NOTE NUMBER 336

viewpoint
PUBLIC POLICY FOR THE PRIVATE SECTOR

JANUARY 2013

VICE PRESIDENCY

FINANCIAL AND PRIVATE SECTOR DEVELOPMENT

THE WORLD BANK GROUP

Resolution Regimes

Dealing with Failing Financial Institutions

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In response to the financial crisis in developed countries, the G-20, the Financial Stability Board, the Basel Committee on Banking Supervision, and other standard setters are pursuing an agenda of reforms aimed at improving laws, policies, and procedures for resolving troubled and failing financial institutions. These reforms offer concepts that deserve attention in the developing world, particularly for dealing with the systemically important banks and other financial firms that are a feature in nearly every country.

The global financial crisis that began in 2008 demonstrated the potential risk to financial systems from "too big to fail" financial institutions. As part of an agenda of reforms to address this risk, the Financial Stability Board (FSB) agreed on a new international standard for resolution regimes for financial institutions. A principal objective is to ensure that the failure of even large, systemically important financial firms can be managed without significant financial or economic disruption and without a risk that taxpayers will have to bear losses.

To achieve this aim, the new standard prescribes a range of powers that should be available to resolution authorities in every jurisdiction. It also requires recovery and resolution planning for firms that are systemically important to any national economy—to minimize the potential that the firms can fail and to increase the potential that the authorities can deal effectively with distress or failure should it occur. In addition, the new standard sets out guidance for cooperation among the supervisory and resolution authorities responsible for significant components of firms operating across borders. Assessment of this standard will be included in the World Bank and International Monetary Fund's Financial Sector Assessment Program, probably beginning in 2014.

Complementary work by the Basel Committee on Banking Supervision has focused on the identification of globally systemically important banks (G-SIBs) for the purpose of requiring these institutions to hold higher levels of capital and undergo greater supervisory scrutiny—and is now expanding this to domestically systemically important banks (D-SIBs). The D-SIB agenda is relevant to nearly all developing countries, and its implementation will require regulatory policy decisions and adoption of new supervisory practices.

This Note reviews guidance and standards recently issued by the FSB and the Basel

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Committee relevant to the resolution of troubled and failing financial firms, particularly systemically important financial institutions (SIFIs). It also summarizes recent actions by FSB member authorities to strengthen their capacity and preparedness to resolve such firms. The emphasis is on developments likely to be relevant to developing country authorities.[1]

Key attributes of effective resolution regimes

The FSB's new international standard is set out in its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (FSB 2011), formally endorsed by the G-20 in November 2011. The following sections describe the range of powers prescribed by the Key Attributes for resolution authorities (box 1), the resolution planning activities that should be undertaken to reduce the risk of failure and prepare for possible resolutions, and other features of the Key Attributes.[2]

Scope

The Key Attributes apply to resolution regimes for all types of financial firms—including banks, insurance companies, securities companies, and financial market infrastructure firms (payment systems, central securities depositories, securities settlement systems, central counterparties, trade repositories)—that could be systemically significant if they were to fail. The scope of coverage also includes holding companies of financial firms, branches of foreign firms, and any significant operational entities (such as service providers) within financial groups, whether or not formally regulated. In practice, the Key Attributes are oriented mainly to the resolution of banks, and more specific guidance for insurance companies, securities and investment companies, and financial market infrastructure firms is likely forthcoming.[3]

Some requirements set out in the Key Attributes are mandatory only for firms designated by the FSB as globally systemically important financial institutions (G-SIFIs), at least at this time (see the

Box 1 Resolution toolkit

The enumeration of a comprehensive and far-reaching set of powers that should be available to all resolution authorities is an important contribution of the Key Attributes. These include the power:

