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Cross border resolution issues for systemic institutions: what are the main remaining challenges, what possible path to address them?

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CROSS BORDER RESOLUTION ISSUES FOR SYSTEMIC INSTITUTIONS: WHAT ARE THE MAIN REMAINING CHALLENGES, WHAT POSSIBLE PATH TO ADDRESS THEM?

ABSTRACT

This paper[1] outlines the main conclusions of two conferences[2] given in 2019 related to cross border issues and resolution of GSIBs and reformulates those issues in two specific questions: From a resolution perspective, what are the key cross border challenges for GSIBs? How to address them and be well prepared?

Three types of frictions in a cross border context are identified: economic and prudential frictions, legal frictions and operational issues. Solutions are suggested to reduce each of them: credible and relevant resolution scenarios for operational resolution plans and credible guarantees to reduce economic and prudential frictions. Legal frictions could be reduced by implementing contractual or statutory recognition of rights of EU authorities in third countries and resolution actions of third country entities with subsidiaries or significant branches. Then, by deepening the cooperation and exchange information within fora such as Crisis Management Groups (CMG) and EU resolution colleges, operational issues such as execution risk can be further understood and reduced.

If this paper focuses on further EU resolution issues, its reasoning and conclusions should be considered in a broader way, and address cross border resolution issues for systemic institutions.

[1] Paper prepared by Marion Zosi, Resolution Expert at ACPR, with advice by Ben KONARÉ deputy head of Resolution Department at ACPR

[2] Panel interventions by Frédéric Visnovsky, Deputy Secretary General, Executive Director for Resolution, in Resolution Readiness Seminar set up by the Central Bank of Ireland (Monday 2 December 2019) and in the BPI-IIF Cross-Border Regulation & Resolution Colloquium New York (Monday 9 December 2019).

Introduction

Following the 2007 financial crisis, international regulation and supervision have been increased to enhance the resilience of banking groups in order to better face financial crises, preserve critical functions and protect depositors, without state support.

However, in the context of cross-border resolution framework, some challenges remain. It is indeed important that large banks can be resolved with limited friction. We will examine these frictions and see what responses can be designed.

1. Three types of frictions can be distinguished:

1.1. The first of these challenges relates to **economic and prudential frictions**, and stems from uncertainties regarding the amount of available capital and liquidity at the local level in case of crisis. Due to those uncertainties, "host" supervisors and resolution authorities tend to implement different ring-fencing measures[3].

Those practices by national authorities generally have the same root causes in different jurisdictions and economic areas. If the host does not have sufficient assurance that, in case of trouble, the parent company, if it is established in another jurisdiction, will not decide to repatriate liquidity and capital located in the subsidiary, it will set ex ante requirements (capital and liquidity buffers).

This issue is relevant and the benefits and costs of this option are well known:

Ressources retained at the local jurisdiction level as a buffer also reduce the possibility for groups to benefit from diversification of activities, potential economies of scale (centralization funding) and efficient liquidity management. More damagingly, from a resolution perspective, ring fencing means that resources available in resolution become fragmented and less fungible, harder to move across borders to support subsidiaries in distress. By limiting private risk sharing and the risk-reducing effects of diversification,

[3] See "Present practices are preventing the emergence of cross-border banking groups", by Edouard Fernandez-Bollo, ACPR, in Banking Perspectives, Third Quarter 2018 (https://www.bankingperspectives)

it may also, ultimately, reduce the resilience of groups and of institutions that are part of them by making them more vulnerable to asymmetric shocks[4].

Imposition of high capital and loss-absorption requirements might also result in an over-calibration of loss absorbing capacity compared to what would be needed in times of crisis for single-point-of-entry resolution strategies[5], making them less efficient. This is why the Financial Stability Board (FSB) has drawn attention to the need for home and host authorities to pay attention to those issues in its "Guiding principles on internal TLAC"[6] and the consultation report on the evaluation of the effects of too-big-to-fail reforms also mentions this issue. However, those situations are not specifically mentioned or dealt with yet in EU legislation on resolution.

1.2. From a practical perspective, fragmentation is not the only relevant issue regarding cross-border groups. Indeed, implementing resolution in a cross border context also creates potential for **legal frictions.**

Two kinds of legal issues should be distinguished in this respect: non-recognition of powers, in particular those of the home resolution authority in the host country, and lack of coordination.

If recognition of resolution proceedings is denied, then cross–border resolution cannot proceed smoothly, effectively or lawfully.

Another aspect of legal friction concerns the power to instruct private actors. For instance, the implementation of bail-in takes place within Central Securities Depositories (CSDs). However, communication channels are established between CSDs and their national supervisors, not between CSDs and the relevant authorities of host countries where bail-in potentially takes place, creating loss of time and effectiveness if the right authorities

[4] Idem

[5] Defined as a strategy in which resolution action is taken only in respect of the parent and the parent is the one issuing loss-absorbing resources externally. The parent then reallocates resources internally (upstream of losses from its subsidiaries and downstream of capital to its subsidiaries in need) through adequate transfer mechanisms.

