‘No Creditor Worse Off’: Resolution Mechanisms Update

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The current economic crisis in which banking institutions’ failures have played such an important role is being accompanied by significant transformations at the level of regulatory frameworks. The globalization trend so prevalent in areas like banking supervision with Basel II and III (or accounting with IFRS) is also stepping in when dealing with resolution mechanisms.

It is interesting to see how the efforts to provide prompt responses made by individual countries to the new demands imposed by the financial crisis are taking place alongside the initiatives promoted by supranational institutions. The overall result is an evolving legal framework: the UK Banking Act (2009), the US Dodd-Frank Act (2010) and the German Bank Restructuring Act (which came into effect in 2011). Similar laws in other countries have just been enacted in 2012, such as in Spain and Portugal, and it is envisaged that this trend will continue to develop and be implemented over the coming months in other jurisdictions.

Systemic Risk

In order to understand what is happening, it is necessary to call the attention to the systemic nature of this crisis. The IMF, in different papers and reports, has highlighted the increasing systemic risks imposed on the financial systems as a consequence of the huge size acquired by some of these financial institutions with international presence in financial markets and extensive linkages with other cross-border ones. The economic reasons which historically justified the need for this type of financial institution such as achieving economies of scale and the need for competing in a global environment were not accompanied by similar transformations in terms of regulation and supervision. If one adds to this the abandonment of a traditional business model towards another in which revenues and fees are mostly derived from dealing with sophisticated financial products, not always understood by managers, the final result is a bank in crisis which lacks a clear strategic direction and which does not have enough resources to cope with the new circumstances. An analysis of the responses given by different governments confirms the
seriousness of this crisis as well as its characterisation as a systemic one: due to being applied, extensively, three out of the five commonly crisis resolution policies: liquidity support, restructuring, asset purchases, significant guarantees and nationalisations.

The BCBS and Its Ten Recommendations

The critical year in the development of resolution mechanisms was 2010. In March of that year, the Basel Committee on Banking Supervision (BCBS) issued ten recommendations which have served as basic stepping stones for all further developments. Essentially, they insisted on the need for any country of being capable of managing a crisis situation in any type of financial institution, emphasising the definition of frameworks which would allow for a coordinated resolution process. This would be reflected in lower levels of complexity of the operations and in the reinforcement of risk mitigation mechanisms. Due to the significant amount of cross-border activities undertaken by these institutions, it was deemed advisable to merge national resolution measures and in turn increase cooperation and information sharing. The pursued goal should be a planned and well-organized resolution process as the final intention is that feasible parts of the business would ‘come back’ to be subject to market discipline.

The FSB’s 3 Resolution Regimes

The Financial Stability Board has been the institution taking the lead in this field. Concerned with the Too-Big-To-Fail issue, has been paying a lot of attention to G-SIFIs (Global Systemically Important Financial Institutions), asking in October 2010, when it made public the FSB-SIFI recommendations, for an assessment of each country’s capabilities for managing resolution situations.

Up to then, there were three main types of resolution regimes:

- Special ones which allowed authorities to take control of banks before or upon insolvency.
- Special administration or management regimes which allowed banking supervisors or authorities to appoint special officials in charge of implementing resolutions, getting into forced liquidation if necessary and, finally,
- Mixed regimes which combined features of the other two but with less power.

The measures developed by the FSB have enjoyed the explicit support of the G-20. In the annual meetings held by the superior authorities of these countries as well as in the periodic meetings of their finance ministers and Central Bank governors, since 2010, they have continuously endorsed the works undertaken by the FSB which have been recently extended to include the D-SIBs (Domestic Systemically Important Banks).

In October 2011, the Financial Stability Board issued one of the most important documents in this area of resolution mechanisms. It defined the key attributes of effective resolution regimes for financial institutions of which two are its main contributions:

1. It identifies up to twelve aspects which any resolution regime should deal with. They comprise the scope, resolution authority and resolution powers, setting-off, netting, collateralisation and segregation of client assets, safeguards, funding of firms in resolution, legal framework conditions for cross-border cooperation, crisis management groups, institution specific cross-border cooperation agreements, resolvability assessments, recovery and resolution planning and access to information and information sharing.
2. It characterises an effective resolution regime as that in which there is no severe systemic disruption, taxpayers are not exposed to a loss and the hierarchy of claims is respected.

The FSB document insists on the importance of applying the “no creditors worse off” principle. This translates, firstly, in the respect of the creditors’ hierarchy. Equity would absorb losses first and senior debt holders would assume losses once subordinated debt has been entirely written-off. Secondly, if creditors do not receive the minimum which would have corresponded to them under the national insolvency regime, they would have the right to a compensation (known as the “no creditor worse off than in liquidation” safeguard).
The European Union Recovery and Resolution Framework

The latest developments in the international arena have been undertaken by the European Union. In June 2012, The European Commission made public its Proposal for a Directive aimed to establish a framework for the recovery and resolution of credit institutions and investment firms. In this document, emphasis is placed upon the development of a framework which would consist of three main pillars: preparatory and preventive measures, early intervention and, finally, resolution powers and tools. It is convened that by acting early, the escalation of the problems may be avoided. The proposed scheme of intervention relies to a great extent in the decisions adopted by resolution authorities. They may request the implementation of specific actions such as, for example, the separation of functions, setting limits on exposures or imposing restrictions on new business lines or products, if these contribute to the resolvability of these institutions. The idea is that resolution would take place if there is no other alternative and reasons of public interest justify it.

This EU document considers four different resolution mechanisms: sale of business, bridge institution, bail-in and asset separation. This last one is the only which, compulsorily, should be applied in conjunction with the others, in order “to minimize competitive distortions and risks of moral hazard”. The basic principle respected by this scheme is the “no creditor worse off”.

Current Consultation Period

Different opinions have been requested from EU bodies about this proposal of directive. The European Central Bank (ECB) in November 2012 expressed its desire for a quick adoption of it, as it advocates the creation of a single European Resolution mechanism. Despite this, it insisted on the need for further clarifications, mainly oriented to insist on the fact that resolution purpose should be the continuity of the essential functions performed by the entity, not its continuance as a failing organization. The ECB called for the definition of the competent authority which should be in charge of determining if the bank has failed or is likely to fail. The other relevant opinion issued to date corresponds to the European Economic and Social Committee which in December 2012 expressed some concerns, particularly in the areas of recourse to some resolution measures not tested before when dealing with a systemic crisis, the need for maintaining confidentiality about recovery plans and a clearer definition and stricter regulation of the powers granted to resolution authorities, in order to avoid potential conflicts with judicial ones.

Editor’s Note: For more information about the issues and organizations referenced above please post your queries on the GLOBAL RISK FORUM on LinkedIn or email Dennis Cox at DWC@riskrewardlimited.com

REFERENCES


