Supporting Financial Stability through Effective Crisis and Resolution Arrangements

Jean Pierre Sabourin

1. Background and Objectives

Financial stability operates within the context of financial regulation, crisis prevention, and crisis preparedness, containment and resolution. During periods of financial instability and crisis, authorities must act with a set of immediate policy responses aimed at restoring public confidence and calming markets so as to minimize the repercussions on the real economy. Crisis responses include policy actions designed to contain emerging crises through measures for providing liquidity support to the banking system, to stem liquidity outflows, and to maintain public confidence.

In a systemic situation, various measures may be taken, but the ultimate aim should be to minimize the length and severity of economic downturns and to help accelerate recovery. At critical moments and under intense pressure, policymakers are expected to explore and identify solutions, often on short notice. To do this as a crisis is unfolding is by itself already a major challenge. The challenges are magnified, as seen during the global financial crisis (GFC), where there are potential unknowns about the reach and complexities of financial conglomerates operating in multiple jurisdictions, and about the possible contagion to the rest of a financial system and the real economy.

From the GFC, it was also observed that deposit insurance did fulfil its primary objective of preventing runs on bank deposits, thereby helping to stabilize market confidence.[1] Since the fallout from the GFC, deposit insurers have increasingly assumed a more prominent role in helping to preserve the stability of the financial system.

This article explores three key considerations pertaining to the role of resolution authorities in contributing to and promoting financial stability following the GFC, namely:

a) the need for a properly designed deposit insurance system or financial compensation scheme to help maintain public confidence during periods of uncertainty;

b) implementing the Key Attributes for Effective Resolution Regimes[2] published by the Financial Stability Board (KAs); and,

c) the role of resolution authorities within the financial safety net.

2. Effective Deposit Insurance Systems and Market Confidence

A well-designed deposit insurance system helps to promote public confidence during times of financial instability and crisis. An improperly designed deposit insurance system renders the financial system susceptible to bank runs and can actually precipitate a crisis, as experienced in the United Kingdom with Northern Rock.[3] Deposit insurance systems should be well designed and well understood to be effective, and equipped with the appropriate mandates, tools and resources. Basic design features include a clear mandate, adequate powers, strong governance and operational independence, access to ex-ante funding and government liquidity support, as well as effective public awareness programs.[4]

Moral hazard issues also tend to be associated with deposit insurance schemes. However, such issues can be addressed through limited deposit insurance coverage and strong prudential supervision. Additionally, imposing differential deposit insurance premiums based on the risk profiles of institutions provides incentives to avoid excessive risk-taking, strengthens risk management, and introduces fairness into the deposit insurance premium assessment process. As to mandate, deposit insurers should have sufficient powers to promptly respond to crisis situations and intervene early in banks, so as to reduce the costs that the failure would otherwise inflict on the deposit insurance funds, taxpayers, as well as the financial system as a whole.

3. Effective Resolution Regimes

A significant issue following the GFC concerns the failures of large, complex or interconnected financial institutions such as systemically important financial institutions (SIFIs). The concern about systemic risks, including the threat of contagion associated with the disorderly unwinding of large bank trading positions (including derivative books), is the major issue that had led governments to resort to massive bailouts of private interests at the expense of the public.

The Financial Stability Board's "Key Attributes for Effective Resolution Regimes for Financial Institutions" recommendations[5] attempts to deal with this concern. Among others:

a) The KAs attempt to address the risks associated with SIFIs and in particular the type of impact that global SIFIs had on other financial systems and consequently on whole economies during the GFC.

b) Underlying the KAs is also an issue not unfamiliar to deposit insurers - moral hazard. The KAs take the position that there should no longer be state support for the financial industry and look to market participants to complement the work of regulators in monitoring financial institutions to reduce excessive risk-taking.

