

Position of the European Financial Congress¹ in relation to the Financial Stability Board's consultative document on Funding Strategy Elements of an Implementable Resolution Plan²

Methodology for preparing the answers

The answers were prepared in four stages:

Stage 1

A group of experts from the Polish financial sector were invited to participate in the survey. They received selected extracts of the consultative document as well as the consultation questions in Polish. The experts were guaranteed anonymity.

Stage 2

The European Financial Congress received over 20 opinions from key financial market institutions in Poland and from individual experts. All the responses were collected, anonymised and presented to the experts who took part in the consultation. The experts were asked to mark in the other consultation participants' opinions the passages that should be included in the final position as well as the passages they did not agree with. Experts could also adjust their own positions under the influence of arguments presented by other experts they had not known previously.

Responses were obtained from:

- banks,
- regulatory bodies,
- law firms,
- the academia.

Stage 3

The survey project coordinators from the European Financial Congress prepared a draft synthesis of opinions submitted by the experts. The draft synthesis was sent to the experts participating in the survey with the request to propose modifications.

Stage 4

On the basis of the responses received, the survey project coordinators from the European Financial Congress prepared the final version of the European Financial Congress' answers presented below.

¹ European Financial Congress (EFC – www.efcongress.com). The purpose of the regular debates held within the EFC Project is to ensure the financial security of the European Union and Poland.

² <http://www.fsb.org/wp-content/uploads/301117-2.pdf>

Answers of the European Financial Congress to the consultation questions

Q 1. Do you foresee any challenges in the development of firm capabilities to facilitate the execution of the funding strategy, as set out in section 1?

The funding strategy is a key element of the resolution plan. It must be formulated *ex ante* and will determine the plan's effectiveness. **Action plans for stressed conditions must be developed and tested**, especially for systemically important banks (SIBs). In practice, however, various difficulties may arise.

The major problem will be to determine liquidity needs in a contingency whose background and circumstances are unknown, on the basis of earlier contingencies observed in the market. **The availability of assumed sources of liquidity depends on many factors, and financial needs may change very quickly and sometimes unexpectedly.** Therefore, the funding strategy may not sufficiently account for all potential problems or it may address them in an inadequate manner. Moreover, in the case of markets where there were no bankruptcies of locally significant banks, **it is difficult to estimate the feasibility of the recovery option.**

The determination of an entity's liquidity needs in the resolution process depends on the scenario adopted, but the problem is the fundamental **difficulty in modelling behavioural and market elements. The problems and shocks projected may turn out to be** greater than those accounted for when determining the funding strategy, and an extremely negative scenario would be an extraordinary event ("black swan") occurring. As a result, the **liquidity reserves accumulated may quickly run out and prove insufficient** in relation to needs, and the assumed **liquidity sources may be unavailable** due to broader market problems. The inability to access market sources of funding in a crisis may result in a need to use extraordinary central bank facilities. The problem in this case may be the **lack of adequate collateral** in the form of high-quality liquid assets (HQLA), which were used up in the recovery phase, due to the non-eligibility of certain types of assets as collateral and the aforementioned worse-than-expected market scenario (lower asset value and lower demand resulting in larger haircuts). The prerequisite for using extraordinary central bank facilities is stripping current owners of the entity of their rights in order to avoid moral hazard (which is not in line with current EU regulations). An important aspect appears to be that the resolution authority and the central bank as the liquidity provider of last resort develop their own information policies. An appropriate information policy should prevent the occurrence of a **panic** (contagion effect) and of a run on bank deposits whose scale would be difficult to estimate and which could result in an SIB with a robust liquidity situation losing liquidity. Such media activity should not be limited exclusively to traditional media, but should also include a broad offensive, including in social media. If the negative scenario unfolds, the challenge will be **proper liquidity risk management** as well as the meticulous **monitoring of funding needs and reporting** to the entity responsible for the bank resolution process.

Appropriate **data availability and the coordination of the information** required for the ongoing assessment at the consolidated level would allow reliable forecasting of future liquidity needs and designing remedial actions, particularly with respect to current and intraday liquidity, and the rapid identification of other entities with similar profiles which operate in the market in order to notify them and to impose increased monitoring and supervisory reporting obligations.

