RTS on the Content of Recovery Plans
- EBA Guidelines provide for a minimum list of qualitative and quantitative recovery plan indicators
- all institutions must have capital, liquidity, profitability and asset quality indicators
- rebuttable presumption that market based and macro-economic indicators are required
- rebuttable presumption that all indicators on minimum list are required (see next slide)

Experience in assessing recovery plans

Indicators and Thresholds

1. **Capital indicators**
 - a) Common Equity Tier 1 ratio
 - b) Total Capital ratio
 - c) Leverage ratio
 2. **Liquidity indicators**
 - a) Liquidity Coverage Ratio
 - b) Net Stable Funding Ratio
 - c) Cost of wholesale funding
 3. **Profitability indicators**
 - a) (Return on Assets) or (Return on Equity)
 - b) Significant operational losses
 4. **Asset quality indicators**
 - a) Growth rate of gross impaired and past due loans
 - b) Coverage ratio [Provisions / (Total gross impaired and past due loans)]
 - c) Restructured loans / Total loans
- Indicators in categories 5 and 6 to be included in the list unless an institution justifies that market based and macroeconomic categories of indicators are not relevant for it
5. **Market based indicators**
 - a) Rating under negative review or rating downgrade
 - b) CDS spread
 - c) Stock price variation
 6. **Macroeconomic indicators**
 - a) GDP variations
 - b) CDS of sovereigns

Experience in assessing recovery plans

Indicators and Thresholds

Previous Requirements

- MaSan E. 3.3.2
- Indicators must enable the bank to initiate recovery options in time to ensure / restore financial solidity
- Quantitative/qualitative indicators with appropriate thresholds, covering in particular capital, risk taking capacity, liquidity, profits, risk profile and exogenous events
- Escalation- and information processes ensuring management and supervisory attention

Positive

- Frequent application of capital, liquidity and risk capacity indicators

Deficiencies

- Insufficient/unspecific choice of indicators
- Lack of relevance for the banks' specifics
- Only few qualitative/forward-looking indicators
- Mixture of early warning indicators and recovery indicators
- Lack of attention to (missing) recovery options when calibrating indicators
- Focus on regulatory minimum requirements

Experience in assessing recovery plans

Scenarios

Requirements

- Article 6 (5) (f) of the EBA RTS on the Content of Recovery Plans
- EBA Guidelines on the range of scenarios to be used in recovery plans
- Categories: idiosyncratic, systemic, combined; slow and fast-moving events
- Pre-defined events for idiosyncratic and systemic events
- Must reach “near default” level
- at least 4 scenarios for G-SIIs and O-SIIs

Identified Deficiencies

- Scenarios did not reflect main risk drivers/specifics
- Intransparent parameterization
- Early warning indicators used as starting point for recovery options
- Limited choice of options in a scenario
- Insufficient assessment of impact on business activities and business model
- Assumptions too optimistic

Experience in assessing recovery plans

Governance and Communication

Requirements

Article 5 and 7 of the EBA RTS on the Contents of Recovery Plans

- Responsibilities for the recovery plan
- Integration in the corporate governance and risk management framework
- Escalation and decision making processes required for the implementation of recovery options
- Management information systems
- Communication and disclosure plan (for internal and external communication and proposals for managing market reactions in a recovery situation)

Deficiencies

- Unclear escalation processes
- Unclear decision making processes
- Unclear responsibilities
- Insufficient description of information flow
- Communication planning not sufficiently detailed

Experience in assessing recovery plans

Cross Comparison and Benchmarking



- BaFin and Deutsche Bundesbank have started working on cross comparison/benchmarking of recovery plans.
- First cross comparison exercise for German banks with regard to the recovery plans for 2013, cross comparison for 2014's recovery plans is currently under way.
- Focus on quantitative data (indicators and recovery options)
- **First findings:**
 - Only approx. 50% of the recovery options contained in the plans are tested in the scenarios.
 - On average banks make use of (only) five indicators.
 - Banks focus on capital (with a strong reference to regulatory capital ratios), liquidity and risk. Income or qualitative indicators are much less significant.
 - Quantitative data provided in the recovery plans is not necessarily useable for cross-comparison (e.g. with regard to the indicators where the banks often use specific key figures deriving from their risk management) and would require restructuring.

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Part 1: Experience in assessing recovery plans

Part 2: Experience in resolution planning

Experience in resolution planning

Implementation of the BRRD

New Resolution Tools

- Bail-In, Sale of Business, Asset Separation
- Bridge Bank Tool already available since 2011

Recovery Planning

- BRRD: mandatory for **all** credit institutions
- Recovery Planning since 2012, but only for systemically relevant credit institutions

Separate Resolution Authority

- FMSA (Financial Markets Stabilisation Agency)
- BRRD requires structural separation of supervisory and resolution tasks to avoid supervisory forbearance.

