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Progress on the resolvability of GSIBs – the FSB perspective

Speech by Klaas Knot at the 2nd SRM-EBF Boardroom Dialogue
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At the second SRM-EBF boardroom dialogue, Klaas Knot gave a speech in which he described the efforts in making banks resolvable. He also mentioned areas of concern for the coming years: trends and priorities for achieving resolvability.

Let me start by saying that I am here in two capacities, wearing two hats as it were. I am here both as vice-Chair of the Financial Stability Board, the FSB, and as president of the Dutch Central Bank. For this speech I will be wearing my FSB-hat.

As you may know, the FSB has actually been the instigator of many of the reforms and policy initiatives on bank resolution, including the topics being discussed today. With the development of the Key Attributes for effective resolution regimes in 2011, the FSB created the blueprint for the European resolution framework. This was followed by the TLAC standard for setting loss absorbing capacity for G-SIBs. So far, this is the only international standard developed by the FSB. Other guidance developed by the FSB covers topics such as bail-in, funding in resolution and operational continuity.

In this speech I will be taking the view of an FSB representative with a keen interest in making banks resolvable. This view should provide insight into the trends and priorities for achieving resolvability. Hopefully it will also guide your own efforts, as you work together with the SRB on topics such as: completing resolution plans, implementing TLAC and modelling funding in resolution. And even though the FSB focuses on policy development for G-SIBs, I think these topics are equally relevant for other banks.

Resolution planning and achieving resolvability

I will start with resolution planning and achieving resolvability, the topic you discussed before lunch. In my view resolution planning has always been a means to an end. It is about getting a deep understanding of how a bank is organized and functions. It is about asking fundamental questions on what functions need to be continued and how to achieve this. Resolution planning forces authorities to consider all these aspects and it focuses the mind. Through resolution planning, the authorities can form an informed view on what is needed to ensure a bank is resolvable.

The FSB monitors progress in resolution planning, in its annual Resolvability Assessment Process and reports on this to the G20. The good news is that significant progress has been made, especially in the area of resolution planning. All G-SIBs have a resolution plan that sets out a resolution strategy. The plans have also been discussed between the various relevant resolution authorities involved with the bank in the crisis management groups. However, this in itself does not make banks resolvable. Resolvability means readiness at both the level of the bank and the authorities, to implement the resolution strategy if necessary. At the FSB, we observe that this reality has now also dawned on both authorities and banks.

We see the positive trend that authorities are increasingly focussing on banks and their own capabilities to execute resolution strategies. This will take time and effort and requires the allocation of sufficient resources to this task across the board.

A lot of the proverbial low-hanging fruit has already been picked by the banks. For instance, identifying and mapping critical services. At the FSB we are finding out more and more that the devil is in the detail. The Resolvability Assessment Process in this context has identified areas in the context of operational continuity where banks and authorities should increase their capabilities.

In my view there are three areas of priority when it comes to ensuring banks are ready to implement the resolution strategy. It is perhaps not surprising that two of those are in the domain of data availability in resolution. I am referring to centralizing contract management for critical service contracts in the context of operational continuity, and ensuring good quality data for valuation purposes. If this data is not quickly and easily accessible, implementing resolution in a short timeframe is extremely difficult.

The other priority area is understanding how financial market infrastructure will react if the bank is in resolution. If banks in resolution cannot conduct market operations, any effort by any authority is likely to fail. All of the three topics I mentioned require a deep-dive into the DNA of a bank - and then I have not even started on TLAC.

TLAC

This morning, you also discussed the setting of MREL in order to achieve resolvability. MREL was developed almost simultaneously with TLAC and there are of course a lot of similarities between the two. The TLAC term sheet developed by the FSB determines the minimum amount of loss-absorbing

capacity G-SIBs should have. Last month, the TLAC principles were implemented in European legislation through the banking package.

This means that, as of last Friday, all G-SIBs in Europe are required to have a minimum loss absorbing capacity of at least 16% of Risk Weighted Assets, plus the combined buffer requirement. The European legislation on some aspects goes beyond the TLAC term sheet, for example by requiring MREL targets for all banks instead of only G-SIBs. Also, the new BRRD2 introduces binding minimum subordination requirements for banks with over 100 billion Euro on their balance sheet. This will ensure that sufficient loss-absorbing capacity is available for bail-in during resolution.

The FSB has been monitoring the progress G-SIBs are making in building up loss absorbing capacity. We see that progress has been steady and significant, both in the setting of TLAC requirements by authorities and in the issuance of TLAC instruments by banks. This has been instrumental in enhancing resolvability and boosting market confidence in authorities' capabilities to address "too-big-to-fail" risks.

However, despite all this, we are not at the end of the road yet. The TLAC review that the FSB recently finalized, has shown that additional steps relating to loss-absorbing capacity are necessary.

I will address three topics where I believe progress is required. First, it is clear that there will be less issues when bailing-in a subordinated liability compared to bailing in a senior instrument.
No Creditor Worse Off issues come to mind in this context. The TLAC term sheet, by way of exception, allows for senior instruments to be counted towards TLAC. In my view, more analysis is required as to how these exceptions influence the resolvability of banks.