[6] Guiding principle 6: if the sum of loss absorbing capacity required at the level of all subsidiaries is higher than the external loss absorbing capacity issued by the parent *"the home authority should take action to ensure that the G-SIB has sufficient external TLAC"*

are not well-identified since the beginning and /or do not cooperate fully and/or efficiently.

Lack of coordination in the exercise of powers is another type of issue, relating to powers being exercised at different times and in different manners by the various authorities involved. For instance, inadequate information of one authority due to restrictive rules on the sharing of sensitive information might cause it to act in a suboptimal way when participating in the resolution of a cross border institution. More generally, the scope of the powers of different authorities, the legal and regulatory constraints they face (for instance, more or less long internal validation processes, need or absence of need for ex ante judicial approval of a resolution decision) and the timeframes within which they can act will differ. Failure to identify the differences that may result in frictions and to take them into account in resolution planning so as to minimise those frictions will, once again, result in suboptimal actions.

1.3. The last type of frictions relates to **operational issues such as execution risk**. A cross border context will involve more actors than a purely domestic one, and those could be located in different time zones. This could result in questions about the effectiveness and timing of the whole process.

Those problems may be compounded by different approaches to both valuation and bail-in. For instance, valuation in a cross border context faces the challenges of assessing the estimated losses across the whole cross border resolution group, of coordination between valuers, and of the possible use of different accounting rules[7].

There are also **different national approaches to bail-in.** International work at the FSB level has identified four approaches: closed bank bail-in, as in the US; open bank bail-in with share cancellation and immediate issuance of new shares, as in Germany; open bank bail-in with interim rights used for recapitalization, as in the UK and the Netherlands; and open bank bail-in with interim rights used for valuation gap adjustment, as in France. In practice, this means there are different approaches in the EU and the US, and also within

[7] For instance, IFRS, although the best-known and more widespread standard, 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 types of accounts)

the banking union. All this could result in frictions and difficulties if not well managed and coordinated.

Finally, the involvement of **different private actors** in many different countries may also be an issue for the execution of the bail-in. For instance, the French and the Luxembourg CSDs have different communication systems, 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. Similarly, the US CSD (DTC) has procedures in place which differ from those of EU CSDs and have to be known by resolution authorities considering a write-down and conversion of US securities t such ADRs held by investors in the EU.

Another example concerns National Numbering Agencies, whose role is pivotal in external bail-in execution because it includes attributing ISINs, needed for the new securities resulting from conversion. It happens that this role can be fulfilled by many different entities depending on the country concerned: CSDs in most EU countries including France, but also exchanges (in Ireland, UK, Malta), different public authorities (securities market authority in Spain, central bank in Italy), or specific entities (in Germany or the US)[8]. There, too, the operationalization of the resolution strategy might potentially be affected by those divergences.

2. Therefore, how to address those three types of friction and get well prepared for cross border resolution?

2.1. In order to increase trust and allay fears of a lack of resources at the crucial time**, two elements are essential:** appropriate and robust **loss absorbing mechanisms** and **credible resolution scenarios.**

In terms of external loss absorbing capacity, each institution should have enough loss absorbing capacity to address risks (loss absorption and recapitalisation) on its balance

[8] https://www.anna-web.org/members-db/

sheet. In addition, resolution entities should have enough capacity to address risks on the balance sheet of those subsidiaries which are not resolution entities.

However, moving from the design of the mechanism to its implementation could raise several operational issues.

How to reassure host authorities, avoid fragmentation, over-calibration of requirements and ring fencing? Developing alternative systems to pre-positioning could be further tested.

One of the key issues in this context is to develop **credible guarantees** provided by parent banks to their subsidiaries, which could be triggered both in a cross border context (unallocated iTLAC) and in the EU , based on EU law and enforced by EU authorities.

Under the 2019 amendments to BRRD, collateralized guarantees are allowed to meet internal MREL targets when the parent and the subsidiary are in the same Member State.

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. Robust guarantees based on EU law and enforced by EU supervisors would increase the level of trust of host supervision and resolution authorities. These guarantees should include ex ante arrangements to upstream losses. Resolution authorities and supervisors in the different countries should work in cooperation to design the adequate guarantee mechanisms for each specific banking group. Those should address the question of group support for subsidiaries during going-concern and not only during resolution. They could be adjusted regularly depending on the evolution of the risk profile of the banking group.

