2 September 2011

Response to Consultative Document of 19 July 2011 on ‘Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines’

Dear Sirs:

The International Centre for Financial Regulation (ICFR) is submitting this letter in response to the Financial Stability Board’s consultation of 19 July 2011 on ‘Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines’.

Based in London with an international remit, the ICFR was founded as a non-partisan organisation with the support of both industry and government. We act as a catalyst for dialogue, thought leadership and scholarship on financial regulation, seeking to provide independent and objective thinking on best practice by way of examples wheresoever they may be found and by consideration of their applicability in other circumstances. We pay particular attention to interactions across sectors of the financial services industry and to the examination of the potential for unintended consequences in any regulatory change. We are cognisant of balancing the need for international convergence and harmonisation to prevent regulatory arbitrage with the exigencies of domestic policies, markets and economic structures.

The rather short window of opportunity in which to reply in full to the FSB’s consultation has meant the ICFR has had insufficient time to craft a full response. However, we do intend to reply in full to the UK Financial Services Authority (FSA)’s recently released consultation paper on ‘Recovery and Resolution Plans’1, with a deadline for response of 9 November 2011; we will be able to voice our stance in greater depth therein. Nonetheless, the following draws on our current thoughts on resolution of financial institutions, as based on a recent analysis by our Chief Economist and Head of Research, Dr Richard Reid.

It is absolutely critical in this process to have a dialogue with industry, given the differences in legal structure across jurisdictions and industry participants. To this end, we believe it would be fruitful for all concerned to organise a discussion on several of the key resolutions issues, notably: those with cross-border implications, those with implications on domestic bankruptcy, insolvency and priority of payment issues, and cross-border information sharing among regulators. Such a meeting, between FSB members and industry and inclusive of relevant academic and professional service firm experts would give FSB members direct access to institutions. The ICFR would welcome an opportunity to work with the FSB on such an event prior to the outcome of any publication of the results of the FSB’s deliberations.

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1 FSA consultation listed in the references and available here.
At the outset, and in the light of increasing concerns over the state of the global economy and sovereign debt worries, it is worth noting that finding the right balance between measures to underpin global financial stability while allowing for fully functioning financial systems will clearly be a major task for policymakers in the current climate. Fortunately, resolution mechanisms themselves are among the measures most likely to encourage confidence and financial stability relative to the cost of their implementation. This is less obvious in the case of living wills, though we would argue that they are worth their cost.

Even if the momentum for pushing ahead with plans to develop resolution mechanisms is now well advanced, this does not equate to saying that effective mechanisms will be in place anytime soon. In this 'implementation phase' for financial regulation, the opportunities for both national discretion in application as well as the difficulty of designing one-size-fits all solutions suggests the framework for resolution regimes will remain quite flexible.

In order to address, at least in part, the issues of moral hazard and minimising the cost to the taxpayer, a central plank of any regulatory response must include the tools and mechanisms to allow for the winding down of a failing institution with as little as possible risk to the overall provision of financial services and economic and financial stability. Individual countries have of late been making significant progress on their domestic resolution frameworks. However, as the ECB (ECB, July 2011) has noted, this was in part a response to the inadequate mechanisms that were in place prior to the crisis. In the case of the EU, the ECB has identified three shortcomings in the mechanisms. First, the financial system is a special case: in most jurisdictions, only normal insolvency proceedings were available and these do not adequately take into account the special credit provision functions of financial institutions (and therefore liquidity impact on the economy). Second, even when there was a credible special resolution regime (SRR) in place, there was a lack or inadequacy of private funding. Third, there was a lack of effective mechanisms for dealing with failing cross-border institutions.

Indeed, reaching workable solutions for cross-border resolutions (re Annex 3) is fraught with a range of both theoretical and practical issues, yet the ICFR believes – following the Lehman Brothers insolvency and given the cross-border reach of the 30 top financial institutions – that this remains the single most important unresolved issue on the G20’s work plan. Nonetheless, the ICFR believes that issues concerning effective cross-border resolution mechanisms will need some time to be agreed upon and organised.

