



Chapter A: The FSB's overall resolution framework

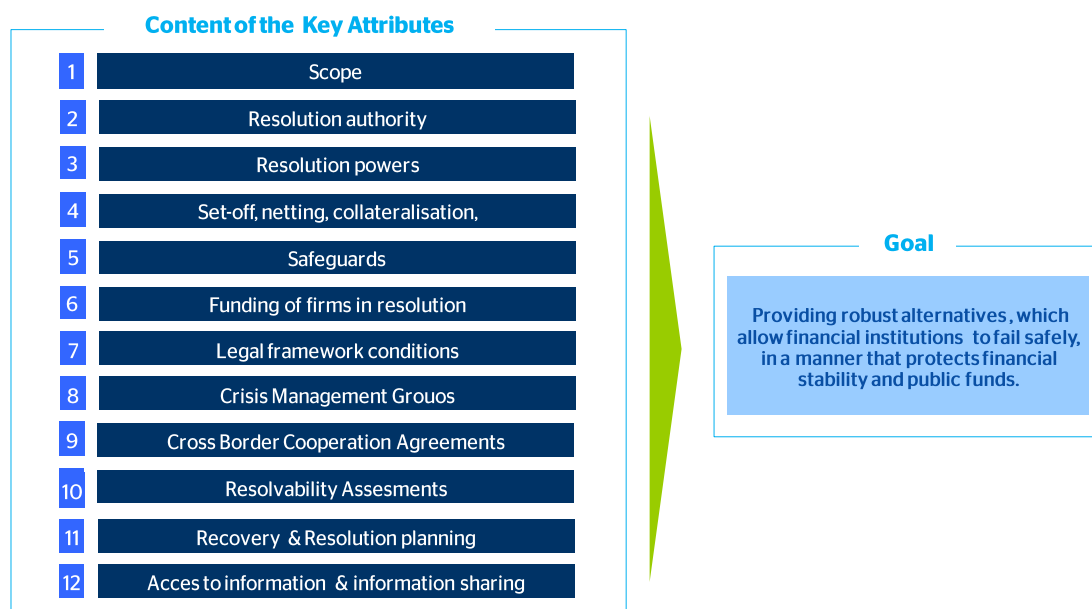
1. Introduction

The Key Attributes of Effective Resolution Regimes for Financial Institutions (the Key Attributes) were endorsed by the G20 leaders at the Cannes Summit in November 2011. This document provides the main guidelines for the basic elements that must be included in any effective resolution framework, namely (i) an experienced resolution authority; (ii) adequate resources and statutory powers; (iii) adequate and varied resolution tools (certainly including bail-in mechanisms); (iv) legal enforcement of cross-border coordination during resolution processes, and (v) mechanisms to ensure that any losses are ultimately borne by shareholders and unsecured creditors.

In this sense, the Key Attributes describe the powers which should be available to designated public authorities in each FSB member jurisdiction to intervene in a swift and decisive manner (over a weekend, theoretically), to bring about the orderly resolution of a bank to safeguard both financial stability and public funds. To secure (close to) uninterrupted provision of critical financial services and minimise the uncertainty which can result in a loss of confidence, the Key Attributes say that it should be possible to carry out resolution without needing to seek the consent of affected parties (see Figure 1).

Figure 1

FSB's key attributes resolution features



Source: BBVA Research



2. Goals of the bank resolution regime

The general goal of any resolution regime is to resolve failing financial institutions quickly, ensuring the stability of the financial system and preserving the main banking operations. In addition, to be effective this resolution regime should:

- ensure continuity of systemically important financial services, payment, clearing and settlement functions;
- protect - where applicable and in coordination with the relevant insurance schemes and arrangements - depositors, insurance policyholders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
- allocate losses to the firm's owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- not rely on public solvency support and not create an expectation that such support will be available;
- avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, the losses for creditors;
- provide for speed and transparency, and as much predictability as possible, through legal and procedural clarity and advanced planning for orderly resolution;
- provide a mandate in law for cooperation, information exchange and coordination, both domestically and with any relevant foreign resolution authorities before and during a resolution;
- ensure that non-viable firms can exit the market in an orderly way; and
- be credible, and thereby enhance market discipline and provide incentives for market-based solutions.

The FSB's Key Attributes develop several minimum requirements in order to achieve these goals and effective resolution regimes for financial institutions that could be systemically significant or critical in the event of failure. The main characteristics of the FSB's Key Attributes are explained in the following section.

