FEATURE ARTICLE

New international standards on effective resolution regimes for financial institutions

By the Banking Policy Department

This article considers lessons learnt during the recent global financial crisis about the risks posed by financial institutions (FIs) which are "too big to fail" (TBTF). From 2007 onwards governments around the world intervened to rescue failing FIs considered TBTF in order to avert dire consequences for financial stability, the real economy and society in general. Subsequently international consensus has emerged on the need to provide for robust alternatives which allow for FIs to fail safely, in a manner that protects financial stability and public funds, thereby restoring market dynamics and limiting moral hazard. To this end, new international standards for *effective resolution regimes* have been drawn up by the Financial Stability Board (FSB) and are outlined below.

Lessons from the crisis

During the global financial crisis, a series of European countries and the United States experienced unexpected and severe banking crises. Those regions not as adversely affected this time around have had their own crises in the past (Latin America in the mid-1990s and Asia in the late-1990s, for example).[1] Box 1 considers a past episode of banking stress in Hong Kong.

Such crises serve as a pointed reminder that idiosyncratic or system-wide shocks may undermine the viability of FIs in any jurisdiction, notwithstanding the sophisticated regulatory and supervisory frameworks designed to promote their resilience.

One factor which appears to have contributed to recent failures was that owners and creditors expected that governments would have no option but to rescue banks getting into difficulties. This was particularly so in cases where banks were so large and interconnected that their failure had potential to cause significant dislocation in the financial system, thus undermining the effective functioning of the economy. In other words, where banks were TBTF.[2]

With few exceptions, expectations of rescue were fulfilled and public funds were used on an unprecedented scale. This may have protected financial stability in the near term but it also put public finances under considerable strain (particularly in countries with large financial systems).[3]

[1] Laeven and Valencia (2012) identify 17 systemic crises and 13 borderline cases in the period 2007 - 2011 (and 147 banking crises in the period 1970 - 2011).

[2] The FSB is overseeing work to identify systemically important financial institutions posing risk globally (resulting in their designation as global systemically important financial institutions). Individual jurisdictions are expected to identify domestic systemically important financial institutions.

[3] Laeven and Valencia (2012) show that some recent crises are amongst the costliest in terms of fiscal outlays and GDP losses.

Rescues served to shield shareholders, bondholders and other creditors from the costs they would have faced had banks gone into liquidation reinforcing the view that some carry an implicit government guarantee.[4] The resulting "moral hazard" has potential to further weaken market discipline making future failures and crises more likely.

Where publicly funded "bail-outs" occurred, it was on an assessment that the costs, in terms of the wider impact on society, would have been greater still had individual banks been allowed to fail. Such costs arise because of the reliance that individuals and companies have on the financial services provided by banks, in going about their daily lives and business. Were a bank to fail, and enter liquidation, it would typically close for business and the provision of such financial services would suddenly end.

Clearly this could, for example, cause hardship for individuals relying on a failed bank to receive income (including salaries) and to make payments for their day-to-day living expenses, because access to their funds, and accounts, would be blocked.[5] Similarly companies with accounts at the failed bank would struggle to pay salaries and to purchase or receive payments for goods and services. Where affected parties run into the hundreds of thousands or millions, and taking into account the other types of critical financial services banks provide, overall consumption, investment and the real economy may suffer.

Box 1: An episode of banking stress in Hong Kong

Hong Kong experienced an episode of banking stress in the period 1983 - 1986 when, following various adverse economic and financial sector developments, seven local banks got into difficulties including the then third largest local bank, the Overseas Trust Bank.