Experience in resolution planning

Challenges and obstacles

- Sufficient loss absorbing and recapitalization capacity
- Complexity of the organisational structure
- Ensuring essential/critical services
- Liquidity needs, funding mechanism
- Document management / IT infrastructure

Experience in resolution planning

Challenges and obstacles



- Coordinated cross-border resolution
- Information sharing
- Close out netting, default, change of control, rights of termination...
- Ring-fencing and liquidity triggers
- Burden sharing

Experience in resolution planning

Challenges and obstacles

- Diverging insolvency laws / legal frameworks
- Outside EU national resolution powers are not fully aligned, thus there is uncertainty with respect to:
 - Recognition of legal acts in other jurisdictions
 - Enforcement of temporary resolution stays or close-out rights
 - Effects of resolution measures on foreign branches and foreign assets
 - Bail-in debt

Experience in resolution planning

Challenges and obstacles

Significant improvements are made in increasing resolvability e.g.:

- MREL
- TLAC
- ISDA Protocol

Experience in resolution planning

Objectives of MREL and TLAC



Sufficient loss absorbing and recapitalization capacity to implement orderly resolution

- Ensure continuity of critical functions post resolution
- Avoid exposing taxpayer funds to risk
- Promote home-host cooperation (avoid ring-fencing)
- Enhance market discipline
- Provide clarity about order in which investors/ creditors will absorb losses in resolution
- Avoid contagion within the banking system

Experience in resolution planning

MREL



- BRRD: Institutions are required to meet a minimum requirement for own funds and eligible liabilities (MREL):

Own Funds + Eligible Liabilities

Own Funds + Total Liabilities (derivatives after netting)

- EBA RTS on MREL: further specify BRRD assessment criteria
- MREL requirement shall apply from January 1, 2016 (Germany: January 1, 2015)

Experience in resolution planning

Criteria for setting MREL



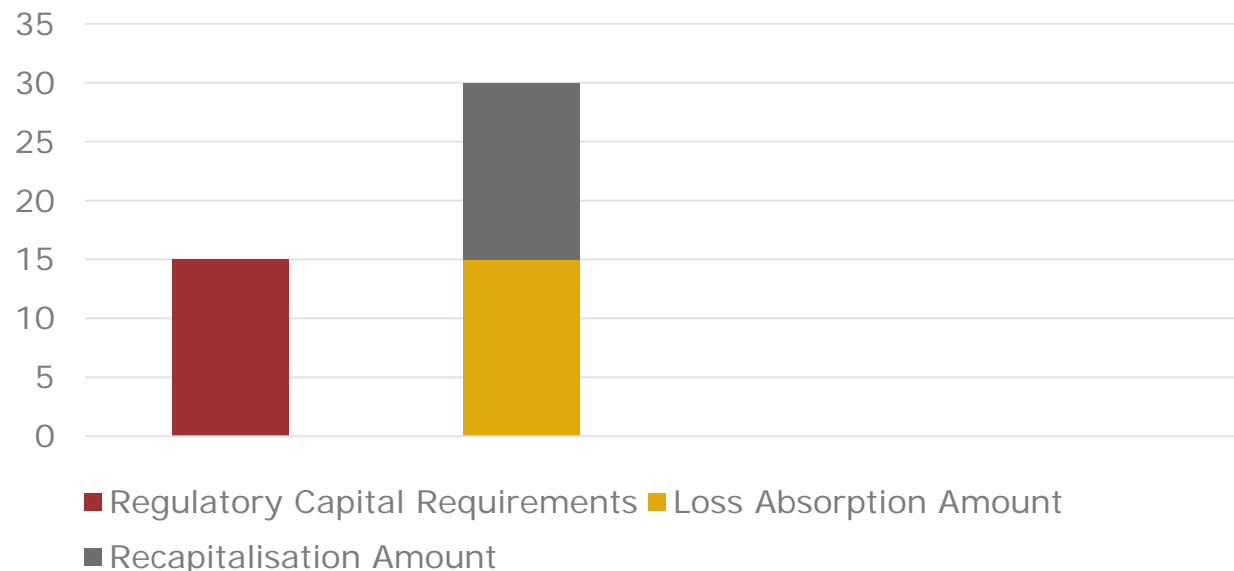
- Need to ensure resolvability of the institution
- Need to ensure **loss absorbtion** and **recapitalisation** of institution after resolution to meet conditions for authorisation and sustain sufficient market confidence
- Possible exemptions from bail-in
- Size, business model, funding model and risk profile of institution
- DGS contributions
- Extent of possible adverse effects of failure of institution on financial stability

Experience in resolution planning

Calibration MREL

MREL = Loss absorption amount plus recapitalisation amount

- Default loss absorption amount: CRR/CRD own funds plus combined buffer requirement
- Recapitalisation amount: meet conditions for authorisation and restore market confidence after resolution



