

Financial Stability Board's Guiding Principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB")

General messages:

BBVA welcomes the opportunity to comment on the FSB's Consultative Document, as we believe that one of the cornerstones of resolution regimes is minimising tax-payer costs either through public capital injection or liquidity provision.

Since 2011, financial regulation has been making progress on providing the authorities with a series of instruments and competences to deal with banking crises in a preventive manner, protecting financial stability and minimising taxpayers' exposure in the event of banking failures. In 2014 and 2015, the resolution discussion was focused on how to recapitalise failed banks and avoid public support through the use of the Total Loss-Absorbing Capacity (TLAC). The FSB is now focusing on the uncharted territory of liquidity provision for failed banks by contributing to the discussion on how to ensure liquidity in a bank resolution process.

In this sense, BBVA supports the FSB's objective of setting up principles on the temporary funding needed to support the orderly resolution of an entity. Liquidity problems during the resolution phase should be dully analyzed as they may turn into a capital problem. It is highly unlikely that an institution could cover all its funding needs after its recapitalisation, or during the phase of implementation of the business reorganisation plan that the resolution authority may impose to restore the long-term viability of the institution. If the bank in resolution is sufficiently recapitalized so that it can perform critical economic functions, the authorities should ensure that it has access to liquidity from the opening of the business day after entering into resolution.

At the same time, we agree on granting access to liquidity to resolve financial institutions in an orderly and effective manner, thereby reinforcing financial stability, restoring market discipline and reducing moral hazard. Nevertheless, given the preliminary state of the discussions, the complexity of the issues and the profound differences in legal and national institutional settings, further progress and clarification is necessary.

BBVA supports the EBF and IIF/GFMA answers to the FSB's Consultative Document. In addition, we would like to make the following **general observations** prior to answering the consultation:

- **The liquidity framework in resolution needs to be straightforward, predictable and credible. It is necessary to clarify the difference between providing a recapitalised and solvent firm during its stabilisation or reorganisation with access to reliable sources of temporary liquidity and providing "bail-out"**

solvency reinvestment. Providing access on a secured basis and on terms that create the appropriate incentives to exit may in some resolution circumstances be important to enable the continuity of a firm's essential functions, and either to return client assets or relaunch itself on re-entering the market. In this sense, it would be more appropriate to modify the title of the consultation to "temporary liquidity support" rather than "temporary funding", to avoid the common misunderstanding between necessary liquidity support and "bail-out" or solvency support. The regulatory regime regarding a firm's liquidity (Liquidity Coverage Ratio - LCR and Net Stable Funding Ratio - NSFR rules) should have been mentioned in the Consultative Document under the objectives and principles, **as both requirements are useful to avoid reaching a liquidity squeeze.** High levels of liquid assets (that are mandatory according to the LCR) minimise and delay the need for liquidity assistance. Liquid asset buffers provide sufficient time for banks to weather periods of illiquidity or market stress without government support or for the authorities to open an orderly resolution procedure.

- It is worth noting that other forms of existing private funding options for insolvency proceedings may be a valuable alternative in resolution, such as **Debtor-In-Possession Financing (DIP)**. Nevertheless, the US and EU resolution regimes have not yet recognised it as a feasible funding alternative in resolution. However, it would be highly desirable to further take it into account in the regulatory discussion.
- Although avoiding moral hazard is critical in a resolution process, it is necessary to achieve an **equilibrium between avoiding moral hazard** issues and **achieving sufficient market confidence in resolution**. For that reason, an entity in resolution must not be excluded from central bank liquidity, but should have access to it under different terms and facilities. Additionally, the backstop must not be a free lunch.
- The guidelines should focus on a case-by-case analysis in each bank's liquidity planning actions that are developed for both the recovery and the resolution plan.
- **Lender of Last Resort (LOLR)**. The central banks' role as lenders of last resort has been critical in the recent crisis and will probably be a necessary liquidity backstop in the future. The new regulatory landscape and, in particular, the resolution regime would help authorities in making the figure of LOLR credible by minimising its shortcomings.
 - First, the new resolution powers and the stress test supervisory exercises help to preserve the "no lending to insolvent firms" principle.
 - Second, the use of the Single Resolution Fund in Europe to cover liquidity needs, especially under an idiosyncratic crisis, should minimise the amount required of LOLR.
 - The use of private resolution sources of funding, along with penalty rates, may offset the future absence of the "constructive ambiguity" approach of central banks in relation to LOLR, which has been called into question during the recent crisis. The future approach to LOLR and its link with the resolution fund should be more transparent than in the past.
 - Despite the expectation of lower and more transparent LOLR, it is likely that central banks will in the future face situations in which a bank in difficulties lies in