The challenge here is the **preparation of indicators that may trigger the resolution process** where the resolution authority finds that liquidity resources are insufficient while capital adequacy and balance sheet liquidity ratios are acceptable. Another problem may be **making the call that the recovery options defined in the recovery plan have been exhausted** and the resolution process should begin. Recovery options may be unavailable due to market conditions or other temporary restrictions. However, this does not mean that they have been exhausted.

The experience of the latest global financial crisis shows that a national legislator may introduce regulations that hinder or even prevent the implementation of measures previously provided for in the funding strategy by limiting the ability to use the assets held as collateral in the process of obtaining extraordinary liquidity. **Legal risk** is also related to the performance of various master agreements, including with respect to derivative transactions, which may cause problems with enforcement in individual jurisdictions and thus may prevent or hinder the effective and smooth implementation of the funding strategy. This risk may also be related to the insufficient development of legal institutions in some jurisdictions, which may lead to difficulties with the effective implementation of the funding strategy. Legal risk also stems from mismatches between agreements that stipulate mutual liabilities of the counterparties.

In the case of cross-border groups, the challenge may be posed by the differences resulting from **diverging policies pursued by central banks**, e.g. concerning receivable purchases. A considerable challenge may be posed by **inconsistent expectations on the part of supervisory authorities** and resolution authorities with respect to the required liquidity levels and sources of liquidity funding. Potential difficulties may be related to the **achievement of cross-border agreements** concerning the allocation of costs of the resolution process to entities within a banking group. Both the BRR Directive and the FSB guidance have established a general framework for determining the contributions of individual resolution authorities to the funding of the process. However, difficulties can be expected in practice at the stage of negotiating specific agreements.

Other challenges and difficulties that may arise in the implementation of the funding strategy include: **inconsistent auditing standards, which are prone to changes over time**, especially with regard to estimating risk and provisioning, **an effective debt collection mechanism** in the resolution process and the **maintenance of adequate resources** (human, IT, etc.) that enable the performance of tasks related to the implementation of the funding strategy.

Q 2. Does section 1 identify all relevant aspects for estimating liquidity needs for resolution? What other aspects, if any, should be considered?

The consultation document identifies the most relevant aspects of estimating liquidity needs for resolution purposes.

An important element of the strategy for funding this process is the ability to use ordinary central bank facilities. A clarification of **what is meant by ordinary and extraordinary central bank liquidity support** would be useful. Central banks in individual countries use different solutions in this area. The proper differentiation between these facilities is necessary in order to correctly identify potential sources for covering liquidity needs for the purposes of resolution. Potential process participants should have *ex ante* clarity rather than in an emergency situation.

If a systemically important bank needs to be resolved, **structural changes** will occur in the banking sector in addition to a significant increase in sensitivity to counterparty risk

and the shortening of interbank loan maturity. These changes mainly consist in the shrinking of the interbank network while the role of banks which play key roles in this network is strengthened, which results in a widening gap in access to liquidity depending on the bank's position in the interbank network. The multi-level structure of interbank markets must be accounted for, since it means that most banks do not lend to one another directly but rather via intermediary banks.

When drawing up a resolution funding plan, **market liquidity risk** should be considered. Under normal circumstances, the liquidation of assets at, or close to, market price does not usually pose large problems. In the event of an external or internal shock, market participants may partially withdraw, which may cause demand to drop and force the liquidation of assets at a price that significantly deviates from the market one, thus increasing losses and causing a considerable gap between the funding plan and the actual possibilities of obtaining funding. In this context, increasing the liquidity cushion for systemically important banks should be considered. Perhaps increasing LCR and NSFR requirements would be a good solution. If problems occur, liquidity is more important than recapitalisation in the pre-resolution stage and thus the priority should be to maintain short-term liquidity to “buy time” for introducing other measures.