For example, the European Central Bank (ECB, July 2011) in its latest assessment of the European Union’s proposals on resolution notes that the EU Commission plans by the end of 2012 to decide whether a reform of bank insolvency regimes is required; by 2014, it will make an assessment of “how a more integrated framework for the resolution of cross-border groups might be best achieved (e.g. though the creation of an EU resolution authority and/or EU resolution fund)” (ibid., p.93). When broadened to include a global reach, especially for the large systemically important financial institutions (SIFIs) (re Annex 5), the complexity of reaching effective mechanisms on any near-term timescale is self-explanatory. The FSB is clearly cognisant of this, but it suggests some interim practicable steps may be needed to ensure that such events can be dealt with expeditiously prior to legislative frameworks’ being put in place.

Having in place credible resolution mechanisms can decrease the costs of failure and the trade-off between costs and financial stability, as well as contributing to the reduction of the moral hazard question. For instance, a 2009 IMF study (Čihák and Nier, 2009) showed that the existence of an SRR was preferable to a disorderly bankruptcy or an injection of public funds under ordinary bankruptcy mechanisms, given that it imposes upon the owners of the failing institution some or all of the losses that would otherwise be carried by the taxpayers. The existence of the SRR also allows the
authorities more flexibility (and time?) to explore the trade-off between fiscal costs and systemic risk containment.

With regard to resolution powers and tools (Annexes 1 and 2), there have been a number of theoretical proposals by different bodies which have been put forward to address a new crisis management framework. These include ex-ante legally binding burden sharing rules, a stringent rules-based framework (similar to the US), or, in the case of Europe, even a full-blown European resolution authority, perhaps in concert with European deposit insurance and resolution funds. In a somewhat pointed comment, the ECB states the need for less ambitious and more practical solutions as embodied in the EU’s proposals:

“Bearing in mind the theoretical possibilities described above, the plans do not go as far as to ambitiously suggest a fully integrated framework under the control of a single European resolution authority. The proposals instead try to pursue a more realistic approach, taking into account the current fiscal and supervisory responsibilities of member states as well as the lack of harmonisation across national solvency laws” (ECB, July 2011).

A number of possible options for simpler, albeit slightly less ambitious systems have been mooted. These include:

1. The toolkit approach, whereby all supervisors speak a common language and have a common sets of tools available so as to make cross-border discussions simpler;
2. The laddered compliance approach, where there are different stages to resolution convergence and individual national supervisory authorities agree on the degree to which they will comply initially, and the timetable for moving up the ladder; and
3. A ‘best practice’ approach, whereby an achievable standard is set, and countries sign up when and as they are capable of meeting that standard.

Another point to bear in mind about SRRs is that there is a common element to most if not all of them: that the primary aim is to avoid failure in the first place. This means that particular attention must be paid to being able to effectively gauge phases (and therefore trigger mechanisms) before the point of non-viability. Some commentators have also suggested that perhaps the existence of bail-in mechanisms (re Annex 2) – allowing a non-viable institution to carry on – might mean that we have more frequent, albeit less disruptive and smaller crises. Although it would be a brave analyst who suggests that this would be a ‘good thing’ and a way of asserting market discipline, an argument could also be made for saying that, by waiting too long to intervene (forbearance), the authorities might contribute to the build-up of a much bigger crisis. The FSB itself has noted that “the complexity and integrated nature of many firms’ group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions of these institutions under current regimes virtually impossible” (FSB, July 2011, p. 10).

Regarding the FSB’s questions on the merits of a stay on early termination rights (re Annex 8), ranging from the length of the stay, the trigger, and exemptions from the stay (for example CCPs), the ICFR draws attention to its conference in June 2011 at which Professor David Skeel outlined some of the issues involved in stays. His paper and a summary of the proceedings are available as sited in the references and on our website.

Last of all, this consultation does not address the linked impact of SIFI surcharges, and changes in capital, funding, liquidity and leverage, that together with resolution are all intended to contribute to a lowering in the likelihood and severity of future bank failures. It is important to consider holistically the contribution of each of these elements so that the implementation of all of them
simultaneously strikes the right balance between incentives for conservative risk assessment and bank management, and incentives to engage actively in credit provision and maturity transformation, that is, the fundamental business of banking. The ICFR believes this would be another key theme to explore at a gathering of industry and regulators in order to get from the theoretical to the practical.

Yours sincerely,

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Chief Executive

cc: Paul Tucker, Bank of England

References


IMF, May 2011. The too-important-to-fail conundrum: impossible to ignore and difficult to resolve. IMF Staff Discussion Note, SDN/11/12.