Experience in resolution planning

MREL - open questions

- **What happens in case of breach of MREL?**
 - BRRD is silent on this
 - TLAC: Breach of TLAC should be treated as severely as breach of regulatory capital requirements
- **Relationship MREL and combined buffer requirement**
 - BRRD allows MREL and combined buffer requirement to be met by the same CET 1 capital
 - Concern: regulatory capital buffers should be usable to absorb going concern losses, but MREL should not be breached
 - TLAC: Problem does not exist: only CET 1 capital in excess of capital requirements and TLAC can count towards combined buffer requirement
 - Therefore: buffers are depleted first before TLAC is breached
 - Changes to BRRD should be made to address this issue

Experience in resolution planning

TLAC - Background



- FSB/G20 efforts to end “too big to fail”
- Proposals called for at the St. Petersburg Summit in 2013 and consisting of
 - A set of principles on loss-absorbing and recapitalisation capacity of G-SIBs in resolution
 - A term sheet for implementing these principles in the form of an internationally agreed standard
- Published for consultation in November 2014
- To be finalised by the time of the 2015 G20 Summit in Antalya

Experience in resolution planning

TLAC - Principles



- FSB TLAC proposal to ensure that sufficient private sector instruments are available to absorb losses and recapitalize an institution at the point of resolution
- A minimum TLAC requirement for each G-SIB is that TLAC
 - Conforms to a minimum Pillar 1 floor agreed by the FSB
 - Is based on appropriately prudent assumptions
 - Suffices to ensure continuity of critical functions and provide confidence to host authorities

Experience in resolution planning

TLAC - Principles



- TLAC-eligible instruments
 - Can be exposed to loss in resolution without giving rise to systemic risk or disruption to the provision of critical functions
 - Are stable long-term claims that cannot be called at short or at no notice
- Interaction with regulatory capital requirements
- Transparency
- Restrictions on holdings
- Review in the FSB resolvability Assessment Process (RAP)

Experience in resolution planning

TLAC - Calibration

- Proposed calibration:
 - Minimum Pillar 1 TLAC range of 16 – 20% of RWAs, or minimum twice the Basel III leverage ratio requirement (higher of the two)
 - Possibility to require a TLAC Pillar 2 component (firm-specific minimum)
- In addition to this, firms have to satisfy additional existing buffer requirements of at least 3.5% - 5% of RWAs
- **As a rule of thumb**, this means that if losses have eroded all of a firm's Basel requirements it can be recapitalized to meet minimum requirements for authorization (plus a margin to promote market confidence). This allows for an orderly restructuring or wind-down
- The exact calibration will be finalised after the impact assessment

Experience in resolution planning

TLAC – Eligible Instruments



- Are issued by resolution entities and held by third parties
- Can be effectively written down or converted in resolution by the competent resolution authority with legal certainty
- Are available at point of entry in resolution - minimum residual maturity of 1 year
- Are not operational liabilities necessary for the performance of critical functions
- Absorb loss in resolution before other liabilities that are not/less loss absorbing (**subordination → exemptions**)

Experience in resolution planning

TLAC – Non Eligible Instruments



- Insured deposits
- Liabilities that are callable on demand without supervisory approval
- Liabilities that are funded directly by the issuer or a related party (unless agreed differently between home and host within the CMG)
- Derivatives or debt with embedded derivatives, such as structured notes
- Liabilities that do not derive from a contract, e.g. tax liabilities
- Any other liability that, under the laws governing the issuing entity, cannot effectively bear losses

Experience in resolution planning

TLAC – Structural Subordination



- Groups headed by a non-operational entity (HoldCo) which issues only eligible liabilities
- In US / UK HoldCo structure is predominant - whereas most banking groups in continental Europe are headed by Operating companies (OpCo)
- High costs associated with structural changes, e.g:
 - Operational costs (complex legal transaction)
 - Tax costs
 - Legal risks regarding approval of shareholders / high cost to pay them out if they refuse

Experience in resolution planning

TLAC – Contractual Subordination



A provision in the terms and conditions of the instruments which defines the subordination level

- This solution does not allow for a quick fix as old senior unsecured debt must be replaced by new issuances
- Does not avoid the higher pricing impact

Possibilities:

- Issuance of securities to the new subordination layer
- Issuance of new Tier 2 instruments

Experience in resolution planning

TLAC – Statutory Subordination



Establishes the subordination of liabilities via changes to legal framework

- Quick fix solution would remove operational burden to achieve subordination of senior unsecured debt
- Subordination of TLAC is a key element for effective resolution
 - Allows liabilities which are most suitable for bail-in to bear losses ahead of others
 - Avoids legal challenges because of violation of pari passu and NCWO principles
 - Creates transparency to creditors