Given the circumstances prevailing at the time, it was assessed that failure of these banks posed a systemic threat and so they were rescued with public funds. Three banks were taken over by the Government temporarily and financial assistance (for example, a guarantee of assets or liquidity support) was provided to facilitate the takeover of the other four banks by private sector entities.[6]

The connections between individual banks create a risk of contagion also, such that the failure of one has the potential to bring down others in a "domino effect". Direct exposures, arising from lending, financial contracts, credit guarantees or the holding of one another's debt instruments, create a channel for contagion. Despite regulatory requirements to limit the size of such exposures, it remains the case that the failure of one bank could result in other banks experiencing relatively material losses.[7]

A loss of confidence provides an indirect channel as other parties, from retail customers through to market counterparties, may become concerned that other banks have material exposures to whatever caused the first bank to fail, and could seek to reduce their exposure to these other banks on a precautionary

[4] There is some evidence to suggest that the implicit subsidy which the world's largest banks enjoy increased following the crisis. See Haldane, 2012.

[5] In many jurisdictions, Hong Kong included, deposit protection schemes provide a measure of protection in such cases by compensating eligible depositors in relation to covered deposits (to a specified limit).

[6] See Li (1999).

[7] The Basel Committee on Banking Supervision recently consulted on a common supervisory framework to improve management of such large exposures. See BCBS (March 2013).

basis. This can result in a run on other banks, putting their liquidity and perhaps capital positions under pressure (those with significant maturity mismatch and high levels of leverage would be the most susceptible).

After the crisis, a broad consensus has developed on the need to find a better way to stabilise failing FIs (or the key parts of their business) so that the critical financial services they provide can be continued, and financial stability protected, but without the need to rely on the use of public funds.

New international standards for resolution regimes

Central to policy measures developed by the FSB to address the risks posed by systemically important financial institutions (SIFIs) are a set of international standards: the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (or Key Attributes), outlining the essential features that resolution regimes in all FSB member jurisdictions should have.[8] The Key Attributes were endorsed by the G20 leaders at the Cannes Summit in November 2011.

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

Scope

According to the Key Attributes (Key Attribute 1), any FI "which could be systemically significant or critical if it fails" should be within scope of an effective resolution regime.[9] It is intended that this standard should be met, as appropriate in each jurisdiction, in relation to banks, securities firms, insurers and financial market infrastructures (both locally incorporated and the branches of foreign firms).

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

Governance arrangements

Under the Key Attributes, one or more public authorities should be made responsible for exercising the powers available under the resolution regime; in other words for acting as a "resolution authority" (Key Attribute 2). Such authorities should be operationally independent in this role and adequately resourced.

Where multiple authorities within a jurisdiction are designated to act, the Key Attributes say that "their respective mandates, roles and responsibilities should be clearly defined and co-ordinated". Additionally, the Key Attributes say a lead resolution authority should co-ordinate the resolution of financial services groups operating across various sectors of a local financial system.

[8] See FSB (October 2011).

[9] The use of "could" reflects that it is not always possible to determine in advance, with any accuracy, the risks associated with failure of an individual FI (these can change over time and depend on the financial and economic conditions prevailing at the time).

Resolution should occur, according to the Key Attributes, where an institution "is no longer viable or likely to become no longer viable" (Key Attribute 3). To contain the negative consequences of an FI's distress, it is considered necessary to allow for "timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out".

Under the framework described by the Key Attributes, and in Table 1, an assessment would be needed as an FI nears the point of non-viability as to whether its failure could be systemically significant or critical, and so whether use of the resolution regime to secure continuity of critical financial services and protect financial stability is justified. In cases where such risks appear to be low, existing liquidation procedures may be used to secure orderly closure and wind-down.

To guide decision making on what approach to take to resolution, the Key Attributes say that resolution authorities' actions should have statutory objectives and functions requiring that they:

(i) pursue financial stability and ensure continuity of systemically important financial services and payment, clearing and settlement functions;