For certain countries, one might question the need to adopt the KAs in the first place. In particular, studies such as the 2013 World Bank Global Survey suggest that economies that suffered from the GFC had weaker regulation and supervision practices as well as less scope for market incentives than the rest.[6]

For example, on the whole, since the Asian Financial Crisis of 1997-1998, there have in fact been significant improvements in prudential regulation and supervision in East Asian countries. Asian authorities are using macroprudential policies to help ensure financial stability and respond to emerging systemic risks by deploying a variety of instruments. With the exception of Japan, the emerging economies in Asia were also largely insulated from the troubled assets and complex derivatives that perpetuated the GFC. Structurally, Asian banks have remained predominantly deposits-funded, with less dependence on wholesale funding compared with counterparts in more advanced global economies. Additionally, state ownership in financial institutions in these jurisdictions is not uncommon.

Thus for jurisdictions such as these, one might ask – what are the implications of the KAs, and why would they adopt the KAs?

3.1 More information

The KAs[7] recommend that authorities require financial institutions to develop clear recovery and resolution plans ("RRP"), and that they carry out resolvability assessments of these institutions.[8] This exercise, properly carried out, will provide meaningful disclosure about the risks that large or complex financial institutions might pose to the stability of the financial system, and allow authorities to be prepared for, and take appropriate actions in the event such risks arise.

Ensuring that financial institutions undergo this exercise has considerable benefits. Among them are the following:

a) Sound risk management. Financial institutions will be required to submit detailed information on their operations, group structures, risk management, IT systems and possible contingency plans to resolve severe distress or failure. In the course of the contingency planning, financial institutions must identify and test their risk assumptions and controls under various economic scenarios. The risks that are discovered as recovery and resolution planning takes place might enlighten even the institutions themselves, better informing their boards about the structures, complexities and risks taken by the organization, and encouraging better risk management practices and even operational efficiencies. In reality boards of these institutions have always had the duty to properly understand the structures of these organizations and the context in which they operate so as to properly manage the risks of failure. The RRP exercise will contribute to sounder risk management particularly in complex institutions as the boards and management become better informed.

b) Minimizing systemic risks. As for the authorities, this exercise will help identify the vulnerabilities of these institutions and the risks they might pose to the stability of the financial system. Once identified, these vulnerabilities may be addressed in a number of ways, for example by requiring additional buffers to account for the uncertainties that these risks pose or by requiring restructuring to mitigate its potentially adverse impacts on financial stability. The process of recovery and resolution planning can lead to a reduction in complexity thus placing the authorities in a better position to limit systemic risks and level the playing field among those that are considered too big to fail (that might otherwise be bailed out) and smaller banks (that would be allowed to fail). This will help minimize systemic risks.

c) Allow for better decisions during a crisis. As highlighted earlier, prompt access to information is difficult where the troubled institution is complex or operates across borders, and there will be a whole range of cross-border issues that must be dealt with. Pursuing recovery and resolution planning and resolvability assessments by the authorities as recommended by the KAs will provide the authorities much of this information in advance and allow the authorities greater awareness about the possible implications of a failure.[9] With a greater understanding of the particular structures of these entities and their involvement in critical economic activity, authorities will be in a better position to weigh the possible solutions during a crisis.

Overall, this exercise will allow authorities and the institutions themselves to develop a complete picture of the organizational structure, funding and liquidity arrangements, loss absorbency capacity and cross-border dependencies. The clear advantage of pre-planning - through the recovery and resolution process - is that it allows authorities the opportunity to identify the unique characteristics of significant financial institutions, thus allowing a better assessment of what might be done in a crisis situation. Absent such information, last minute attempts to resolve complex financial institutions in a way that preserves economic value and stems systemic risks are much more likely to fail.

3.2 Resolution Outside Normal Insolvency Regimes

The Basel Committee on Banking Supervision[10] has called for reform of domestic resolution regimes and tools. Resolution authorities must be able to deal with financial institution failures and have in place a wide range of mechanisms to deal with failures, including those not available to them during the recent global financial crisis. The KAs contemplate that special resolution regimes for financial institutions will also "... provide the resolution authority with a broad range of powers and options to resolve a firm that is no longer viable, and has no reasonable prospect of becoming so."[11] Resolution authorities need a range of bank restructuring and resolution tools - early intervention measures, stabilization options to achieve continuity of systemically important functions, and approaches for winding-down the financial institution or parts of the institution that are no longer deemed viable, and these should be provided

in clear and sound legislative backing. Several countries have addressed this by instituting special resolution regimes.[12]

Resolution regimes should also clearly prioritize the hierarchy of losses, beginning with shareholders and creditors who have assumed the risk of bank failure. They should, as far as possible, protect depositors and taxpayers from loss. The framework should also be designed to allow the preservation and maximization of value of the failed business for the satisfaction of creditors and other stakeholders.

