Regulation Outlook:
Compendium on resolution strategies: an multiple-point-of-entry view

December 2014
Global Economics, Regulation & Public Affairs

- Guidance on Developing Effective Resolution Strategies: meeting the resolution planning requirements under the FSB Key Attributes.
- Multiple-Point-of-Entry resolution strategy: a natural approach for decentralized retail banking groups.
- Cross-border recognition of resolution strategies: legal aspects.
- Operational subsidiarisation in practice under a multiple point of entry resolution strategy.
- Critical economic functions’ role: a key pillar of the resolution strategy.
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Executive Summary

Achieving an effective resolution regime to resolve banks quickly, avoiding disturbances to the financial system, minimizing the use of public funds —thus protecting taxpayers—, and continuing the critical financial services that they provide is one of the main goals of authorities in the current regulatory reform.

Authorities are developing a new resolution framework that sets out the responsibilities and powers to enable them to resolve efficiently cross-border banks in trouble. In this sense, the FSB outlines two polar resolution approaches for resolving global banks: the Single Point of Entry (SPE) and Multiple Point of Entry (MPE) resolution strategies, although many hybrid options may lie in between.

Banking groups vary significantly in their business models, corporate and legal structures, and their financial and operational interdependencies. For all these reasons, the optimal design of a resolution strategy should take into account the firm’s particular characteristics. The way cross-border banks plan to die should be consistent with the way they lived.

The resolvability assessment and the definition of the optimal resolution strategy given the structure and business model of each bank is the cornerstone in all the process. This Compendium on Resolution Strategies seeks to put in context the current advances made in the resolution strategy framework, focusing on a comprehensive view of the Multiple Point of Entry (MPE). It will facilitate its understanding through the description of its main characteristic and prerequisites, the legal cross border challenges, how to apply the operational subsidiarization, and the role of critical economic functions in a resolution process.

Form the resolution standpoint, the MPE approach is a resolution strategy particularly well suited to the current ring-fenced world. Home and host authorities should understand well the MPE features (their legal independence, their own financial and risk management, the absence of intragroup financial links, etc.) and work together to develop a comprehensive resolution plan clearly delimiting the roles and duties of each authority. Collaboration and coordination among the host and home authorities is vital to develop an effective MPE resolution strategy.

This paper is divided into five chapters that explain how the above referred topics apply to an MPE resolution strategy:

A. Developing effective resolution strategies

The FSB's guidance on developing effective resolution strategies defines two stylised approaches for resolving significant financial institutions: the multiple-point-of-entry (MPE) and single-point-of-entry (SPE) and analyses the pre-conditions for applying them.

- **Single Point of Entry:** A single national resolution authority applies resolution powers at the top, either holding or parent company, level. An SPE strategy operates through the absorption of losses incurred within the group by the ultimate parent or holding company through, for example, a bail-in. Provided that sufficient Loss Absorbing Capacity (LAC) is available at the parent or holding company level, any operating subsidiaries should be able to continue as going-concerns without entering resolution.

- **Multiple Point of Entry:** This involves the application of resolution powers by two or more resolution authorities to different parts of the group, including strategies in which a group is broken up into two or more separate parts. The group could be split on a national or regional basis, or on the business lines, or some combination of both. There is no need for the resolution powers applied to the separate parts to be the same, and they could involve different resolution options.
Deciding between a Multiple Point of Entry (MPE) or Single Point of Entry (SPE) resolution scheme depends on each firm’s particular characteristics. The MPE model is consistent with retail banking, deposit funding and stand-alone entities under the legal form of subsidiaries; and the SPE scheme is more applicable to investment banks relying basically on wholesale funding and intra-group support.

Authorities should regularly undertake resolvability assessments to evaluate the feasibility and credibility of resolution strategies and their operational plans, to identify potential barriers that may hamper the effective implementation of resolution actions. Authorities and firms should ensure that those barriers are removed or materially mitigated in a timely way, but always aligned to each resolution strategy.

B. The Multiple Point of Entry resolution strategy

Cross-border retail business models comply with the MPE strategy when the following preconditions are met: i) they are structured by local subsidiaries, ii) their client base is mainly local households and SME’s, iii) capital and liquidity are located and managed in host countries and are financially self-sufficient, and finally, iv) there is no systematic intra-group support.

The MPE approach has multiple implications in terms of resolution. First, the resolution process will always be led by local authorities (host). Second, the role of the home regulator will be more a “coordination figure”. Third, each subsidiary in the group that may be subject to a separate resolution action should have sufficient loss absorbency capacity individually (TLAC). And forth shared services – IT and back office processes – should be organized on a stand-alone basis facilitating their continuity in case of resolution of any part of the group.

The decentralized model inherent to MPE implies benefits for global financial stability that far offset its costs. Indeed, this resolution strategy entails certain cost in terms of less efficiency in capital and liquidity management, but its benefits in terms of resolvability and contribution to global financial stability are greater. MPE banks provide with a high degree of flexibility on the business strategy. Moreover, they have proven its resilience during the financial crisis due to intrinsic firewalls between different parts of the group in case of a home or host financial crisis. Stand-alone subsidiaries also contribute to the development of local capital markets. On the contrary, the decentralized model has costs in terms of lower efficiency in capital and liquidity management and more loss absorbency capacity requirement (LAC) in the whole group, to the extent that potential synergies in the group are not exploited. These costs can be seen as a price to be paid for more prudent behaviour and a greater contribution to global and domestic financial stability.

C. Legal cross-border challenges

For international banks, the legal and operational cross-border issues are key to achieving an effective and credible resolution. In that vein, the effectiveness of a cross-border resolution will be restricted unless it is immediately accepted as legally binding and operationally effective by all parties, and national authorities act collectively in a coordinated and predictable manner.

The FSB has outlined the main elements to develop a feasible cross-border resolution. Although, some jurisdictions (as the US and EU) have started this transposition, the impression is that its successful implementation is still very far from being reached. Three legal facts hold the key:

- First, the new resolution regimes are incomplete and divergent.
- Second, national insolvency and resolution laws have a clear “territorial approach” aligned with the growing ring-fencing trend.
Third, the implementation of the new resolution regime only in the US and EU is not enough. Transposition should be global as banks are global too, especially in emerging countries with a significant presence of foreign institutions.

Thus, the lack of mutual recognition in the law and the lack of trust among authorities are the root of most legal cross-border issues. These topics have different connotations, depending on whether an SPE or MPE resolution strategy is adopted.

- From an MPE standpoint, cross-border issues do not imply a major challenge. The resolution applies to the subsidiary, led by the host authority under the local resolution laws. Thus, cooperation between home and host authorities is important but not essential.

- From an SPE standpoint, cross-border issues may hamper an efficient resolution and become operationally unfeasible. A high degree of harmonization in resolution regimes is necessary and formal Cross-Border Cooperation Agreements between home and host are essential.

- Against this backdrop, the FSB proposes a gradual approach to effective cross-border recognition of resolution actions. First authorities should promote the use of contractual clauses –temporary stays on early termination rights in the derivative markets and contractual recognition of bail-in in debt markets. And second authorities should implement a comprehensive and harmonized statutory resolution approaches in all jurisdictions. In this sense, the new ISDA resolution protocol agreed in November 2014 by the largest players in derivative markets is an important step in the right direction.

Against this backdrop, the FSB proposes a gradual approach to effective cross-border recognition of resolution actions. First authorities should promote the use of contractual clauses –temporary stays on early termination rights in the derivative markets and contractual recognition of bail-in in debt markets. And second authorities should implement a comprehensive and harmonized statutory resolution approaches in all jurisdictions. In this sense, the new ISDA resolution protocol agreed in November 2014 by the largest players in derivative markets is an important step in the right direction.

D. Operational subsidiarisation under an MPE

How critical share services are organized in a MPE bank is a key question when designing the resolution strategy. As a principle, the critical shared services of MPE banks must be organised in a way that would permit the group to maintain those critical services when some part of the group enters resolution. This is what has been termed as “effective operational subsidiarisation”.

The main characteristics of operational subsidiarisation are the following: i) shared services should be provided from a separate legal company, ii) the financial viability of the shared service company should be driven by services provided rather than by corporate contributions from the parent; and should be supported by a robust and audited transfer pricing policy, iii) the shared service company should be sufficiently funded ex-ante, iv) robust service level agreements (SLAs) between group entities are a requirement, and iv) IT service companies should be able to produce specific legal entity data.

Conceptually, the operational subsidiarisation is equal in an SPE and MPE approach because it has to be in an independent company. Under an MPE strategy, different levels of decentralisation are feasible ranging from a more centralised to a more decentralised scheme. Thus, the main challenge for the MPE approach is to choose between the following two alternatives:

- Centralised subsidiarisation approach, shared services are provided by a common and unique company located below the top-tier holding company for the whole group.
• Decentralised subsidiarisation approach, structure considers each shared service company as a “silo”, where each bank subsidiary is self-contained and owns and operates its own shared services.

Benefits of the operational subsidiarisation are significant, ranging from a more effective resolution – securing operational segregation – to a more efficient service – cost optimisation. When choosing between the two approaches, MPE banks need to strike a pragmatic balance between the optimal scheme from a resolution standpoint – the decentralised model – and the need to maintain an economically viable business model – centralised option. In this regard, the benefits of the centralised model, especially under a subsidiary structure, clearly outweigh its resolution threats, which could be resolved by robust SLAs and ex-post capital and funding agreements.

E. Critical economic functions’ role

Critical economic functions play a key role in the resolution agenda and will become the cornerstone in any resolution process. Authorities and banks should focus their efforts on ensuring the continuity of critical functions carried out by the failed bank and liquidate those non-critical functions. Therefore, the discussion of the optimal resolution strategy (MPE and SPE) that guarantee the provision of critical economic functions has clear interlink with other critical issues, at least, two areas: i) the minimum Total Loss Absorbing Capacity (TLAC) required for each bank that will provide sufficient financial resources to recapitalize those entities in the group that perform only critical functions and ii) legal and operational structural changes that should ensure the maintenance of critical functions.

The debate has just only started, and banks and authorities will spend more time thinking about it. This issue is likely to become one of the hottest topics in the regular dialogue on resolution and resolvability assessment among banks, resolution authorities and supervisors. In this vein, it is essential to have clear and objective guidelines to ensure consistency in the identification and application of these critical functions, to allow cooperation among entities with the supervisor and to guarantee the level playing field and the credibility of the new resolution framework.
A Developing Effective Resolution Strategies

1. Introduction

The Financial Stability Board (FSB) published its final guidance on the development of resolution strategies on 16 July 2013. The document is key, as it complements the Essential Elements of Recovery and Resolution Plans set out in the FSB’s Key Attributes.

These guidelines on recovery and resolution planning outline the main characteristics of the two stylised approaches for resolving global financial institutions: the Multiple Point of Entry (MPE) and Single Point of Entry (SPE). Deciding between an MPE or an SPE resolution strategy depends on each firm’s particular characteristics, as explained in the following chapters of this compendium.

While the guidance focuses primarily on resolution strategies for global systemically important banks (G-SIBs), FSB also suggests that many aspects will be relevant for domestically systemically important banks (D-SIBs), as well as non-banks potentially subject to resolution requirements.

In this sense, the main key points of the guidance are the following:

- The detailed preconditions for single point of entry (SPE) and multiple points of entry (MPE) resolution strategies.
- The necessary elements for a complete and coherent development of resolution strategy, which include:
  - Loss-absorbing capacity (LAC) requirement, including consideration of identifying and publicly disclosing the quality and the location where it should be held within a group.
  - A variety of common considerations including cross-border arrangements, fall-back options, and data availability for valuations, with guidance on how crisis management groups (CMGs) supported by institution-specific cross-border cooperation agreements (COAGs) should approach the issues.

These FSB guidelines do not have the force of law and are only advisory, but established the bases that individual countries should fulfil in the future, in the context of the global resolution framework.

2. Single Point of Entry and Multiple Points of Entry

As mentioned in the introduction, resolution strategies are “broadly based” around two “stylised approaches”, SPE and MPE. The FSB recognises that there is not a binary choice between the two. Both strategies should help to achieve an orderly resolution and facilitate the effective use of resolution powers, with the aim of making the resolution of any firm feasible without severe systemic disruption and without taxpayer solvency support.

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2: Financial Stability Board (October 2011), Key Attributes of Effective Resolution Regimes for Financial Institutions.

3: The concept of LAC currently is called Total Loss Absorbing Capacity (TLAC). In this sense, FSB proposal on TLAC rules is expected by November 2014 and the final rules not before 2015, as explained the FSB Chairman’s letter of September 2014 to G20 Ministers and Governors on “Financial Reforms – Completing the job and looking ahead”, established (Link).
To achieve these goals, the resolution strategy in a banking group should answer several questions related to the resolution process, such as: who is responsible to lead the resolution process, when this process must start, the group-level affected by it or the resolution tools that the authority can use.

