Cross-Border Resolution: main challenges and how to get well prepared[1]

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Supervision of banks at the consolidated level has driven for long the international supervision framework and cooperation. With the resolution regime, new challenges occur, especially to apply the bail-in as often the preferred resolution tool in the context of a cross border resolution.

1. Main challenges related to cross border resolution execution:

The first challenge is arising from supervisory/resolution authorities' policies and the **fragmentation** they create: ring fencing of capital, liquidity, eligible liability making single point of entry strategies that are based on transfer of funds difficult.

The second is of legal nature, the main issue here is **contractual bail-in** recognition.

- In the EU, it is mandated in article 55 BRRD, but how to ensure it is effective? Through legal opinions? Then, what criteria to use to analyze those opinions and make sure they are reliable? How to find the right balance between asking for details in all contracts (financial contracts, IT

[1] Contribution prepared by Marion ZOSI, resolution expert at ACPR

contracts..) in order to provide assurance to the authorities and limiting the burden for banks?

- At the international level, we need international agreements: this covers therefore all kinds of « memorandum of understanding ». Why so limited "Memoranda of understanding » have been already signed between resolution authorities? What is the missing path to "boost" the signature of MOUs, in order to ensure a swift, effective and efficient decision-making? Is this a political rather than technical question?

The third is an operational challenge: the main issue here is the **execution risk**.

- Timing and effectiveness: a cross border context will involve more actors than a purely domestic one, with actors potentially in different time zones. It is therefore more essential to ensure a quick bail-in, which will have to take place based on a provisional valuation 2, which raises issues related to how to address the valuation gap between the provisional valuation 2 and the definitive valuation 2. Did Authorities deal with this issue? If yes, potentially different approaches adopted in different countries?

- Different approaches to valuation: challenges raised by assessing the estimated losses across the whole cross border resolution group, coordination with local valuers and possible use of different accounting rules, since IFRS is not used all over the world (not in the US for instance) nor for all types of accounts (in the EU, IFRS is mandatory only for some).

- Different approaches to bail-in: FSB distinguished three general approaches (« closed bank bail-in » as in the US, « open bank bail-in with share cancellation » in Germany, and « open bank bail-in with interim rights » as in the UK and the Netherlands), and one hybrid approach in France. In practice, it means one approach in US and different approaches in the banking Union, which could raise operational challenges?

– Differences stemming from the existence of different private actors in different countries :

• The French and the Luxembourg CSDs have different communication systems (one uses SWIFT, the other e-mails), which should be known and taken into account when bailing-in securities issued by the same French bank but some of which are held by the French CSD and some others are held by the Luxembourg one.

• The role of National Numbering Agency, very important in external bail-in execution because it includes attributing ISINs (needed for the new securities resulting from conversion) can be performed by many different entities : CSDs in most EU countries of which France, but also exchanges (in Greece, Ireland, UK, the Baltic States), public authorities (in Spain (CNMV, the securities markets authority) , Italy (Banca d'Italia)), are specific entities (in Germany (WM daten services), Austria (Oesterreichische Kontrollbank Aktiengesellschaft (OeKB)), Belgium (SIX financial information), US (CUSIP)). There to, the operationalization of the resolution strategy might potentially be affected by those divergences.

• The US CSD, DTCC, has in place specific procedures that have to be known by resolution authorities considering a write-down and conversion of US debt (ADRs) held by investors in the EU

2. How to get well prepared to cross border resolution

Three components seem essential:

First credible resolution execution need to be supported by relevant resolution strategies based on **relevant resolution scenarios/options**:

One needs to take a prudent but realistic approach. Issues related to cross border resolution cannot be ignored, they can happen even in countries with limited

cross-border financial activity: it just takes the need to apply bail-in on one class of liabilities governed by foreign law. This is why in France we are very careful to treat cross-border issues in our approach to bail-in. Cross border and credible resolution scenario should be considered.

Recovery options that may, when implemented, decrease (sale of business) or decrease (recapitalization by the parent) interdependencies between groups and therefore between the different jurisdictions where the members of the group are located. Recovery options could affect the capital needs and liquidity needs.

At this stage, there is not sufficient clarity regarding the definition of a Resolution Group and a Resolution Entity and how they are treated differently at the time of a resolution action.

Currently, the definition of a resolution entity is ambiguous as it is defined only in respect of resolution actions taken while actions to upstream losses and downstream capital may be taken in respect of entities, which are not themselves, resolution entities. Furthermore, it seems that this definition excludes entities located in third countries with no resolution regime, as in this case it will not by definition be possible for resolution action to be taken with respect to the entity.