- To remove and replace management and directors and recover money from them
- To appoint an administrator to take control of a firm and manage it
- To take any action necessary to restructure a firm or wind down its operations, including terminating or assigning contracts, purchasing or selling assets, and writing down debt
- To ensure continuity of critical functions by requiring other group companies to continue to provide services to a firm in resolution or by procuring the necessary services from third parties
- To override the rights of shareholders of a firm in order to facilitate a resolution, including any requirement for shareholder approval of transactions
- To establish a temporary bridge institution to take over and operate the critical functions and viable operations of a failed firm
- To establish an asset management vehicle, whether as a subsidiary of the firm in resolution or otherwise, and to transfer to it assets for management, sale, or collection
- To transfer or sell assets, liabilities (deposits, insurance policies), and other rights and obligations to a third party, including a bridge institution or asset management vehicle, without a requirement for the consent of the counterparty (depositor, policyholder) and without the transfer or sale constituting an event of default or termination
- To reverse any transfer of assets and liabilities to a bridge institution
- To carry out creditor-financed recapitalization (bail-in within resolution) as a means to achieve or help achieve continuity of essential functions
- To temporarily stay the exercise of early termination rights that might otherwise be triggered upon a firm's entry into resolution or in connection with the use of resolution powers, to impose a moratorium with a suspension of payments to unsecured creditors and customers, and to impose a stay on creditor actions to attach assets or otherwise collect money or property from the firm
- To effect the closure and orderly wind-down (liquidation) of all or part of a firm with timely payout or transfer of insured deposits and prompt access to transaction accounts and to segregated client funds.

Source: Key Attributes 3.2–3.4.

section on resolution of G-SIFIs). In November 2011 the FSB designated 29 internationally active firms as G-SIFIs—firms that because of their size, complexity, or systemic interconnectedness could cause significant disruption to the financial system and economic activity should they fail in a disorderly manner. Presently the list includes only banking groups, but it may eventually contain other types of financial groups.

Bail-in within resolution

Among the powers prescribed in the Key Attributes, one of the most debated is bail-in within resolution. In principle, bail-in is a means to force unsecured creditors to absorb losses and recapitalize a firm being resolved, thereby reducing the potential need for taxpayer support. In effect, the Key Attributes require that resolution authorities have the power not only to write down shareholders' equity but also to write down the claims of unsecured and uninsured creditors and to convert some or all of them into equity. Under the Key Attributes, this write-down and possible conversion into equity would respect the hierarchy of claims in liquidation and would probably be used in conjunction with other resolution powers allowing the restructuring of the recapitalized firm to ensure its long-run viability (Key Attributes 3.5–3.6).[4] Bail-in would also include the power to convert or write down any contingent convertible or contractual bail-in debt whose terms had not been triggered before the firm's entry into resolution.[5]

The basic approach in bail-in is similar to the outcomes achieved in other resolution techniques. In a typical bridge bank transaction, for example, some liabilities (such as deposits) as well as good assets are transferred to a new, viable bridge entity. The remaining creditors are left with a claim on the original (failing) legal entity, which is put into liquidation. The effect is to "bail in" the creditors whose claims were not transferred to the bridge entity. The Key Attributes seek to provide resolution authorities with the power to do essentially the same within the original legal entity and thereby restore its solvency.

Supervisory and resolution authorities in FSB member countries have a diversity of views on bail-in. Some would like to see the issuance of a minimum amount of contingent convertible or contractual bail-in debt made mandatory at least for G-SIFIs.[6] Some are concerned that the potential for unsecured creditors to be bailed in will create incentives for them to try to secure their investments with collateral—with the result that a growing proportion of firms' assets will be pledged to wholesale creditors, leaving fewer assets available to cover deposit liabilities (and to protect any deposit insurance authority).

Moreover, there is debate about whether strictly adhering to the hierarchy of claims in liquidation is appropriate. Some authorities advocate exceptions on the grounds that imposing losses on certain creditors in a class could potentially undermine financial stability (depending in part on the hierarchy of claims in the jurisdiction). Others argue for strictly adhering to the hierarchy of claims in liquidation in determining which creditors are bailed in. These and other policy debates are ongoing.