**Figure 1**

**Objectives of the resolution strategy**

<table>
<thead>
<tr>
<th>Who?</th>
<th>Who would lead the resolution process?</th>
</tr>
</thead>
<tbody>
<tr>
<td>When?</td>
<td>When would the resolution process start?</td>
</tr>
<tr>
<td>Whom?</td>
<td>At what group-level would the resolution process apply?</td>
</tr>
<tr>
<td>How?</td>
<td>Which resolution tools would the authority use?</td>
</tr>
</tbody>
</table>

![Applying either a centralized -SPE- or decentralized -MPE- resolution strategy is the key](source: BBVA Research)

To develop an efficient resolution strategy (SPE or MPE) there are some considerations that must be borne in mind. They are relevant to all resolution strategies, although the necessary outcomes (for example, the location of total loss absorbing capacity within a group) may vary depending on the strategy that is pursued.

**The following considerations should guide the development of resolution strategies:**

1. Sufficient total loss-absorbing capacity (TLAC)
2. Positioning of TLAC in the creditor hierarchy
3. Operational and legal structure and operational continuity
4. Resolution powers to deliver the strategy
5. Enforceability and implementation of “bail-in”
6. Treatment of financial contracts in resolution
7. Funding arrangements
8. Cross-border cooperation and coordination
9. Coordination in the proximity of failure
10. Approvals or authorisations needed to implement the strategy
11. Maintaining essential functions and services (“fall-back options”)
12. Information systems and data requirements
13. Post resolution strategy

Box 1 explains the concept of the new TLAC requirement to ensure that banks have sufficient loss-absorbing and recapitalisation capacity available in resolution to implement an orderly resolution that minimises any impact on financial stability, ensures the continuity of critical functions and avoids exposing taxpayers to losses.
Box 1. TLAC: a new requirement to absorb losses

The new resolution framework seeks to provide the authorities with a series of instruments and competences to deal with banking crises in a preventive manner, protecting financial stability, preserving critical functions and minimising cost to taxpayers in the event of banking failures.

As the central premise of the new regulation framework, any banking rescue will have to be supported in the first instance by shareholders and private creditors through the bail-in tool.

In order for this new banking rescue philosophy to be effective, banks must, at all times, have enough liabilities to absorb losses. That is, banks need to comply with a minimum Total Loss-Absorbing Capacity (TLAC), which is the complement of the bail-in tool.

The final TLAC definition is still under discussion. The FSB published a consultation paper that will be under consultation until 2 February 2015 and is likely to be approved by the next G20 2015 summit in Turkey. In parallel with the consultation period, the FSB will carry out a comprehensive Quantitative Assessment Study (QIS) in collaboration with the Bank Committee on Banking Supervision, to assess the optimal Pillar 1 minimum TLAC requirement.

Once the consultation period has finished, G20 countries will have the compromise to transpose the TLAC requirements to their own resolution regimes. The FSB proposes in the consultation paper that the TLAC requirement should not be in place before January 2019, allowing G-SIBs to gradually adapt their funding structures to this new requirement.

It is clear that banks should have TLAC in “sufficient amounts” and “at the right location” to facilitate recapitalisation.

TLAC placement depends on resolution strategy

In this sense, as the FSB preconditions establish, the minimum TLAC should be tailored to each resolution strategy (MPE and SPE). The TLAC will be applied at parent level in SPE banks and at each resolution subsidiary in MPE ones, but only to cover losses in “material” subsidiaries.

The consequence is that neither SPE nor MPE banks would be required to assess the TLAC based on the consolidated balance-sheet, but on their material subsidiaries’ balance-sheets.

TLAC scope depends on material subsidiaries

The anchor of the TLAC assessment will be the “material” subsidiaries:

- SPE banks would have to issue TLAC at parent level and transfer it downstream via either on-balance sheet items or collateralised guarantees (internal TLAC). Internal GLAC should only be pre-positioned with those subsidiaries that are relevant within the group.
- The concept of materiality in MPE banks is different. The logic of the model implies that subsidiaries which are relevant in their local market (e.g., Domestic SIFIs) should be the only ones that have to issue external TLAC, regardless of their relevance in the group. Moreover, under an MPE approach, the TLAC requirement at each point of entry should be based on the local regime established by the host authority with similar characteristics to the local entities, rather than the regime of the home authority.
To ensure greater harmonisation when it comes to defining the applicable strategy, FSB has set forth a series of preconditions that the entities should comply with, in order for the authorities to apply one approach or the other. Resolution authorities may also decide to apply a combined approach if the situation requires it. It is important to remark that the assumptions and preconditions to be applied in each resolution strategy (SPE vs. MPE) diverge, due to them depending on each firm’s particular characteristics (legal structure, business model or capital and funding management).

Below are listed the preconditions for both SPE and MPE resolution strategies.

### 2.1 Preconditions for SPE

Under an SPE resolution strategy, the resolution powers are applied at the parent or holding company level through a single resolution authority that in general will be the home where the supervision is applied on a consolidated basis. The assets and operations of the subsidiaries are preserved on a going concern basis, avoiding the need to apply resolution at a lower level within the group. Cooperation from the resolution authorities of the branches, or especially subsidiaries, is critical for the success of this strategy.

The following preconditions should be considered to develop an SPE resolution strategy:

<table>
<thead>
<tr>
<th>Preconditions to apply SPE</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Point of entry and scope of the resolution</strong></td>
<td>At the top level or holding entity</td>
</tr>
<tr>
<td><strong>Resolution authority and tools</strong></td>
<td>They need to be located in jurisdictions with resolution regimes that provide for effective resolution powers</td>
</tr>
<tr>
<td><strong>Adequate amount of TLAC</strong></td>
<td>Available at the top parent or holding entity and assess whether it is likely to be sufficient to absorb losses sustained within operational subsidiaries or other affiliates of the group that are intended to be maintained in resolution</td>
</tr>
<tr>
<td><strong>Quality of TLAC</strong></td>
<td>Equity or long–term debt held “in the rights hands”</td>
</tr>
<tr>
<td><strong>Financial structure</strong></td>
<td>Up–streaming losses and down–streaming capital: how the (domestic and foreign) group entities that are to remain a “going concern” in resolution are able to pass their losses to the top of the group. The group’s capital and liability structure therefore needs to be set up in a way that allows for losses in group entities to be absorbed by (or “up–streamed” to) the top parent or holding company.</td>
</tr>
<tr>
<td><strong>Cross-border aspects</strong></td>
<td>Home authority providing adequate assurances to the host authorities</td>
</tr>
</tbody>
</table>

Source: BBVA Research

### 2.2 Preconditions for MPE

Under an MPE strategy, the application of resolution powers is possible by one or more resolution authorities to one or several parts of the group, including the possibility of breaking up the group into two or more separate parts. The home authority should play a key role in ensuring that the resolution is coordinated. Although FSB suggests that the MPE strategy involves the simultaneous resolution of different parts of the group, this case is unlikely to happen since the model is designed in a way to make the correlation of a crises in different parts of the group very unlikely. A resolution of one subsidiary will involve two authorities, host and home.

The following preconditions should be addressed when developing an MPE resolution strategy:

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4: This is the definition of the 2013 FSB guidance, but final TLAC definition is still under discussion. FSB’s new proposal is expected by November 2014.
### Table 2
**Preconditions to MPE**

<table>
<thead>
<tr>
<th>Precondition</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Point of entry and scope</strong></td>
<td>Points at which entry into to resolution is likely to occur: the legal entities to be subject to resolution powers, and the operating subsidiaries and affiliates of those points of entry that will be included in the resolution action, including where any regional or other blocs are envisaged.</td>
</tr>
<tr>
<td><strong>Resolution authority and tools at the point of entry</strong></td>
<td>Discrete resolution action at each point of entry:</td>
</tr>
<tr>
<td><strong>TLAC at points of entry</strong></td>
<td>At each legal entity that may be subject to a separate resolution and those branches or subsidiaries below it</td>
</tr>
<tr>
<td><strong>Legal and operational structure</strong></td>
<td>Much greater degree of financial and operational separation of entities identified as “points of entry” so that host resolution authorities can effectively resolve such an entity (and those below it) in a manner that results in their separation from the wider group.</td>
</tr>
<tr>
<td><strong>Critical functions and services</strong></td>
<td>Effective service level agreements and maintenance of the critical shares services Ability to maintain access to FMI agreements Stand-alone booking and cross-entity booking and risk management practices</td>
</tr>
<tr>
<td><strong>Financial structure</strong></td>
<td>Intra-group financial interdependencies should be limited</td>
</tr>
<tr>
<td><strong>Legal – entity specific information</strong></td>
<td>Critical management information available at the level of “point of entry”</td>
</tr>
<tr>
<td><strong>Cross-border co-ordination</strong></td>
<td>Institution-specific COAG describing the approach to coordination between the authorities responsible for each point of entry and the role of the home authority in coordinating the resolution actions</td>
</tr>
</tbody>
</table>

Source: BBVA Research

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**Figure 2**

**Main Characteristic of SPE vs. MPE resolution strategy**

![Diagram showing SPE and MPE resolution strategies with a comparison table]

<table>
<thead>
<tr>
<th></th>
<th>Single-Point-of-Entry</th>
<th>Multiple-Point-of-Entry</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Point-of-entry</strong></td>
<td>Parent - failure the consolidated Group</td>
<td>Subsidiary - failure individual subsidiaries</td>
</tr>
<tr>
<td><strong>Resolution powers</strong></td>
<td>Home authority - parent</td>
<td>Host authority - subsidiary</td>
</tr>
<tr>
<td><strong>Authority role</strong></td>
<td>Home - Global executor Host - Secondary executor</td>
<td>Home - Coordinator &amp; local executor Host - Executor (local)</td>
</tr>
<tr>
<td><strong>Losses / bail-in</strong></td>
<td>Upstream losses – downstream support</td>
<td>Local losses – parent voluntary support</td>
</tr>
<tr>
<td><strong>TLAC (*) placed to third investors</strong></td>
<td>TLAC at parent level</td>
<td>TLAC at individual level</td>
</tr>
<tr>
<td><strong>Legal structure</strong></td>
<td>Branch and subsidiary</td>
<td>Subsidiary</td>
</tr>
<tr>
<td><strong>Operational services</strong></td>
<td>Centralized but independent</td>
<td>Decentralized – operational subsidiarization</td>
</tr>
</tbody>
</table>

(*) TLAC – Total loss absorbency capacity

Source: BBVA Research
The MPE and SPE strategies respond to different business models. For each to work properly, it is important to align the incentives of all the stakeholders, including home and host authorities. In this sense:

- The MPE model is consistent with retail banking, deposit funding and stand-alone entities under the legal form of subsidiaries with a decentralised capital and funding management.
- The SPE model seems more applicable to investment banks relying basically on wholesale funding and intra-group support under the legal form of branches.

### 2.3 Cross border considerations in MPE and SPE

According to FSB guidance developing a credible and feasible cross-border resolution regime is essential to restore financial stability and minimise disruptions to global financial markets.

As the cross-border dimension is the main challenge for an orderly resolution in different jurisdictions, FSB has included new language stating that resolution plans or cooperation agreements should specify the circumstances in which home and host authorities will cooperate, as well as the conditions for cooperation.

In that vein, coordination between home and host authorities is important in both SPE and MPE approaches. However, under an MPE strategy, the coordination among resolution authorities should not be as critical as under an SPE scheme. In that vein, it is necessary to take into account the following elements:

- **The Resolution Colleges and the Crisis Management Group are a key element of effective resolution regimes.** Providing a clear definition of roles and duties for supervision authorities in both the design and the implementation of the resolution powers is crucial under both SPE and MPE schemes.
- **Institution-specific Cross-border Agreements (COAGs)** are a critical element in enhancing trust and confidence between the home and relevant host authorities, especially for SPE banks.
- **The scope of host authorities to be considered in designing the resolution strategy is critical.** Deciding which host authorities would participate in the Crisis Management Group (CMG) is not trivial and has different connotations between an SPE and MPE. Under an MPE scheme, CMG's host authorities could be considered both, those which are relevant in their local market (e.g. D-SIBs), and those which are relevant in the group.

Finally, it is worth mentioning that the sharing of information among all authorities is essential for planning and carrying out resolution.