The estimation of liquidity needs could involve an **internal control system** that should also address liquidity risk and, above all, ensure the proper and effective functioning of the liquidity risk management process. Combining this aspect with the **public disclosure mechanism** would enable market participants to reliably evaluate the bank's liquidity risk management system and its liquidity position during resolution. This could be supplemented with **tools for the comprehensive measurement of liquidity risk** in order to support the liquidity risk management process to enable the identification of heightened risk, emerging liquidity position weaknesses or an increase in liquidity needs. Another important issue with respect to the assessment of liquidity needs in the resolution process is **the bank's appropriate organisational structure**, i.e. a structure that corresponds to the bank's scale of operations and risk profile and ensures the separation of functions between the units which conduct transactions that affect liquidity risk and those responsible for monitoring and controlling liquidity risk.

Given the increasing popularity of factoring services provided by banks and of loans secured by assignment of receivables under contracts, the **examination of the quality of assigned receivables, their maturity and the debtors' rights to offset these receivables** may be of particular importance. Attention should also be paid to the liquidity needs related to the breach of clauses embedded into the funding obtained, e.g. concerning **additional collateral or restrictions on creating security** on assets. On the other hand, a positive solution would be for banks to have **long-term contingency liquidity supply agreements**, e.g. with other banks, although the question remains whether it would be effective in the resolution stage.

Q 3. Are there any obstacles to the identification and mobilisation of assets that could be used as collateral for both private and temporary public sector backstop sources of funding? How might any such obstacles be addressed?

The identification of assets itself does not appear to be a problem. The problem, however, may be their use as collateral for private sources of funding. Past experience demonstrates that these sources are often funded by banks (e.g. in Italy). Such a solution threatens systemic risk, since the difficulties faced by a large bank could be shifted to a group of banks or even

to the entire banking sector, and thus it should be eliminated. During the implementation of a specific resolution strategy, it may turn out that owing to exceptional market difficulties, the private sector funding assumed will not be available owing to the fact that certain types of assets are not eligible. Moreover, concentration may occur, thus reducing the ability to dispose of the assets concerned. The limited availability of private sources means that the potential cost of conducting transactions (even collateralised) with private entities is difficult to estimate and test, which makes it difficult to assess the impact of these transactions on profitability and solvency under resolution conditions. This type of obstacle can be removed by using **support from public sector institutions**. In this case, a question arises: in what scope and on what scale can this support be lent? Currently, we have no information on the terms and conditions of extraordinary liquidity support by the central bank, and the resolution plan cannot assume the use of its extraordinary facilities. Nevertheless, the entity subject to resolution may apply for such support after it has met certain conditions. This type of obstacle can be removed by **informing banks about the types of collateral that are eligible for acceptance by the central bank in connection with extraordinary operations**.

Owing to the fact that any assistance by the central bank cannot be extended on terms significantly deviating from the market ones, **banks should have a sufficient amount of unencumbered assets that can serve as collateral**, which will enable them to use the infrastructure made available to commercial banks by the lender of last resort.

Therefore, **balance sheet items that may be used as collateral** in transactions with the central bank need to be **monitored** on an ongoing basis. At systemically important banks, the leverage ratio should also be further reduced.

The main obstacle to the use of assets that could be used as collateral for private sources of funding may be the fact that no current valuation of these assets performed using prudent methods is available; this valuation must then be performed in a short time in circumstances where the value of assets recorded in the books of the entity subject to resolution may deviate significantly from their real value. Therefore, **bank assets should be regularly valued** by independent and credible experts who are recognised on the market, applying a range of prudent valuation methods that are used by providers of private funding in order to convince them to accept the risk of investing their funds.

The need to predict behaviours of individual market participants in an unusual, stressful situation may also cause considerable difficulty in using the assets. One cannot assume that the behaviours observed in the past will be repeated in the current contingency. Possible speculation in the market will also have an impact on securing funding sources (e.g. when FX structure is being adjusted). In a contingency, any estimates concerning the feasibility and implementation of corrective measures on a large scale and with significant effects such as the separation and sale of part of a bank may be erroneous to a considerable extent.