As experienced over the financial crisis, crisis responses might tend to favor the most politically expedient response in the short-run and not focus on the longer term and more sustainable solutions. Ensuring sound special resolution regimes are in place will help mitigate systemic risk and can reduce the impact of the disorderly failure of individual systemic institutions. Having a legislative regime that provides the appropriate resolution tools and having access to sufficient information to prevent a disorderly failure means, first, that it becomes more likely that authorities will allow distressed financial institutions to fail, thereby diminishing the likelihood of resorting to taxpayers monies. Also, by lessening the impact of failure, special resolution tools can reduce the chances that political pressures might be brought to bear on authorities during a crisis.

3.3 Collaboration Across Borders

The recent global financial crisis revealed conflicting priorities among national authorities and their respective insolvency regimes in relation to the resolution of cross-border financial conglomerates. National resolution authorities effected measures at the single entity level and failed to consider the cross-border implications of a failing financial institution in its jurisdiction. Some national authorities ring-fenced assets belonging to the bank within their jurisdiction. Other countries announced a blanket guarantee, forcing neighboring countries to enhance their deposit protection systems to stem deposit outflows from their own banking systems. Yet others excluded foreign depositors from their deposit insurance coverage.[13]

The KAs provide a welcome reminder about the urgent need to bolster cross-border information-sharing and cooperation from the perspective of achieving effective resolutions of institutions with extensive cross-border operations. Clear areas for improvements include mechanisms for more information to be shared, the harmonization of national laws for easier and more effective resolution and legal certainty, and the co-ordination of national crisis responses.

The KAs highlight the following key matters:

a) Exchange of information. Where institutions are active across borders, the resolution authorities must co-operate and information exchange must take place. This should take place in advance for countries that are home and host to SIFIs and their material legal entities.

b) Harmonization of laws. The closing of gaps between national regulatory regimes will facilitate the co-ordinated and orderly resolution of firms that are active in multiple jurisdictions. This will, for example, provide legal certainty about the consequences of a winding-up of a financial conglomerate on foreign subsidiaries or branches. Current legal impediments that would impact an orderly cross-border resolution such as automatic ring-fencing of assets, or the winding up of subsidiaries in the event of intervention in the parent, would also need to be addressed. Without harmonization of relevant laws, cross-border recognition of foreign resolution action becomes difficult or impossible.

c) Co-ordination of national crisis responses. The global financial crisis is a reminder of the need for nations to act in a coordinated manner when taking crisis management actions. Thus the KAs recommend that resolution authorities should give prior notification to their international counterparts and should consider the impact on financial stability in other jurisdictions should they take "discretionary national action" to achieve domestic stability.[14]

One of the key challenges for resolution planning is to create a system capable of allowing the failure of individual financial institutions while preserving global economic and financial stability. The KAs recommend that "Crisis Management Groups" ("CMGs") be formed by the authority in the jurisdictions where the G-SIFI resides ("the home authority"), together with authorities in the jurisdctions where the G-SIFI has a significant presence ("host authority"). The CMGs – akin to supervisory colleges – lay out plans for orderly resolution of each SIFI together with host authorities, and it is intended that CMG members discuss, and ultimately agree to, the plan's credibility. Multilateral co-operation agreements are expected to emerge from the CMGs.[15] This process increases the chances for an orderly resolution of a SIFI, and is intended to mitigate potential obstacles to such resolution.

Generally, authorities in the United States, Canada and Europe have made some progress in their collaboration efforts. Elsewhere, establishing appropriate bilateral agreements with resolution authorities and supervisors in other jurisdictions to achieve greater cross-border collaboration have a long way to go.

