



# **Resolution Funding: Who pays when financial institutions fail?**

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# Resolution Funding—Objectives

Key element of the international reform agenda since the Global Financial Crisis to:

- Strengthen resolution regimes
- Make government bailouts the last, not first, resort

## FSB Key Attributes of Effective Resolution Regimes (2011)

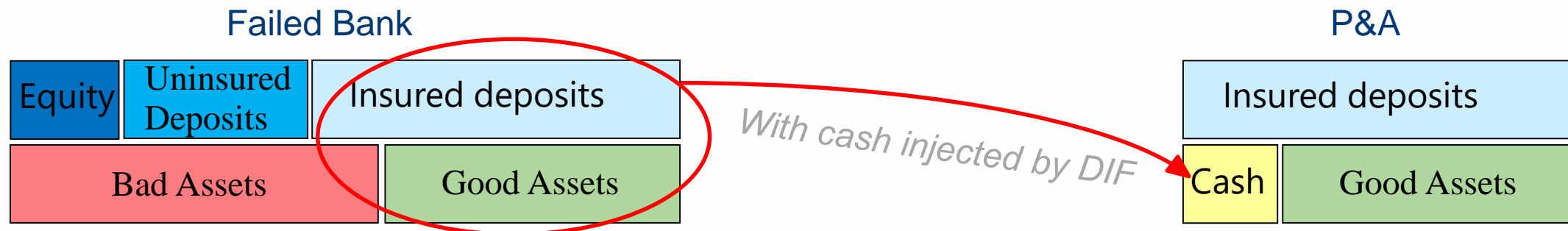
- Set out a range of powers and tools which should be available to resolution authorities to resolve failing SIFIs
- Requires resolution funding arrangements established in advance



# Why Resolution Funding is Needed

Effective resolution regimes need effective resolution funding arrangements:

- When a SIFI fails, its buffers of liquidity and capital typically eroded
- Firm-specific, loss-absorbing capacity (LAC) is critical, but LAC may be insufficient or not 'bail-inable' during severe stress
- Resolution tools may need additional funding e.g., to back a transfer of deposits to another bank, or provide liquidity to a bailed-in bank
- Resources required vary significantly, depending, inter alia, on 'systemicness' of case and wider circumstances



## **Key Attributes 6—Funding of Firms in Resolution**

The resolution authority should be able to access (or promptly mobilize) additional resources necessary for orderly resolution

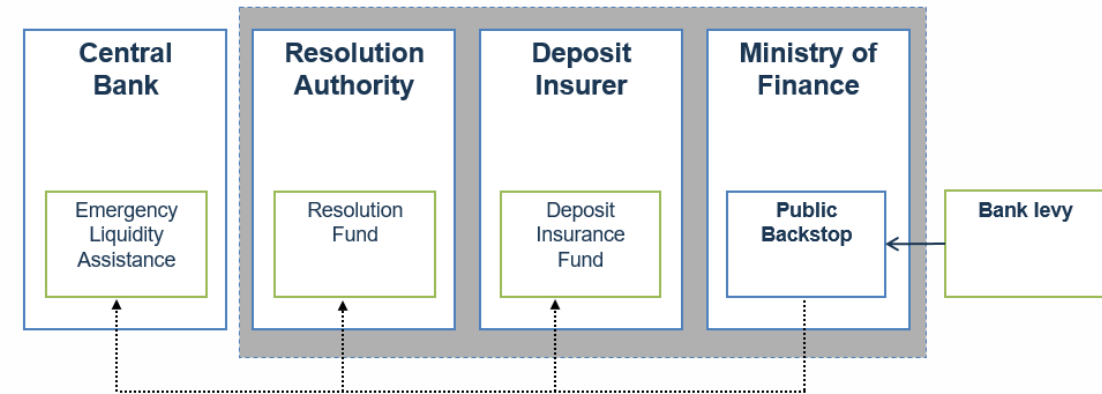
### **Key Attribute 6 notes:**

- Policies should be in place so that “authorities are not constrained to rely on public ownership or bail-out funds as a means of resolving firms”
- If temporary funding is needed to maintain essential functions in resolution, losses should first be imposed on shareholders and unsecured creditors, and then recovered from the financial industry

## Key Attributes 6 cont.

KA 6 requires one of the following sources of resolution funding:

- Privately funded deposit insurance schemes (DIS); or
- Privately funded resolution funds (RF); or
- Recourse to public funds when:
  - ▶ Necessary for financial stability
  - ▶ Private funding exhausted
  - ▶ Shareholders written down, unsecured/uninsured creditors bailed-in
  - ▶ It is coupled with an ex post cost recovery mechanism



KA 6 is silent on the amount of resolution funding required & other details (including sequencing)