A potential obstacle to the use of the assets that could be used as collateral for temporary public sector backstop funding may be related to concerns that the funding could be considered to constitute unlawful state aid by the European Commission, which would result in the obligation to recover it immediately together with interest from the date on which unlawful aid was provided. The problem related to the lack of definitions and procedures concerning possible temporary public sector backstop funding may be alleviated by making reasonable efforts to ensure that public sector funding is provided on an arm's length basis. The positive result of the **private investor test** would provide proof that the transaction was executed on an arm's length basis. This test should demonstrate that the bank's assets serving

as collateral for public funding are sufficiently credible and reliably estimated that they could serve as standard collateral for private funding.

A failure to implement a recovery plan for the bank, e.g. in the Polish jurisdiction, prevents the central bank from waiving the reserve requirement, thus without the implementation of the recovery plan, even the bank's highest-rated assets (HQLA) will not enable it to access its required reserve. It is therefore important to **approve and implement** as soon as possible **the bank's recovery plan**, which should be based on **conservative assumptions** and should be developed before resolution is initiated.

In essence, legal obstacles that may hinder or prevent the use of assets held as collateral for funding sources may be effectively removed only within the home jurisdiction, because we are talking about systemically important banks whose uncontrolled bankruptcy could trigger a systemic crisis in the country in question. However, legal obstacles cannot be effectively removed in relation to host jurisdictions, which will first of all try to protect their own banking sector in the face of a crisis. In Poland, the regulatory authority has challenged the use of collateralised funding, i.e. mortgage bonds issued by mortgage banks, as a recovery option at the level of the parent undertaking (through a transfer of funds within a group of companies). Owing to the safety they afford to investors, it is precisely collateralised instruments which will become the most likely instrument used to obtain funding in a crisis, and thus similar **recommendations concerning the use of collateralised instruments should also apply to recovery plans.**

Q 4. Are there any other actions that should be taken by G-SIBs and authorities to support the development and implementation of resolution funding plans?

Essentially, the consultation document appears to address all relevant activities aimed at ensuring the proper development and implementation of resolution funding plans, and the selection of specific activities depends on multiple factors, including bank size and position.

The development and implementation of funding plans must be accompanied by a range of **risk mitigation** and **public relations** measures. Risk mitigation activities involve primarily strengthening the debt collection process and the temporary suspension or significant limitation of lending, which should be restricted exclusively to loans secured on assets with a high recovery rate. At the same time, a communication plan and a consistent media message should be developed by preparing model messages and selecting channels for their transmission. These communications should be aimed at stabilising the bank's situation and lending credence both to the corrective measures taken and to the bank itself. This concerns both the bank's external communications and those with its employees in order to retain them and convince them that the actions taken will enable it to survive temporary difficulties. Proper communications have a significant impact on the funding plan implemented and on the bank regaining liquidity.

Guidelines should be developed that will cover reporting structure and methods and other operational functioning aspects under resolution conditions. Supervisory reports are largely based on audited data, which are characterised by considerable delays, and thus a different reporting system is needed. It is critical that the information held by the resolution authority is credible and up-to-date. In order to avoid the interpretation uncertainties associated with non-standard reporting, resolution authorities should make greater use of the standard reports

drawn up by banks and submitted to the competent authorities, i.e. to the supervisory authority, resolution authority and central bank. This approach would not only guarantee access to reliable data which were verified during their generation process in earlier periods, but would also ensure that these data are more frequently available from competent institutions that gather data from the banking sector. Moreover, in response to an individual request by the resolution authority the bank would be able to generate a standard statement much faster than in the case of non-standard processing, which is additionally associated with the risk that data will not be fully comparable across the sector. It should be ensured that **the resolution authority can gain rapid access to the required data that are included in the reports and statements regularly provided by banks to other supervisory institutions** as well as that a framework be established for open dialogue in the case of dedicated reports that must be prepared on a case-by-case basis by the banks. The banks selected as possible candidates to acquire the institution in question should be informed of this fact as soon as possible, e.g. already at the recovery plan implementation stage, in order to conduct initial valuation and shorten/facilitate the resolution phase (see Santander's acquisition of Banco Popular).

Resolution authorities should be very sensitive to any measures proposed in resolution funding plans whose effectiveness depends on the legal environment in foreign jurisdictions, since even if such measures were possible earlier, it may turn out that they are no longer lawful in the jurisdiction at the time when they must be taken.