### 3. Resolvability Assessment

The FSB establishes that authorities should regularly undertake resolvability assessments to evaluate the feasibility and credibility of resolution strategies and their operational plans, to identify factors and conditions that have an impact on the effective implementation of resolution actions and to help determine the specific actions necessary to achieve greater resolvability. In order to do so accurately, authorities will need to review the resolution strategies, plans and institution COAGs and their alignment with the firm's legal, financial and operational structures.

In line with FSB guidance, EBA launched a consultation with a deadline of 9 October 2014 on draft Regulatory Technical Standards (RTS) on the content of resolution plans and on the matters and criteria
which resolution authorities should apply in their assessment of resolvability. This RTS is part of EBA’s work to promote a consistent and coherent approach to bank resolution across the European Union.

EBA states that the resolution authority should make an assessment of resolvability, in order to identify barriers that may exist for the resolution of a group, that must follow these stages:

- Assessing the feasibility and credibility of liquidation.
- Assessing the feasibility of a resolution strategy in five areas: structure and operations, resources, information, cross-border issues, legal issues.
- Assessing the credibility of a resolution strategy.

Both FSB and EBA establish that when resolvability assessments identify potential barriers to the implementation of the preferred resolution strategy, authorities and firms should ensure that those barriers are removed or materially mitigated in a timely way. Additionally, in its consultation paper EBA goes further than FSB, and establishes that the resolution authority should clearly identify a single preferred resolution strategy, but may also need to include here “variant strategies” to be applied in circumstances in which implementation of the preferred strategy is not feasible. These variant strategies must seek to achieve the same resolution objectives, and should be assessed against the same criteria.

Additionally, EBA has also launched a consultation on draft guidelines on measures to reduce or remove impediments to resolvability. The document sets measures and conditions that the resolution authority could require of the entity to address the impediments identified in the resolvability assessment (changes in its financial, operational or legal structure).

The following list summarises the specific measures proposed by EBA to improve the resolvability of an institution:

- Change the legal or operational structure
- Set up a parent financial holding company
- Divest specific assets, sale business or limit activities
- Issue debt instruments (Minimum Requirement of own funds and Eligible Liabilities, MREL)
- Imposing specific and regular information requirements
- Revise intragroup financial agreements
- Tighten maximum individual risk exposure
B The Multiple Point of Entry resolution strategy

1. Introduction

SPE and MPE resolution strategies are the opposite ends of a spectrum where many resolution options may lie in between. There is no binary choice between the two approaches. 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.

A certain degree of flexibility is necessary in developing different resolution strategies for different banks’ structures taking into account their business models, corporate and legal structures, and their financial and operational interdependencies. In this note we argue that the optimal resolution strategy for global retail banks based on a decentralized model is the MPE approach.

Section 2 of the note outlines why the case of decentralized retail banks fits in general better with the MPE resolution strategy. Section 3 outlines the main implications that a MPE strategy has on the resolution authorities and the overall group (parent + subsidiaries).

2. Decentralized retail banking and the MPE strategy

2.1 Decentralized retail banking groups meet all MPE pre-conditions

Decentralized retail business models rely inherently on the following MPE pre-conditions:

A. They are structured by local subsidiaries.

Major internationally-active retail banks entered host countries financial systems through acquisitions of local subsidiaries and structured them through local or functional intermediate holding companies.

The local resolution authority is the only one in charge of defining at local level the resolution point of entry, the minimum loss absorbency capacity, how the local critical functions are preserved, etc. On the contrary, the home authority does not have any responsibility for resolving subsidiaries outside its country. Thus, the existence of either a local subsidiary or intermediate holding companies paves the way to implementing an efficient and timely resolution of a local subsidiary follows the local resolution regime. That is to say, a banking group structured by local subsidiaries allows to implement multiple and independent resolution strategies led by local authorities, which are in fact a global MPE for the whole group and an SPE within any jurisdiction.

However Europe, in particular the Eurozone, could be the exception to this rule. To the extent that the Banking Union implies that the Eurozone will at the end of the process be structured as one jurisdiction – with one supervisor, a common resolution legislation, one resolution authority, a single resolution fund, and ultimately, a single deposit guarantee scheme –; it would make sense to envisage the SPE model as the optimal resolution strategy for the Eurozone’s subsidiaries even for banks that are structured globally under the MPE model (for further details see Section 2.3).

B. The client base of decentralized retail banking groups is mainly local households and small and medium enterprises. Retail deposits, normally in local currency, constitute the main source of
funding at subsidiary level, and are protected by the local deposit guarantee schemes (to which these subsidiaries contribute).

In global retail banks’ subsidiaries, the client base is mainly focused on households and small and medium enterprises. This business model is especially relevant in emerging countries where subsidiaries finance their own growth relying predominantly on deposits denominated in local currency and other traditional sources. As the Basel Committee illustrated recently, the loan-to-deposit ratio and the non-core-funding ratio in emerging countries are well below those of the developed ones: 0.8 and 0.2 versus 1.2 and 0.3, respectively.\(^5\)

SPE regimes fit better for banking groups that issue most of their debt out of a top company, as an investment bank. However, it would not work so easily for retail-oriented groups around the world which are funded to a very large extent from insured deposits.

Additionally, from the host authority perspective, the MPE strategy may ensure that local interest would be protected in case of resolution affecting a group. In fact, host authorities would necessarily lead the local resolution process in order to protect the local uninsured depositors and local deposit guarantee schemes (DGS). When local financial stability is at stake, host authorities would not as a rule rely on home authorities to take key decisions.

C. Retail subsidiaries of global banks often have a significant market-share and a leadership position in their host countries. Thus, host retail franchises usually become a key player in local economic development.

Foreign investments of global banks usually seek a local leadership position in each franchise. As a consequence, host subsidiaries have critical implications for local growth and financial stability. Local authorities are responsible for regulating and supervising subsidiaries of foreign banks, without prejudice of the responsibility of home authorities for consolidated supervision. In this function it is important that they ensure a level playing field with other significant local players. Their responsibilities as concerns foreign subsidiaries include the following:

- Local capital and liquidity buffers.
- Local resolution requirements.
- Local on-site inspections and reporting.

These prudential requirements in a context of global institutions are not new; but the concern for contagion and spill over effects has been exacerbated in this crisis. The most difficult cases are when a subsidiary is systemic in the host country (D-SIFI) but not for the group as a whole, and/ or the parent is not systemic in the home country, but these cases are quite unusual. The concern for contagion also applies to home authorities, some of which have adopted regulatory measures to avoid an excessive assumption of contingent claims abroad. Both home and host countries face incentives for an MPE model in case of deposit-funded banks in order to reduce contagion effects.

In essence, for deposit funded bank, host resolution authorities would like to decide how and when the resolution would be activated in their jurisdiction including: i) when the resolution of the local subsidiary is likely to occur (resolution trigger), ii) which local legal companies and subsidiaries should enter into resolution (resolution scope), iii) how local resolution should be done (resolution tools) and how their

\(^5\) Basel Committee on Banking Supervision (October 2013), “Global liquidity: selected indicator”.
creditors would be affected, and, finally, iv) how much loss absorbency capacity the local subsidiary should have in advance to minimize and in the limit eliminate local tax-payer cost (minimum LAC).

D. Capital and liquidity are located in subsidiaries with stand-alone rating. Subsidiaries manage their capital locally to support their own growth and are financially self-sufficient when they need to resort to the market.

As mentioned before, global retail banks that structure their foreign activities following a subsidiary model have normally to comply with tougher local prudential requirements in terms of capital and liquidity compared with branch models, usually relying on wholesale banking, where capital and liquidity requirements are decided by the home supervisor. In addition to subsidiary versus branch differences, emerging countries have usually tougher prudential requirements compared to developed markets.

Additionally, their business model has been designed to be decentralized, so that subsidiaries are self-sufficient in their funding, which is often raised under their own name with stand-alone rating independent to their parent banks. In case of a local liquidity shortage, subsidiaries may tap the parent for assistance, albeit at market prices and on a voluntary basis as a principle.

In the case of subsidiaries in emerging markets, a decentralized capital and liquidity framework contributes to the development of local capital markets.

Concerning TLAC, although the debate is in its early stages and there are substantial differences in the approach in each jurisdiction (see figure 3), in the case of retail banks, we envisage a situation where, for MPE banks, each legal subsidiary in a global retail group would be required by the host authority to have sufficient total loss absorbency capacity (TLAC) to cover its likely losses in resolution.

Figure 3
Main loss absorbency characteristics under different proposals

<table>
<thead>
<tr>
<th>Nature</th>
<th>FSB</th>
<th>European Authorities</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>TLAC (*)</td>
<td>Equity, junior debt and senior debt</td>
<td>Equity, junior debt, senior debt, and other unsecured liabilities (pending EBA Technical Standard)</td>
<td>Senior unsecured debt</td>
</tr>
<tr>
<td>Subordination</td>
<td>Pending to define</td>
<td>The subordination is statutory through different hierarchy of claims (senior debt is subordinated to SME and retail deposits)</td>
<td>The subordination is structural through requiring senior unsecured debt at the holding level</td>
</tr>
<tr>
<td>Sizing</td>
<td>Common Maximum between 16% RWA (19%−23% with capital buffers) and 6% leverage</td>
<td>Case by case in each entity over total liabilities</td>
<td>Pending to define but typically above RWA</td>
</tr>
<tr>
<td>Location within the group</td>
<td>At Group or individual level depending the resolution strategy</td>
<td>At Group or individual level depending the resolution strategy</td>
<td>At holding level</td>
</tr>
</tbody>
</table>

(*) TLAC - Total loss absorbing capacity  
(**) MREL - minimum requirement of eligible liabilities  
(***) PLAC - primary loss absorbing capacity, and SLAC - secondary loss absorbing capacity

Source: BBVA Research

6: For example, in Peru, BBVA pioneered the first local issuance of senior notes in 2005, the first issuance of subordinated notes in local currency in 2007 and the first Mortgage Backed Securities also in 2007, opening the way to other local players.
E. Absence of systematic intra-group support.

Closely related to the decentralized financial model, a key additional element in the resolution of a decentralized group is that the possibility of providing financial support within the group is a private and voluntary management decision of each entity subject to home regulation. In fact, the inexistence of financial support agreements and intra-group exposure between the parent and subsidiaries paves the way to apply an MPE scheme.

The US and Swiss authorities have recently stated that intra-group senior debt should be critical when designing an SPE resolution strategy of global cross-border banks. Indeed, whether the loss-absorbing debt at sub-holding level is sold to the parent level (intra-group exposure) or to a third party is a key decision with important implications for the optimal resolution strategy of the whole group.

- If the loss-absorbing debt of the sub-holding company is sold to the parent, the effects of the intra-group bail-in would be material and may drive the parent into resolution. Therefore, an SPE resolution strategy would be optimal.
- If the loss-absorbing debt of the subsidiary is sold to a third party, the parent and the rest of the group are isolated from the senior debt bail-in. Therefore, the absence of intra-group financial interdependencies between group entities would reduce the risk of contagion through the group. An MPE resolution strategy would be optimal in such cases.

In a nutshell, the nature and extent of intra-group exposures is tightly related to the resolution model. Under an MPE model, intra-group support should be only occasional and at market prices, to preserve the financial independence of each subsidiary.

2.2. SPE approach fits better with other business models

It is broadly agreed that the SPE is the best solution for the business models of globally active and highly integrated wholesale institutions with concentrated funding and risk management structures and a central booking policy with a systematic reliance on intra-group funding.

The core SPE element is the centralized financial model where the parent bank covers almost the entire internal financing needs of each group. Therefore, senior or junior debt is mainly issued centrally. Within each group, funding is distributed to host subsidiaries in the form of intra-group positions.

Those intra-group positions play a key role in the SPE scheme. They would be the liabilities used by the resolution authorities to recapitalize failed subsidiaries and to implement the bail-in tool within the group.

One of the clearest centralized and wholesale business models is Switzerland’s two big GSIFIs where FINMA stated in August 2013 that the SPE is the optimal resolution strategy.

2.3. Hybrid approach for the Eurozone

Although decentralized retail banks fit naturally in the MPE model, a hybrid approach could be the optimal resolution strategy in some cases. When thinking in a hybrid approach, we envisage a banking group where part of the subsidiaries would follow an MPE approach and others would follow an SPE approach. The key

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8: An important question in this regard is the seniority of intra-group positions. We assume here that intra-group positions would be subordinated to other liabilities vis-à-vis third parties regardless of the rank in which these positions are materialized. Those are complex issues currently unsolved.

deciding factor to implement an SPE strategy in a decentralized bank is whether there is at least a supranational resolution authority, a common resolution regime, and a fully harmonized deposit guarantee scheme over part of the group.