In BRRD 2, the definition of resolution group is clearer and the difference between resolution group and prudential group has been made extremely clear.

At the time of a resolution, resolution tools will apply at the level of the resolution entity. Entities outside the scope of the resolution group will support

However, there is still an ambiguity in the definition: could we apply resolution powers to entities, which are not resolution entities (probably yes, and in practice it could be necessary)? Should an SPE cover all the entities of the group? If yes, may a multiple-point-of-entry strategy facilitate for some groups the resolvability and design more realistic resolution strategies? Is it possible to establish a third country resolution group that would only include a third country subsidiary established in jurisdiction with no resolution framework? A literal reading of BRRD might prevent

this because it defines a resolution group as a “resolution entity and its subsidiaries that are not (…) entities established in a third country that are not included in the resolution group in accordance with the resolution plan and their subsidiaries;”, and since it is unclear whether there can be resolution entities in third countries, the definition is problematic.

Second, appropriate and robust **loss absorbing mechanisms**:

- External/internal LAC: of course, each institution should have enough loss absorbing capacity to address risks on its balance sheet and resolution entities should in addition have enough capacity to address risks on the balance sheet of their subsidiaries that are not resolution entities. However, in order to avoid fragmentation, over-calibration of requirements and ring fencing, the potential of some systems alternative to pre-positioning should be tested. For instance, collateralized guarantees are allowed to meet internal MREL targets when the parent and the subsidiary are in the same member States. They offer reassurance that loss absorbing capacity is there without need for prepositioning, so they are interesting from the point of view of reducing fragmentation. They should be more often used in the future, and should ideally be made available cross border in a future amendment of BRRD2.

- Clear and robust internal mechanisms for upstreaming losses and recapitalize in a cross border context the subsidiary and then the resolution authority of the parent can execute bail-in according to its own approach. However, it creates a need for each authority to understand well the approaches adopted by the others so that everyone is prepared and might also create uncertainty, for instance on the exact amount of losses and the exact operationalization of loss upstream/capital downstream in case the resolution authority of the subsidiary uses interim rights.

- In this respect, cross-border execution playbooks, as provided for in BRRD2, will help to further define these roles. We absolutely need some cross-border execution playbooks and we need to understand how each

authority understand the key resolution concepts and intends to support resolution actions. In our view, it is important that bail-in playbooks focus on operational steps, procedures and identify the relevant information and data needs for the purpose of the implementation of the resolution tool. For example, the first priority is for us to better understand the US approach (both resolution authorities and financial market infrastructures), which, unlike the EU, is not an open bank bail-in, as we have a significant number of issuances made by EU GSIBs (notably French banks…). As mentioned, the US CSD, DTCC, has in place specific procedures, which have to be known by resolution authorities considering a write-down, and conversion of US debt (ADRs) held by investors in the EU. The European Bank Federation has launched some work on it. Expanding this approach on step-by-step basis will be much more welcome, for instance for UK issuances and JP issuances first.

Third, dealing with legal certainty and cooperation in a pragmatic way

The FSB Key Attributes relating to cross-border cooperation have been effectively implemented and put in to practice. The Key Attribute 7, which sets out the legal framework conditions for cross-border cooperation, has identified 7 key elements. All of them have been implemented in Europe through the transposition of BRRD) and the creation of the Single Resolution Mechanism for the banking union. For instance, the issuances of the senior non-preferred debt, the implementation of the clauses related to the contractual recognition of bail-in (article 55) and the transposition of the stay power (article 71) enable to make more effective and transparent the implementation of the resolution strategy;

However, cross border cooperation but beyond home and host cooperation should continue to be improved in order to address key practical challenges and strengthening the credibility and effectiveness of resolution strategies:

- Legal certainty on the effectiveness of bail-in powers and the division of tasks between home and host authority. There, BRRD2 introduces a possibility to waive the article 55 requirement in case it is not “practicable” to include the

contractual term. Now this exception will need to be framed in level 2. How to find the right balance between the need to catch as many potentially bailinable liabilities as possible and the need not to impose unrealistic burdens on institutions?

- Adequate preparedness and thorough knowledge by each authority of the procedures and methods used in the jurisdictions it will have to interact with

- Trust, cooperation and good working relationships between authorities

- Clear and comprehensive « memoranda of understanding » in the case of countries outside the EU, and in any case many discussions and interactions among authorities and between authorities and the industry (banks, but above all FMIs) : research, bilateral contacts between authorities, workshops, conferences, industry dialogues…