The implications of the KA recommendations on cross-border issues for host authorities include the following:

a) Actions by host authorities can affect the orderly resolution of a G-SIFI, for example by ring-fencing a G-SIFI's funding sources, requiring the liquidation of the local bank branch, or limiting the availability of its shared services. Host authorities will thus be increasingly pressured for domestic institution

resolution plans as well as for explanations about how their jurisdictions have addressed any gaps in their resolution regimes. Host jurisdictions that fail to offer these resolution plans or explanations might find that they have limited or no influence in establishing an effective cross-border resolution plan that considers their country's interests.

b) The Financial Stability Board also recognizes that there will be non-CMG host authorities that might be impacted by the CMG plans for G-SIFIs. Thus, non-CMG hosts are encouraged to submit their assessments of the systemic importance of the G-SIFI's local operations to home authorities so as to enable the CMG to agree on arrangements that will address the needs of the non-CMG host authorities.[16] Again, taking a proactive stance in these circumstances will help ensure that the country's interests are not jeopardized by resolution plans for the G-SIFI.

4. Inter-agency Collaboration

Finally, financial crisis responses should take place within a framework that abides by principles of good governance. Freedom from political influence and intervention should be underpinned by legislation and the relevant institution's governance arrangements.[17] Legislation and protocols must support the following concepts:

a) Authorities will bear the responsibility for the restoration of financial stability and protecting the real economy and the public. They must exercise their authority in a way that reflects public interests.[18] Their mandates and roles for financial stability should be clearly set out, and their authority must come with appropriate accountability, in particular if it involves the distribution of public resources among various constituents.

b) "Close co-ordination between the central bank and the resolution authority is understood to be both inevitable and critical".[19] This recognizes the need for clarity about the roles of the various financial safety net players when faced with a systemic crisis, so that policymakers better understand how they must work during times of crisis.[20] In particular, there should be protocols on early communication even before the institution is non-viable, so that there can be co-ordinated responses to the crisis.

Deposit insurers, as significant actors in financial institution crisis management and resolution, should be involved in national crisis management and resolution arrangements. From a cross-border perspective, they should also be actively involved in discussions and policy decisions on issues such as RRPs and resolution strategies. In order that they are able to access cross-border information and to manage their risks effectively, they should also be privy to the discussions of the supervisory colleges.

5. Conclusions

As to the questions posed earlier, namely, the implications of the KAs and the rationale for their adoption, even in jurisdictions that may not today necessarily share the same types of risks, the following observations can be made:

a) First, one would need to be prepared for changes in financial landscapes, which will be likely as economies grow and integrate. In particular, as has been experienced both during the Asian financial crisis as well as the more recent crisis, much can and must be done to ensure better cross-border collaboration and co-ordination during crises. Regulatory cooperation has become key as the financial sectors become increasingly integrated, and countries – including resolution authorities - should play an active role in international fora if they wish to ensure that the process towards collaboration takes into account the interests of their country or even their region.

b) Also, as discussed earlier, G-SIFIs often have a presence in other jurisdictions including Asian jurisdictions. Authorities in such countries will be compelled to consider the KA recommendations and participate in relevant discussions, regardless of whether those jurisdictions are part of the CMGs, in order to protect their national interests.

c) Finally, while state ownership is a feature in some countries in Asia, it does not mean that it will remain the case in the future. In any case, for the reasons described earlier, undertaking processes such as the RRPs, informs authorities and has indisputable advantages for early identification and management of potential systemic risks as well as for orderly resolutions of financial institutions.

Authorities must remain alert to the types of risks that affected countries during the recent financial crises and other risks that come with regionalization and global integration. The global financial crisis has provided invaluable lessons on cross-border risks and the risks that come with complexity, size and opacity. Studying the KAs and applying the appropriate recommendations to the jurisdiction's circumstances would not in the least be a futile exercise. A key objective in the course of this exercise should be to ensure that authorities, subject to appropriate accountability measures, are sufficiently prepared and have a wide variety of resolution options and tools that are well-defined in legislation to meet the considerable challenges of dealing with financial crises in a way that minimizes long-term adverse consequences on the economy and the public.