Temporary public ownership

One resolution option that has often been used for systemically important firms is nationalization—or temporary public ownership, as it is referred to in the Key Attributes. The Key Attributes envision turning to temporary public ownership, and the taxpayer support that it implies, as a last resort for the purpose of maintaining financial stability (Key Attribute 6.5).[7]

Funding for a firm in resolution

While bail-in is intended to avoid the need to resort to taxpayer support to recapitalize a failing firm, official support may nonetheless be required to provide liquidity during resolution. Fair allocation of losses under bail-in arrangements requires a valuation of the firm in resolution, a process that takes time. During this valuation period the firm's financial situation might be so uncertain that market participants may be unwilling to provide operating funding. Recognizing this, the Key Attributes envision temporary public support for funding a firm in resolution.[8] They call for making arrangements to recover any losses that might be incurred in providing temporary liquidity support from shareholders, from unsecured creditors, and, if needed, from the financial system generally.

Temporary stays

Another set of powers advocated by the Key Attributes but not traditionally enjoyed by resolution authorities is aimed at reducing the potential for counterparty actions (such as by a firm's creditors or by a payment and settlement system of which the firm is a member) to undermine effective resolution action. The Key Attributes call for legal frameworks and contractual arrangements providing that a firm's entry into resolution or the exercise of resolution powers does not trigger statutory or contractual setoff rights or entitle a counterparty to exercise contractual acceleration or early termination rights, as long as the firm continues to meet contractual obligations (such as making payments or delivering securities). Where contractual acceleration or early termination rights may nevertheless be exercisable, the Key Attributes stipulate that resolution authorities should have the power to temporarily stay their exercise—within limits, including with respect to time (Key Attribute 4).[9]

Creditor safeguards

The ability of resolution authorities to exercise the far-reaching powers prescribed in the Key Attributes is subject to safeguards. A key principle is that no creditor should be worse off in a resolution outcome than it would have been had the firm been liquidated (Key Attribute 5). Resolution authorities generally find that liquidation and the payout of insured or otherwise protected depositors is a high-cost resolution technique, particularly where there is franchise value in the firm. Consequently, liquidation is generally a worst-case outcome for an unsecured creditor. Under the Key Attributes, creditors should have the right to compensation where they do not receive at least what they would have received in liquidation.

Judicial review

The "no creditor worse off" safeguard and the right to compensation are intended in part to facilitate the recommendation that legislation establishing resolution regimes should not allow for judicial actions that could constrain or reverse measures taken by resolution authorities acting within their legal powers and in good faith. Instead, the Key Attributes call for redress through compensation (Key Attributes 5.4–5.5).[11]

Resolution trigger

Supervisory and resolution authorities have commonly acted too slowly to resolve failed firms, as evidenced by the often deep insolvency discovered upon failure. The Key Attributes require that authorities act to resolve firms before they are balance sheet insolvent and equity is fully written off. Toward this end, the Key Attributes stipulate that authorities should define clear standards and indicators of nonviability (Key Attribute 3.1).[12]

Recovery and resolution plans

The Key Attributes require that supervisory and resolution authorities engage in regular planning to reduce the risk of failure of systemically important firms and ensure that they can implement resolution if required. The requirements for recovery and resolution planning apply at least to domestically incorporated firms that could be systemically significant if they fail (Key Attribute 11 and annex 3). Recovery and resolution plans are intended to serve as guidance for firms and the authorities, with implementation based on the circumstances at the time.

Recovery plans should specify options for restoring a firm's financial strength (capital and liquidity) under stress scenarios that fall short of meeting the conditions or triggers for entry into resolution. Preparing these plans is the responsibility of the firm's senior management and board of directors, under guidance by the supervisory authorities. Recovery plans should include measures to conserve capital (such as by reducing or eliminating dividends) and reduce the firm's risk profile and should also address such matters as asset divestitures and debt restructuring. The plans should be routinely updated.