3. Key Attributes proposed by the FSB

3.1 Scope of the resolution regimes

The Key Attributes establish that any bank **"which could be systemically significant or critical if it fails"** should be within the scope of an especial resolution regime. It is intended that this standard should be met, as appropriate in each jurisdiction, in relation to banks, securities firms, insurers and financial market infrastructures (both locally incorporated and the branches of foreign firms).

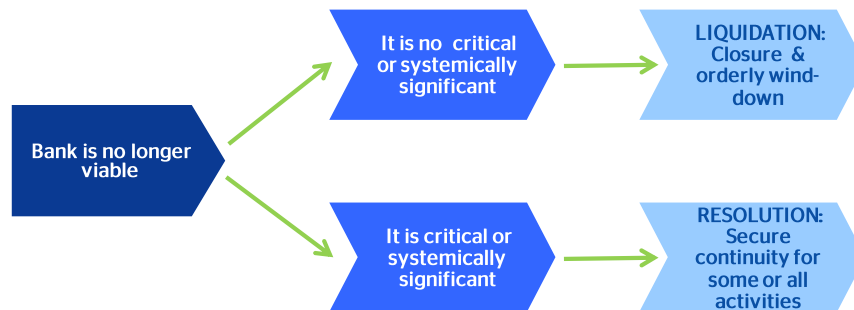
Banks may have a series of structural, financial and operational dependencies on other group entities, such as unregulated holding companies or affiliated operational entities. Recognising this, the Key Attributes say that it should also be possible to deploy resolution powers in relation to these other group entities.

The framework described by the Key Attributes establishes that an assessment would be needed, as a bank nears the point of non-viability, as to whether its failure could be systemically significant or critical, to decide if the bank must be liquidated or resolved as shown in Figure 2.



Figure 2

Decision-tree scheme on liquidation and resolution



Source: BBVA Research

3.2 Resolution Authority

Under each jurisdiction, **one or more public authorities should be designated to act as resolution authorities**. These authorities should be **operationally independent in their role and adequately resourced**. Where there are multiple resolution authorities within a jurisdiction, their respective mandates, roles and responsibilities should be clearly defined and coordinated.

Additionally, the FSB's Key Attributes state that a **lead resolution authority** should co-ordinate the resolution of financial services groups operating across the various sectors of a local financial system.

Moreover, the document says that the resolution authority's actions should have **statutory objectives and functions**, requiring that they:

- pursue financial stability and ensure continuity of systemically important financial services, and payment, clearing and settlement functions;
- protect depositors, insurance policyholders and investors as are covered by such schemes and arrangements;
- avoid unnecessary destruction of value and seek to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives; and
- duly consider the potential impact of its resolution actions on financial stability in other jurisdictions.

3.3 Resolution Powers

The FSB's Key Attributes set a toolkit of resolution options and powers for the designated resolution authorities to enable them to step in and take speedy and decisive action to stabilise and restructure an entire institution's business or, if appropriate, a part thereof.

These tools are the following:

- Remove and replace the senior management
- Appoint an administrator to take control of and manage the affected firm
- Operate and resolve the firm
- Ensure continuity of essential services and functions by requiring other companies in the same group to continue to provide essential services to the entity in resolution



- Override rights of shareholders of the firm in resolution
- Transfer or sell assets and liabilities
- Establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations of a failed firm
- Establish a separate asset management vehicle
- Carry out bail-in within resolution
- Temporarily stay the exercise of early termination rights
- Impose a moratorium with a suspension of payments to unsecured creditors and customers
- Effect the closure and orderly wind-down (liquidation) of the whole or part of a failing firm

These tools could be classified in two groups:

a) Stabilisation options

- Compulsory transfer of entire or some of its business to: i) another financial entity; or ii) a bridge institution.
- **Bail-in:** This is a new tool that enables resolution authorities to:
 - (i) write down - in a manner that respects the hierarchy of claims in liquidation - the equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses;
 - (ii) convert into ordinary equity all debt or other instruments of ownership of the firm under resolution.

b) Dealing with residual parts of institution

- Asset management vehicle.
- Normal liquidation procedure.

3.4 Set off, netting, collateralization, segregation of client assets

The FSB's Key Attributes states that the legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures.