a grey area between liquidity and solvency problems. In such cases, if the bank is finally resolved, the starting situation will be one in which the central bank has a substantial liquidity position vis-à-vis the troubled bank, and the questions of how to deal with this position and how to interact with the resolution fund need to be tackled.

- Finally, liquidity crisis preparedness and how to ensure liquidity and collateral provision in liquidity stress scenario and resolution are becoming more important. Central banks, but also supervisors, resolution authorities and banks should periodically assess the collateral availability from a LOLR perspective.

In the following sections, BBVA submits detailed responses to the FSB's consultation.

Replies to questions

Question 1: Are the principles on temporary funding in resolution identified in the report appropriate? What additional elements, if any, should be considered for inclusion?

The principles set out in the document are appropriate, however they need to be further developed in order to be more concrete. As mentioned above, the central bank's role as LOLR will still be a crucial crisis management tool in the coming future. According to the pure theory of LOLR, liquidity should be available in unlimited quantities, but only against good-quality collateral. However, the **use of LOLR against only a narrow class of very high-quality collateral is not credible**. Three facts hold the key:

- Under a liquidity squeeze, banks have normally exhausted all options for raising funds in the market. In this sense, given the financial instability risks and spillovers, it is highly unlikely that a central bank would refuse to lend to a solvent or recapitalised bank against a wider range of assets, even though they are not standard collateral.
- The range of securities that can reliably be traded and posted as collateral in a systemic crisis may turn out to be much smaller than expected. In this context, rating downgrades, valuation and haircuts play a central role.
- The empirical evidence of the recent crisis has shown that central banks allowed the use of a wide range of collateral in standard lending operations. In fact, several central banks responded by broadening the range of collateral accepted in central bank operations.

In this vein, not only authorities but also the **financial sector should work on enhancing their liquidity crisis preparedness** and how to ensure liquidity and collateral provision in a liquidity stress scenario. Difficult events must be met with a forceful response, prepared well in advance. This preparation may come in several different forms, most of them aimed at enhancing the flexibility of central bank operations and rapid responses:

- **Central banks should periodically reassess what constitutes a suitable inventory of assets** for use as collateral, evaluate the collateral supply and improve the risk management capacity. The supply of high-quality and liquid assets might be

insufficient during stress periods, and this must be anticipated by the central bank in order to overcome this issue in a timely manner.

- **Supervisors, resolution authorities and central banks should be prepared** in advance for a quick response in a crisis situation apart from broadening the eligibility criteria in terms of quality, new types of assets might need to be accepted as collateral. Global shocks may suddenly change the markets' scenario while not allowing time for the authorities to react. If new types of assets are going to become eligible, this must be analyzed and planned for well in advance.
- **Banks may incorporate a comprehensive collateral analysis**, including emergency liquidity assistance, into the resolution plan. By these means, supervisors can assess the management of liquidity risk and impose additional liquidity requirements if necessary, especially during stress periods when extraordinary measures are likely to be implemented. The Internal Liquidity Adequacy Assessment Process (ILAAP) required for banks, under the Supervisory Review Evaluation Process in Europe, in order to monitor the liquidity risk management process is also helpful and complementary to the new liquidity ratios introduced by Basel III.
- Finally, **ensuring that banks hold enough collateral to be pledged** at the central bank under a severe liquidity squeeze scenario may be a very controversial topic. The Liquidity Covered Ratio (LCR) seeks to ensure that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately into cash in private markets in order to meet their liquidity needs for a 30 calendar day liquidity stress scenario.¹

However, the LCR in its current design does not recognize as liquid assets all the central bank's eligible collateral. That is to say, all LCR liquid assets are eligible collateral for a central bank's operations, (the exception that proves the rule is the equity participation) but not all a central bank's eligible assets may count towards LCR. Although some asset classes are more likely to remain liquid irrespective of circumstances, it is not possible to know ex-ante which specific assets might be subject to shocks ex-post and which would be accepted as collateral under emergency liquidity assistance. Therefore, it may be worth considering a case-by-case analysis in each bank rather than designing a new ratio.

