

20 April 2018

EBF_030439F

Discussion paper on funding in resolution under BRRD

The Bank Recovery and Resolution Directive (BRRD) is aimed at enabling resolution authorities to restore the viability and solvency of a bank in resolution. The existing resolution tools are focused on loss absorption and recapitalisation (together with restructuring). The implicit assumption in BRRD is that once the institution's own funds are restored, it will be possible to access funding to refinance its liabilities as they fall due. Nevertheless, as the Financial Stability Board (FSB) pointed out "*potential market volatility and information asymmetry create funding risk for a recapitalized institution after resolution.*"¹

Although from a regulatory point of view we do not see any obstacles or insufficient legal tools to provide resolved banks with liquidity during a resolution scenario, we think that the legal framework can be improved in two ways:

- Provide more powers and more clarity to the existing mechanisms which could potentially provide a resolved bank with liquidity in a resolution scenario (e.g. national central bank monetary policy, resolution fund);
- Allow for a credible and quickly available public sector backstop from central banks in order to avoid contagion and market disruption if market confidence is not yet sufficiently restored for the resolved bank to raise funding by itself. The mere existence of this tool, could help resolved banks to raise funds in the capital markets without the need to use the public-sector backstop itself.

EBF Members call for a credible and effective public sector backstop funding mechanism, which is quickly available to solvent institutions, for the rare cases where it will be necessary to complement the tools available under BRRD, in order to safeguard market confidence and sustain private sector counterparties to provide funding to a financial institution in resolution.

¹ FSB, 2016 paper on Guiding Principles on the temporary funding needed to support the orderly resolution of a global systemically important bank

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Any provision of temporary funding through public sector backstop mechanisms should be done in a manner that reinforces market discipline, minimises moral hazard and facilitates as well as incentivises private sector funding to solvent credit institutions under resolution.

Funding under BRRD

Resolution tools: limited provision of liquidity

The BRRD defines four resolution tools: 1. sale of business, 2. bridge institution, 3. asset separation, and 4. bail-in (Article 37). Only the sale of business and asset separation tools, which primarily focus on the recapitalisation of the bank, provides the resolution entity also with some possible liquidity benefits, but as a side effect only and provided that the acquirer funds the entity sold (including the stock of outstanding funding).

The four resolution tools addressing first solvency concerns, are long term liquidity solutions complemented by moratorium tools, providing liquidity in case of short term or « flash-crash » liquidity needs.

Ancillary powers

According to Article 63 (j) in the BRRD, the resolution authority has the power to amend or alter the maturity of debt instruments and other eligible liabilities issued by an institution under resolution. This article allows for the temporary mitigation of refinancing risk, primarily in the wholesale funding market. It does however not provide any additional funding. The limit of this tool is that it transfers the liquidity risk to counterparts and creates contagion.

Resolution fund

The resolution fund is defined as a possible source of liquidity in the BRRD. BRRD Article 101 and correspondingly Article 76 of the Single Resolution Mechanism Regulation (SRMR) address the use of resolution financing arrangements. Several of these options allow for the provision of funding to an institution, where the provision of a guarantee on assets/liabilities and the provision of a loan are the most likely options for the generation of additional funding. Unlike the Orderly Liquidation Fund (OLF) in the US, loans from the resolution fund do not benefit from a preferential ranking among the liabilities of the bank in resolution, nor from a pledge on assets. Also, unlike the OLF, the resolution fund does not have a fiscal backstop.

Recent policy makers inputs

EU authorities have recently questioned a possible insufficient size of the resolution funds in case they have to provide temporary funding to financial institutions, in exceptional cases where the access to markets is difficult. The industry believes that the provision of a guarantee might possibly be leveraged to create a greater amount of liquidity.

In the eurozone, this situation would nevertheless be eased if the European Stability Mechanism (ESM) or the European Monetary Fund (EMF) in the future is able to commit funding to the Single Resolution Fund (SRF).

In addition, in its recent consultation on funding in resolution, the FSB has stated again that an effective public sector backstop mechanism should be available to secure liquidity in resolution while banks would maintain available non-encumbered assets. The industry considers that a resolution may take place in a situation where high quality assets may be lower than the level the resolution authority needs. Central banks, assumed as having a

quicker and safer access to data than private lenders, should be allowed to fund the bank on the basis of available non-HQLA, non-encumbered assets. Private investors could subsequently substitute the central bank funding once the quality of assets is assessed by them.