Another important issue related to the measures that must be taken by banks and resolution authorities is transparent **cooperation in the definition of critical functions** with respect to institutions that play important roles in both resolution plans and recovery plans. Where a bank is part of a cross-border group that applies a consistent methodology for determining critical functions within individual units, the precise determination of uniform selection criteria and the list of critical functions by banks in cooperation with resolution authorities is of particular importance for ensuring proper management and appropriate approach to the part of their business that constitutes a critical function not only with respect to the recovery or resolution process but also at earlier management stages. Sets of critical functions related to the recovery and resolution processes may or may not overlap. On the other hand, **banks should be given greater rights to inspect the resolution plans** drawn up by resolution authorities (currently only a summary of key aspects of the plan is to be made available) if they are to adjust their contingency liquidity plans to resolution plans and ensure their feasibility. A more comprehensive dialogue on this subject should be initiated with resolution authorities. More attention must be paid to **ensuring appropriate competences and resources** (including the continuity of competent expert work) both on the part of the resolution authority and the bank subject to resolution.

Additionally, resolution authorities could consider a moratorium which would affect the method of funding the process, and above all could **temporarily reduce the bank's liquidity needs**. The issue whether it would be possible to suspend payments for a few days is currently discussed in the EU as part of work on amending the BRR Directive. The question is whether the moratorium will be effective and how it will affect the credibility of the relevant market and the scale of disruption. Support for the **development of the securitisation market** would be helpful as well in order to enable broader access to this source of funding, which would also make the cost of obtaining funding from this source in contingency and during resolution more transparent.

Funding plans should involve **pessimistic assumptions regarding possible loss of funds** within the entity and within the entire group of companies at the consolidated level. The following

questions must be answered: What is the depositors' tolerance of bank problems? Does the deposit guarantee scheme provide sufficient security for those with deposits of up to EUR 100,000? What will be the scale of the outflow among those depositors who hold more than EUR 100,000 in the bank? This comment also applies to all other liabilities that are due shortly or are assigned to long-term liabilities under contractual provisions but may become due shortly as a result of unfavourable conditions. In this context, market risk exposure and derivatives should also be discussed. The derivatives issued, especially American options, may be exercised by the buyer at any time. Buyers of such options may close their positions in a contingency. This may result in a need to conduct settlements on a greater scale than that suggested by internal bank models. Uncovered positions may additionally exacerbate the situation.

Q 5. Do the funding strategy elements in the consultative document address all relevant aspects of a resolution funding plan? What other aspects, if any, should be considered?

In essence, the consultation document addresses elements of the resolution funding strategy in an exhaustive manner. In particular, the availability of funding sources and markets in which assets can be sold as well as the valuation of assets should be taken into account. More emphasis could be placed on legal aspects. Possible **hidden reserves** could be explored.

In the event of resolution of a cross-border group using the SPoE formula, it may be necessary to **maintain the liquidity of the entity operating in the host country**. The question arises whether, if liquidity needs to be assisted by public entities (central banks), it can be assumed that this task will be performed by the home country central bank. And what if support in host country currency is necessary?

As concerns obtaining liquidity in foreign currency, in addition to obtaining foreign currency funding from the central bank, **currency derivative contracts** (FX swaps, CIRS) **concluded with the central bank** could be taken into account. In a contingency, access to these instruments in the market may be limited; if their availability is ensured by the central bank, this will allow liquidity needs in foreign currencies to be met by converting liquidity surpluses in the local currency.

As concerns the identification of obstacles in the transfer of liquid assets between entities covered by single consolidated supervision, liquidity requirements and large exposure limits should not constitute obstacles to the implementation of a resolution plan. Prudential limits should apply to normal circumstances and at the recovery plan stage. In the resolution process, **saving the threatened entity should be the overarching goal**, even at the expense of temporarily suspending prudential norms.

Communications with the sector should be structured by providing up-to-date information on threats to entities with similar liquidity risk profiles. This would reduce the effect of the affected entities being excluded from access to private sources of funding in the wholesale market and also mitigate the risk of spillover.

The **principle of proportionality** should apply as far as possible to all aspects of development of resolution funding plans.