26 July 2019

EBF 037928D

EBF Response to FSB Consultation:

Solvent Wind-down of Derivatives and Trading Portfolios

Key points:

- **Greater international consistency could be achieved by dedicated workshops between jurisdictions' resolution authorities and domestic industries**
- **As the proposals will likely result in very granular requirements, a cost-benefit analysis should be taken into account when deciding whether individual banks have to undertake this effort. Solvent wind-down planning should be focused on significant trading book activities – however, if derivatives positions largely stem from internal hedging, a solvent wind-down would even be counterproductive**
- **Future FSB guidance, if any, should foremost focus on resolution planning, as winding down a derivatives portfolio raises unique issues in resolution that cannot be inferred from recovery planning. If the future guidance was to also cover recovery planning, different provisions should apply to mirror the different contexts of recovery and resolution.**

EBF position:

We understand the FSB's motivation for considering solvent wind-down planning as an additional resolution preparedness measure. We also appreciate the efforts made to achieve greater international consistency in this regard.

That said, the questions at hand are very complex and we believe that costs vs. benefits need to be thoroughly assessed, for example with regard to the application of solvent wind-down planning requirements to individual banks. As a general rule – and for reasons of proportionality – we believe that the focus should be on large banks with significant trading book activities. However, derivatives positions that are used for internal hedging should not be covered by the requirement – in this case a wind-down would create additional risk, rather than reduce it.

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At this stage we believe that further discussions would be beneficial and could build on this consultation and feedback received. For example, the FSB could encourage and participate in workshops between the resolution authorities of individual jurisdictions and the domestic banking sectors. These could be used to assess what focus and degree of solvent wind-down planning would be reasonable given the respective context and the nature of banks' activities. Reaching a common understanding in this regard would help achieve international consistency in a proportionate manner and appropriately reflect the cost-benefit trade-off for banks.

From a Eurozone perspective, we would like to add the consideration that a bank's overall capabilities to support the preparation of such plans are already overlapping with existing resolution/ resolvability requirements by the Single Resolution Board (SRB). We are confident that the FSB will remain open to avoiding unnecessary duplications and complexity.

We also recall that the FSB has just launched an evaluation of the impact of the global Too-Big-To-Fail reforms. We welcome this evaluation and believe that it will help identify more clearly how urgently further action is needed.

Please see below our responses to the FSB's specific questions.

1. **What is your view on the rationale presented in the paper for solvent wind-down in recovery and resolution? Should the development of solvent wind-down plans be a component of both recovery and resolution planning?**

The EBF urges the FSB to clearly distinguish between recovery and resolution. Recovery and resolution are very different situations, even more so in the context of winding down a large derivatives portfolio.

As presented in the table hereunder, resolution and recovery differ fundamentally in terms of:

- Timing
- Priority given to wind-down costs
- Market sentiment towards the bank concerned
- The legal means to implement the wind-down

	Recovery	Resolution
Timing	The bank has time to wind down its portfolio (i.e. several months), if this recovery strategy is privileged by the bank	Once the bank has entered into resolution, the resolution authority has 48hrs (the time given by the stay) to decide on the appropriate resolution strategy. It is only if the authority decides not to liquidate the bank (hence transfer the derivative portfolio to a "good bank") that a solvent wind-down would be envisaged

	Recovery	Resolution
Priority given to wind-down costs	Minimizing wind-down costs is a priority	Minimising wind-down costs is less of a priority – as long as they do not escalate to the point of triggering a potential legal action by creditors under the NCWO principle
Market sentiment towards the bank concerned	No particular lack of confidence. The bank remains otherwise on a going concern basis	Market confidence severely tested
Legal means at disposal	None. The bank can only rely on negotiations with its counterparties	Resolution authorities can impose a stay of early termination rights Resolution authorities can create an asset management vehicle to isolate the run-down

The development of solvent wind-down plans should be a component of:

- Recovery planning only to the extent that the bank considers winding down its derivative portfolios as a recovery option and for those portfolios only (it may have a recovery option to wind down only a portion of its trading books, close equity derivatives and maintain interest rates and foreign exchange derivatives)
- Resolution planning only to the extent that the relevant resolution authority considers this part of its resolution strategy and communicates it to the bank concerned

The FSB mentions (page 3) that a G-SIB implementing a wind-down may also be exposed to a similar process initiated by a counterparty. This is a possibility but has no bearing on the analysis of a firm's capacity to manage the wind-down of its own portfolio. Moreover, the fact that a counterparty also wishes to wind-down may be a helpful factor, rather than a hindrance.

Lastly we would like to highlight that not all G-SIBs undertake significant derivatives and trading book activities. As a consequence, dedicated wind-down plans may not be relevant for all G-SIBS. If a jurisdiction, e.g. the EU, considers implementing such requirements it should be very mindful of its relevance for its domestic G-SIBs.

2. Do you consider that the discussion paper adequately identifies relevant firm capabilities that may be needed to prepare for and execute a solvent wind-down? Are there other firm capabilities that could be considered?

We find that, with some exceptions, the FSB's document adequately identifies the relevant firm capabilities to prepare for and execute a solvent wind-down.

