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**Your Ref: Comment letter on Consultative Document
- Effective Resolution of Systemically Important Financial Institutions**

Dear Sir,

Thank you for giving us the opportunity to comment on your consultative document on Effective Resolution of Systemically Important Financial Institutions. I will first make some general comments, and then discuss some more detailed points.

Overview

You are proposing certain policy measures to improve the capacity of authorities to resolve systemically important financial institutions (SIFIs) without systemic disruption and without exposing the taxpayer to the risk of loss. This is vitally important, and I support the principles-based approach that you have taken. I strongly support that shareholders and creditors should take full financial responsibility for the costs of a SIFI crisis resolution, and I would not support any approach or condition which would allow states, on an ongoing basis, to support or rescue failing SIFIs. State or supranational support should only be provided as a last resort, for example to ensure the functioning of payment systems, or to prevent other, related systemic breakdowns.

I would support a common sense approach, in order to achieve a state-neutral SIFI recovery and resolution framework. For example, I support that losses should be borne by those with whom the risks properly reside – first shareholders, and unsecured and uninsured creditors – rather than taxpayers;¹ that the scope of application should apply to financial institutions of all sizes that could be systemically significant or critical in particular circumstances;² that the

¹ P.9, consultative document.

² Ibid, p.11.

mandates of resolution authorities should be framed so that they have a duty to consider the potential impact of their resolution actions on financial stability in other jurisdictions,³ that an effective resolution regime should not rely on public solvency support and not create an *ex ante* expectation that such support will be available;⁴ and that resolution authorities should have the statutory power, but not the obligation, to apply a bail-in within resolution⁵ etc.

I also support the various proposals that would enhance authorities' planning and early intervention powers. If these are both anticipatory and credible, then they would minimise the risk of a SIFI resolution having to occur in the first place.

Recovery and resolution plans

These are obviously very important. The main reason that Lehmann's failure was so critical was their lack of preparation for a bankruptcy filing. The absence of the information suggested in Annex 1, paragraphs 11.3 and 11.4, and any planning required under Annex 5, made the circumstances and consequences of their bankruptcy significantly worse.

There are clear links between reverse stress testing and RRP. Where credible reverse stress testing indicates that the SIFI will fail as an ongoing entity, this requires the SIFI to introduce credible operational, structural and financial mitigations, and will inform the RRP accordingly. Likewise, the development of the RRP will inform the SIFI's reverse stress testing.

I would suggest that we need more clarity on the triggers for implementing recovery and resolution measures. These are briefly mentioned in Annex 5, paragraph 2.1(iii); however I would expect that some SIFI and international consistency would add value here. Triggers should be timely, objective and capable of being easily monitored.

Paragraph 6 of Annex 1 discusses the funding of firms in resolution. Given our overriding objectives, which include reducing moral hazard and not "exposing taxpayers to loss", I would like to clarify that SIFIs should only include normally available facilities in their RRP and not any "extraordinary assistance".

Bail-in within resolution

I strongly support the proposed use of debt-equity conversion and write-down tools as a key resolution tool. It is imperative that we restore public confidence in the integrity and fairness of SIFI resolution, and as a general principle, shareholders and creditors should take the full responsibility for the costs of a SIFI crisis resolution. This would be a strong signal to markets and the public, in improving business standards for SIFIs, particularly too-big-to-fail SIFIs. It would also reduce moral hazard, reduce the potential for systemic risk and reduce current public perception of a corporatist style of government, which socialises SIFI losses.

³ *Ibid*, p.14.

⁴ *Ibid*, p.23.

⁵ *Ibid*, p.35.

The consultative document makes it clear that bail-in within resolution should be available to resolution authorities for any SIFI meeting the trigger conditions for entry into resolution. For example, the introduction to Annex 2 states that: “Bail-in within resolution... should be part of a robust resolution regime that satisfies the *Key Attributes*. Resolution authorities should have the statutory power, but not the obligation, to apply a bail-in within resolution”. I agree that jurisdictions should consider the introduction of an appropriate transitional period before bail-in powers are exercisable, in order to manage market expectations here. Bail-in within resolution should respect the statutory order of priorities. Generally, equity should be written off first, then all subordinated debt should be converted or written off, and then all senior debt should be converted or written off by an appropriate amount, in order to ensure that the SIFI is returned to solvency. In answer to your specific questions, I would say that it is desirable that the scope of liabilities covered by statutory bail-in powers is as broad as possible, and that this scope is largely similarly defined across countries. I would also suggest that authorities should require minimum levels of bail-in debt,⁶ with a minimum maturity profile.

I would answer any questions concerning the market capacity for such “bail-in” instruments positively. Investors buy similar securities, in economic terms, which carry the risk of similar restructurings today. Markets are incredibly innovative, and are used to pricing instruments based on the available information. In fact, the implementation of debt-equity conversion and write-down tools as an additional resolution tool would forcibly strengthen market discipline on SIFIs, which would in itself be a positive outcome.