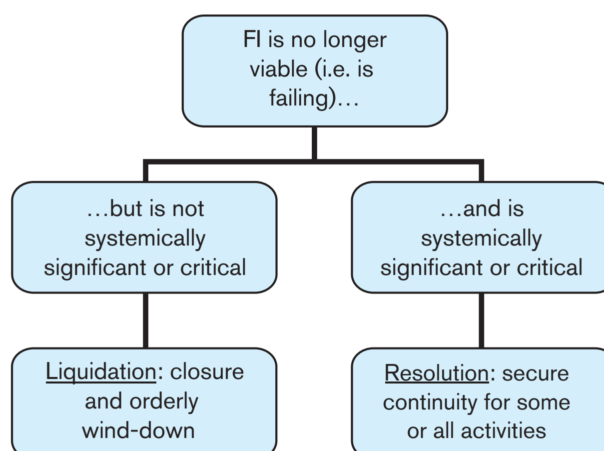
(ii) protect depositors, investors (with client assets at an FI) and insurance policy holders covered by a protection scheme;

(iii) avoid unnecessary destruction of value and seek to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives;

(iv) duly consider the potential impact that resolution actions may have on financial stability in other jurisdictions.

Table 1

Resolution as an alternative to liquidation



Resolution options

The Key Attributes outline a menu of resolution or "stabilisation" options, with supporting powers, which should be made available (Preamble and Key Attribute 3, see Table 2 for a summary of the options). The most important are those designed to allow the resolution authority to step in and take speedy and decisive action to stabilise, and restructure, an entire FI, or key parts of its business.

To this end, the Key Attributes say that it should be possible for the resolution authority to arrange a compulsory transfer of ownership of a failing FI, or of some or all of its business, to another FI (option (a)(i) in Table 2). This technique is attractive because following the intervention another FI takes on responsibility for providing (close to) uninterrupted access to financial services and for meeting transferred claims in full. In practice this could mean, for example, that over the course of a weekend, deposit accounts (and credit balances) in a failing bank are transferred to a sound institution, and that depositors could continue to access them as normal on Monday.

Recognising that more time will be needed to find a willing acquirer in some cases, the Key Attributes say that it should be possible to make use of a bridge institution as a temporary solution (option (a)(ii) in Table 2). Resolution authorities should be able to establish a legal entity for this purpose, over which they have an adequate degree of control, and to transfer some or all of a failing FI's business to it. The bridge institution can then continue the activities until they can be returned to the private sector.

Table 2

Menu of resolution options

<table>
<tr><td colspan="4">(a) Stabilisation options</td></tr>
<tr><td colspan="3">Compulsory transfer of entire FI or some or all of its business to:</td><td rowspan="2">(iii) Bail-in</td></tr>
<tr><td>(i) Another FI</td><td colspan="2">(ii) A bridge institution</td></tr>
<tr><td colspan="4">(b) Dealing with residual parts of firm</td></tr>
<tr><td colspan="2">(i) Asset management vehicle</td><td colspan="2">(ii) Liquidation</td></tr>
</table>

There are likely to be cases where the sheer size and complexity of a failing FI means that its activities cannot be taken on by another FI.[10] Size and complexity may also act as barriers to efforts to break up an FI into several "more manageable" parts. To limit the need to fall back on a public rescue in such cases, the Key Attributes say that resolution regimes should provide statutory powers to carry out a bail-in. Such powers allow for shareholders' and certain unsecured creditors' claims to be written down to absorb losses followed by the imposition of a debt-for-equity swap on certain unsecured creditors to recapitalise an FI, restoring its creditworthiness, so it may continue to operate (option (a)(iii) in Table 2).[11]

Where the residual parts of a failing FI's business (i.e. those not stabilised) comprise a substantial portfolio of assets, protecting financial stability and avoiding unnecessary value destruction may mean that such assets need to be managed for a period of time until they can be sold on or wound-down safely. So the Key Attributes also require that resolution regimes provide for an asset management vehicle (option (b)(i) in Table 2).

In other cases, however, the residual parts of the FI could be dealt with by means of a normal liquidation procedure (option (b)(ii) in Table 2).