In Europe, recent progress towards Banking Union and related institutional developments have paved the way to implement a feasible SPE scheme when designing the resolution strategy of a banking group with presence in two or more Eurozone countries. In particular, advances in terms of a Single Rule Book, a Single Supervision Mechanism, and, especially, the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) are breaking down the national banking barriers.

As the resolution of Fortis/ABN AMRO highlighted, in times of distress it is harder for an individual country to internalise the broader impact of cross-border resolution on global financial stability, even in an integrated area like the Eurozone, sharing important elements of sovereignty like monetary policy. The banking union process, together with common resolution legislation, will facilitate solving these types of crises in the future. To the extent that the Eurozone moves towards a single jurisdiction in terms of banking resolution, the use of a MPE resolution strategy inside the area seems hardly beneficial, although it can still be used when dealing with third countries.

3. MPE implications for banks and authorities

In this section we analyze the implications and main takeaways that institutions and authorities should take into account when developing an MPE strategy and resolution plan. The four main areas of interest are the following:

1. Activation the resolution process.
2. Cooperation among resolution authorities.
3. Loss-absorption capacity requirements: nature, location and side effects.
4. Shared services organized on a stand-alone basis.

3.1. Activation the resolution process

As a general principle, the resolution process of one bank (or group) is triggered when the bank simultaneously fulfils the following three preconditions: i) the bank does not comply (or is not likely to comply) with its prudential requirements, ii) there are neither private alternatives nor parent support for restoring the situation, and iii) the failure of the institution could entail financial stability damage. Thus, the conditions should permit timely entry into resolution before a bank is balance-sheet insolvent and before all equity has been fully absorbed\(^{10}\).

As regards the activation of the resolution process it is worth to consider the following:

- Multiple points of entry. As mentioned previously, MPE subsidiaries are independent for each other, so local authorities would have all resolution powers to activate the resolution process independently in the subsidiaries under their jurisdiction. In other words, an MPE approach entails more than one point of entry and more than one national resolution authority.

\(^{10}\): See KA 3.1. Financial Stability Board (November 2011), “Key Attributes of Effective Resolution Regimes for Financial Institutions.”
- Only local triggers. As a consequence of this local authorities’ independence, we envisage that the local resolution process should be triggered only when the local subsidiary or local sub-holding located under the resolution power of each authority has failed or is likely to fail and there is no support from the parent bank.

- No ring-fence measures. The absence of financial interconnections, which become one of the main MPE preconditions, implies that the activation of the resolution process in a host as a result of financial distress in the home or a third-country subsidiary is not necessary in order to protect domestic financial stability. The European crisis showed that, in some cases, host authorities have had concerns about the capital and liquidity situation of the EU parent institutions and, therefore they have proposed introducing several ring-fence measures such as resolution trigger events based on the parent’s financial performance\(^\text{11}\). These triggers are unnecessary when there is no intra-group support. Thus, under an MPE model these ring-fence measures should be avoided.

- Under the PME model, resolution will normally be activated by one authority in one country, due to the absence of intra-group contagion. Only in the case of crises not specific to the bank, but of a systemic nature and resulting from cross-country correlations is the occurrence of simultaneous crises inside the group likely; but also in these cases, the MPE acts as a natural firewall to spillover effects.

### 3.2. Cooperation among resolution authorities

The resolution process in an MPE banking group would be under the direction or control of two or more national authorities, each one responsible for the resolution process in its jurisdiction, and one of them (the home authority) in charge of overall coordination.

As a general principle, coordination between home and host authorities is important in both an SPE and MPE approach. However, under an MPE strategy, the coordination among resolution authorities should not be as critical as under an SPE scheme\(^\text{12}\). As shown Figure 4, under an MPE model, the ultimate responsibility for resolving any subsidiary lies in the host resolution authority. In fact, the role of home regulator will inevitably be more a “coordination figure,” and the role of host regulator will grow in relevance as the “sole executing figure.”

![Figure 4](https://example.com/figure4.png)

*Source: BBVA Research*

Against this backdrop, we envisage two different steps in cooperation and involvement among authorities under an MPE scheme.

\(^{11}\): For example, the Foreign Bank Organization proposal in the US.

\(^{12}\): The FDIC and the Bank of England highlighted the need for a tougher cooperation under the SPE when dealing with highly cross-border interconnected groups in their joint paper realized in December 2012.
• First, in the design of the high-level resolution strategy, home and host authorities should understand well the MPE approach of their counterpart and work together to develop a comprehensive resolution plan clearly delimiting the roles and duties of each authority. In this step, collaboration and coordination among host and home authorities is vital.

• Second, when the resolution strategy is implemented, as a difference with SPE, in a MPE model host and home authorities can act with relative independence, to the extent that the responsibility of each of them has been clarified ex ante. As compared to the SPE, where for example decisions on loss absorption have cross-border implications, the need of cooperation under a MPE is smaller.

A successful MPE strategy implementation will require the effective coordination of different resolution actions undertaken by home and host authorities. In this sense, specific cooperation agreements (COAGs) should allow them to face the right incentives and meet their expectations. It is necessary to take into account four elements.

• First, as the FSB outlined, cross-border cooperation agreements (COAGs) within the Resolution Colleges and the Crisis Management Group are a key element of effective resolution regimes. Providing a clear definition of roles and duties for supervision authorities in both the design and the implementation of the resolution powers is crucial under both SPE and MPE schemes.

• Second, COAGs may be more flexible under an MPE model because the resolution strategy is applied locally, normally in only one country and the home authority does not have any power in relation to the local resolution implementation. In fact, each host authority has independent powers to execute the resolution in its jurisdiction.

• Third, the scope of host authorities to be considered in designing the resolution strategy is critical. Under an MPE, all subsidiaries that are systemically important in their local jurisdiction (domestic SIFIs) should contribute to effective crisis management planning, whilst, under an SPE scheme, the key subsidiaries are those that are systemic within the group.

• Thus, enhancing coordination and communication between the Crisis Management Group and the Supervisory Colleges is necessary in crisis preparedness. And fourth, effective information-sharing is essential for planning and carrying out resolution. The ability to exchange information between resolution authorities is fundamental in coordinating the effective planning, preparation and implementation of resolution. Nevertheless, the MPE requirements for the information will be different from an SPE strategy. In fact, local empowerment and local involvement throughout the resolution process is higher in the decentralized decision-taking, whereas information exchange is again less critical than in the SPE.

3.3. Loss-absorption capacity requirements: nature, location and side effects

The application of the LAC within a group reflects the group resolution strategy and, therefore, is tailored to the group business model and resolution plan.

For MPE groups, this implies that each legal entity or sub-holding in the group that may be subject to a separate resolution action should have sufficient LAC individually to cover its likely losses in resolution and those of subsidiaries below it for which a separate resolution is not planned.

13: See Principle 7 of the BIS’s consultative document on “Good Practice Principles for Supervisory Colleges” (January 2014).
Despite being an individual requirement set by local authorities, the LAC’s nature and hierarchy of claims in case of MPE resolution should ideally be consistent among different jurisdictions. We use the word “consistency”, not “harmonization”, because domestic conditions and circumstances often compel regulators to adapt the local framework out of global financial stability considerations. Two examples:

- Equity and subordinated debt should always assume losses; however, the rest of the liabilities should be adapted to the local idiosyncrasy of each jurisdiction, and be flexible enough to exclude creditors where it would cause domestic systemic issues or would jeopardize the incipient development of capital markets. This is especially relevant in emerging countries where loan-to-deposit ratios and non-core funding ratios are well below those in developed ones.

- Another example concerns the degree of harmonization of resolution legislation required under the SPE/MPE models. Under an SPE, the hierarchy of claims harmonization is critical to ensure intra-group and cross-border inter-creditor fairness (for instance as regards the treatment of intra-group positions external creditors, or how the structural subordination of home versus host creditors is defined). That is not the case under an MPE scheme where further degree of flexibility could be possible.

We have outlined previously that the LAC should be required at individual level, mainly in the form of equity and unsecured debt and placed externally to third investors. This requirement is consistent with the absence of intra-group exposures, which is one of the key MPE pre-conditions. The LAC characteristics mentioned above have the following effects:

- First, the total LAC amount at consolidated level placed to third investors is higher under an MPE approach than under an SPE one. Therefore, MPE banks would have higher costs in terms of lower economies of scale in funding activity and lower capital and liquidity management optimization.

- Second, in most emerging countries the LAC requirement would, in practice, imply higher capital requirements due to the lack of development of their local capital markets. Subsidiaries in emerging countries would not be able to issue a significant amount of the new bail-in debt, and therefore, they would be forced to cover the LAC requirement with pure equity, increasing the total capital amount.

- Third, on the contrary, at parent level, an MPE scheme would imply that capital surcharges to cover future capital shortfalls in host counties are not necessary.

Box 2 shows the main characteristics of the FSB TLAC requirement under an MPE context and some elements that FSB has to take into account when carrying out the QIS and the subsequent recalibration during 2015.
Box 2. TLAC MPE characteristics and the FSB calibration challenges

The minimum TLAC is rightly tailored to each resolution strategy (Multiple-Point-of-Entry MPE and Single-Point-of-Entry SPE). In an MPE context the TLAC is required at each material resolution subsidiary or subgroup and not at consolidated level.

In other words, the resolution entity or sub-group is the group of entities that includes a single resolution entity and any direct or indirect subsidiaries of the resolution entity which are not themselves resolution entities or subsidiaries of other resolution entities.

This TLAC approach for MPE banking groups presents the following challenges:

Local TLAC based on local rules

The TLAC requirement at each resolution subsidiary or sub-group should be based on the regime established by the host authorities for banks with similar characteristics to the local entity, rather than the regime of the home authorities for much larger entities or the wider Group under a Single Point of Entry approach.

Therefore it will be for each country to put in place the legal framework which transposes the FSB TLAC requirement. Moreover, these local resolution regimes will need to be applied to also to Domestically Systemically Important Banks (D-SIBs) as well as local subsidiaries of G-SIBs.

The focus of the host requirements should be on the instruments and/or liabilities which are available in the local market in sufficient quantities to fulfil the local TLAC requirements, establishing a level playing field between the local players, especially D-SIBs and foreign subsidiaries.

Material subsidiaries under an MPE scheme

All material subsidiaries in a banking group should have TLAC either placed internally (SPE approach) or externally (MPE approach). Therefore, the anchor of the TLAC assessment will be the “material” subsidiaries. However, the concept of material subsidiaries is different between SPE and MPE.

Under an MPE scheme, subsidiaries which are relevant in their local market (e.g., D-SIBs) should only be the ones that have to issue external TLAC, regardless their relevance in the Group as the SPE requirement of internal TLAC.

FSB calibration challenges

The TLAC calibration and subsequent QIS that the FSB will carry out in 2015 is very important. In carrying out this task, the FSB should consider two facts:

- The minimum TLAC should take into account the specific features of local debt markets, especially in Emerging Markets. If TLAC instruments are not available in sufficient quantities, GSIBs’ subsidiaries will be forced to deleverage, hampering the ability to provide credit that are vital to local economic growth.

- In case of MPE retail subsidiaries founded mainly in deposits (loan-to-deposit <100%), an desigual TLAC requirement could increase the systemic risk and potentially undermine financial stability. Banks may be forced to artificially leverage their balance-sheet and /or driven to a “riskier yield searching strategy” to compensate the TLAC cost.
3.4. Shared services organized on a stand-alone basis: Operational subsidiarisation

As mentioned before, MPE groups usually organize themselves into well-defined regional and functional subgroups. In this sense, an MPE approach does not only apply to bank units, but also to shared services, such as IT or back-office processes. Thus, critical shared services of MPE banks must be organized in a way that would permit the group to maintain critical services when other parts of the group enter into resolution. This is what has been termed as “effective operational subsidiarisation.”

The main features and pre-requisites of the operational subsidiarisation are the following:

- Shared services should be provided from a separate legal company.
- The financial viability of the shared service company should be driven by services provided rather than by corporate contributions from the parent; and should be supported by a robust and audited transfer pricing policy.
- The shared service company should be sufficiently funded ex-ante.
- Robust service level agreements (SLAs) between group entities are a requirement.
- IT service companies should be able to produce specific legal entity data.

Benefits of the operational subsidiarisation are significant, ranging from a more effective resolution – securing operational segregation – to a more efficient service – cost optimisation.

As shown Figure 5, operational subsidiarisation in MPE banks may be structured in two ways: i) a centralised approach based on either branches or subsidiaries where the shared services are provided by only one company, and ii) a decentralised approach each branched or subsidiary has an individual shared service company. When choosing between the two approaches, banks need to strike a pragmatic balance between the optimal scheme from a resolution standpoint –the decentralised model – and the need to maintain an economically viable business model –centralised option.