Question 2: What are your views on the most effective means for maximising the availability and use of private funding sources in resolution in a manner consistent with orderly resolution? Are there particular formats of private funding that should be considered?

The FSB's discussion of potential private funding is generally appropriate. In Europe, the new resolution regime establishes a series of tools ranging from asset sales to financial arrangements to deal with banks in trouble that, from a liquidity and funding standpoint, have different implications.

¹ Basel Committee on Banking Supervision (January 2013): "Basel 3: The liquidity covered ratio and liquidity risk monitoring tools".

Regarding the use of private financing arrangements, there are two European independent schemes: i) the deposit guarantee scheme that is liable for the amount of losses that covered depositors would have suffered, and ii) the resolution fund that would be available to support institutions under resolution via loans, guarantees, compensation to fulfill the 'no creditor worse off' (NCWO) condition, asset purchases or capital for bridge banks. Here, we would like to bring the attention to the Consultative Document stance regarding the treatment of resolution funds and deposit insurance funds (paragraph 2 on page 12). To **label a funding source as public or private the decisive feature should be the nature of the providers of the financial contributions**, even if they are not responsible for their management. If these funds are financed exclusively by private sector entities without recourse to State/public guarantees then they should be considered as private sources of funding even if they are managed and administered by public authorities. Another solution would be to include these funds in a "semi-private" or "mixed" category of sources of funding in order to avoid confusing customers, investors and markets more generally.

However, the relatively small size of the European resolution fund, for example (ex-ante funds "only" represent 1% of covered deposits, EUR 55 billion in the eurozone), and its use for multiple purposes, capital and liquidity, **seriously limits its potential effectiveness to deal with a massive deposits and wholesale funding run**. This is especially relevant in a context of a systemic crisis, when many banks would simultaneously suffer a capital shortfall and a liquidity squeeze. For example, in October 2008 only HBOS and RBS received liquidity assistance from the Bank of England with an intraday peak of GBP 61.5 billion, according to the report presented to the Court of the Bank of England in 2012.²

Against this backdrop, it seems that the use of the resolution fund would be the main new resolution tool which could be used to fund banks in resolution starting on the resolution weekend (when the resolution authority takes control of the institution), albeit with limited firepower, especially under a systemic liquidity crisis.

Apart from the use of a resolution fund, it is worth noting that other forms of existing private funding options for insolvency proceedings may be a valuable alternative in resolution. This is particularly the case of the **Debtor-In-Possession Financing (DIP)** under Chapter 11 of the US Bankruptcy Code. In general terms, if the company that has filed for bankruptcy can demonstrate that financing could not be procured on any other market basis, the court may authorise the failed company to receive a loan that has priority over pre-bankruptcy creditors.

There are, at least **two challenges to the implementation of DIP financing** within a bank resolution procedure. First, the resolution authority should be empowered to grant a DIP-style funding option. However, giving new powers to change the hierarchy of claims by providing a privileged super-priority to certain liabilities without court approval may pose legal issues (NCWO principle). Second, DIP financing volume in the past has been relatively small in relation to funding needs in the financial sector. In a corporate bankruptcy process, the immediate cash as well as ongoing working capital needs during the reorganisation process are very likely to be lower than in a bank liquidity squeeze, especially if the bank suffers a run on deposits.

In any case, **the US and EU resolution regimes have not yet recognised DIP financing** as a feasible private funding alternative in resolution. However, despite the limited volume

² [1](#). Plenderleith (October 2012), "Review of the Bank of England's provision of emergency liquidity assistance in 2008-09"

and the aforementioned legal challenges, it could be a feasible private funding option which could be taken into account in the regulatory discussion.

Question 3: In cases where public sector backstop funding is needed in resolution, how should such funding ideally be structured so as to minimise the risk of moral hazard, reduce the need for temporary liquidity support from the public sector, and allow the firm to return to private sector funding (i.e. timing of disbursements, term of funding, pricing, collateral requirements, potential use of public sector guarantee authority where available, exit incentives, etc.)?