In conclusion, the KAs are by no means an infallible solution to the vexing question of how to solve the complexities of financial crises. Nevertheless, at the very least, by identifying the critical points that expose financial systems to contagion, working on greater cross-border and inter-agency collaboration, and working on their resolution regimes, authorities will be better off in ensuring a more sustainable state of financial stability needed to support the continued growth of their economies.

Jean Pierre Sabourin is the Chief Executive Officer of Perbadanan Insurans Deposit Malaysia (PIDM), the Malaysian Deposit Insurance Corporation, and has held this position since PIDM was established in 2005. Mr. Sabourin began his career at the Canada Deposit Insurance Corporation (CDIC) in 1976 and progressed to more senior positions until his appointment by the Government of Canada as President and CEO in 1990, a position he held for 15 years until his retirement in April 2005. Under his leadership, CDIC developed into a best practice deposit insurer while successfully resolving over 40 financial institution failures. Over his 35-year career in deposit insurance, Mr. Sabourin' s expertise has been widely sought by many jurisdictions around the world planning to establish or improve their deposit insurance systems. In May 2002, he led the development and establishment of the International Association of Deposit Insurers (IADI) and was elected as the first Chair of the IADI Executive Council and President, a post he held until 2007. Under his leadership, IADI developed the Core Principles for Effective Deposit Insurance Systems, jointly adopted by IADI and the Basel Committee on Banking Supervision in 2009 and subsequently endorsed by the Financial Stability Board.

Endnotes

1. Traditionally, deposit insurance systems have been regarded as playing a limited role during a financial crisis, and are generally designed to deal with isolated or a few bank failures.

2. Financial Stability Board, "The Key Attributes for Effective Resolution Regimes," re-issued 15 October 2014.

3. Northern Rock failed on 22 February 2008.

4. The International Association of Deposit Insurers' "Core Principles for Effective Deposit Insurance Systems," reissued November 2014.

5. Financial Stability Board, "The Key Attributes for Effective Resolution Regimes", re-issued 15 October 2014, Key Attribute 11.

6. "Global Financial Development Report 2013: Rethinking the Role of the State in Finance." World Bank Publication.

7. Ibid, Key Attribute 11.

8. Ibid, Key Attribute 10.

9. Ibid, Page 37, I-Annex 3: Resolvability Assessments.

10. The Basel Committee on Banking Supervision's "Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, Available at: http://www.bis.org/publ/bcbs169.pdf.

11. Financial Stability Board, "The Key Attributes for Effective Resolution Regimes," re-issued 15 October 2014, Page 3.

12. 2011: At the Cannes Summit, the G20 Leaders endorsed the implementation of an integrated set of policy measures to address the risks to the global financial system from systemically important financial institutions (SIFIs), and the timeline for implementation of these measures. Specific measures focus on global SIFIs (G-SIFIs) to reflect the greater risks that these institutions pose to the global financial system.

13. In contrast, some jurisdictions, such as Malaysia and Singapore, were seen to announce government guarantees at the same time.

14. Financial Stability Board, "The Key Attributes for Effective Resolution Regimes," re-issued 15 October 2014, Key Attribute 7.2.

15. These agreements must expand beyond basic knowledge-sharing initiatives, and address co-operation and coordination to deal with bank resolutions and financial crisis situations. In many jurisdictions, amendments to laws are also likely necessary to allow the entry into cross-border agreements for these purposes.

16. Financial Stability Board's "Guidance on Cooperation and Information Sharing with Host Authorities of Jurisdictions where a G-SIFI has a Systemic Presence that are Not Represented on its CMG."

17 Financial Stability Board, "The Key Attributes for Effective Resolution Regimes," re-issued 15 October 2014 page 6, paragraph 2.5.

18. "Financial crisis containment and its governance implications," Seraina N. Gruenewald, Available at: http://www.palgrave-journals.com/jbr/journal/v12/n1/full/jbr201022a.html.

19. Zeti Akhtar Aziz, (2013), "The Central Bank Financial Stability Mandate and Governance Challenges," *SEACEN Financial Stability Journal*, Volume 1, p. 14, October.

20. "Developing a Framework for Effective Financial Crisis Management," by Dalvinder Singh and John Raymond LaBrosse, OECD Journal: Financial Market Trends, Volume 2011 – Issue 2 OECD 2012.