Experience in resolution planning

TLAC – Statutory Subordination

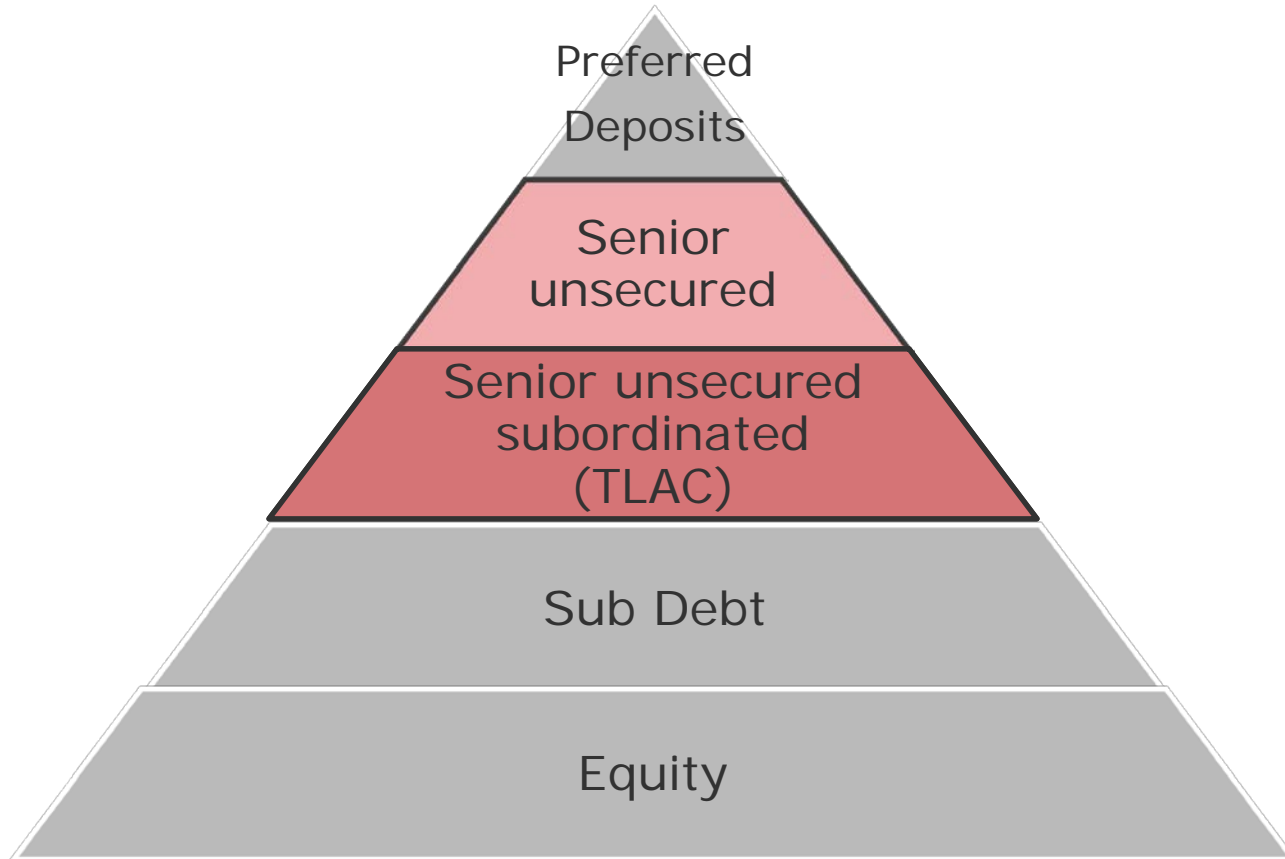


Disadvantages:

- *Retroactivity* – subordination is applied to existing liabilities (possibly raising constitutional issues)
- *Cross-border applicability* to securities issued in third countries
- *Impact on monetary policy operations regarding the eligibility of collateral* (potentially, only a higher haircut would be required as the probability of default remains the same)

Experience in resolution planning

TLAC – Statutory Subordination – German Law



Experience in resolution planning

ISDA Resolution Stay Protocol



- 2014 ISDA Resolution Stay Protocol applies to OTC bilateral derivatives contracts
- Voluntary signed through 18 G-SIBs
- Extension of the protocol through a securities financing transaction annex with re-adherence planned later this year (SFT-Annex)
- SFT-Annex will cover securities lending and repo agreements

Experience in resolution planning

ISDA Resolution Stay Protocol



- Promotion of broad adherence to the protocol by other firms through development of regulatory measures
- Discussion on adherence mechanics to the protocol for buy-side firms
 - General adherence as with G-SIBs or
 - As far as it is required through regulation

- The potential impediments are identified
- Implementing FSB Standards and BRRD to overcome the impediments
- Much is already done, but much is still to do ...

Thank you for your attention.