Resolution plans define the detailed actions needed to implement a resolution, including maintaining and restructuring operations that will be continued and winding down in an orderly manner those that will not be. Having detailed resolution plans in place is essential to minimizing the financial and economic disruptions and the potential call on taxpayer funds that can be associated with a firm's resolution. Resolution plans ultimately are the responsibility of resolution and supervisory authorities, but firms are required to provide inputs, including data and information, and will need the capabil-

ity to deliver required information in a timely manner.

Cross-border cooperation

The Key Attributes seek to promote cross-border cooperation in the resolution of regional or international institutions, in particular by requiring the involvement of key host jurisdictions in the planning activities being led by home authorities, by discouraging the use of ring-fencing by host authorities,[13] and ultimately by harmonizing national resolution regimes.

Under the Key Attributes, the mandates of resolution authorities should include a responsibility to minimize the costs of resolution not only in their own jurisdiction but also in others—and to take into consideration the impact of their actions on financial stability in other jurisdictions (Key Attribute 2.3). For example, the Key Attributes seek to empower and encourage resolution authorities to act to achieve a cooperative resolution with foreign authorities; to ensure that their legal regimes do not contain provisions that trigger automatic action as a result of an intervention, resolution, or insolvency action in a foreign jurisdiction; to avoid discriminating against creditors on the basis of their nationality or the jurisdiction in which their claim is payable; and to share information with authorities in foreign jurisdictions.

Resolution of G-SIFIs

As noted, some requirements are mandatory only for FSB-designated G-SIFIs. These include the requirement that home and key host authorities maintain crisis management groups, enter into institution-specific cross-border cooperation agreements, and undertake periodic resolvability assessments. The last two of these require agreement on an overall resolution strategy for each G-SIFI.

Crisis management groups are permanent bodies specific to each G-SIFI and generally include the home authorities and those host authorities responsible for the group entities most material to the G-SIFI's resolution. While similar to supervisory colleges, they include not only supervisory authorities but also resolution authorities, central banks, other bodies responsible for administering deposit protection or other guarantee schemes, and often finance ministries. The Key Attributes require that they cooperate closely with nonmember host authorities in other jurisdictions where the firm is systemically important.[14] The main role of crisis management groups is to oversee the development and ongoing strengthening of the recovery and resolution plans, cross-border cooperation agreements, and resolvability assessments required for each G-SIFI (Key Attribute 8).

Cross-border cooperation agreements, entered into by home and host authorities participating in crisis management groups, set out each authority's roles and commitments in recovery and resolution planning, in resolvability assessments, and in resolution. They define cooperation and information sharing arrangements within crisis management groups and with other host authorities. They thus define the framework in which home authorities inform and consult with host authorities (and vice versa) when there are problems with the G-SIFI, before individual authorities take significant enforcement actions or resolution measures. The agreements require that senior officials from the home and relevant host authorities meet annually to review the G-SIFI resolution strategy (Key Attribute 9 and annex 1).

Resolvability assessments are formal evaluations of the feasibility of implementing the resolution strategy for a G-SIFI. They are conducted by the home authorities in coordination with other crisis management group members—and by host authorities for key subsidiaries in coordination with the home authorities. Resolvability assessments should identify impediments that may arise, for example, from weaknesses in the legal regime or from the G-SIFI's structure, organization, or business practices. The Key Attributes require that the authorities have the power to direct the G-SIFI to make structural changes to improve its capacity to be resolved (Key Attribute 10.5).

Resolution strategies are prerequisites for preparing detailed resolution plans. They must be agreed on by the crisis management group and must be in place in order to undertake resolvability assessments. Resolution strategies define the overall approach envisioned for the resolution of each G-SIFI. As noted, they are to be reviewed annually. In practice, they will continue

to be updated and improved with changes in such factors as resolution powers, the nature and structure of the firm, and the preferences of the authorities.