Second, we have to make sure that adequately distributing loss-absorbing capacity within the group, needs to be prioritized. This means making sure losses in subsidiaries can be upstreamed to the parent company, and capital generated through bail-in can be downstreamed from parent to subsidiary. Without an efficient internal mechanism, bail-in simply will not work. It is good to know: this topic also has the attention of the SRB.

Third, further work is needed on bail-in execution. This has also been recognized within the FSB. Both banks and resolution authorities should consider how they can ensure that the execution of bail-in is effective.
Executing bail-in is a complex process that involves many actors and actions by both banks and authorities. Bail-in also has distinct cross-border elements, as many banks have issued bail-inable instruments in other jurisdictions. This is an area the FSB will be focusing on this year. I am glad that the SRB and the banks are also making progress with the development of bail-in playbooks.

Funding in resolution
I will now turn to the topic, that will be discussed this afternoon: "funding in resolution". This topic, which has often been referred to as the elephant in the room, is now firmly on the radar screen of banks and authorities alike. Within the FSB we have observed that work has slowly started to ensure that funding and liquidity will not be the constraining factor for an orderly resolution.

Resolution funding strategies and plans are being prepared. Banks have started building up core capabilities, by developing automated scenario modelling and forecasting to address funding in resolution, in line with the FSB's guidance on Funding Strategy Elements for an Implementable Resolution Plan. However, this takes time and it requires a different mindset from bankers.
So here we encounter a third area of recommendations, after those on operational continuity and TLAC. The area of bank's capabilities on funding in resolution.

Preparing for a resolution scenario goes beyond normal liquidity stress testing and contingency planning in going concern. Banks must be able to estimate and address potential funding needs in a variety of stressed situations and resolution scenarios, by applying even more conservative assumptions than in normal stress tests. In addition, banks need to identify and monitor the collateral that can be mobilized in a resolution scenario. So, I would like to urge everyone around the table to dedicate sufficient resources to this topic tasks and not to consider this as something already covered by recovery planning.

Despite efforts undertaken, liquidity gaps may eventually arise when an institution is put into resolution. In particular in a slow-burning crisis situation, there is a risk that in the run-up to resolution, more and more assets are being encumbered or disposed, as part of the recovery strategy. A consequence of this, inevitably is that when the institution is declared failing or likely to fail, there is insufficient collateral left for the institution to fund itself.

And here we encounter the fourth and final area of concern: the authorities. Authorities should therefore work in parallel in two directions, to avoid institutions being unable to be resolved because of a lack of funding. First, to avoid ending up in such a situation where all collateral is gone, it is important that the bank is placed in resolution at a sufficiently early stage. In line with the FSB Key Attributes of Effective Resolution regimes, liquidity indicators should be an important element in when authorities determine that an institution is failing or likely to fail. Second, private and public funding mechanisms should be put in place to close any potential liquidity gaps. In line with the FSB Guiding principles, private sources of funding should be relied upon as a first-choice source of funding, to the degree that such funding is available. In addition, an effective public sector backstop funding mechanism should be available as last resort.

In several jurisdictions such mechanisms have been put in place in recent years: in countries like the United States and the United Kingdom, through a combination of a resolution fund and a central bank resolution liquidity facility. At the level of the Banking Union, the public backstop funding mechanism is still very much a work in progress.

I understand the SRB has been exploring how the Single Resolution Fund can best be used for funding in resolution. There are quite a few challenges that need to be overcome, like the form in which liquidity will be provided and obtaining a rating for the Fund. I am sure the SRB will rise to the occasion on these topics.

What has been achieved, is that the ESM will become the common backstop to the SRB's Single Resolution Fund. This backstop can be used in case the Single Resolution Fund has been depleted. It is therefore also available to provide liquidity support to resolved banks. Yet, we all know this may not be sufficient to cover the liquidity needs of a GSIB

This leaves the question of the role of the Eurosystem, with regards to funding for banks in resolution. At the moment, the technical work within the Euro Working Group focuses on ways to access ordinary central bank liquidity facilities. The recent letter from Eurogroup President Centeno mentions further work on proposals on SRB guarantees to the Eurosystem, and on the capacity of the SRB to provide collateral to banks in resolution. You can imagine that, with my central bank hat on, I can only support these initiatives.

Whatever the outcome of the technical work, the instrument should be designed in line with the FSB Guiding Principles. This means: it should only be available on a temporary basis, when private funding sources are insufficient, on conditions that minimize moral hazard.

Concluding remarks

When looking at the progress made on bank resolvability, I can say that from an FSB perspective the glass is half full and that I remain optimistic. Much progress has been made on resolution planning, TLAC and funding in resolution. This has helped to increase the resolvability of the banks and the preparedness of the authorities.

The challenge will be to keep up the good work. This means banks should invest in improving their capabilities to execute the resolution strategy. Authorities need to continue to provide the banks with guidance and make sure they are operationally ready for a resolution case.

I hope I can count on your efforts in this endeavour of making your banks resolvable, especially in the areas of operational continuity, TLAC and funding in resolution.

Thank you!