Figure 5
Operational subsidiarisation structure approaches: centralised vs. decentralised

Source: BBVA Research

4. MPE benefits in decentralized retail banks outweigh its costs

We argue that MPE is the natural resolution strategy for decentralized retail banks. In the following section we describe the main pros and cons of the MPE strategy in decentralized retail banks from a double perspective: the bank vs other stakeholders and the home vs host authorities.

14: See “Chapter D: Operational subsidiarisation in practice under an MPE resolution strategy” for further details.
4.1 The bank’s perspective

The decentralized business model carried out by global retail banks – inherent to MPE resolution strategies – provides the following benefits to the bank:

- Firstly, it allows for a fair assessment of the risks involved in the financial activity. The decentralized model has a medium- / long-term orientation, avoiding short-termism and allowing for a proper evaluation of risks. Broadly considered, this business model provides adequate tools to account for the risks each subsidiary undertakes. As a result of this, its corporate structure avoids risk undervaluation related to cross subsidies inside the group. Furthermore, this approach ensures the sustainability of each subsidiary on a stand-alone basis.

- Secondly, the decentralized model does not exclude a sharing of a risk culture inside the group, in particular as regards credit and liquidity risk management. Subsidiaries share i) corporate liquidity and credit risk identification, measurement and control methodologies, ii) liquidity and credit management best practices, iii) access to a conditional corporate emergency liquidity facility that is constrained for idiosyncratic operational risk events or exceptional one-off market disruptions and iv) a common human resources management culture. Moreover, the need for building pools of liquidity constitutes a guarantee against sudden reversals in market liquidity conditions.

- Thirdly, the decentralized liquidity and capital management model creates natural firewalls in the event of a crisis. This model generates inbuilt limits to contagion.

- Finally, accountability and transparency are enhanced by a subsidiary model by reducing complexity. These factors anchor agents’ expectations and lower risk perception in financial markets.

Nevertheless, there is a cost attached to this resilience in terms of lower economies of scale in funding activity, lower capital and liquidity management optimization, and more loss absorbency capacity requirement (LAC) placed to third parties in the whole group. This potential cost in terms of lower efficiency in the subsidiary model could be considered a price to be paid for more flexibility in the business model and a greater contribution for global financial stability when it comes to resolution.

4.2 The host and home authorities’ perspective

A key consideration for home or host authorities in weighing the merits of the MPE or SPE resolution approach will be their implications for local growth and financial stability, as well as the incentives for all stakeholders, including the authorities themselves, to act in the benefit of global financial stability. Thus, while certain features of the two schemes are relevant only for host countries, other features have different implications for home and host and hence entail different preferences.

In normal times, one would anticipate that a centralized business model (aligned with SPE) could provide host country borrowers with easier access to foreign credit. Intuitively, the structure that has fewer restrictions on intra-group transactions should make the provision of credit to subsidiaries easier. However, excess of capital flows for foreign banks may exacerbate bubbles in host countries. The recent crisis showed that countries that experience huge increases in asset prices fuelled by net capital inflows from banks suffered particularly badly. In particular, high external interbank debt and maturity and currency mismatches contributed to foreign rollover risk.\(^\text{15}\).

An additional clear example is the comparison between the role of foreign subsidiaries in Central and Eastern Europe (based on centralized model that relies on a systematic support from the parent) and in Latin

\(^{15}\) Bank of England (October 2013), “The role of external balance sheets in the financial crisis”.
America (where most foreign subsidiaries operated under a decentralized model). The credit boom and the sudden stop in the first case contrast with the resilience in Latin America. There is abundant literature that attributes this difference, to a certain extent, to the different business models of foreign banks.\(^{16}\)

Additionally, MPE subsidiaries could foster local financial markets’ development in host countries because these subsidiaries are more likely to rely on local savings and local financial market developments.

The dilemma appears in stressed times or when a financial turnover is on the horizon. In those scenarios, home and host regulators may have opposite preferences regarding the optimal group structure: decentralized versus centralized or, what is the same, MPE versus SPE. Thus, the key is the financial strength of each country.

- On one hand, home authorities would prefer a decentralized-MPE approach when their banks expand into countries with weak economies and a risky business environment. Additionally, host authorities might also prefer the MPE model if conditions in their country are better than those in the home country or in a third host country, in order to protect the local subsidiaries from the problems of the parent or any part of the group.

- On the other hand, host authorities will prefer the SPE model when they have a very high degree of confidence on the home resolution authorities or underdeveloped financial systems and weak economies as in SPE strategy the parent bank can facilitate support.

It is important to keep in mind that resolution strategies should be consistent along the business cycle and across countries, and designed in a way that is not contingent on the position in the cycle, either at home or in the host countries. In other words, resolution strategies as well as business strategies of global banks should be designed to operate for the good and especially for the bad times.

\(^{16}\) See for example: S. Fernandez de Lis (April 2013); Cull and Martinez Pería (2012), and Fiechter et al (2011).
C Legal cross-border challenges under MPE and SPE

1. Introduction

The G20 leaders and the Financial Stability Board (FSB) are aware that jurisdictions should have in place a resolution regime that provides the resolution authority with a broad range of powers and options to resolve failed banks, and, what is more relevant in global banks, to facilitate a coordinated resolution approach in multiple countries. A key challenge for a cross-border resolution is therefore to develop a feasible solution that relies on a variety of legal regimes and overcomes all reluctances among the different national authorities involved – mainly home and host issues.

Recently, European and US authorities have each taken decisive steps forward in developing a resolution regime in their jurisdictions. However, many operational and legal details are still being worked out, especially on cross-border issues. The extent to which cross-border issues will be clarified in the following months is critical to identify the potential legal challenges in the case of a global bank's resolution. Chief among them are:

- Incomplete and divergent insolvency and resolution laws among jurisdictions
- Legal border issues. The “territoriality” approach of the insolvency laws.
- The bail-in tool in issuances of debt governed by third-countries’ laws.
- Treatment of intragroup exposures in third countries.

Irrespective of the final design of these technical issues, current cross-border legal and operational challenges also have variable consequences depending on the resolution strategy (SPE or MPE).

2. Divergent insolvency and resolution laws: is a cross-border resolution feasible?

As a general principle, a resolution regime for a global banking group will be restricted unless it is accepted as legally binding by all relevant stakeholders in the resolution process in the different jurisdictions. In a situation in which the bank and all its relevant shareholders and creditors were located in a single jurisdiction, the legislation of that jurisdiction would suffice for resolution purposes. However, cross-border banks have to deal with multiple jurisdictions and, in case of resolution, with multiple legal regimes.

The main legal challenge focuses on the existing differences between legal frameworks.

- There is a common understanding that normal insolvency laws are inherently unsuitable for banks. This is due to the systemic risk that a bank failure may pose. Normal bankruptcy proceedings not only take months at best, and banks require quicker action to retain franchise value and limit collateral damage. A specific insolvency and/or resolution regime is needed.

18: European authorities have published the Bank Recovery and Resolution Directive (BRRD) and the US authorities have outlined the resolution strategy and process for the orderly resolution of a large bank in the US.
19: The UK experience with Northern Rock (2007) and Bradford & Bingley (2008) provides a good illustration of the benefits of introducing an especial resolution regime for banks.
• Additionally, most jurisdictions around the globe do not comply with all FSB's key resolution attributes\(^{20}\). In fact, only a few (i.e., the EU, the US and Hong Kong) are working on accommodating to the FSB’s key resolution attributes. Thus, global banks’ presence in jurisdictions that do not comply with FSB recommendations may hamper achieving a coordinated and orderly resolution in case of a failure. For example, host authorities may not recognise neither the home authority’s resolution powers over local subsidiaries and/or branches nor operational resolution tools and procedures such as bail-in or temporary stay clauses.

Despite being a necessary condition, complying with FSB principles is not enough for host authorities to recognise home authorities’ actions. The FSB principles provide that institution-specific cooperation agreements (the so-called Cross-border Agreements (COAGs)) should be in place between the home and relevant host authorities that need to be involved in the planning and crisis resolution stages.\(^{21}\) However, reaching an agreement is not an easy task. Its successful implementation would not only depend on the trust and confidence among authorities (as stated below in section 3), but also on a consistent resolution regime which provides them with legal certainty.

As shown in Table 3, despite complying with FSB principles, the EU and US resolution regimes still lack complete consistency.

<table>
<thead>
<tr>
<th>Table 3</th>
<th>High-level comparative analysis between the US and EU resolution regimes</th>
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<tbody>
<tr>
<td></td>
<td>US (Dodd-Frank Act–Title II)</td>
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</table>
| Goal     | i) To resolve failing financial institutions quickly, ensuring the stability of the financial system  
           ii) To minimize taxpayer contributions to resolution episodes | ✓ |
| Scope    | Only large and complex banks | All credit Institutions and investment firms | X |
| Resolution Authority | Existing Federal Deposit Insurance Corporation created by the Congress, among other things, insure deposits | In EZ: new Single Resolution Board composed by national and European representatives | X |
| Trigger for resolution | Failing or likely to fail institutions  
To protect public interest and financial stability; and  
No private alternatives to prevent the default of the institution. | ✓ |
| Recovery Plan | No requirement | Annual review, update and submission to the resolution authority and supervisor | X |
| Resolution Plan | Annual review, bank ownership | Annual review; resolution authority ownership | X |
| Resolution Strategy | Single-Point-of-Entry | Multiple-Point-of-Entry or Single-Point-of-Entry | X |
| Bail-in - Hierarchy of claims | Four layers: Capital + senior debt +uncovered deposits + covered deposits | Four layers: Capital+ senior debt paripassu with uncovered corporate deposits + uncovered deposits of SME & households+ covered deposits | X |
| Resolution Fund - Usage | Liquidity support | Liquidity and capital support | X |
| Resolution Fund - Funding | Ex-post funding by the financial sector contributions (if needed) | Ex-ante funding by the financial sector contributions | X |
| Public support (*) | Not allowed under any circumstances | Limited to “a very extraordinary situation of a systemic crisis” | X |

Source: BBVA Research

\(^{20}\): See FSB (Nov 2014) Report to the G20 on Progress in Reform of Resolution Regimes and Resolution Planning for Global Systemically Important Financial Institutions (G-SIFIs).  
\(^{21}\): As stated above, COAGs are particularly necessary from an SPE standpoint.
The presence in multiple jurisdictions with different insolvency and/or resolution laws poses a legal challenge in the context of a cross-border resolution. However, its complexity degree would largely depend directly on the resolution strategy chosen by each group.

2.1 MPE - Different resolution regimes would not be a major legal impediment

In essence, in an MPE resolution strategy each resolution authority would apply resolution tools in their local jurisdiction following the local legal regime, based on either normal insolvency procedures or bank-specific resolution procedures (e.g., complying with the FSB resolution principles).

Although some degree of coordination is needed between home and host authorities, local authorities have all legal powers in their own jurisdiction without jeopardising the rest of the group.

In a nutshell, a feasible and efficient cross-border resolution is possible in an MPE group with a presence in jurisdictions with different legal resolution regimes.

2.2 SPE - Different resolution regimes would hamper an efficient coordination among authorities

An SPE resolution scheme is grounded in the principle that the home authority will carry out and coordinate the resolution of the group as a whole. This is not feasible if the host authorities and local resolution regimes do not legally recognise the home authority's powers on a statutory basis, it is necessary to implement COAGs.

An alternative theoretical solution would imply the creation of a resolution regime entirely by private contract; including the relevant provisions in the contracts of the entity concerned (e.g., including in the issuances of debt clauses allowing the write down in case the banking group experiences financial problems in other jurisdictions for global groups following an SPE approach).

However, this would, at its best, only be a partial solution since such contractual provisions would always be limited by the application of local laws (protecting, among others, creditors, depositors and minority shareholders) and to the discretion of the relevant host authorities and courts. At the end of the day, the effectiveness of such an approach would be questionable in the context of failure of large and complex financial groups.

3. Regulatory border issues in resolution

Regulatory borders are those between jurisdictions, where the regulatory regimes differ from country to country (e.g., in Europe, the resolution border will be set at eurozone level once the Single Resolution Mechanism is fully loaded).

This “territoriality” principle of regulation implies that a declaration of insolvency or resolution is only effective in the country in which it is initiated. Under this principle, if a foreign subsidiary enters into resolution, the assets of the subsidiary are collected and realised first for the benefit of its creditors. That is to say, host authorities have full authority over all assets and liabilities of subsidiaries within their jurisdiction. Host authorities may also have jurisdiction over local branches. For instance:

- Section 606 of the NY banking law seems to authorize the New York Department of Financial Services to take possession and liquidate branches licensed in New York of foreign banking organizations; and
• The BRRD states that member states retain the right to act in relation to branches of institutions having their head office in third countries, when the recognition and application of third-country resolution proceedings relating to a branch would endanger financial stability in the Union or when Union depositors would not receive equal treatment with third-country depositors.

