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**13th IADI Annual Conference**  
**“Updated Core Principles to Strengthen the Financial Stability Architecture”**

**Resolution Tools – Constraints and opportunities for use in bail-in**

**IADI research on bail-in**

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## Research project on *Bail-in implications for deposit insurance and funding.*

### Bail-in

- The most complex resolution tool,
- New and untested instrument in the resolution toolkit,
- DIA is usually not a creditor until deposits pay out
- Resolution is alternative option to deposits pat out

In November 2013 IADI established a Subcommittee on Bail-in implications for deposit insurance and funding.

- Identify, analyse and discuss key issues, challenges and risks related to the interaction between bail-in tools and a deposit insurance system
- Impact of bail-in on DIS tasks and responsibilities and DIS funds, taking into account the different DIS mandates and roles in the financial safety-net.

*Pending project*

## What is essential difference between resolution tools?

Instrument	Solvency funding	Loss allocation respecting hierarchy of claims
Partial transfer to purchaser and liquidation of residual part	If any in form of financial incentives for purchaser	Depends of transfer structure
Partial transfer to bridge bank and liquidation of residual part	Equity of bridge bank covered with resolution fund or other similar sources (sector contribution)	Depends of transfer structure
Bail in Open bank option	By creditors (new shareholder structure)	Yes except excluded liabilities
Bail in Closed bank option	By creditors (new shareholder structure)	Yes except excluded liabilities

## FSB

## Definition

Key Attributes of Effective Resolution Regimes for Financial Institutions – KA 3.2 and 3.5:

„Resolution authorities should have at their disposal a broad range of resolution powers, which should include powers to do the following:

(ix) Carry out bail-in within resolution as a means to achieve or help achieve continuity of essential functions either (i) by **recapitalising the entity** hitherto providing these functions that is no longer viable, or, alternatively, (ii) by **capitalising** a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated) (see Key Attribute 3.5)”

„Powers to carry out bail-in within resolution should enable resolution authorities to:

- (i) write down in a manner that respects the hierarchy of claims in liquidation (see Key Attribute 5.1) equity or other instruments of ownership of the firm, **unsecured and uninsured creditor claims** to the extent necessary to absorb the losses; and to
- (ii) **convert into equity or other instruments of ownership** of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), **all or parts of unsecured and uninsured creditor claims** in a manner that respects the hierarchy of claims in liquidation;
- (iii) upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (i) or (ii).”

Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions (draft) – definitions:

“Bail-in within resolution” – restructuring mechanisms (howsoever labelled) that enable the **recapitalisation** of a firm in resolution or the effective **capitalisation** of a bridge institution through the cancellation, write-down or termination of equity, **debt instruments and other senior** or subordinated unsecured **liabilities** of the firm in resolution, and the conversion or exchange of all or part of such instruments or liabilities (or claims thereon) into or for equity in or other instruments issued by that firm, a successor (including a bridge institution) or a parent company of that firm .

Explanatory Notes EN 3(x):

„ ... Bail-in may also be achieved, for example, by termination of the corporate rights (other than economic claims) of equity and unsecured debt holders upon entry into resolution and a claims payment process whereby former equity and unsecured debt holders bear losses and received payment for remaining value in the form of equity and debt securities of a newly established company. ...”



## Definition

### Bank Restructuring and Resolution Directive

#### Definition:

**„Bail-in – means the mechanism for effecting the exercise by a resolution authority of write-down and conversion powers in relations to liabilities of the institution under resolution.”**

#### The bail tool:

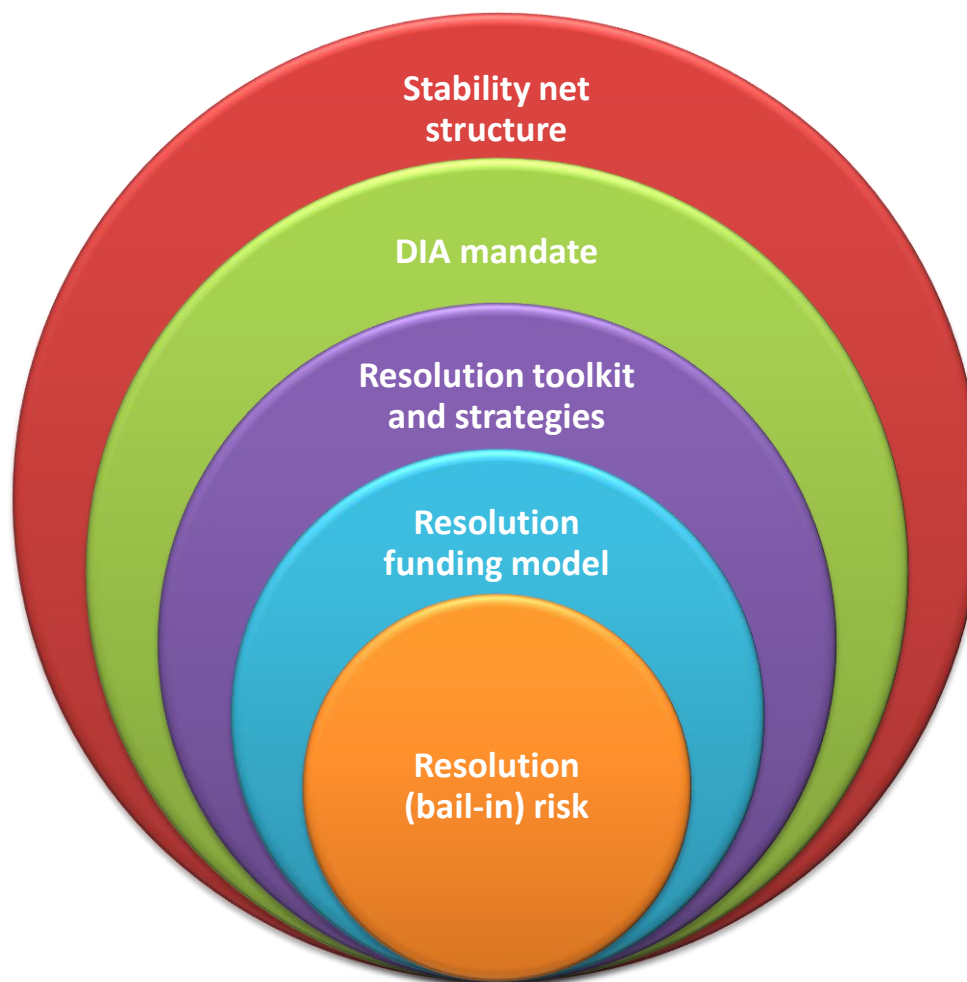
**„Member States shall ensure that resolution authority may apply bail-in tool to meet the resolution objectives ... in accordance with resolution principles ... for any of following purposes:**