3.5 Safeguards

To ensure an effective and orderly resolution, the Key Attributes establish a mechanism to compensate creditors for any losses that they could suffer over and above those they might have sustained in liquidation. This is called the "Principle of No Creditor Worse off than in Liquidation (NCWL)".

In this sense, resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (pari passu) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to



maximise the value for the benefit of all creditors as a whole. In particular, equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely (whether or not that loss-absorption through write-down is accompanied by conversion to equity).

3.6 Funding of firms in resolution

The FSB 's Key Attributes states that jurisdictions should have in place **privately-financed deposit insurance or resolution funds, and/or a funding mechanism for ex-post recovery** from the industry of the costs of providing temporary financing to facilitate the resolution of the firm. The goal is to avoid bail-outs and protect public funds.

Nevertheless, the Key Attributes recognises that in special circumstances, **subject to strict conditions, the authorities could provide temporary funding:**

- To foster financial stability and to permit the implementation of a resolution option that is best able to achieve the objectives of an orderly resolution, and where private sources of funding have been exhausted or cannot achieve these objectives.
- The allocation of losses to equity holders and residual costs, as appropriate, to unsecured and uninsured creditors and the industry through ex-post assessments, insurance premiums or other mechanisms.

The central bank's role as lender-of-last-resort is critical in most banking crises in order to reduce the risk of unexpected spill-over effects and bank panics. Moreover, banks' resolution normally takes place after liquidity problems, which implies that normally central banks are already heavily involved in the funding of the bank, with collateral not always of the highest quality³. This has important implications in terms of resolution options.

3.7 Legal framework conditions for cross-border cooperation

In order to resolve cross-border entities, it is necessary to have **coordinated and cooperative approaches among different jurisdictions**. For this reason, the Key Attributes set several conditions to support coordination and cooperation.

The first of these conditions is that the *"the statutory mandate of a resolution authority should empower and strongly encourage the authority wherever possible to act to achieve a cooperative solution with foreign resolution authorities"*.⁴

The second is that the resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority or, in exceptional cases, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability.

Finally, jurisdictions should provide for: (i) transparent and expedited processes to give effect to foreign resolution measures, and (ii) confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

Although the FSB is fully aware that cross-border issues are critical, their high-level cooperation principles are very vague.

3: The role of Central Banks in financial crisis is deeply analyzed by B. Bernanke in his book "The Federal Reserve and the Financial Crisis (2013)

4: See FSB Key attribute paragraph 7.1



3.8 Crisis Management Groups (CMGs)

The Key Attributes require that a **Crisis Management Group (CMG) must be established for each Global Systemically Important Financial Institution (G-SIFI)** to facilitate the resolution of the institution.

The CMG allows authorities (home and host) to coordinate and develop the preferred resolution strategy of the financial institution. Moreover, CMGs should keep under active review and report on:

- progress in coordination and information sharing within the CMGs and with host authorities that are not represented on the CMGs;
- the recovery and resolution planning process for G-SIFIs under institution-specific cooperation agreements; and
- the resolvability of G-SIFIs.

3.9 Institution-specific cross-border cooperation agreements

The Key Attributes maintain that **institution-specific agreements, containing the essential elements on how home and host authorities will cooperate, must be signed.**

These agreements, among others, should: establish the objectives and processes for cooperation through CMGs; define the roles and responsibilities of the authorities pre-crisis and during a crisis, and set out the process for information sharing.

3.10 Resolvability assessments

Resolution authorities are required to regularly undertake, at least for G-SIFIs, **“resolvability assessments” that evaluate the feasibility of resolution strategies** and their credibility in light of the likely impact of the firm’s failure on the financial system and the overall economy.

In undertaking resolvability assessments, resolution authorities should in coordination with other relevant authorities assess, in particular:

- the extent to which critical financial services, and payment, clearing and settlement functions can continue to be performed;
- the nature and extent of intra-group exposures and their impact on resolution if they need to be unwound;
- the capacity of the firm to deliver sufficiently detailed accurate and timely information to support resolution; and
- the robustness of cross-border cooperation and information sharing arrangements.

3.11 Recovery and resolution planning (RRP)

The Key Attributes intend that each jurisdiction put in place an ongoing **process for recovery and resolution planning, covering at minimum domestically incorporated firms that could be systemically significant or critical if they fail.**

Firms’ **recovery plans** should include:

- credible options to cope with a range of scenarios including both idiosyncratic and market wide stress;



- scenarios that address capital shortfalls and liquidity pressures; and
- processes to ensure timely implementation of recovery options in a range of stress situations.

