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# Working paper on resolution

## What kind of scenarios to enhance the credibility and the feasibility of resolution strategies

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# WHAT KIND OF SCENARIOS TO ENHANCE THE CREDIBILITY AND THE FEASIBILITY OF RESOLUTION STRATEGIES[1]

**ABSTRACT**

*A resolution strategy for banks needs to be feasible and credible. Asking banks to work on their resolvability is a major issue and therefore the resolution strategy developed by the authorities needs addressing the scenarios that are most likely to materialise and lead the institution to resolution. The aspects to be considered are the speed of the scenarios, the liquidity risk to be faced rather a solvency one, the consideration of systemic and idiosyncratic shocks and the perimeter of the resolution group. Based on the experience, there is a need to improve resolution planning and selection of the most adequate resolution strategies. This should cover the range of scenarios considered in resolution planning that has to be broadened in, how to better take into account recovery options in resolution planning and Minimum Requirement for Own Funds and Eligible Liabilities setting, how* to *consider systemic scenarios in the preliminary public interest assessment and finally what should be the perimeter of the resolution group.* W*hile resolution planning has made very good progress as resolution regimes have been established, taking into account those points will be major improvements.*

## INTRODUCTION

Following the 2007 financial crisis, the authorities have established a new framework at the international level for the resolution of banks, which is applied in Europe through the Bank Recovery and Resolution Directive (BRRD).

As many new regulations, this framework raised several issues, one of which is to assess what the group to be resolved is or, to be more precise, would the group to be resolved be the current one or do we consider that the bank will have taken several measures (what we call recovery actions) before going into resolution depending on the scenarios.

The basis of a resolvability assessment is whether resolution or liquidation, depending on the case, is feasible and credible.[2] In this context, feasibility refers to the possibility of applying the selected resolution strategy effectively in an appropriate timeframe without impediments, while credibility relates to the likely impact of resolution.[3]

It logically follows from this requirement that, in the case of institutions that will be subject to resolution, the resolution strategies identified have to be feasible and credible themselves.

This could only be so if those strategies have been selected with the view of addressing the scenarios that are most likely to materialise and lead the institution to resolution. Those will depend on the specific features of the institution considered, among which are its size, business model, legal structure or investor base.

This paper intends to discuss what lessons can be drawn from experience concerning those scenarios and what consequences are to be drawn in terms of recovery and resolution planning.

## 1 - WHAT KIND OF SCENARIOS TO BE CONSIDERED?

What are, on the basis of experience, the aspects of resolution scenarios that do not seem to have so far been taken into account as much as they should have?

There are four aspects of concern where there appears to be room for improvements.

### 1.1. - The first is the speed of the scenarios

While scenarios considered in recovery plans are typically wide-ranging, encompassing different types of scenarios, resolution plans typically contemplate on a narrower range of scenarios. It appears that, at this stage, for example, resolution plans of all French global systemically important banks are based on a fast-moving solvency scenario. This, however, is far from being the most likely scenario and hence the most credible. A sudden entry into resolution in a solvency crisis is in particular unlikely for large banks, such as global systemically important insurers or domestic systemically important insurers. For instance, it can be estimated that losses within the range of €30–€60bn would be necessary to trigger the resolution of a French global systemically important institutions, which is unlikely to materialise fast, particularly in the absence of systemic stress.

Those institutions have significant loss-absorbing capacity. They are able to benefit from business and geographical diversification, which makes their activities more separable in case of need. They can finally benefit from a more favourable market positioning (credit ratings, large and diversified investor base, confidence in brand names) than smaller institutions, facilitating the implementation of measures which rely on markets such as sales of business or capital raisings.

All those elements mean large institutions will have the time and ability to implement measures such as deleveraging, capital raising or sale of some assets or subsidiaries already before entering resolution. This ability will likely translate into protracted recovery phases, with a comparatively larger number of recovery options triggered before

resolution starts and potentially safeguards measures taken even prior to recovery. By contrast, brutal entry into resolution remains relatively credible for small institutions.

Experience shows that measures were often taken before the triggering of a banking solvency crisis. For instance, during the subprime mortgage crisis, Lehman Brothers began deleveraging in August 2007, while it filed for bankruptcy more than a year later, in September 2008. Similarly, Merrill Lynch raised US$6bn through the sale of a subsidiary in commercial finance business and of various other participations in September 2008, almost one year prior to its takeover by Bank of America.