Bail-in instruments are clearly a type of hybrid capital that is suitable for rating by rating agencies. Any additional costs of capital on bail-in debt should be limited, as markets would expect smaller losses from a bail-in resolution, compared to a forced or crisis liquidation. Finally, I would suggest that funding costs have been artificially depressed anyway, due to markets’ expectations of public support for crisis SIFIs, and that this has distorted the efficient allocation of capital in markets. The implementation of debt-equity conversion and write-down tools as an additional resolution tool would help to rectify this imbalance.

Insurance companies

The consultative document makes it clear that the objectives set out in the *Key Attributes* will apply to all SIFIs, not just banks. I strongly agree that a bespoke approach will provide the best outcome for different businesses and financial institutions. However, it is also important to find consistent solutions for different businesses and financial institutions, including consistent coverage, triggers and resolution powers, in order to avoid the risk of regulatory arbitrage between the different classes of business and financial institutions. I would therefore strongly recommend that effective resolution should be based on “substance over form”. For example, I agree with the *Scope of application* on p.17 of the consultative document that: “to the extent that insurers conduct activities which are bank-like, the application of banking sector resolution tools to such activities rather than to the insurer as a whole or to its core traditional insurance business may be appropriate”. This is critical in order that the appropriate resolution plans are applied to the relevant businesses.

⁶ E.g. the Swiss authorities have recently introduced a similar regime for their two largest banks.

I would suggest that a measured approach will be most suitable for traditional insurance businesses. The insurance business model is based on pooling policyholders' risks, and increasing size provides greater diversification here. Product design normally includes various buffers and management levers in order to reduce risk, and investment policy is predominantly based on matching assets against liabilities. Economic and market crises rarely generate a "run on insurers" that banks often face. Insurance companies are also less interconnected than banks, do not require wholesale funding and carry out few systemically important functions.

The excellent report "Systemic Risk in Insurance: An analysis of insurance and financial stability" by the Geneva Association,⁷ concludes that based on the FSB criteria, no insurance companies pose a systemic risk. The report indicates that even hypothetical failures in the more concentrated, interconnected and globally pooled reinsurance market would have a negligible impact on the wider insurance market.⁸ Whilst I agree with these conclusions, I would suggest that certain activities do require more attention, including bank-like activities (see above), highly complex financial transactions, for example to hedge complex contracts such as variable annuities, and further derivatives trading on non-insurance balance sheets. I do not want to comment any further on this here, but my strong recommendation would be that effective resolution planning for insurance companies should be based predominantly on existing and currently proposed regulatory reforms in the insurance sector. I look forward with interest to see how this develops.

Stress testing

The consultative document refers several times to the importance of using stress testing to determine the options available under the RRP for a SIFI to recover financial strength and viability, and for the ongoing review of the adequacy of the RRP.⁹ Naturally stress testing should allow for shocks and variations along the following lines:

- 1) changing individual assumptions and parameters (sensitivity testing);
- 2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
- 3) changing the dependencies assumed between assumptions and parameters.

The importance of point 3 above is often underestimated. I would recommend that you should specifically emphasise the importance of considering dependencies and correlations under stress testing, particularly as typically observed and expected dependencies may not apply in the tail conditions and events that underlie many stress conditions and scenarios.

⁷ Available at:

http://www.genevaassociation.org/Portals/0/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf

⁸ Ibid, p.52: "The total loss for the primary insurance industry out of an immediate failure of 20 per cent of reinsurance capacity would be about USD 28 billion – representing less than 2 per cent of global primary non-life insurance premium".

⁹ See Annex 1 paragraphs 11.3 and 11.8; and Annex 5 paragraphs 1.3, 1.16 and 3.4.

I would also recommend that you should specifically refer to operational risk as a potential risk factor for stress testing.¹⁰ Operational risk is critical as operational risk failures effectively allow other types of risk, such as credit risk and market risk to be excessive. I note that operational risk was mentioned as a risk factor for stress testing in the Basel Committee on Banking Supervision's report on Principles for sound stress testing practices and supervision.¹¹

Other comments

For completeness, I would recommend the following specific wording changes in the consultative document:

- change "policy holders" to "insurance policy holders" in Annex 1, paragraph 2.3;
- change "and take other actions necessary" to "and take any other actions necessary" in Annex 1, paragraph 4.1(iii);
- change "temporary sources of funding" to "temporary, non-extraordinary sources of funding" in Annex 1, paragraph 6.2; and change "temporary funding" to "temporary, non-extraordinary funding" in Annex 1 paragraphs 6.2 and 6.4;
- the RRP should reference "cross-border activity" in Annex 1, paragraph 11.2, in order that the requirements therein would be consistent with the BCBS's Consultative Document on "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement";
- change "Stress scenarios should be sufficiently severe" to "Reverse stress testing should be credible and stress scenarios and should be sufficiently severe" in Annex 5, paragraph 1.3.

Yours faithfully

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¹⁰ Operational risk is commonly defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

¹¹ See page 3 in Principles for sound stress testing practices and supervision, BCBS, May 2009, available at: <http://www.bis.org/publ/bcbs155.pdf>