Firms' **resolution plans** should include:

- financial and economic functions for which continuity is critical;
- suitable resolution options to preserve those functions or wind them down in an orderly manner;
- data requirements on the firm's business operations, structures, and systemically important functions;
- potential barriers to effective resolution and actions to mitigate those barriers;
- actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated client assets; and
- clear options or principles for the exit from the resolution process.

Both **Recovery and Resolution plans should be updated regularly, at least annually** or when there are material changes to a firm's business or structure, and subject to regular reviews within the firm's CMG. Moreover, if resolution authorities are not satisfied with a firm's RRP, the authorities should require appropriate measures to address the deficiencies.

3.12 Access to information and information sharing

As a well-functioning resolution framework requires the highest level of cooperation and coordination between all the authorities involved in resolving a cross-border banking group, **information sharing to support the resolution is key. The Key Attributes set some requirements in this regard:**

- Jurisdictions should ensure that no legal, regulatory or policy impediments exist that hinder the appropriate exchange of information, including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes.
- Jurisdictions should require firms to **maintain Management Information Systems (MIS)** that are able to produce information on a timely basis, both in normal times, for recovery and resolution planning, and during resolution.



Box 1. Resolution Strategies: MPE & SPE

In July 2013, the FSB guidelines on recovery and resolution planning outlined the main characteristics of the two stylized approaches for resolving global financial institutions: the Multiple Point of Entry (MPE) and Single Point of Entry (SPE). Deciding between an MPE or n SPE resolution strategy depends on each firm's particular characteristics.

Choosing the optimal resolution strategy is not a binary decision

Supervisory and resolution authorities involved in the Crisis Management Group will be responsible for defining the high-level resolution strategy outlining whether the firms should be resolved based on an SPE or MPE scheme. Both schemes are the opposite ends of a spectrum where many resolution options may lie in between. In practice, a combination might be necessary to accommodate the structure of a bank and the local regimes in the key jurisdictions where it operates. Thus, authorities will examine each firm's particular characteristics: i)-business models, ii)-corporate and legal structures, iii)- operational interdependencies, and iv)- capital and liquidity management.

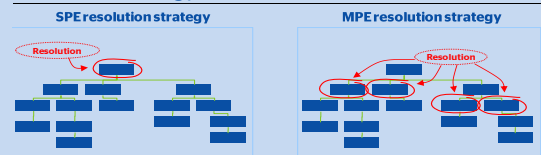
Both SPE and MPE differs in many different aspects

The SPE strategy is characterized by the home resolution authority, which applies resolution powers at the parent company level. After losses have occurred in any part of the group, a sole resolution process is initiated led by a sole home resolution authority. The implementation of the bail-in occurs at the parent level only and, therefore, losses in subsidiaries can be covered only through the holding company (by means of a downstream of new capital). That implies significant interconnections between the parent and subsidiaries, and requiring that Loss Absorption Capacity (LAC) should be located in the holding company.

On the contrary, the MPE strategy involves the application of resolution powers by two or more resolution authorities to different parts of the group, and this is likely to result in a break-up of the group into two or more separate parts preserving essential functions without causing contagion to the rest. Legal, financial and operational independence implies that the LAC is located at each point of entry, each subsidiary is resolved by local authorities and cross-border agreements can be focused on coordination and information exchange.

Figure 3

Resolution strategy alternatives



Source: BBVA Research

Decentralized retail banks meets inherently the MPE's preconditions

The SPE is the best approach for the globally active and highly integrated wholesale institutions with concentrated funding and risk management structures with a systematic reliance on intra-group funding. On the other hand, the MPE is the natural resolution strategy for decentralized retail banks due to the following reasons: i) they are structured by local subsidiaries, ii) their client base is mainly local households and small and medium enterprises. Retail deposits are the main source of funding normally denominated in local currency and protected by the local deposit guarantee scheme, iii) Capital and liquidity are located in host countries with a stand-alone rating. Host subsidiaries manage their capital locally to support their own growth and are financially self-sufficient when needing to resort to the market, and finally, iv) There is no systematic intra-group support, either from the parent to the subsidiary or in the opposite direction. This support is however not excluded under certain circumstances, but always as a voluntary business decision.