Two general approaches to resolution strategies are emerging. One is a top-down approach, known as single point of entry, that relies on the resolution of the parent entity of the group (for example, the holding company or parent bank). In this approach losses in any downstream entities are crystallized at the parent, which is then recapitalized through bail-in of the parent's creditors. The group remains largely intact. The other basic approach, multiple point of entry, involves parallel resolution of one or more key operating subsidiaries. Losses are crystallized at the level of one or more subsidiaries, which are then resolved separately. In this approach the group is likely to be broken up to some extent (for example, into different regional or functional groups). A combination of the two approaches might also be used.

By November 2012 crisis management groups had been established for nearly all the FSB-designated G-SIFIs. The work of FSB members on G-SIFI resolution is being coordinated by the FSB's Cross-Border Crisis Management Group, which meets several times a year and in which the World Bank participates.

Standards for systemically important banks

The methodology used by the FSB to formally designate international financial firms as globally systemically important is that adopted by the Basel Committee in late 2011 for designating banks as such—for the purpose of requiring additional loss absorbency (capital) and thereby reducing the probability of their failure. The methodology focuses on the potential impact on the global economy should the firm fail (rather than, for example, on the riskiness of the firm). It uses an indicators-based measurement approach to capture different factors that make a firm critical for global financial stability. There are five categories—size, cross-jurisdictional activity, interconnectedness, substitutability, and complexity—with all but the size category including two or more quantitative indicators. All the indicators are combined to produce a score for each firm. Possible scores are grouped in four buckets, each associated with different higher capital requirements (to be phased in during 2016–19). International banks will be assessed annually to see whether they meet the criteria and thus require higher capital. The criteria will be reviewed and updated every three years.[15]

The Basel Committee and the FSB are now extending the framework to banks that are domestically systemically important. The focus is on the potential impact of the failure of an international, regional, or domestic firm on individual national economies. The D-SIB framework uses a principles-based approach rather than the prescriptive indicators-based approach used for G-SIBs, reflecting the wider variance in the nature and characteristics of D-SIBs and allowing greater national discretion in designating D-SIBs and in deciding on policy tools that should be applied to them.

Relevance to developing countries

All these recent developments are relevant to developing countries. FSB-designated G-SIFIs operate in many developing countries, and supervisory and resolution authorities in these host countries need to be aware of the recovery and resolution plans for these firms, especially when a local subsidiary or branch is systemically important in the host jurisdiction. In principle, resolution action should be coordinated with all host authorities, not only those participating in crisis management groups. The FSB recognizes the need for G-SIFI home supervisors and crisis management groups to communicate with host authorities that are not members of these groups. It will develop a formal process for ensuring good communications in 2013.

These developments also have more universal relevance, through the guidance they offer for regulatory requirements and supervisory practices for the locally licensed systemically important firms that are a feature in nearly all developing countries. Under the FSB Key Attributes, recovery and resolution plans are mandatory for systemically important firms in all countries. And under the Basel Committee guidelines, systemically important firms in all countries should be subject to higher capital charges and greater supervisory scrutiny.

These measures will prove useful in developing countries. Supervisors find that the required recovery planning by firms, and the review and approval of such plans by authorities, are providing valuable insights into the structure and operations of systemically important firms and thus helping to improve supervisory processes and identify needed policy reforms. Similarly, resolution planning by supervisory and resolution authorities will help to identify legal and policy impediments to dealing with distress in such firms, which can inform essential reforms to resolution frameworks. Assessments of whether systemically important firms can be resolved can inform decisions on prudential regulatory requirements (capital charges, liquidity standards, operational or structural limitations) as well as supervisory practices. In this sense a focus on resolutions should drive improvements to core regulatory and supervisory frameworks.

As noted, an assessment of adherence to the FSB Key Attributes will become part of the Financial Sector Assessment Program as early as 2014.[16] Developing country authorities may wish to begin undertaking self-assessments in advance—particularly of the resolution regimes for systemically important institutions, which in most countries probably include banks and financial market infrastructure firms.