# Using Central Bank Funds in Resolution

As lenders of last resorts, central banks (CBs) should be able to provide liquidity support to a viable bank in resolution, subject to adequate safeguards:

- A bank in resolution may need liquidity to ensure the continuation of critical functions
- The viability assessment depends largely on the resolution measures being implemented by the resolution authority
- Close dialogue between the CB and the resolution authority crucial; they must cooperate in agreeing a resolution strategy that may require ELA
- Should be at the discretion of the CB whether to provide ELA, including any prudent safeguards (e.g., indemnity from the government if uncertainty high)

The central bank should not provide capital or unsecured loans to a bank in resolution

# Using Deposit Insurance Funds in Resolution

Strong arguments for using the DIS to support bank resolutions and not just paying out depositors in liquidation:

- Bank resolution and deposit insurance have closely aligned roles in preserving financial stability and preventing bank runs
- Potential economies of scale to use the deposit insurance fund (DIF) to support a bank resolution which ‘substitutes’ for a payout of insured deposits
- Efficiency gains through maximizing value and reducing disruption when transferring deposits from the failing bank to another bank (so called P&A)



## Using Deposit Insurance Funds cont.

The use of DIF in resolution should be possible when:

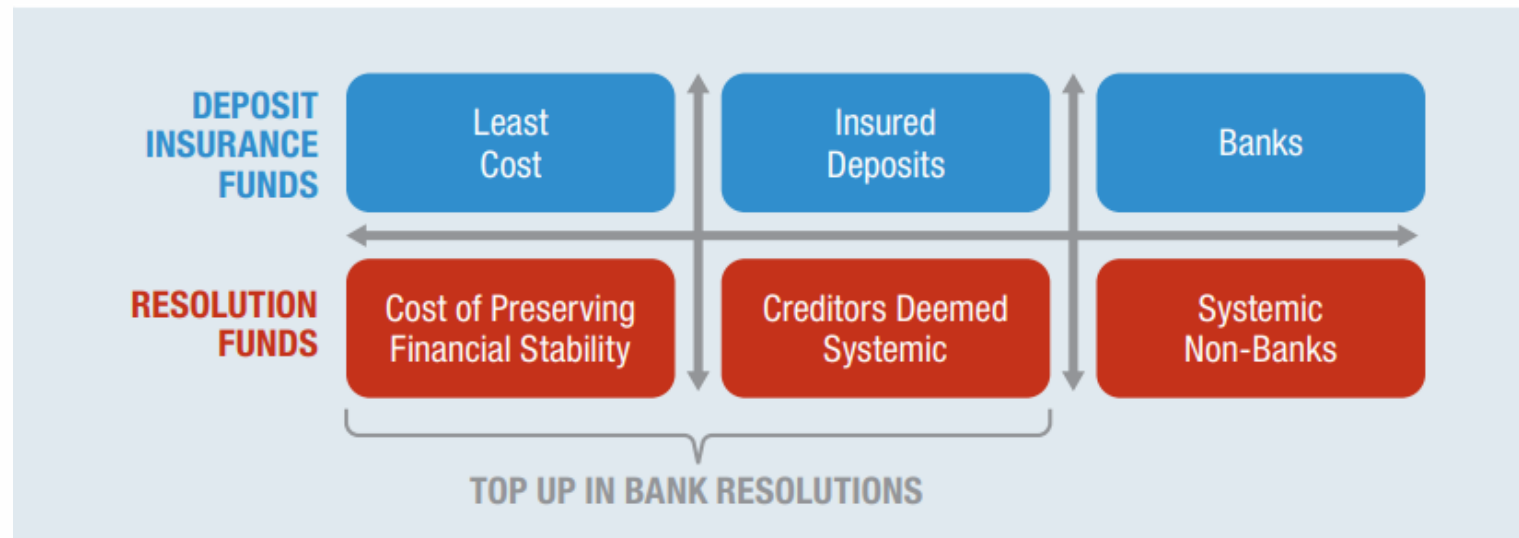
- The deposit insurer has a “paybox plus” mandate or a dual mandate (DIS and resolution authority) allowing it
- Safeguards are in place such as a least-cost test (IADI CP 9, EC 8)
- A back-up line of credit from the government (to deal with systemic cases)
- Liquidity support for banks (“open bank assistance”) should not be allowed

Staff typically recommend a pay box plus; an ex ante fund with sufficient funding; plus ability to contribute to resolution

# Separate Resolution Funds

A separate RF may be useful in some countries for dealing with systemic risks:

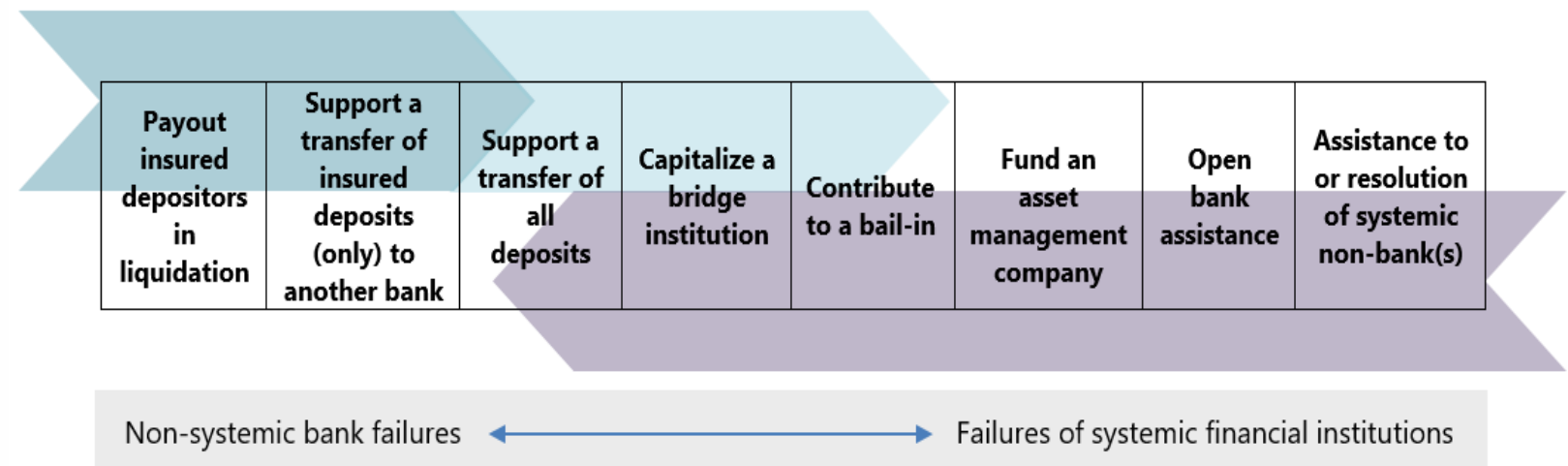
- To 'top up' least cost funding available from the DIF
- To protect uninsured creditors (*in extremis*) when needed to prevent contagion and preserve financial stability
- To resolve systemic non-deposit taking financial institutions



# Separate Resolution Funds cont.

In principle, a separate RF could:

- Make capital contributions to a bridge bank, bailed-in institution or AMC
- Make loans to a systemic financial institution in resolution
- Support other measures deemed necessary to preserve critical functions and maintain financial stability
- As a last resort, guarantee the assets or liabilities of, or provide capital for, systemic institutions outside of resolution (“open bank assistance”)



# Conclusions

**Choice of resolution funding arrangements** should reflect the broader institutional market and policy context

- *Characteristics of the financial system* (size, concentration, structure, and systemic risk the financial system)
- *Capacity of the financial industry to contribute to resolution funding* and the relative systemic importance of bank vs nonbank financial institutions
- *Legal and institutional architecture* of the safety net (use of DIF in resolution)
- *Institutional capacity* of the authorities
- *Regional considerations* (in the context of harmonized frameworks across economic or monetary unions)

## Conclusions cont.

### The case for establishing a separate RF not strong in many countries:

- If the DIF is ex-post or underfunded, priority should be given to increasing the DIF's resources and making it available to fund bank resolutions (subject to safeguards)
- Where there is a preference for setting up a RF, it may be advisable to set up an ex post resolution fund (e.g., countries with scarce national savings)
- If separate RFs are established, they should have clear legal and operational frameworks and safeguards to minimize moral hazard

# Summary

## Main Conclusions

- CBs should be prepared but not required to provide liquidity to banks in resolution which are viable; CBs should not provide capital or unsecured loans
- (Subject to preconditions) countries should put in place well funded, ex ante DIS, with capacity to contribute to resolution (subject to safeguards) & with back-up line of credit from the government
- Staff typically do not recommend establishing separate resolution fund, e.g., in countries with simple deposit funded financial systems, and where national savings are scarce

# IMF Technical Note on Resolution Funding

TECHNICAL NOTES AND MANUALS

## **Resolution Funding: Who Pays When Financial Institutions Fail?**

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*Monetary and Capital Markets Department*

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<https://www.imf.org/en/Publications/TNM/Issues/2018/08/16/Resolution-Funding-Who-Pays-When-Financial-Institutions-Fail-46124>

INTERNATIONAL MONETARY FUND

**Thank you**



# Appendix

# Frameworks for Resolution Funds

If RFs are introduced they must have measures and mechanisms to enhance their credibility and mitigate moral hazard risk:

- A government backstop to the fund (subject to subsequent recovery from the industry) necessary to enhance credibility
- The institution authorized to manage the fund should be well governed and operationally independent
- Effective resolution regime should be in place to mitigate moral hazard
- Losses should be imposed on the shareholders, subordinated creditors, and potentially senior unsecured creditors of the failed firm (burden sharing) and management should be replaced

# Ex Post Versus Ex Ante Resolution Funds

## Ex ante Fund

- Moral hazard
- Prefunding reduces the procyclicality of levies and can mitigate moral hazard risks if risk-based contributions are used
- Deciding on the fund's appropriate size and assessing the opportunity costs of the earmarked resources will be difficult
- Does an ex ante RF help to reduce the risk of creditor runs (like an ex ante DIF)?

## Ex post Fund

- Moral hazard
- A failed institution will not bear the cost of its resolution
- Recovering the public funds through levies on the industry, if applied shortly after a crisis, may exacerbate the downturn phase of the credit cycle

# FSB KA 6. Funding of firms in resolution

**6.1** Jurisdictions should have statutory or other policies in place so that authorities are not constrained to rely on public ownership or bail-out funds as a means of resolving firms.

**6.2** Where temporary sources of funding to maintain essential functions are needed to accomplish orderly resolution, the resolution authority or authority extending the temporary funding should make provision to recover any losses incurred (i) from shareholders and unsecured creditors subject to the “no creditor worse off than in liquidation” safeguard (see Key Attribute 5.2); or (ii) if necessary, from the financial system more widely.

**6.3** Jurisdictions should have in place privately-financed deposit insurance or resolution funds, or a funding mechanism with *ex post* recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm.

## **FSB KA 6. Funding of firms in resolution cont.**

**6.4** Any provision by the authorities of temporary funding should be subject to strict conditions that minimise the risk of moral hazard, and should include the following:

(i) a determination that the provision of temporary funding is necessary to foster financial stability and will permit implementation of a resolution option that is best able to achieve the objectives of an orderly resolution, and that private sources of funding have been exhausted or cannot achieve these objectives; and

(ii) the allocation of losses to equity holders and residual costs, as appropriate, to unsecured and uninsured creditors and the industry through ex-post assessments, insurance premium or other mechanisms.

## IADI Core Principle 9. Use of funds

The deposit insurer should have readily available funds, including assured liquidity funding arrangements. Responsibility the cost of deposit insurance should be borne by banks

- **EC1:** Ex ante funding
- **EC4:** Emergency funding arrangements including pre-arranged and assured sources of liquidity funding. Sources may include a funding agreement with the government, the central bank or market borrowing. If market borrowing is used it is not the sole source of funding. The arrangement for emergency liquidity funding is set up in advance, to ensure effective and timely access when required

# IADI Core Principle 9. Use of funds

- **EC8:** :Where the deposit insurer is not the resolution authority, it has the option, within its legal framework, to authorize the use of its funds for resolution of member institutions other than liquidation. In such situations the following conditions are met:
  - ▶ the deposit insurer is informed and involved in the resolution decision-making process;
  - ▶ the use of the deposit insurer's funds is transparent and documented, and is clearly and formally specified;
  - ▶ where a bank is resolved through a resolution process other than liquidation, the resolution results in a viable, solvent and restructured bank, which limits the exposure of the deposit insurer to contribute additional funding in respect of the same obligation;
  - ▶ contributions are restricted to the costs the deposit insurer would otherwise have incurred in a payout of insured depositors in a liquidation net of expected recoveries;
  - ▶ contributions are not used for the recapitalization of resolved institutions unless shareholder's interests are reduced to zero and uninsured, unsecured creditors are subject to pari passu losses in accordance with the legal claim priority;
  - ▶ the use of the deposit insurer's funds is subject to an independent audit and the results reported back to the deposit insurer; and
  - ▶ all resolution actions and decisions using the deposit insurer's funds are subject to ex post review.

# Least-Cost Test and Systemic Risk Exemptions

## Net least-cost test:

- The costs to the deposit insurance fund (DIF) of contributing to a resolution event are no higher than the costs the DIF would otherwise have incurred in a payout of insured deposits, net of expected recoveries.
- In cases where the net cost in liquidation to the DIF estimated at zero, DIF should not be prevented from supporting resolution if delivers better policy outcomes (e.g., continuity of depositor services) and would also be zero net cost. An upfront cash or 'gross' contribution (up to the value of insured deposits) by the DIF should be allowed to effect the resolution.

## Systemic risk exemption:

- Some countries (e.g. Canada, Japan, USA) allow the DIFs to depart from least-cost where adherence to them could have a severe impact on financial stability.
- Any exemption should be subject to strict governance safeguards to minimize moral hazard and ensure only deployed *in extremis*.