Strengthening the cooperation and concrete information sharing is also another critical step which could be taken in order to improve the situation for cross-border banking groups. A **more significant involvement of the host countries in the ex-ante management of CMGs** would allow for an increased level of trust between authorities. This dialogue should be strengthened before the next banking or financial crisis arrives, in particular covering recovery planning and early intervention phases in order to build up confidence between jurisdictions before a crisis erupts.

Then, resolution execution needs to be supported by relevant operational resolution plans, which are based on credible and feasible resolution strategies and on relevant resolution scenarios and 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. On the one hand, cross border and credible resolution scenario should be considered as much as possible in order to improve the capacity of the resolution authority to deal with the concrete implementation of the resolution action. On the other hand, one should accept that it will not possible to cover all scenarios ("What if"), and the resolution authority should accept to focus on the most relevant one in order to deal with appropriate resolution tools.

In addition, recovery options may, when implemented, decrease (sale of business) or increase (recapitalization by the parent) interdependencies between group entities and therefore between the different jurisdictions where subsidiaries of the group are located. In this context, recovery options which could also affect the capital needs and liquidity needs, should be taken into account.

2.2. As regards legal frictions, the issue of **non-recognition of resolution powers** in the European Union arises only in respect of third countries.

The choice made in EU to address it was to resort to mandatory contractual recognition of different powers.

Article 55 BRRD requires the inclusion of a clause recognizing the bail-in powers of EU resolution authorities in the documentation of liabilities governed by third country law, with only a few exceptions. However, the question here is the proper way to ensure contractual recognition is effective and enforceable. This is usually checked through the request of legal opinions from institutions, but there is also a need to ascertain the quality of those opinions. This is why the Single Resolution Board (SRB) has developed in its

MREL policy criteria for legal opinions to be met in order for them to be taken into account.

There is also the issue of the potential operational challenge for institutions related to the inclusion of the clause (for instance in case of contracts that cannot be amended bilaterally), which has led to Article 55 BRRD being amended in 2019. A system has been created for institutions to be able to argue the impracticability of the inclusion of the clause in order to, if the resolution authority concurs with the assessment of the institution, such inclusion not to be required for some classes of instruments (with the instruments not counting towards the MREL requirement). Some aspects of this regime are currently being defined at the level of the European Banking Authority and a proper balance is progressively being established between asking for details in all contracts (financial contracts, IT contracts..) in order to provide reassurance to the authorities and limiting the burden for institutions.

The 2019 amendments to BRRD will also introduce a similar requirement for financial contracts governed by third country law to include a clause recognizing the resolution stay powers (articles 33a, 69, 70 and 71 BRRD) of EU resolution authorities and the EU rule prohibiting termination on of contracts on the sole ground of the institution being in resolution (Article 68 BRRD). This regime is new and concerns only financial contracts and its wording is similar to this of Article 55 before the introduction of the "impracticability regime" while of course the type of powers concerned are different. It remains to be seen how it will be applied in practice, whether or not it will pose challenges similar to this of the "old version" of Article 55 and how to address such challenges if they arise and how to articulate the new obligation with pre-existing contractual recognition obligations that may be imposed nationally due to international commitments (FSB, ISDA). EBA published a consultation paper related to this specific article 71.a.

On the statutory side, provisions of the BRRD allow the recognition of resolution proceedings of third country jurisdictions. Article 94 gives power to resolution authorities, or resolution colleges through a joint decision process, to recognize resolution proceedings relating to third country entities with subsidiaries or significant branches in several EU Member States or having assets, rights or liabilities located or governed by the law of several Member States. Article 95 does set out a right to refuse such

recognition, but on clearly identified grounds relating to public interest or conflicts with national law. [9]

As for it, the lack of coordination in the execution of powers is typically dealt with through Memoranda of Understanding, that is, agreements between authorities setting out the rules on information exchange and coordination in the use of powers. Some legal ways of taking a European approach to the conclusion of those memoranda do exist under BRRD.

Article 97 BRRD empowers the EBA to conclude framework cooperation arrangements with authorities under the jurisdiction of which fall third country parents of subsidiaries and branches established in several Member States, or the subsidiaries and branches of BRRD entities, which also have subsidiaries in at least another EU Member State. It lists some elements that may be included in such agreements (exchange of information necessary for the preparation and maintenance of resolution plans and for the application of resolution tools and exercise of resolution powers, consultation and cooperation in the development of resolution plans, early warning to or consultation of parties to the cooperation arrangement before taking any significant action under this Directive or relevant third-country law affecting the institution or group to which the arrangement relates, coordination of public communication in the case of joint resolution actions…).

Article 93 also empowers EU authorities, which is the Council of the Union on a proposal of the Commission, to conclude international agreements on resolution issues with the authorities under the jurisdiction of which fall the entities mentioned above.