The FBS's consultative document should make clear in page 12 in section 2, that a recapitalised firm in resolution must retain the opportunity to access liquidity under a central bank's ordinary facilities. In addition to the considerations mentioned in that paragraph, clarity about normal-case access to lender-of-last-resort (LOLR) and other facilities could be critical to stabilising the firm and paving the way for its access to the financial markets.

The recent crisis has brought the LOLR's role into the spotlight. There was broad agreement that central bank liquidity support during the crisis was key in stabilising the global financial system. The increase in demand for liquidity during the crisis, not only in foreign but also in local currency, could not be met by private sources and, therefore, central banks were the only funding providers able to limit the liquidity squeeze's side-effects on financial stability.

However, the central banks' response to the crisis has been different from the past. In the decades prior to the crisis, the need for LOLR support was infrequent and usually on a small scale, confined to idiosyncratic crises. "Constructive ambiguity" was a central tenet and the way to limit moral hazard, implying that central banks did not commit to a particular course of action ex-ante in case of liquidity crises, in order not to create the expectation of public support that could introduce incentives for risky strategies on the part of the banks. But in the wake of the current crisis, when wholesale and interbank markets practically disappeared, the constructive ambiguity of LOLR was seen as increasingly difficult to implement. The liquidity squeeze entailed a run not only on deposits but also on markets. This new feature of the recent crisis compelled authorities to respond in a different way.

The cornerstone of the authorities' response was that central banks provided liquidity through many different schemes, against a wide range of collateral, to a wide range of counterparties and for a long term. This implied a widening of traditional or standard channels of liquidity provision, and also the use of Emergency Liquidity Assistance (ELA) to deal with cases for which these channels were insufficient. And central banks reassured markets by committing to generous liquidity support, contrary to the "constructive ambiguity" tradition.

Despite their central role during the crisis, the LOLR is perhaps one of the most controversial central banks' tasks. On a massive scale, it has no minor second-round effects in terms of moral hazard and stigma, exposing central banks to large financial risks, and blurs the boundary with fiscal policy. The general thinking on the policy options to mitigate the LOLR's side-effects is the following:

- Moral hazard issues could be solved by charging a penalty over the rate prevailing in regular market conditions. Nevertheless, the penalty should not endanger the recovery of the entity.
- Stigma concerns are a serious impediment to the use of LOLR support, since it is understood as an indicator of weakness.
- Strengthening collateral, governance and accountability practices would also help to mitigate excessive risk-taking and fiscal interlinkages in central banks.

Therefore, the right question is not whether LOLR is necessary or should be avoided, but how to implement it in the new regulatory framework in the wake of the financial crisis (higher capital and liquidity requirements, periodic stress test exercises, enhanced disclosure, bail-in instead of bail-out, etc.). The new regulatory landscape would help authorities in making the LOLR credible, clarifying the distinction between liquidity and solvency problems, and preserving the “no lending to insolvent firms” principle.

High levels of liquid assets (due to the LCR) together with ILAAP minimise and delay the need for LOLR assistance. Liquid asset buffers provide sufficient time for banks to weather periods of illiquidity without government support, or for the authorities to open an orderly resolution procedure.

In a nutshell, the new regulation regime (the resolution fund) and LOLR are complementary tools. In this sense, the **bank in trouble would gradually lose access to capital markets, and would increase its dependence on the central bank.**

As we have argued before, the resolution fund has limited firepower, especially in case of a systemic liquidity crisis or in the failure of large institutions. In this scenario, a credible backstop is needed. The straightforward one should be the central bank acting as LOLR.

Once an institution enters resolution, authorities impose a tough restructuring plan in order to restore the bank’s long-term viability. After a considerable period of time (unlikely to be less than 3-6 months) the institution may start to recover market confidence. Insofar as the market allows it, the institution would gradually recover to a state of ‘business as usual’.

The new resolution regimes not only reduce the need for central bank liquidity support by using the resolution fund, but also shorten the time that markets are closed. Restoring market confidence as soon as possible is also one of the priorities of the resolution authority, especially after the resolution week-end. The recapitalisation via bail-in and the implementation of a business reorganization plan ensure its long-term viability. If the market considers that the business reorganization plan is credible and realistic, then the markets’ closure will end earlier and the liquidity needs will be lower.