Safeguards

As securing orderly resolution requires that action be taken quickly and decisively, resolution regimes inevitably empower resolution authorities to act in a manner that can affect contractual and property rights as well as the payment that shareholders and creditors receive in resolution. This creates a clear need for a set of appropriate checks and balances, both to safeguard the position of those affected by resolution as well as to reduce, to the extent possible, uncertainty about the outcomes that resolution will deliver.[12]

Resolution may be less value-destructive because some or all activities can then be continued on a going concern basis and so in some cases, all parties may be better off under resolution than would have been the case in liquidation. This cannot be guaranteed, however, and the Key Attributes say that a mechanism to compensate creditors for any losses suffered over-and-above those they might have sustained in liquidation, should be provided for. This is known as a "no creditor worse off than in liquidation" safeguard (Key Attribute 5).

[10] It may be that few other FIs are large enough to absorb them, or that any such acquisition would result in excessive concentration in the financial system.

[11] A bail-in might take one of a number of forms, resulting in recapitalisation of the failing FI itself, its holding company or a successor (such as a bridge institution).

[12] Providers of funds to (creditors of) an FI would otherwise expect to be compensated for the increased uncertainty about their losses in a resolution scenario with potentially significant implications for funding costs and market efficiency.

An important motivation for establishing a resolution regime is that it should support the orderly resolution of failing FIs in a manner which protects public funds. The Key Attributes recognise that there may be cases, however, where it is determined "that the provision of temporary funding is necessary to foster financial stability and will permit implementation of a resolution option that is best able to achieve the objectives of an orderly resolution, and that private sector sources of funding have been exhausted or cannot achieve these objectives". It should be possible, therefore, to recoup losses from shareholders and unsecured creditors and, thereafter, from the wider financial system (e.g. through a privately-financed resolution fund or ex post assessments) (Key Attribute 6).

Cross-border co-ordination

The FSB considers that where FIs operate cross-border, their orderly resolution may require a co-ordinated and co-operative approach between resolution authorities in the key jurisdictions in which a group operates. An alternative, where various jurisdictions take unilateral action to protect their domestic interests, including by ring-fencing local assets, has the potential to descend into a "run" on a group precipitating its disorderly break-up and value destruction as individual businesses become "gone concern".

The Key Attributes set several requirements to support co-ordination and co-operation, the first of which is that "the statutory mandate of a resolution authority should empower and strongly encourage the authority wherever possible to act to achieve a cooperative solution with foreign resolution authorities" (Key Attribute 7).

A resolution authority should then have "the capacity to use its powers either to support a resolution carried out by a foreign home authority... or, in exceptional cases, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability".[13] Supporting a resolution carried out by a home authority requires "transparent and expedited processes to give effect to foreign resolution measures". See Box 2 for details of what form such group-wide resolutions could take.

Of critical importance to co-ordination both domestically and cross-border are legal gateways allowing for information sharing to support resolution, subject to safeguards to protect confidentiality. The Key Attributes set some requirements in this regard (Key Attribute 12), and the FSB recently issued for public consultation a new annex to the Key Attributes outlining principles for information sharing.[14]

Resolution planning

Moving sufficiently quickly to resolve a large complex FI is unlikely to be possible unless resolution authorities seek to identify well in advance what form each resolution should take (given the way an FI is structured and operates). The Key Attributes set a number of requirements in relation to resolution planning, in both a cross-border and domestic context.[15]

The Key Attributes require that Crisis Management Groups (CMGs) be established for each global systemically important financial institution (or G-SIFI) (Key Attribute 8), as a forum for home and key host authorities[16] to co-ordinate on planning and in the event of any actual resolution. CMGs are expected to

[13] In requiring that the scope of domestic regimes extend to branches of foreign firms, as noted under the "scope" sub-section, the Key Attributes intend that this will support co-ordinated and co-operative approaches as well as direct resolution actions.

[14] See FSB (August 2013).

[15] The Key Attributes also say that FIs should be subject to recovery planning requirements (under which FIs develop a menu of options they can draw on to recover from a severe shock).

[16] In other words, those authorities playing host to entities which are significant in relation to the wider group. Membership of each CMG is determined by the home resolution authority.

identify preferred resolution strategies for each G-SIFI and to convert these into operational plans. Institution-specific co-operation agreements, setting out how home and host authorities will co-operate should be signed (Key Attribute 9).