Therefore, it appears that the most credible scenario for large banks would be a slow-moving scenario.

### 1.2. - The second issue is liquidity

The conditions for declaring an institution failing or likely to fail are noncompliance with prudential requirements, cessation of payments or negative net asset value.[4] Two of them are solvency-related and only one, cessation of payments, has connection with liquidity. In addition, resolution plans shall not assume 'any central bank emergency liquidity assistance or any central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms'.[5] Finally, liquidity is within the remit of central banks rather than resolution authorities. Therefore, liquidity may have appeared as somehow out of scope of resolution planning and in any case not a first priority. Liquidity and solvency, however, have a clear relation, the most simple and obvious channel being through potential fire sales in situations of financial stress which, aiming to address liquidity issues, end up negatively affecting the solvency of the institution. Therefore, scenarios originating in liquidity crises, and the appropriate resolution strategies to deal with them, have to be considered.

### 1.3. - The third issue: Systemic and idiosyncratic shocks

The BRRD states that 'the resolution plan shall take into consideration relevant scenarios including that the event of failure may be idiosyncratic or may occur at a time of broader financial instability or system wide events'.[6] Therefore, both systemic and idiosyncratic scenarios must be envisaged in resolution plans. The practice, resolution planning in the Banking Union has been to base the so-called 'preliminary public interest assessment', which informs the choice between resolution and winding up under national insolvency proceedings, only on an idiosyncratic analysis. The assessment of the credibility and the feasibility of the winding-up under normal insolvency proceedings and that of resolution and finally the choice of a preferred resolution strategy on the basis of the compared effects of resolution and normal insolvency proceedings are all performed on the basis of an idiosyncratic scenario. Systemic scenarios are only taken into account at the next stage, when deciding on a specific preferred resolution strategy and selecting resolution tools. Against this background, it might be argued that considering both types of scenarios already at the primary public interest assessment stage might give additional flexibility for resolution authorities to reflect reality in the best possible way and to take into account for the assessment the worst case scenario, which may well be a systemic one.

### 1.4. - The final issue related to the perimeter of the resolution group

The main issue faced by resolution authorities in relation to the perimeter of the resolution group is the choice between a single point-of-entry strategy where the resolution group is identical to the prudential group and a multiple point-of-entry strategy where several resolution groups are defined within a single prudential group.

Single point-of-entry strategy is a concept that deserves more investigation to understand all of the consequences. While single point-of-entry strategies are by far the most common, multiple point-of-entry strategies may for some groups help facilitate resolvability and design more realistic resolution strategies. This is particularly the case when the group includes subsidiaries in jurisdictions where no resolution regime is in force. There, it would not be credible to assume in the resolution strategy the application

at the local level of tools, which by definition are not available. It might not, however, be realistic either to assume, especially in this case of small, separable entities, that the parent entity will automatically step in and fully recapitalise them, especially as, in the absence of the internal Minimum Requirement for Own Funds and Eligible Liabilities (MREL) framework, there are no pre-positioned resources that provide certainty on upstream of losses and downstream of capital. The case is rather similar when a group includes entities that would go into liquidation without endangering the financial stability: by definition, it is not planned to have those operating after resolution. Does it therefore make sense to include them in resolution groups?

## 2 - WHAT ARE THE LESSONS TO DRAW?

What are then the conclusions to draw from this overview and what recommendations can be made in order to improve resolution planning and selection of the most adequate resolution strategies?

Four recommendations in four main areas have been identified, echoing the four aspects that one considers could be improved.

**2.1. - The first set of recommendations is that the range of scenarios considered in resolution planning has to be broadened** in order to take into account the role of liquidity and the high likelihood of slow-moving scenarios. The focus on slow-moving solvency-based scenarios should be considered for large banks.

Then scenarios taking better into account liquidity issues should be added. Liquidity-based scenarios may be fast-moving, such as in the case of a liquidity crisis triggered by a sudden outflow (supervisory fine or operational incident, for instance). They might also be slower-moving, leading to scenarios under which the liquidity situation slowly deteriorates, gradually causing a deterioration of the solvency situation and, after the unsuccessful implementation of recovery options, entry into resolution. Supervisory liquidity stress testing may serve as a basis for the assessment of the liquidity component of those scenarios.

Resolution authorities are aware of the challenges, and they are starting to reflect on new types of scenarios for the next resolution cycle. This is a very encouraging move, and the efforts made in this direction should be maintained. The new scenarios added to resolution plans may then be refined over time. The Single Resolution Board (SRB) seems to be going in this direction as discussion on the most adequate resolution scenarios is starting and expected to develop within the Internal Resolution Teams (IRTs[7]) in charge of the different banks.