In order to implement a smooth resolution (in particular for entities following an SPE approach), regulatory borders should be eliminated. Thus, the cross-border cooperation managed by the home authority should drive the entire resolution process. This would entail each country accepting compliance with the laws of other jurisdictions as compliance with its own laws. Mutual trust among authorities and a full harmonisation/coordination of legal frameworks is a prerequisite to break down regulatory borders.

Despite being desirable, the current resolution work is at a very early stage and policy-makers have only drafted general recommendation papers. Two steps done in the right direction are the following:

• The FDIC and Bank of England joint paper on resolving global banks,22 which focuses on the application of an SPE resolution strategy. The paper discusses how such an SPE strategy could be implemented for a U.S. or a U.K. financial group in a cross-border context; and identifies further areas to work on.

• The consultative paper released by the Hong Kong authorities last January. The Hong Kong authorities propose to allow the home resolution authority to carry out the resolution at parent level, but under the premise that local creditors would not be penalised more than those located at the home level.23

Moreover, any “territoriality” features in terms of cross-border resolution and the degree of their impact are variable, depending on each resolution strategy.


23: Consultation paper on “Effective resolution regime for financial institutions in Hong Kong” jointly published by the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority (January 2014).
Box 3. FSB Internal TLAC requirements

As mentioned in Box 1, the minimum TLAC should be tailored to each resolution strategy (Multiple-Point-of-Entry MPE and Single-Point-of-Entry SPE). The main characteristics of the FSB internal TLAC requirement are the following:

**Internal TLAC objective**

Requiring parent banks of SPE groups to preposition the external TLAC issued seeks to ensure confidence among all parties, especially between home and host authorities in the credibility and effectiveness of the parent support.

This internal TLAC may mitigate host resolution authorities’ concerns that the home authority may not trigger bail-in at the parent company level and then recapitalize the loss making bank or bank holding subsidiary. In fact, host authority would trigger the bail-in of the internal TLAC in case of the local subsidiary had been entered into resolution and the parent had not been injected capital in it.

**Material subsidiaries**

Resolution is not “resurrection” and, therefore, the internal TLAC should be used to restructure those subsidiaries which are either relevant for the group or performs critical economic functions. Thus, internal TLAC should only be placed in those subsidiaries that are considered material.

The FSB is proposing a material objective criteria based on a percentage (5%) of the consolidated risk-weighted assets, revenues and leverage exposure. The list of material entities in each group should be reviewed on annual basis in the context of the Crisis Management Groups.

**Internal TLAC level**

In principle, all TLAC at group level should be external issued by the parent and placed downstream in all subsidiaries. However, the FSB is aware of the significant impact of this requirement on banks with centralized capital and liquidity management.

Therefore, the FSB envisaged that the total quantum of internal TLAC may be less than the requirement set at the consolidated level for the resolution group in which that legal entity resides.

The 75% to 90% proposed range will be review in the QIS. In any case, the home and host authorities in the Crisis Management Group should define the optimal internal TLAC in each subsidiary.

**Internal TLAC instruments**

The characteristics of the internal TLAC instruments are one of the most controversial issues in this context. Host authorities would tilt towards required on-balance sheet instruments which are subordinated to the operating liabilities of the subsidiary.

On contrary, SPE banks would prefer greater flexibility over how this downstream is achieved. In particular, it could be structured so as to give the subsidiaries at which resources were to be held a legal claim to a portion of the pool, subject to some condition such as collateralized guarantees.

Whereas host authorise would prefer on balance-sheet items, other forms of internal TLAC may be agreed in the Crisis Management Groups. A key challenging discussion will be who has the power to trigger the internal TLAC, either the host, the home or a joint decision.
4. The FSB approach: solving cross-border recognition issues

As we have described previously, the challenge for cross-border resolution is to develop a feasible solution that relies on a variety of legal regimes and overcomes all reluctance among authorities—mainly home and host.

Designing an effective resolution framework has to face the following issues: i) divergent resolution legal regimes around the globe (e.g., different hierarchy of claims in deposits), and ii) the “territoriality” principle of the resolution law.

But, being aware of the existing barriers and obstacles to carry out an effective cross-border resolution is clearly not enough. At the St. Petersburg G20 Summit in 2013, the FSB made a commitment to develop policy proposals on how legal certainty in cross-border resolution can be further enhanced.

As a principle, there is a common understanding that effective statutory recognition of cross-border resolution via harmonized resolution regimes across all jurisdictions is the preferred goal. However, until comprehensive statutory regimes have been adopted in all jurisdictions, contractual arrangements offer a workable interim solution. The FSB proposes two particular cases where achieving cross-border recognition is a critical prerequisite for orderly resolution:

- bail-in clauses of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity, and
- temporary restrictions or stays on early termination rights in derivative contracts as the ISDA’s contractual amendments can help to support cross-border enforceability.

In particular, the recent agreement of a Resolution Stay Protocol by ISDA is a significant and important step to improve the effectiveness of cross-border resolution actions. The major investment banks have agreed to sign this new protocol, that will impose a stay on cross-default and early termination rights within standard ISDA derivatives contracts in the event that one of them is subject to resolution action in its jurisdiction. The Protocol essentially enables participating counterparties to opt into certain overseas resolution regimes via a change to their derivatives contracts. While many existing national resolution frameworks impose stays on early termination rights following the start of resolution proceedings, these stays might only apply to domestic counterparties trading under domestic law agreements, and so might not capture cross-border trades.

Although the protocol will become effective on 1 January, 2015, the adherent banks will comply with it on a voluntary basis by early November 2014 (which implies that over 90% of their OTC bilateral trading activity will be covered by stays of either a contractual or statutory nature), but it is expected that the Stay Protocol will be gradually adopted by the rest of the entities.

In any case, trust and confidence among authorities through an effective coordination and cross-border recognition of resolution actions is a necessary prerequisite. The FSB highlights that a jurisdiction’s discretion to refuse recognition of a foreign proceeding may exist where the foreign resolution measures would have adverse effects on local financial stability. In practice, these exceptions would give national regulators a certain degree of discretion not to implement coordinated recognition of foreign resolution measures.

25: International Swaps and Derivatives Association (ISDA) (October 2014).
Box 4. Contractual recognition clauses in TLAC instruments

In order to be effective, TLAC instruments require a law which recognises the bail-in. In fact, TLAC particularly needs a specific bail-in law which forces creditors to shoulder much of the burden of the cost of recapitalisation via write down procedures or equity conversion.

Cross-border bail-in issue
From the cross-border resolution standpoint, carrying out a cross-border bail-in could be a chaos. National laws do not usually recognise the application of bail-in under the laws of other jurisdictions. This is especially relevant because the majority of banks have a significant portion of senior debt governed by laws other than those of their place of incorporation — for example, most large continental European banks have bonds governed by either English or New York law.

The need of contractual clauses
One of the legal questions discussed in connection with this topic is whether to include contractual bail-in clauses or to apply a statutory approach – without such clauses – in senior debt issuances placed under a third country law.

The FSB proposed that TLAC subject to the low of a jurisdiction different form the issuer must include legally enforceable contractual provisions recognizing the application of resolution tools by the relevant resolution authority if the resolution entity enters resolution, unless there is equivalent binding statutory provision for cross-border recognition of resolution actions.

Being aware that resolution regimes will neither converge in the short-term nor the regulatory borders will be broken down, it appears that the inclusion of contractual provisions in debt issuances governed by third-countries’ laws enforcing the bail-in will be needed.

The EU approach to contractual clauses
The European resolution regime (BRRD) are already prepared to recognise bail-in compromises of creditors’ rights by either statutory or contractual approaches.

In particular, the BRRD (article 55) does not require the contractual recognition of bail-in when the instrument issued can be subject to write-down and conversion powers by the resolution authority of a Member State, whether because of the laws of that third country jurisdiction or because of a binding agreement between the Member State / EU and the third country.

It is important to note that European banks may issue senior debt without bail-in clauses in a third country which does not have a bail-in regulation, but such senior debt will not be used to comply with the Minimum Required Eligible Liability ratio (MREL), the equivalent ratio to the TLAC.
Operational subsidiarisation under an MPE

1. Introduction

A key consideration for developing a successful resolution strategy is to identify and remove the potential barriers to the implementation of the preferred resolution strategy. A critical barrier for MPE banks is the minimum requirements for operational continuity and structuring shared services\(^\text{26}\). In fact, arrangements that work perfectly well in a going concern, in which all entities are part of the same group with common goals, may fail in a resolution scenario. Resolution may result in one or more entities going into administration, being sold off or entering some form of special resolution or bridge-bank regime. In this case, each entity will be managed independently and the management or administrators of each entity cannot then necessarily rely on continued operational service being provided.

MPE banks’ shared services (e.g. data processing centre, software development and maintenance or back-office services) must be organised in a way that would permit the group to maintain services to ensure that those services are available even when other parts of the group enter into resolution. As the FSB notes, “this entails the provision of critical shared services or functions out of adequately capitalised separate legal entities that are dedicated to service provision, or advance preparation for a carve-out in a crisis”\(^\text{27}\). This is what has been termed as “effective operational subsidiarisation.”

Operational subsidiarisation and resolution challenge the prevailing shared services model. Nowadays, most banks use shared services to a greater or lesser degree. This may vary from the use of staff or technology owned by one entity to process transactions of others through to an independent centralised company providing a shared service, or, even, outsourced.

2. Operational subsidiarisation: facts and pros

2.1 Contextualisation in the resolution debate

Maintaining shared services in or for a particular entity when the bank or another part of the group fails is the main objective of the operational subsidiarisation.

In the event of failure, knowing how the shared services are structured is important. This is especially critical in global MPE banks operating in multiple jurisdictions. Host authorities may be concerned as to whether entities in different countries may or may not be able or encouraged to continue delivering services in their country. These doubts may even arise within the same country when rules that are being introduced to ring-fence certain banking activities (e.g. the Vickers rule in the UK or the structural banking reform proposed by the EU Commission). In this context, operational subsidiarisation may mitigate authorities’ and bank managers’ concerns.

In practice, operational subsidiarisation establishes that the part of a bank’s infrastructure that is vital to ensure ongoing operations of critical functions should be placed into a separately capitalised and solvent company remote from the whole group. This ensures that the critical functions provided by a self-sufficient and independent company are able to continue to operate in the event that a bank becomes non-viable.

\(^{26}\) P. Tucker (May 2013), speech at INSOL International World Congress “Resolution and future finance.

\(^{27}\) Multiple-point-of-entry preconditions (see chapter A FSB July 2013).
The operational subsidiarization is not only a conceptual requirement. Authorities may consider requiring institutions to move shared services into separate operational subsidiaries as a preventive resolution measure, if this new structure removes or reduces impediments to resolvability.28

2.2 Main characteristics and pre-requisites of the operational subsidiarisation

When designing and establishing an operational subsidiarisation, the following elements will need to be considered to mitigate the potential obstacles in case of resolution:

A. Shared services should be provided from a separate legal company

See Section 3 for an analysis of the various alternative structures

B. The financial viability of the shared service company should be driven by the services provided rather than by corporate contributions from the parent; and should be supported by robust and audited transfer pricing policy.

The conditions of a related party transaction should not differ from those that would have been established among independent companies. This is the “arm’s length principle” stated by the OECD in its Transfer Pricing Guidelines29 and the G20 initiative of the base erosion and profit shifting.

The billing of the subsidiary for the services rendered should be at market prices. That is to say, the transaction should not be treated differently for tax purposes from comparable transactions between independent enterprises, simply because the transactions are between enterprises that happen to be associated.

The method to be used to determine arm’s length transfer pricing for intragroup services should be determined according to the OECD’s Guidelines. Often, the application of the Guidelines will lead to use of the Comparable Uncontrolled Price Method (CUP) or Cost Plus method for pricing intra-group services. A CUP method is likely to be the most appropriate method where there is a comparable service provided between independent enterprises in the recipient’s market, or by the associated enterprise providing the services to an independent enterprise in comparable circumstances. On the other hand, if a Cost Plus Method is used, the final price should also include any mark-ups necessary to address tax considerations. An appropriate mark-up should be added to the cost incurred in the rendering of the services, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and market conditions.