Proposal for additional public backstop provided by Central Banks: Resolution Liquidity Assistance (RLA)

As a preamble, it is important to recall that public financing does not constitute state aid if certain conditions are respected, and must neither be perceived as equivalent to government stabilisation tools under BRRD², which address solvency issues and are subject to different conditions.

As stated in the European Commission communication on Banking Union from 11 October 2017³, it is important that there is sufficient liquidity available and the fund could be used in combination with central bank liquidity. A clear communication by central banks⁴ (as by the Bank of England recently) on their willingness to provide liquidity to banks in resolution (if needed and under conditions) would reassure stakeholders that the resolution framework is complete and workable.

EBF therefore recommends, in line with the UK⁵ and US⁶ frameworks, to allow for a Resolution Liquidity Assistance (RLA), provided by the central banks⁴, once the entity has been resolved. The RLA would be earmarked for banks that meet temporary funding difficulties in resolution and its access would be strictly subject to the following conditions:

- The bank has been recapitalised through bail-in;
- The liquidity is dedicated to sustain the credit institution in the execution of the resolution strategy;
- The liquidity is provided at a penalty rate but without deteriorating the solvency capacity of credit institutions;
- The liquidity is secured. The EBF welcomes some flexibility depending on the situation. In some cases, collateral could be provided by the resolved entity (collateral framework for the RLA should be wider than the ELA collateral framework) or in other cases by the resolution fund (as it is envisaged by the BRRD);
- The financing is temporary and must be replaced by private funding as soon as possible;
- The RLA enables the stabilisation of the bank after entry into resolution by providing confidence to markets and clients. It avoids moral hazard given its limited duration and its penalty rate, and the fact that it is only available in resolution. Existing monitoring of asset encumbrance enables identification of available collateral.

The RLA should further consider funding needs in the various major and relevant currencies.

Additionally, and complementary to the RLA, more clarity should be provided in the current resolution framework as well as with regards to the resolution fund functions.

² Articles 56-57-58 BRRD

³ https://ec.europa.eu/info/publications/171011-communication-banking-union_en

⁴ The proposed liquidity framework should be consistent with the respective legal framework and jurisdiction, e.g. the banking union requires a banking union wide solution to correspond with the single supervisory and single resolution mechanism (SSMR and SRMR).

⁵ See the Bank of England's approach to resolution (October 2017)

⁶ See Orderly Liquidation Authority and Bankruptcy Reform (February 21st, 2018).

Other prospect: ranking of new funding

A way to protect the new funding arising from the above liquidity assistance might be to grant a preferred ranking to liquidity lines compared to senior debt.

However, possible side effects may need to be assessed before triggering such a preference in resolution time. This would ultimately depend on the availability of non-encumbered assets or even the structure of remaining liabilities (e.g. when only covered/insured deposits are left). This is why it might be contemplated to consider this preferred ranking as an available option to resolution authorities, impacting the conditions of the new funding in return.

In all case, the resolution authority would be in charge of ensuring the exit from resolution and therefore from RLA. As such, the refunding of the RLA should be considered under a long-term perspective.

Accommodation in BRRD

According to the proposed FSB guidelines on «*funding strategy elements of an implementable resolution plan*», all funding sources should be clearly identified at the stage of the resolution plan (including preparatory measures like collateral identification or IT channels to be used). However, such identification should not be seen as contradictory to Article 10 of the BRRD, as it is also clearly stated in footnote 18 of the above-mentioned FSB guidelines. Resolution Authorities should update their policies accordingly, so that they carry out this necessary identification, in line with the FSB guidance. If Article 10 of the BRRD is considered an insurmountable constraint, it should be modified and items b) and c) in the sentence “*The resolution plan shall not assume any of the following: (b) any central bank emergency assistance (c) any central bank liquidity assistance under non-standard collateralisation, tenor and interest rate terms*” should be adjusted to allow the access to RLAs, when the opportunity for a BRRD amendment arises.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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