Resolution authorities are required to regularly undertake "resolvability assessments", at least in relation to G-SIFIs, to consider how far it would be possible to carry out a resolution of each in a manner that fulfils the objectives set for resolution. Supervisory or resolution authorities should seek the removal of any significant impediments or barriers to the resolution of individual firms which are identified in the course of these assessments and should be empowered to require action by the FIs in this regard (Key Attribute 10).

The Key Attributes intend that each jurisdiction should replicate these arrangements by putting in place an ongoing process for (recovery) and resolution planning, along with resolvability assessments, covering at a minimum those FIs whose failure could pose a risk to local financial stability (Key Attribute 11).

Implementation of the new standards

The FSB recently called on G-20 leaders to renew their commitment to undertaking the legislative reform needed to implement the Key Attributes by the end of 2015.[17] The FSB reported that following recent reform, substantive progress towards this goal has been made in jurisdictions including Australia, Germany, France, Japan, Netherlands, Spain, Switzerland, the United Kingdom and the United States. The anticipated adoption of the European Union's Recovery and Resolution Directive will represent an important step towards implementation across European Union member states.

All FSB member jurisdictions, Hong Kong included, have undertaken self assessments to identify gaps in their existing frameworks. The FSB drew on these to make its own assessment of the reforms needed, as summarised in a recently published "Thematic Review on Resolution Regimes, Peer Review Report".[18]

In the case of Hong Kong, these assessments confirmed that legislative reform is needed to meet the standards set in the Key Attributes. The relevant authorities (the Financial Services and the Treasury Bureau) and the sectoral regulators are working to develop proposals for public consultation.

Progress is also being made on resolution planning work. Group-level planning is being carried out in CMGs established for a number of global systemically important banks (G-SIBs); a process the HKMA participates in as a key host authority.[19] Several home jurisdictions (and the FSB) have begun to outline potential strategies publicly (see Box 2).[20]

As noted, FSB member jurisdictions are required to establish local frameworks for (recovery and) resolution planning also. The HKMA recently consulted industry on a framework under which authorized institutions under the Banking Ordinance would be required to develop and maintain recovery plans and to provide information and analysis to support resolution planning.

[17] See FSB (September 2013).

[18] See FSB (April 2013).

[19] For G-SIBs assessed (by home authorities) to have significant operations in Hong Kong.

[20] See Federal Deposit Insurance Corporation and Bank of England (2012), FINMA (Swiss Financial Market Supervisory Authority) (2013) and FSB (July 2013).

Conclusion

There is broad international consensus on the need for all FSB member jurisdictions to establish effective resolution regimes meeting the standards set out in the Key Attributes. Alongside resolution planning for individual FIs, it is intended that these reforms will help to reduce the implicit subsidy that has been enjoyed by FIs assessed to be TBTF. Achieving this goal requires that it be possible, in the event of any future failures, to ensure that the costs of an orderly resolution which protects financial stability, fall primarily on the shareholders and certain unsecured creditors of failing FIs, rather than being met by taxpayers.

Box 2: Resolution strategies

Two (stylised) approaches to resolution are emerging from resolution planning work for G-SIBs.

Under a "single point of entry approach" FIs operating in a highly integrated manner, might be resolved through resolution at the level of the ultimate holding company of a group by the home resolution authority. Losses across the group could be absorbed and the group recapitalised through, for example, the write-down and bail-in of liabilities issued by the holding company. If sufficient loss absorption capacity is available, operating subsidiaries could continue as a going concern.[21]

Under a "multiple point of entry approach" FIs with a decentralised structure (i.e. subgroups of relatively independent, capitalised and separately funded subsidiaries) might be resolved through resolution actions taken by two or more resolution authorities resulting in a group being split on national, regional or functional lines. The options deployed in relation to the separate parts of the group could differ, with any combination of resolution options being deployed as appropriate.

[21] Some jurisdictions, as well as the FSB, are considering whether FIs should be required to issue debt instruments in sufficient quantity and with the features necessary to support such a bail-in.

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