In line with the above, although there are different ways to price and charge back intragroup services, using a robust transfer pricing policy is more than desirable. While unrealistic transfer prices do not affect the overall bank directly (not taking into consideration additional taxes or minority shareholders impacts), they become a concern when they are misused to reduce profits at a subsidiary or regional division of the banking group that is located in a country that levies high taxes, and raise profits in a country that levies no or low taxes. It is worth to note that an incorrect transfer pricing policy could lead to high penalties and tax adjustments. Additionally, an intense focus on transfer pricing by almost all tax authorities around the globe, together with a growing focus on international exchange of information, drives the implementation of an audited transfer pricing procedure, either internally or externally.

28: See for example ank Recovery and Resolution Directive (BRRD), article 15 (5g) and EBA draft guidelines on measures to reduce or remove impediments to resolvability (EBA/CP/2014/15) and EBA draft regulatory technical standards on the content of resolution plans and the assessment of resolvability (EBA/CP/2014/16).
Developing a shared service income business model supported by a robust transfer pricing policy would enhance transparency and mitigate tax and resolution authorities’ concerns.

C. The shared service company should be sufficiently funded and capitalized (capital and liquidity).

Operational companies would have the necessary financial and managerial resources to ensure that they can continue providing shared services in case of resolution of any subsidiary of a group.

Besides having a comfortable financial situation (capital and liquidity) in a business-as-usual basis, what is really relevant in an extreme adverse situation is to maintain the financial strength when the group is under resolution.

The failure of a subsidiary and the subsequent past-due payments of the shared services may threaten the financial viability of the operational company and put at risk the continuity of the critical functions of the whole group. In fact, the provision of liquidity should maintain the day-to-day services and continue to pay the salaries, software licenses, etc. to preserve the failed bank’s critical functions. Therefore, maintaining a liquidity buffer in the operational company would constitute a feasible back-stop against contagion risk.

In this regard, the Prudential Regulatory Authority of the Bank of England envisages that the optimal amount of capital and liquidity should be related to the annual fixed overheads. In particular, “capital resources equivalent to 25% of annual fixed overheads and liquidity resources equivalent to 50% of the annual fixed overheads.”

D. Robust service level agreements (SLAs) between group entities are necessary, including cross-border inter-company service agreements, which can be enforced in resolution.

Operational subsidiaries need to have in place robust SLAs with their bank customers, which can be enforced in resolution. These SLAs serve as “market” contracts within the group with specific clauses for resolution scenarios, which guarantee the continuity of the service for an agreed period, and, therefore, maintain the critical functions of the failed bank.

The SLAs should include, at least two critical provisions:

- **Minimum prescribed period.** The cornerstone in the SLAs is the provision to continue providing services for a minimum period of time (e.g., 120 days post-resolution) to identify and arrange for an alternative service provider, or to build the in-house capability to perform the services. A long lag period provides greater flexibility to resolution authorities in order to maximise the value of the failed institution and find the optimal resolution strategy, normally through a bridge-bank strategy.

  The provision of services should also be extended to a potential third-party purchaser or the bridge bank for this period of time; and, reciprocally, the third-party purchaser or bridge bank would continue to fund the provision of those services.

  For example, Figure 6 shows that contracts for such services should assure that critical functions could continue to be provided for an extended transition period, notwithstanding the possibility that entity A1 could cease to be part of the group.

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Operational subsidiarisation and bridge-bank resolution strategy

Source: BBVA Research

- **Minimum cancellation period.** The SLAs may also determine that it would be possible to transition away from the services provided by the operational company and for the bridge bank or third-party purchaser, as applicable, to perform those services within a minimum number of days. Therefore, the xx-day (e.g. 60 days) notice period would be sufficient time to allow for alternative service arrangements to be made and to prevent disruption.

**E. Operational companies, that provide shared information and IT services to several subsidiaries within the group, should be able to produce legal entity-specific data.**

Data information systems are a key component of the banking strategy, particularly in global groups. Data systems enable the business and regions to effectively manage information on key areas such as risk management, finance, accounting or reporting. In particular, they provide information and reporting needs at all levels with local and group consolidated financial and non-financial information considering the diversity of views, objectives and structures but maintaining the integrity and corporate criteria.

Such data information processes are usually carried out through independent and common data processing centres that should be able to produce critical management information at the subsidiary level. As the FSB stated in July 2013, this includes detailed information on capital, subordinated debt, contingent capital and debt, as well as operational links. Additionally, data information shared services should be readily separable from the rest of the corporate organisation so that they can be relied on at the level of relevant subsidiaries or local blocks.

**2.3 Advantages of operational subsidiarisation**

The advantages of the operational subsidiarisation in case of resolution of a large and complex group have already been highlighted by the authorities, as for instance the UK Independent Commission on Banking (ICB).

From the standpoint of the authorities, operational subsidiarisation could prove very effective means of securing operational segregation. Chief among them:

- It involves placing into an independent company the key infrastructure needed for a bank to preserve the critical functions either for the economy or the bank itself. Operational subsidiarisation constitutes a natural firewall against contagion risk.

31: See FSB (July 2013).
32: The Independent Commission of Banking (UK) identifies the operational subsidiarisation as the best approach to carry out shared services within a global group. See final recommendation (September 2011).
• It also allows critical infrastructure to be re-opened immediately after resolution is invoked. Being segregated from the banking entity paves the way to carry out their shared services whilst the resolution authority controls the failed bank.

• Placing critical shared operations in neither a deposit-taking nor a trading entity could facilitate operational continuity, regardless of which entity experiences stress. Such an approach could reduce the loss in default experienced by enabling ongoing services to the banks continuing operations. That is to say, this structure is more resilient to face shocks, either idiosyncratic or systemic.

From the standpoint of the bank managers, the operational subsidiary approach is more efficient than providing services within the operative entity.

• Shared service businesses, such as back-office process or IT data processing, is very far away from the banking sector. Operational subsidiarisation provides bank managers with a greater degree of flexibility. In fact, group managers may allocate specialised human, IT and software resources to fully comply with their shared services task.

• The costs, if structured correctly, would primarily be one-off and related to the transfer of infrastructure, but not financials, assets into the new entity.

• In addition, a group would incur the cost of capitalising the subsidiary to ensure that it can operate for a set period post-resolution without additional funds, as well as some incremental operational costs of coordination.

• Setting up an independent service company represents an opportunity to banks which have invested heavily in their shared services platforms and may consider commercialising these and providing services to other banks.

• From a strategy point of view, it generates better customer focus and allows offering better services to clients, billing them at “arm’s length”.

In the case of an MPE resolution strategy, the operational subsidiarisation is gaining relevance. It is important to note that under an MPE strategy, subsidiaries are independent from each other, so local authorities would have all resolution powers to activate the resolution process independently in the subsidiaries under their jurisdiction. Thus, operational subsidiarisation is inherent to MPE banks.

However, whether to have a unique centralised shared service company or multiple decentralised companies is a key question that bank managers and authorities should carefully analyse in order to assess the resolvability of MPE banking groups.

Would host authorities allow centralised shared services in a third country? Which are the minimum SLAs that they might require to enhance trust? Which is the most efficient and least costly structure to carry out shared services?

Section 3 analyses different operational structure alternatives, either centralised or decentralised, that MPE global banks should consider guaranteeing that critical services can be maintained in a resolution scenario.
3. Operational subsidiarisation structures in MPE banks

MPE groups usually organise themselves into well-defined regions and functional subgroups with limited and non-systematic financial and operational interdependencies. In this sense, an MPE approach does not only apply to bank units, but also to shared services, such as IT or back-office processes.

Operational subsidiarisation is a key prerequisite for MPE banks in order to facilitate and eliminate the barriers to resolution. Thus, common services should be provided by stand-alone companies facilitating the continuity and survival of any part of the group in case of breakup.

As shown in Figure 7, there are two alternatives to implement a stand-alone support of critical and shared services under an MPE resolution strategy.

1. Centralised subsidiarisation approach.

Under a centralised approach, shared services are provided by a common and single company located below the top-tier holding company for the whole group. This does not mean that all shared services are carried out within the same company, as the single refers to a common company for each shared services. Therefore, operational centralised banks may have several shared services companies that provide different shared services.

In the case of MPE groups which operate in several jurisdictions, shared services in host countries may be provided following two schemes: i) local branches, or ii) local subsidiaries.

Carrying out shared local services through an operational subsidiary is a middle-way approach that may minimise host authority concerns of a fully centralised scheme. Despite a common operational parent company, resolution authorities may apply an MPE resolution scheme and control both the local bank subsidiary and the local operational subsidiary in order to assure the maintenance of critical functions.

From the bank managers’ standpoint, a centralised approach structured through several operational subsidiaries may ensure one decision-making unit whilst decentralising low-value activities. For example, a company may have a single decision-making unit for investing and building out its call centre, but the call centre organisation may still consist of decentralised personnel working from their homes and having decision rights over maintaining their systems.

Finally, it is worth mentioning that both schemes, operational branches and subsidiaries, require formal and audited contracts and SLAs as a basis for services. At the end of the day, those are unavoidable pre-requisites in practice.
2. Decentralised subsidiarisation approach.

At the opposite end of the spectrum, a decentralised structure considers each shared service company as a “silo”, where each bank subsidiary is self-contained and owns and operates its own shared services.

The resolution principle of self-sufficient shared services - operational subsidiarisation - may be interpreted by orthodox authorities as requiring all shared services to be provided within each entity in geographical or business division-led silos.

A decentralised approach may at first sight look the most straightforward scheme from an MPE resolution standpoint – multiple-points-of-resolution within a group are aligned with multiple independent shared service companies. However, lack of flexibility and cost are the major drawbacks (see below for further details).

3.1 Pros & Cons of both approaches

The discussions about the optimal structure of an MPE banking group should take into account the following factors:

- **Efficiency and economies of scale**: the centralised model provides enormous economies of scale through centralisation of services on a global level as banks share operational processes (administrative services) and technology across divisions and legal entities. Additionally, absence of duplication of function and sharing common IT and administrative activities will boost performance and cut administrative costs.

  In contrast, centralised organisations can suffer from the negative effects of several layers of bureaucracy. These businesses often have multiple layers of management stretching from the owner down to the frontline operations. Business owners responsible for making every decision in the company may require more time to accomplish these tasks, which can result in sluggish shared service operations.

- **Resolvability**: from the point of view of resolution, the decentralised approach seems to be the preferred approach. This model often involves the application of resolution powers to different parts of the group including the subsidiary and the company services provider. Nevertheless, in a centralised model the local subsidiary could be resolved but not the company that provides services across multiple divisions and entities.

  When assessing firms’ resolvability, at least two concepts should be analysed:

  - **Continuity of services**: in the case of a decentralised model, local authorities would have every incentive to maintain shared services of the failed subsidiary in order not to disrupt the continuity of the critical functions which may pose a local systemic risk.

  - **Resilient during financial crises**: a decentralised operational approach also creates natural firewalls in the event of crisis. This model generates inbuilt limits to contagion.

- **Home perspective**: From the perception of local authorities the decentralised model could be optimal because each subsidiary is self-sufficient with respect to the services in case of resolution. Moreover, in a decentralised model, the coordination between authorities could be lower than in a centralised model. Although coordination between home and host authorities is important in both models, and in both approaches the ultimate responsibility for resolving any subsidiary lies with the host resolution authority, in a centralised model there will inevitably be better coordination with other regulators and with the home regulator, although the centralized company is not necessarily located in the home jurisdiction.
Regardless of all the positive features mentioned above, the decentralised scheme structured through local subsidiaries could in practice have the same benefits from the resolution authority standpoint.

- **Data information system at entity level:** Operational subsidiarisation ensures two MPE pre-conditions: i) authorities may obtain subsidiary data and information at individual level, and ii) data systems should be readily separable from the rest of the corporate organisation. Differences between the centralised and decentralised approach arise in terms of corporate standards and management vs. flexibility in order to adapt information to local needs.

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<th>Table 4</th>
<th>Pros and cons between centralised and decentralised operational subsidiarisation approach</th>
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<tr>
<td><strong>Pros</strong></td>
<td><strong>Cons</strong></td>
</tr>
<tr>
<td>Centralised</td>
<td>• Cost is lower as there are economies of scale and lower ongoing maintenance costs</td>
</tr>
<tr>
<td></td>
<td>• Services are provided across multiple divisions and subsidiaries</td>
</tr>
<tr>
<td></td>
<td>• As the service company is a separate entity, it can continue to provide services to different parts of the group in the case of the failure of a subsidiary</td>
</tr>
<tr>
<td></td>
<td>• Higher resilient during the crisis</td>
</tr>
<tr>
<td></td>
<td>• Data systems can be used at the local subsidiary or bloc level</td>
</tr>
<tr>
<td></td>
<td>• Corporate-wide operational reporting is standard</td>
</tr>
<tr>
<td>Decentralised</td>
<td>• Each subsidiary is self-contained and owns and operates its own processes</td>
</tr>
<tr>
<td></td>
<td>• Resolvability is higher within each entity</td>
</tr>
<tr>
<td></td>
<td>• Preferred option from home authorities’ perspectives</td>
</tr>
<tr>
<td></td>
<td>• Provides the greatest configuration flexibility between regions and allows diversity</td>
</tr>
<tr>
<td></td>
<td>• Separate data bases</td>
</tr>
</tbody>
</table>

Source: BBVA Research

### 3.2 Decision-making dilemma

Decentralised or centralised operational subsidiarisation are extreme models, many intermediate options may lie in between. As shown in Figure 8, firms need to strike a pragmatic balance between the desires of the regulators and the need for maintaining a viable business model.