**2.2. - The second set of recommendations relates to taking into account recovery options in resolution planning and MREL setting**. As explained earlier, the credibility of a scenario in which entry into resolution would be sudden and no recovery option would have been resorted to is very low, in particular, for large banks. The consequences of this situation should be drawn.

In terms of resolution planning, this means there is a need for a better understanding of the interlinkages between recovery and resolution. Resolution authorities need to reflect together with supervisory authorities to understand what recovery options may affect the resolution strategy planned. They may decrease the feasibility of a resolution measure (eg a capital raising increasing the interconnectedness of a group and therefore making a multiple point-of-entry strategy less feasible), they may affect MREL ratios and risk-weighted assets (RWAs), they may affect the critical functions that resolution aims to preserve or they may hamper the post-resolution restructuring of the entity (eg a sale of assets reducing the franchise value of the entity post-restructuring and changing its business model). Research on this issue has to be deepened, and the work stream of the European Banking Authority (EBA) Resolution Committee on the interlinkages between recovery and resolution is a welcome step in the right direction. Further work and research on the interactions between recovery and resolution are also expected to be helpful for resolution authorities in their daily task of 'identifying any actions in the recovery plan which may adversely impact the resolvability of the institution' and 'mak(ing) recommendations to the competent authority with regard to those matters', as required under BRRD.[8]

The activation of recovery options prior to resolution also needs to be factored in when calibrating the MREL requirements of institutions. If those options are implemented, the recapitalisation need that the MREL requirement aims to cover will apply to an entity resulting from the implementation, which will not be identical to the pre-recovery and pre-resolution entity. It follows that the base of the MREL recapitalisation amount should be adjusted for recovery options. The BRRD as amended by the recent banking package mentions that the MREL calibration should use the 'most recently reported values [ . . . ], adjusted for any changes resulting from resolution actions set out in the resolution plan'.[9] It is therefore acknowledged that the entity resulting from resolution is not the same as the entity that existed prior to resolution and this fact should be reflected in the MREL requirements. As explained in the first part of this paper, what experience, however, shows is that the distinction between recovery and resolution becomes slightly blurred in slow-moving scenarios, which are the most likely, with recovery options being implemented at an early stage.

This is why, in order to take into account this likely scenario and set requirements in the most adequate way, it is important that the whole spectrum of actions and measures mentioned in the resolution plan is factored in. Those measures should be considered irrespective of whether they are taken by the authority or the institution and of whether they are taken in recovery or in resolution. Measures set out in the resolution plan but implemented before resolution would need to be subject to some sort of assessment as it is difficult to know ex ante with certainty which specific measures would be implemented. There should not, however, be any preset criteria for measures to qualify. The most realistic approach to this aim would be to take into account, for each institution, a minimum amount, which would be likely to result at all times for the implementation of any of the resolution actions, and allow the adjustment of the RWA base of the MREL recapitalisation amount for the amount identified. At this stage, an easy proxy for this amount is simply the planned decrease in RWAs resulting from the resolution action with the lowest foreseen impact. This adjustment factor would be bank-specific, and therefore flexible. This approach would be conservative as only the lowest estimated change would be taken into account. It would also be predictable and realistic enough to provide

confidence to markets and authorities as, being the lowest change, it would also be the one which has the highest probability to materialise. This approach would ease the concerns, expressed by some authorities, relating to the difficulty of foreseeing exactly what options would be implemented once resolution starts and to the risk of potential undercaptialisation.

**2.3. - The third set of recommendations relates to considering systemic scenarios in the preliminary public interest assessment.** Such an approach may prove relevant in some cases, in order to reflect national market specificities. For instance, assuming the simultaneous failures of a subset of less significant institutions with a similar business model and active on the same market could be justified when assessing the substitutability of critical functions.

The current legal framework, however, already provides for sufficient flexibility to do so. It is, for instance, already possible for resolution authorities, within this framework, to develop their own specific numerical indicators and benchmarks to be used, for example, when carrying out the impact assessment that is part of the supply-side analysis of critical functions. In this respect, contagion channels between a subset of banks with very similar features could be used as an additional indicator when performing the public interest assessment.