Most banks that are active in derivatives trading will have the operational capability to perform the SWD analysis (even though they would need time to set up the process). However, we need to highlight that by nature this sort of forecast takes account of multiple external dependencies and will result in a great range of outcomes for both exit and operational costs:

- Exit cost modelling for the entirety of the D&T portfolio is very complicated and would have multiple external dependencies.
  - Market environment (price, liquidity, etc.) in all assets
  - Hedging cost (and its development) over time
  - Behaviour modelling (willingness of counterparties to trade; willingness of clients to terminate, etc.)
  - Rate of return required for counterparties to trade (in particular for derivative novations)
- Operational cost modelling is also very complicated. To name a few factors:
  - Ability to reduce indirect costs as the operations wind down
  - Approximating cost reductions by small parts of the business is even more difficult (in particular for indirect costs / shared services / shared systems)
  - Ability to model behaviour (willingness of vendors to terminate; willingness of employees to voluntarily leave the platform rather than be severed/retained; etc.)
- In addition, operational costs will often hinge on exit speed which has all the associated difficulties outlined above in exit costs.

Concerning the necessary capabilities identified in the paper, we would argue that capabilities 4 ('ability to access financial resources') and 5 ('ability to identify and mobilise unencumbered capital') are in fact not specific to solvent wind-down activities. These are questions linked to the availability of liquidity in resolution and equally relevant to all forms of resolution actions. Linking them to wind-down of derivative and trading portfolios complicates the approach to wind-down. It would be preferable to deal separately with liquidity in resolution.

We also find that in several cases, the FSB approach seems to consider that derivative portfolios should be wound down 'at all cost'. This is apparent in capability 11 ('ability to estimate financial resource impacts'), notably where it evokes the impact on other parts of the firm not subject to solvent wind-down. The same is true for capability 14 ('ability to model costs of exiting positions') which includes the cost of executing replacement hedges. We feel that this approach could be improved by drawing the distinction between derivative and other positions that are the result of trading activity, and those positions which are internal hedging positions linked to other activities of the bank (for example rate and FX derivatives that hedge past bond issues, interest rate derivatives that hedge a fixed rate mortgage book, etc.). Such internal hedging positions should not be seen as being material for an accelerated wind-down. They should simply be wound down at the same speed as the activities they are hedging. As internal hedges, they do not carry the risk of generating losses, as they are designed to offset positions in other areas of the bank – on the contrary, it would be their forced wind-down that would generate open positions.

As regards the contractual recognition clauses mentioned as a means to mitigate the risk of financial contracts due to close-out, we believe it is necessary to recognise the limits of these recognition clauses: We, of course, agree that the close-out of positions upon initiation of resolution measures can negatively affect the resolution measures. However, we also believe that the importance of close-out netting as a risk mitigation mechanism requires a certain level of protection of close-out netting. Thus, the interests of the party under resolution and the interests of the counterparties relying on close-out netting to mitigate their exposure need to be balanced. Temporary resolution stay-powers which also include safeguards for close-out netting arrangements strike the right balance. Contractual recognition clauses confirming these resolution stay-powers are helpful in this connection by complementing the regulatory resolution stay-powers. However, they have limits: it will, for example, not be possible to include them in every single agreement (especially existing agreements) and they may also – in case of a resolution action based on these contractual rights – open a new forum for legal challenges. Thus, they should not be seen as the ideal or only solution to mitigate the risk involved. The most effective way of ensuring that resolution stay-powers can be used in cross-border situations is through international / statutory agreements on the reciprocal recognition of these regulatory resolution powers.

3. What is your view on the identified evaluation/verification mechanisms for firm capabilities presented in the paper? Are there other mechanisms that could be considered?

We do not see another mechanism that could be considered.

EBF members are fundamentally opposed to developments that would imply that their derivative management capabilities are analysed by an independent third party. The valuation and simulation capabilities that are required to model solvent wind-down are the same capabilities that are used by banks in their going-concern trading activities, and it would not be commercially acceptable to allow access to this internal expertise to third parties.

Going-concern supervisory bodies are the appropriate bodies to certify banks' capacity to correctly manage their derivative and other trading capacities.

4. Does the paper adequately identify the considerations for home and host authority cooperation? Are there other considerations?

We agree entirely with the FSB that home/host cooperation is an essential aspect of successful resolution. We do not disagree with the individual points raised, yet we would like to point out that they are not specific to derivatives and other trading activities in resolution situations.

With regard to point 1 ('discussions between home and host') we underline that this dimension is common to all aspects of resolution planning and execution and does not require any particular focus in the case of solvent wind-down.

Regarding the 'additional considerations' for home and host authorities (point 2 and 3 respectively), we would recall that all of the issues raised are shared with all other resolution actions. To a very large extent these are issues that arise in all cases of 'business as usual'. No particular treatment specific to solvent wind-down is required.

5. **Should authorities distinguish between different solvent wind-down scenarios (e.g. going vs. gone concern, different situations of banks, initiation of wind-down by a counterparty, or interaction with insolvency proceedings) when they develop solvent wind-down plans?**

We are not convinced that, given the uncertainties inherent in this sort of exercise (see answer to Question 1), much additional value is created from seeking to analyse different types and scenarios of solvent wind-down exercises. That said, an analysis of multiple scenarios in parallel would create considerable workload that is probably disproportionate compared to its possible benefits.

6. **Are there any other actions that are not discussed in this paper that could be taken by authorities or firms to help facilitate successful solvent wind-down in the event of resolution?**

We do not see other actions that could be taken by authorities or firms.

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About the EBF

The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international – while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.

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