![Figure 8: Decentralised vs. Centralised Subsidiarisation Approach](image)

Source: BBVA Research
The past two/three years have been a time of unprecedented pressure in the banking sector. Customers have become even more demanding – and less forgiving; regulators’ expectations are more onerous than ever before; and margins and profits are slipping back into minimum levels.

Benefits of the operational subsidiarisation are significant, ranging from a more effective resolution – securing operational segregation – to a more efficient service – cost optimisation. When choosing between the two approaches (decentralized or centralized subsidiary operation structure), MPE banks need to strike a pragmatic balance between the optimal scheme from a resolution standpoint – the decentralised model – and the need to maintain an economically viable business model – centralised option. In this regard, the benefits of the centralised model, especially under a subsidiary structure, clearly outweigh its resolution threats, which could be resolved by robust SLAs and ex-post capital and funding agreements.

Against this backdrop, discussions between bank managers and authorities are tilting towards a centralised approach with strong SLAs.
The critical economic functions’ role in resolution

1. Critical economic functions in the resolution framework

The new legal framework for the resolution of financial institutions enables authorities to resolve failing financial institutions quickly, ensuring the stability of the financial system and preserving the main banking operations while trying to minimise taxpayer contributions to resolution episodes.

To achieve these goals, the authorities and banks have two new ex-ante resolution tools with a pre-emptive nature in order to help financial institutions to recover their stability, and ensure a quick resolution process: i) the recovery plan, and ii) the resolution plan. In particular, the resolution plan should help to ensure that the resolution strategy and the resolution operational plan include appropriate actions that help to maintain the continuity of the critical economic functions, while avoiding unnecessary destruction of value and minimising, where possible, the costs of resolution to home and host authorities and losses to creditors.

In this sense, a key component of the resolution planning is the identification of the essential, systemically and “critical” functions provided by banks. The FSB defines critical functions as “activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group’s size or market share, external and internal interconnectedness, complexity and cross-border activities.”

Because one of the cornerstone of the resolution process are the critical economic functions, the designing of two of the most critical issues in the resolution agenda such as the loss-absorbing capacity (LAC), the recovery plan, and the measures to remove impediments to resolvability should take into account the critical economic functions that each bank.

2. The TLAC sizing and critical economic functions

As the FSB stated, “the purpose of the total loss-absorbing capacity (TLAC) is to provide sufficient financial resources for a bank to be resolved, while minimising taxpayer capital support and without causing severe financial instability.

Thinking on optimal sizing of the TLAC, there is a mistaken trend towards ensuring that the bank should be fully recapitalised, after the bail-in, to the extent that it would be able to carry out the same activities as before entering the resolution process. In this context, some argue that the optimal amount of TLAC should be measured taking into account the whole balance-sheet in a business-as-usual situation, that is to say, prior to entering into resolution.

This approach probably ensures that any failed bank has enough TLAC to absorb losses when it enters into resolution, but it undoubtedly seems excessive conservative and overestimates the minimum TLAC required. This can be explained by two main factors:

- First, the minimum amount of TLAC should be limited to the amount sufficient to recapitalise those entities in the group that perform only critical functions. As Sir John Cunliffe from the Bank of England recently argued: “we are not seeking an amount of GLAC capable of resurrecting any failing bank including the global giants. Rather, we are looking for sufficient GLAC to recapitalise the entities carrying

34: Financial Stability Board (September 2014) “Financial Reforms – Completing the job and looking ahead”.
out critical economic functions to a level sufficient to regain and maintain market access. For the remaining entities, sufficient capacity to provide for an orderly run-off is what is required. Sir John introduced the critical economic functions in the GLAC discussion as a key factor when sizing the minimum GLAC. It is worth remembering that one of the main objectives of the resolution plan and the resolution strategy is to identify which functions are economically critical and should be preserved, and which are not, and should therefore be liquidated.

For example, two banks with the same balance-sheet and risk profile but carrying out different critical economic functions should not have the same minimum TLAC requirement. As Figure 9 shows, the bank which may pose higher systemic risk – let us say with more critical functions - should have more TLAC, in order to ensure a smoother and less disruptive resolution process.

Figure 9
Critical economic function role when sizing TLAC

![Diagram showing critical economic function role when sizing TLAC]

Note: CEF – Critical Economic Function, NCEF – Non-Critical Economic Function

Total consolidated Assets Bank A = Total Consolidated Assets Bank B
Risk profile Bank A = Risk profile Bank B
TLAC Bank A > TLAC Bank B

Source: BBVA Research

- Second, there are many doubts about the assumption that the bank would be the same size post-resolution. Entering into resolution is not a situation that happens suddenly at a bank, as the financial conditions usually deteriorate gradually. In this regard, before entering into resolution, failed banks have already taken several measures included in the recovery plan which reduce the size of the bank, such as deleveraging, asset disposals, etc. Moreover, the resolution process implies a tougher business restructuring that would significantly reduce the bank's balance-sheet.

Critical economic functions are key element in the resolution plan, but not the unique. Other factors such as the resolution strategy (Single-Point-of-Entry or Multiple-Point-of-Entry), the risk profile of the institutions, the systemic feature of the group and its subsidiaries (G-SIFI, D-SIFI, none) should also play a key role when designing the minimum quantum of the TLAC. Against this backdrop, the TLAC should be assessed individually, based on a case-by-case analysis, should be tailored to each bank’s resolution framework (recovery plan, resolution plan and resolvability assessment) and, therefore, should take into account the critical economic functions that should be preserved in each institution. Therefore, the higher TLAC should be imposed via a firm-specific requirement (a Pillar 2 TLAC) rather than a higher Pilar 1 requirement.

35. Ending Too Big Too Fail – progress and remaining issues”. Speech at The Barclays European Bank Capital Summit (13 May 2014).
Box 5. Additional Pillar 2 TLAC requirements

The FSB states that term sheet for a requirement for Total Loss Absorbing Capacity would include a range for the minimum pillar 1 requirement for the total amount of loss absorbing capacity that G-SIB must hold at all times.

This Pillar 1 requirement would be complemented by a Pillar 2 TLAC requirement for individual firms over the minimum standard as shown the Figure below.

![Figure 10 TLAC requirement](image)

Source: BBVA Research

A firm-specific minimum TLAC

Supervisory and resolution authorities involved in the Crisis Management Group would be responsible for determining case-by-case the minimum TLAC take into account the recovery and resolution plan, their systemic feature, their business model and complexity, the risk profile and the organization structure. In this sense, higher Pillar II requirements and lower Pillar I level will create positive incentives to improve the resolvability of a bank.

Pillar 1 and Pillar 2 objectives

The FSB envisages a TLAC approach with the same philosophy as the capital requirements.

- Setting a common Pillar 1 TLAC requirement would help to achieve a level playing field internationally.
- Setting a Pillar 2 requirement rightly recognizes that not all GSIFIS are the same and seeks to determine a firm-specific minimum TLAC based on the resolution features of each Group where the critical economic functions may play a key role.

EU MREL versus Pillar 1&2 TLAC approach

The definition of a minimum standard (Pillar 1) at the FSB level is one of the main differences between the loss absorbing concept in Europe (known MREL-Minimum Required Eligible Liabilities) and the FSB’s TLAC.

European authorities consider that supervisors and resolution authorities are the responsible of ensuring a level-playing field trough setting minimum MREL case-by-case to each banking group. That is to say, the MREL requirement in Europe may be considered as a full Pillar 2 requirement due to the absence of a common Pillar 1 requirement.

Whether the FSB approach of a common minimum standard would change the MREL or not is still unknown. In any case, the EBA will have to review the MREL definition by October 2016 and, without any doubt the TLAC features defined by the FSB will become a target model.
3. Critical economic functions and bank structure

Banking groups, especially those which are active in multiple business and/or geographies encompassing critical and non-critical economic factions, should be organised in a way that their legal structure does not hamper the resolvability of the group, while ensuring the maintenance of the critical functions.

From a pure resolution standpoint (we are not taking into account any other economical or strategic criteria), banking groups may have organised their legal structure into independent legal entities where some carry out core business lines with critical functions while others do not. The way in which banks structure their legal and operational business conditions in large measure affects the feasibility of carrying out an efficient resolution process.

For example, Figure 11 shows two banks carrying out the same critical and non-critical economic factions but organised in different structures. In this simple case, we may argue that resolution authorities may have a more efficient resolution process with Bank A than Bank B.

![Figure 11 Bank legal structure and critical economic functions](image)

Note: CEF – critical Economic Function, NCEF – Non-critical Economic Function
Source: BBVA Research

The rationale behind this argument is the following:

- If Bank A entered into resolution, the optimal resolution strategy would be the recapitalisation of the subsidiaries A1 and A2 and the liquidation of A3, as it does not perform any critical activity which may pose a systemic risk. The liquidation of A3 should not have any regulatory impact on the rest of the group’s subsidiaries as long as they are legally independent. Other interdependencies such as financial or operational interconnections should also be carefully analysed in order not to hinder the resolution process.

- In contrast, the resolution of Bank B may be more challenging. Resolution authorities may have two different alternatives: i) recapitalise the three subsidiaries as they each carry out at least one critical function, or ii) move, and group together, the critical economic functions and other economic functions when the bank enters into resolution.

Grouping economic functions ex-ante as a measure to improve the resolvability of a group, or in a resolution process, may be hampered by legal or regional impediments. In this regard, a possible alternative way of solving it may be the creation, for example, of regional independent blocks that carrying out both types of functions as shown in Figure 12.
The requirement to change the legal or operational structure of a banking group, so as reduce complexity and improve resolvability, is a very controversial issue. Last July, the EBA had already opened this debate in the resolution context with the publication of the consultative paper on measures to reduce impediments to resolvability. In particular, the EBA states that resolution authorities may require changing the legal or operational structure of an institution to ensure that critical functions may be legally and economically separated from other functions.  

Banks and authorities have only just begun to think about it and we still do not know what the optimal structure is – if there even was an optimal one. But what is certain is that critical and non-critical economic functions will play a central role in this discussion.

4. The recovery and resolution plan and critical economic functions

The relevance of the critical economic functions in resolutions is also underscored by the authorities in the recovery and resolution plan.

In the recovery plan, the critical economic functions play a role when describing the entities covered by it. In particular, European authorities require indentifying in the recovery plan the “core business lines and critical functions and set out the key steps to maintaining those core business lines and critical functions in a situation of financial stress.”

That's mean that, although critical economic functions may be seen more appropriate situated in the resolution plan, a detailed description of the critical functions should facilitate the assessment in terms of credibility and feasibility of recovery options, such as divestments and sales of business lines. For example, if the mortgage lending business of a subsidiary has been identified as critical, the group should not include the liquidation of the subsidiary in the group recovery plan.

In this regard, it is important to highlight that authorities have to evaluate the extent to which the recovery plan or specific options within it could be implemented without causing any significant adverse effect to the financial system, and, in this context, the economic functions’ description is rightly incorporated in the recovery plan.

36: European Banking Authority (July 2014). Consultation paper on “measures to reduce or remove impediments to resolvability” (EBA/CP/2014/15).
From the resolution standpoint, the critical economic functions are the anchor around which the resolution strategy is been assessed. This is particularly relevant on the premise that authorities should identify the optimal resolutions strategy that ensures the continuity of those functions.

As we mentioned above, separate critical from non-critical functions in different legal entities may facilitate resolution. In fact, it may broaden the range of resolution options available applying different resolution tools to the critical functions’ entities and the rest of the group, and may facilitate a wider range of options for restructuring following resolution. For example, in the context of the UK structural reform, the PRA envisages that banking groups may resolve a failed investment banking subsidiary (which may be consider non-critical) without disrupting the activities of the retail banks (which may perform critical functions).\textsuperscript{38}

\textsuperscript{38} Prudential Regulation Authority - Bank of England (October 2014), Consultation paper on “the implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities.”
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