This being said, indicators designed in that should always be optional and aim to complete the existing common methodology to facilitate the choice between a liquidation strategy and a resolution strategy. They have to be explained and justified, but could not by themselves justify the choice of a preferred resolution strategy.

Not setting the limits mentioned earlier and using a systemic scenario for the preliminary public interest assessment would dramatically include the number of less significant institutions earmarked for resolution, thereby submitting institutions to requirements that would not always be proportionate and increasing the work burden for authorities.

Another problem is that taking into account systemic scenarios has been sometimes understood in practice as requiring the development of two preferred strategies for one single less significant institution, within the same resolution plan (ie one with liquidation as preferred resolution strategy under an idiosyncratic scenario, and one with a resolution strategy under a systemic scenario). This would be very problematic as it would create confusion for institutions and legal uncertainty with the existence of two MREL targets.

Finally, relying mostly on an idiosyncratic scenario for the public interest assessment ensures a level playing field within the Banking Union and the European Union. As the systemic scenarios applied would by nature be diverging across member states, using a systemic scenario would result in a lack of harmonisation and its resulting competition bias within the Union and the Banking Union, where two different resolution strategies would be applied in respect of two similar banks.

**2.4. - The last set of recommendations relates to the perimeter of the resolution group.** This perimeter should be set in a way that will reflect the most credible scenario in the most possible way. The best way to address the cases of entities established in jurisdictions without the resolution framework is likely to be, provided the subsidiaries concerned are economically and operationally separable, to exclude them from the main resolution group and adopt a multiple point-of-entry strategy with a core resolution group subject to resolution and a third-country resolution group comprising the subsidiary concerned and on which the losses assumed will be higher. In a similar way, there should be discretion for authorities to exclude from resolution groups those entities known to be earmarked for liquidation and the continuation of whose functions is not foreseen after resolution.

When calibrating the MREL recapitalisation amount, it is important to take into account the fact that not all subsidiaries of a group would have to be safeguarded in resolution. Beyond the strict list of critical functions, it is also important to identify the perimeter of activities, if any, that need to be funded in resolution. The identification of funding needs in resolution is a complex subject, requiring the development of assumptions that primarily depend on the resolution strategy and on the perimeter of the resolution group.

The current framework for resolution allows a lot of flexibility both in the choice of the preferred resolution strategy, whether the single point-of-entry or multiple point-of-entry, and the perimeter of the resolution group. The issue of the perimeter is therefore not a question for debate in itself. It, however, is for each authority and, in the banking Union, on each internal resolution team, to choose the most adequate perimeter.

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In conclusion, identifying the most realistic scenario, that is, the scenario which describes the events most likely to be faced is crucial for good resolution planning. The actions and measures planned in resolution have to be selected in order to allow the resolution authority to tackle the exact difficulties that may be encountered by institutions: a resolution strategy, which addresses perfectly well risks that are, however, unlikely to materialise, or, conversely, which does not address the risks that may actually materialise, fails to meet its goal.

Therefore, reflection on scenarios has to be a central element of resolution planning, and it can hugely benefit from the practical experience acquired by supervisory and resolution authorities.

As shown in this analysis, while resolution planning has made very good progress as resolution regimes have been established, a number of points seem to still present room for improvements. They relate to the exact types of scenarios to be considered in resolution planning, the proper way to take into account recovery options in resolution planning and MREL setting, the types of scenarios considered for the preliminary public interest assessment and the perimeter of resolution groups. On each of those elements, this paper presents recommendations aimed to make resolution planning more effective and efficient by taking into account the reality faced by the institution and resolution authorities. The objective is to foster discussion on these topics between resolution authorities and all stakeholders.

## References and Notes

(1) Contribution published in Journal of Financial Compliance - Volume 3 Number 4 and prepared with Marion ZOSI, resolution expert at ACPR with the advice of Carine Henry, head of resolution unit at ACPR.
(2) Articles 15 and 16 of the BRRD.
(3) See Articles 26 to 32 of Commission Delegated Regulation (EU) 2016/1075.
(4) Article 32 of the BRRD.
(5) Article 10(3) of the BRRD.
(6) *Ibid*.
(7) IRTs are the main forum in which the SRB and National Resolution Authorities (NRAs) cooperate in performing resolution activities (resolution planning and preparation of resolution schemes). IRTs are composed of staff of the SRB and the relevant NRAs. They are headed by coordinators appointed from the SRB's senior staff.
(8) Article 6(4) of the BRRD.
(9) Article 45c(3) of the BRRD.