The basic elements of the G-SIFI agenda also have relevance to developing countries where regional banks and other institutions are systemically important to more than one national jurisdiction (such as in Central America or East Africa). For such firms, supervisory and resolution authorities could consider establishing bodies similar to crisis management groups, with at least supervisory and resolution authorities from the jurisdictions critical to the possible resolution of the firm. Similarly, these authorities will find value in articulating a basic resolution strategy for each firm, undertaking resolvability assessments in the context of that strategy, developing more detailed plans for implementing the strategy, and entering into formal cooperation agreements that help to institutionalize different authorities' roles and responsibilities in the event of distress in the firm. The greater collaboration that would result could help reduce the risk posed to national economies by cross-border financial firms.

Notes

1. The FSB and Basel Committee work described in this Note is part of a broader range of reforms aimed at SIFIs, including requirements for greater supervisory intensity and higher capital requirements. The details of those complementary reforms are not addressed in this Note.
2. The Basel Committee standards discussed later in this Note prescribe prudential requirements and supervisory activities that complement the objective of reducing the risk of failure of systemically important firms.
3. For example, in July 2012 the Committee on Payment and Settlement Systems at the Bank for International Settlements (CPSS) and the International Organization of Securities Commissions (IOSCO) published a consultative report on how to interpret and apply the Key Attributes for financial market infrastructure firms.
4. The hierarchy of claims refers to the order in which different classes of unsecured creditors are paid in liquidation. For example, employees' salaries and pensions may have highest priority, followed by tax liabilities, depositors, senior debt holders, general unsecured creditors, and, finally, subordinated debt holders.
5. Some jurisdictions require certain banks (for example, those that are systemically important) to issue debt that is convertible into equity under specific conditions. In some cases the conversion can be triggered under the terms of the contract (for example, if the regulatory capital ratio should fall to a certain level), in what is known as contractual bail-in; in other cases it can be triggered by the resolution authorities (for example, if the firm should be put into resolution), in what is known as statutory bail-in. In effect, the Key Attributes require that all such debt be converted into equity once a firm is placed into resolution.
6. This would not only ensure the existence of a contingent capital buffer in all G-SIFIs but would also jump-start the nascent market for such debt.
7. The Key Attributes do not prescribe temporary public ownership as a necessary resolution power.
8. Such liquidity support could be provided by, for example, the central bank, a deposit insurance fund, a resolution fund, the treasury, or a combination of these sources.
9. The Key Attributes suggest limiting a temporary stay to two days, indicating the speed with which resolution authorities are expected to be prepared to act. Annex 4

of the Key Attributes sets out additional conditions for issuing a temporary stay.

10. Rather than liquidation, it is usually less expensive to pay another bank to assume the insured or protected deposits or even all the deposits of the failing bank, probably along with the good assets (marketable securities, performing loans, branches). Liquidating a bank, especially a systemically important bank, can destroy substantial franchise value.

11. The Key Attributes acknowledge that in some jurisdictions the courts will continue to have a role in triggering or reviewing resolution actions.

12. The recently adopted International Association of Deposit Insurers (IADI) Core Principles also seek to reduce the risk of the authorities being too slow to trigger resolution. Principle 15 requires that the recognition that a bank is, or is expected to be, in serious financial difficulty be made early and on the basis of well-defined criteria.

13. Ring-fencing involves the imposition of restrictions that have the effect of trapping excess capital or liquidity in a subsidiary or branch in a host jurisdiction, which can impede resolution of the parent entity or the broader group.

14. This will include many developing country jurisdictions.

15. The International Association of Insurance Supervisors (IAIS) is preparing a similar framework for globally systemically important insurers.

16. An assessment methodology is being developed and will be tested in early 2013.

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Produced by Carol Siegel

Printed on recycled paper