

19 December 2012

Response to the European Commission Consultation on a possible recovery and resolution framework for financial institutions other than banks

Introduction

The ESRB supports the work of the European Commission regarding the development of an effective framework for recovery and resolution for financial institutions other than banks¹. The ESRB welcomes the opportunity to provide input from a macro-prudential perspective to this work and herewith submits its main messages.

The ESRB agrees with the need for a common EU recovery and resolution framework also for financial institutions other than banks. The failure of these institutions may pose the economy with systemic risks, which are inadequately dealt with by insolvency law. The goal of financial stability therefore requires a recovery and resolution framework as a necessary component alongside prudential regulation and insolvency law. This is definitely true for central counterparties (CCPs), central securities depositories (CSDs), large insurers with systemically important activities² and systemic payment systems not owned and operated by central banks. The cases for trade repositories, other insurers, trading venues for financial products, money market funds, and possibly other types of funds (such as large defined benefit pension funds and hedge funds) require further analysis. The ESRB would welcome any initiative to further analyse this question, particularly with reference to the objectives of the framework.

¹ European Commission, Consultation on a possible recovery and resolution framework for financial institutions other than banks, 2012

² For this assessment the European Commission may draw on the analytical work by the International Association of Insurance Supervisors: IAIS, Global Systemically Important Insurers: Proposed Assessment Methodology, 2012.

Aim and scope

The framework should be more explicit about the objectives and precise scope. The ESRB believes that the objectives should be to preserve financial stability and to preserve functions critical for, and avoid contagion to, the real economy or the financial system, whilst maintaining market discipline and protecting public funds. For insurers, the adequate protection of policyholders should be an additional objective. This is in line with the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (the 'Key Attributes')³.

The ESRB notes that the consultation paper focuses on systemically important sectors and institutions. Next to the institutional approach proposed by the Commission, an activity-based resolution framework for systemically important assets and liabilities is another approach⁴. This would mean that next to systemically important institutions also systemically important activities are identified to which a resolution regime would apply, independent whether these activities are carried out by the institutions identified as systemically important. The ESRB sees potential merits in combining both approaches and would welcome further analysis of this.

The decision whether or not to apply one or more tools of a resolution regime should depend on the assessment of the systemic risks and the public interests at stake at the point of failure. The scope of the institutional resolution framework should be clearly defined, but not limited to institutions that are considered systemically important today. Systemic importance is a dynamic concept. An institution which is not considered to be systemic in good times may turn out to be systemically important at the point of failure. Systemic risks change over time due to market movements, regulation, herd behaviour and evolving insight in this relatively new domain. Moreover, a limited scope of the framework may cause an uneven playing field, leading to regulatory arbitrage and therefore a move of the systemic risks to those institutions not covered by the framework, which would tend to exacerbate rather than mitigate these risks.

³ Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011

⁴ Acharya and Öncü, A Proposal for the Resolution of Systemically Important Assets and Liabilities: The Case of the Repo Market, 2011

The Key Attributes require that any financial institution that could be systemically significant or critical if it fails, therefore threatening financial stability, should be subject to a resolution regime. As regards financial market infrastructures, the CPSS-IOSCO Principles for Financial Market Infrastructures presume all CSDs, CCPs, securities settlement systems (SSSs) and trade repositories (TRs) systemically important, while payment systems could qualify as systemically important if they have the potential to trigger or transmit systemic disruptions⁵.

The ESRB takes the view that all CCPs, CSDs, systemic payment systems not owned, operated and financially guaranteed by central banks and maybe trade repositories should be considered as potentially systemically important and should therefore be covered by a European resolution framework. As regards insurance undertakings, resolution arrangements may be only necessary for large insurers, in particular those which are engaged in significant non-traditional or non-insurance activities, or which are highly interconnected with other financial firms. More work is needed on how large, traditional insurers – which often have complex asset and derivative portfolios – should be resolved. The consultation document does not touch upon trading venues and funds such as money market funds, hedge funds and large defined benefit pension funds. In the view of the ESRB, the failure of some of these entities may also pose systemic risks and therefore further analysis is merited into whether these should also be included in the scope of any recovery and resolution framework for financial institutions other than banks.