Finally, it is worth mentioning that this dynamics of **central bank and resolution fund dependence have direct implications on the amount and quality of the liquid assets** that the institution may have. As the liquidity situation worsens and central bank support increases, the quality and quantity of liquid assets decrease.

The main drawback in a systemic crisis of the pattern described above is that if the resolution fund is not able to cover all the liquidity needs, then the central bank is forced to provide further emergency liquidity assistance. If these funds are substantial, there is a risk that **taxpayers may ultimately bear part of the resolution costs**, contravening the spirit of the new resolution regime. Although the funding provided by the central bank would be collateralized, the quality of the collateral used by the institution is likely to be lower.

An “out-of-the-box” alternative which may be worth considering is the possibility that the **central bank can provide liquidity directly to the resolution fund**, and then the failed institutions would receive liquidity assistance from the resolution fund. By this means, the latter, supported by the whole sector, would be able to collateralize higher-quality assets and, what is more important, collateral and resolution costs would be shared by the whole industry and not by the public sector.

There are a **couple of important caveats** that should be overcome before making this measure a possible course of action. First, the resolution fund is not considered to be a fully licensed bank, and therefore it cannot have access to a central bank’s discount window. Second, the collateralized capacity of the resolution fund is limited. In fact, it does not have more collateralized assets than those obtained through the ex-ante contributions. Should it be necessary to broaden the collateral capacity of the resolution fund, other sources may be worth analyzing, such as any kind of collateralized guarantee between banks and the resolution fund.

Question 4: Do you agree with the suggested elements of resolution planning for temporary funding in Section 5? What additional elements, if any, should be considered for inclusion?

BBVA agrees with the suggested elements included in the Section 5 discussion, nevertheless some clarification will be needed regarding the following items:

- In the identification of assets that could be sold or collateralized, there would not be a fire-sale.
- The FSB should include as a principle that central banks should have in place currency-swap facilities.

Question 5: Do you agree with the approach outlined for cross-border cooperation between home and host jurisdictions? What additional principles or procedures, if any, should be considered?

BBVA supports the principles established in the FSB document and considers that, to achieve a successful resolution of a G-SIB, it is key that institution-specific cooperation agreements should be in place between the home and relevant host authorities, because cross-border cooperation agreements help to facilitate institution-specific crisis management planning (funding planning) between the relevant authorities cooperating in the event of the firm’s resolution.

In this sense, coordination between home and host authorities is important in both an SPE and an MPE approach. However, under an MPE strategy, the coordination between resolution authorities should not be as critical as under an SPE scheme.

The resolution process in an MPE banking group would be under the direction or control of two or more national authorities, each one responsible for the resolution process in its jurisdiction, and one of them (the home authority) in charge of overall coordination.

Under an MPE model, the ultimate responsibility for resolving any subsidiary lies in the host resolution authority. In fact, the role of the home regulator will inevitably be more a

“coordination figure,” and the role of the host regulator will grow in relevance as the “sole executing figure.”

Against this backdrop, we envisage two different steps in cooperation and involvement among authorities under an MPE scheme:

- First, in the design of the high-level resolution strategy, home and host authorities should fully understand the MPE approach of their counterpart and work together to develop a comprehensive resolution plan that clearly delimits the roles and duties of each authority. In this step, collaboration and coordination between host and home authorities is vital.
- Second, when the resolution strategy is implemented, as opposed to the SPE approach, in an MPE model host and home authorities can act with relative independence, to the extent that the responsibility of each of them has been clarified ex ante. In an SPE, however, decisions on loss absorption have cross-border implications. Consequently, the need for cooperation under an MPE resolution strategy is smaller.

Furthermore, banks with an MPE resolution strategy and composed of independent and financially autonomous subsidiaries funded mainly with capital and liquidity located and managed directly in the host countries avoid to the maximum degree incurring in currency-mismatch risks.

Question 6: Are there any other actions that could be taken by firms or authorities with regard to the temporary funding needed to support the orderly resolution of a G-SIB?

See response to question 1 above