Memoranda of Understanding and arrangements are **crucial for the smooth functioning of coordinated resolution actions by providing predictability and certainty** and acting

[9] (a) (..)the third-country resolution proceedings would have adverse effects on financial stability in the Member State in which the resolution authority is based or that the proceedings would have adverse effects on financial stability in another Member State; or (b) (..) that independent resolution action under Article 96 in relation to a Union branch is necessary to achieve one or more of the resolution objectives; or (c) (..) creditors, including in particular depositors located or payable in a Member State, would not receive the same treatment as third- country creditors and depositors with similar legal rights under the third-country home resolution proceedings; (d) (…) recognition or enforcement of the third-country resolution proceedings would have material fiscal implications for the Member State; or (e) (…) the effects of such recognition or enforcement would be contrary to the national law.

as a sound basis for the development of a regular working relationship between authorities. **An EU approach to those** is certainly desirable. Therefore, one wonders why so few memoranda of understanding have been signed and why the issue is not really prominent in debates and reflection.

2.3. Finally, in order to be able to tackle operational challenges and reduce execution risks**, increased cooperation between authorities is concerned, it is a prerequisite to fostering trust between host and home countries. It can concretely take place in several fora: Crisis Management Groups (CMGs) at the international level or resolution Colleges.**

In order to ensure adequate loss absorbing capacity and coordinate actions ex ante with the involvement of host authorities, CMGs prescribed by the FSB and resolution colleges established by the BRRD have a major role to play.

They are, first and foremost, fora for cooperation and **exchanges of information**. Therefore, we must make sure that information is exchanged effectively, efficiently, meaning without undue delay, and that it covers all needs of both the home and host authorities. This means there is a need for detailed and exhaustive memoranda of understanding and cooperation arrangements between authorities. The respective laws and confidentiality provisions of each jurisdiction must be respected, of course, but apart from those safeguards there should be no barrier to information exchange and it is better to be too ambitious than not ambitious enough. One needs to wonder why so limited "Memoranda of understanding » have been so far signed between resolution authorities and what is the missing path to "boost" the signature of such agreements in order to ensure a swift, effective and efficient decision-making. The question might be as political as it is technical.

However, information exchange alone does not ensure effective cooperation on a day-to-day basis. For such a cooperative relationship between authorities to be created, there is a need for a clear framework and in depth analysis: **meetings need to have concrete follow-up and discussions need to have a concrete basis.** In this spirit, **work programmes for CMGs should be further developed**. The **focus on resolvability**

should be clearly outlined in those work programmes and the **Resolvability Assessment Templates provided by the FSB are a concrete and useful tool for building them**.
Resolution colleges, established by the BRRD and soon also by the EU regulation establishing a framework for the recovery and resolution of CCPs, are a slightly different matter than CMGs. Unlike CMGs, they **already have concrete work programmes driven by joint decision takings** on resolution plans, MREL targets and impediments to resolvability procedure. Therefore, **in the case of colleges, the focus should rather be on timely exchange of information and on effective and constructive discussion and dialogue** in order to facilitate decision-making. Attention should also be paid to **limiting the divergences in practice** among different colleges, since those might ultimately have consequences on the way resolvability is built and assessed.

In Europe, the European Banking Authority (EBA) plays an important role to promote the **effective and consistent functioning of colleges** across the EU.[10] The last EBA report on the functioning of resolution colleges underlined significant improvements achieved but also noted that resolution is a complex task, which requires continued effort to increase preparedness of college members. This needs to cover all aspects of the resolution strategy for them to become fully operational. In particular, (i) resolution plans need further improvement in some key operational aspects such as bail-in execution, funding in resolution or access to financial market infrastructures (payment systems, CCPs), (ii) progress from banks in removing impediments to resolvability remains limited and uneven.

Lastly, the banking Union has strengthened cooperation on supervision and resolution matters at EU level. This framework should now fully deliver confidence that there will be no national/home bias, thanks to a centralized power. For resolution, the establishment of the Single Resolution Mechanism (SRM) by 19 Member States (but open to all EU states) is a clear progress, even if we should take care that the Single Resolution Board (SRB) clearly avoid participating in the increased fragmentation by imposing unjustified internal MREL on some subsidiaries.

[10] See "EBA report on the functioning of resolution colleges in 2017", July 2018 (https://eba.europa.eu)

In this respect, progress still needs to be made on issues such as the introduction of the possibility of cross-border capital waivers similar to the already-existing possibility of creating cross-border liquidity subgroups[11]. However, of course, the granting of such a possibility should take into account the legitimate concerns of host supervisors. If it is clear that addressing cross border issues is not an easy task, further progress need to be done on those issues in order to improve resolvability of GSIBs, to be better prepared for resolution execution, and avoid unnecessary market fragmentation by having a better understanding of interaction between recovery and resolution.

[11] Article 8 CRR

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