Triggers and tools

Recognising the need for a degree of predictability and legal certainty, the framework should be sufficiently flexible to allow authorities to respond to various scenarios and future circumstances in an optimal way. It is important to note that authorities and market participants will never be able to predict and prepare for all possible scenarios that might trigger resolution. The ESRB is of the view that the conditions for resolution should be sufficiently forward looking so that if, in the

⁵ CPSS-IOSCO, Principles for financial market infrastructures, 2012

judgment of the relevant authority, the entity in question is failing or likely to fail (for whatever reason) - and nothing outside of resolution may be done to prevent its failure - then resolution should be triggered to avoid an insolvency if it is in the public interest and in order to preserve financial stability, to do so. Flexibility of triggers is also needed to allow for a broad scope of the framework while maintaining the principle of proportionality when applying it. Flexibility gives authorities the discretion not to apply resolution in case of non-systemic failures.

The same holds for the tools. The ESRB believes that the resolution authority should be able to apply one or more resolution tools to a given financial institution other than a bank as appropriate to the type of risk at stake, the institution and the circumstances of the case to meet the resolution objectives. For instance, different tools might need to be applied to FMIs which are not exposed to credit risk (some CSDs) as opposed to those which are (CCPs). The Commission may need to consider whether there are obstacles in existing European legislation to the effectiveness of a resolution framework, and work to remove them.

The ESRB generally agrees with the European Commission that resolution authorities should have a broad range of tools at their disposal. The list of tools in the consultation document seems to be comprehensive but may not be complete and needs further analysis. It is good to have all tools listed in the consultation document in the toolbox of a resolution authority. These tools will help avoid the costs of disorderly failure or the use of taxpayer funds. They should however be used with care, with due consideration to the specific circumstances and the potential detrimental side effects, in order to be instrumental in preserving financial stability. The ESRB looks forward to seeing further details of the tools discussed in the consultation paper. Furthermore these details need to be developed in line with work of CPSS-IOSCO and the IAIS in their respective fields of work to guarantee international consistency.

Recovery should be separated from resolution. The former is the responsibility of the management of the financial institution, under the supervision of the relevant competent authorities. The latter is based on a predefined framework and statutory

rules that the financial institution cannot change. Resolution is the responsibility of the resolution authority, although institutions may be required to prepare for orderly resolution and cooperate with the resolution authority. In order to minimise the likelihood that resolution tools need to be used, it is crucial that effective recovery plans are designed and implemented. Early intervention powers to enforce parts of this recovery framework should be available to authorities.

A framework for recovery and resolution for institutions other than banks should, as far as possible, be consistent with the framework for recovery and resolution of banks currently being developed. Although these institutions differ to a great extent from each other, unwarranted differences between sectoral frameworks should be avoided. The frameworks for different types of financial institutions should be carefully modelled on the FSB Key Attributes, adopting differences in sectoral approaches only where this is justified by the different nature, function, activities, business model and risks of the entities concerned. Where institutions fall within scope of more than one possible resolution framework, which may be the case in some countries where CCPs and CSDs are credit institutions, the decision of which framework to use in the event of failure should be taken by the resolution authority, based on the nature and core functions of the failing entity. However, for clarity to the institution and its users, a provisional ex-ante decision on the applicable regime should be taken by the relevant authority.

Resolution authority

Resolution arrangements for entities that have operations or services in more than one country should seek to minimise coordination problems. The consultation document does not address the exact institutional arrangements of any framework. More clarity should be provided in terms of the designation of resolution authorities, roles, powers and funding. Furthermore, the boundaries and mandates relative to supervisory authorities, including the supervisory authorities' powers to review recovery plans and request changes where appropriate, should clearly be established.

Some ESRB-members favour a centralised resolution authority on top of cooperation arrangements among national authorities for the resolution of cross-border institutions and activities, because it avoids coordination problems and helps building a high level of expertise. The financial crisis has shown that the coordination of large scale resolution interventions in some cross-border institutions between national authorities is often too slow and ineffective. A centralised resolution authority would need direct access to supervisory information in order to take adequate and swift resolution decisions. Other members consider this preference premature, given that a centralised resolution authority would also require further centralised supervisory arrangements and centralised arrangements for the funding of resolutions, which currently only exist - if at all - on a national level. Moreover some believe that national authorities are better placed to know the specifics of the institution to be resolved and the circumstances of the relevant market. Whether or not centralised arrangements are developed for all or part of the EU, there will still need to be cooperative arrangements in place for coordination with third countries and any countries within the EU not subject to such centralised arrangements, for instance in the form of colleges of authorities.

The ESRB does not object to the publication of this ESRB response to the Consultation by the European Commission.