- (a) to recapitalize institution or an entity ... that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation ... and to carry on the activities fir whicz it is authorised ... and to sustain sufficient market confidence in the institution or entity;**
- (b) to convert to equity or reduce the pricipal amount of claims or debt instrument that are transferred:**
  - (1) to a bridge institution with the view to providing capital for that bridge institution; or**
  - (2) under the sale of business tools or the asset separation tool.**

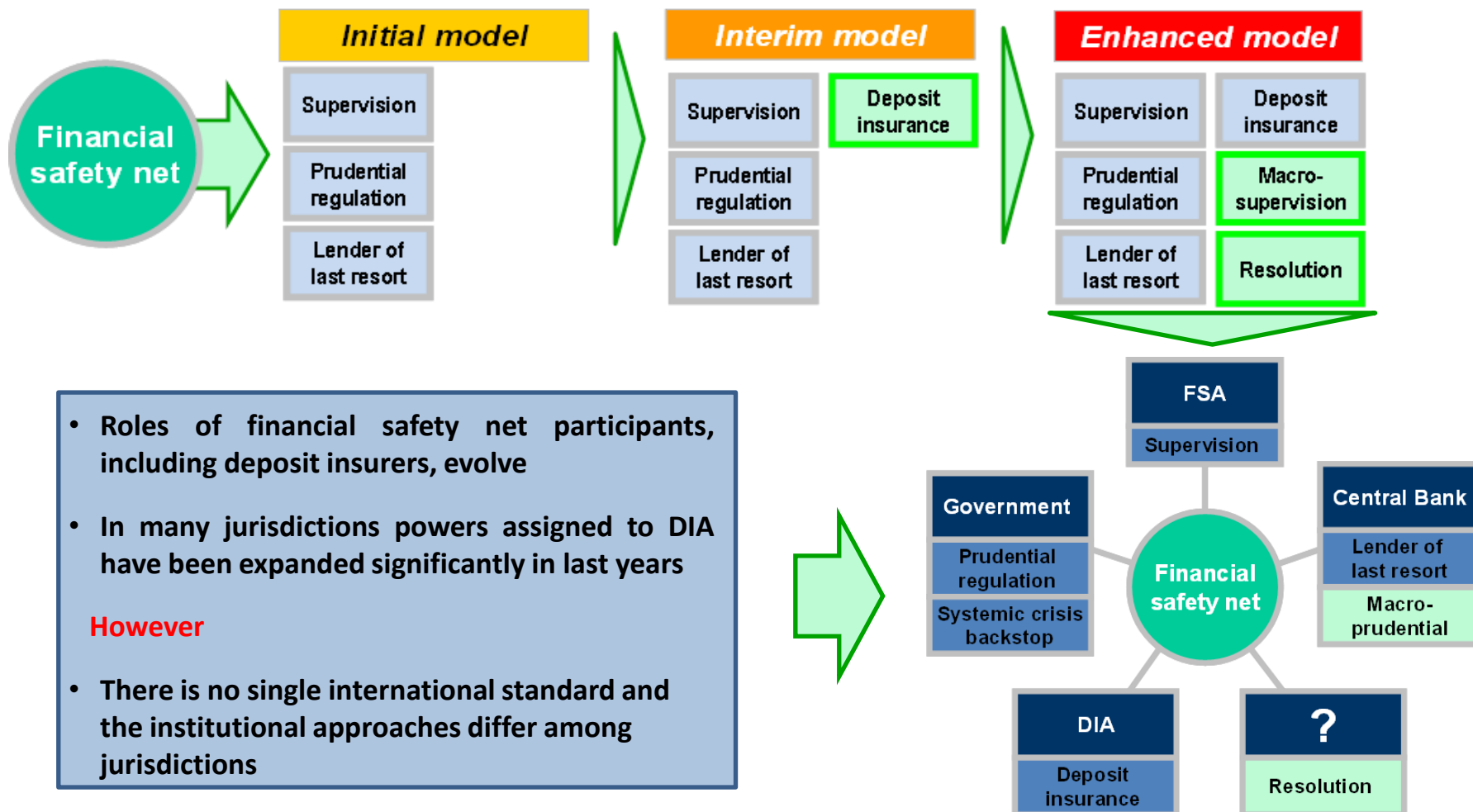
#### General principles of resolution tools:

**„Where a resolution authority decides to apply a resolution tool to an institution or an entity and that resolution action would result in losses being borne by creditors or their claims beeing converted, the resolution authority shall exercise the power to write down and convert capital instruments ... immediately befor or together with the application of the resolution tool.”**

## What is important for DIA?



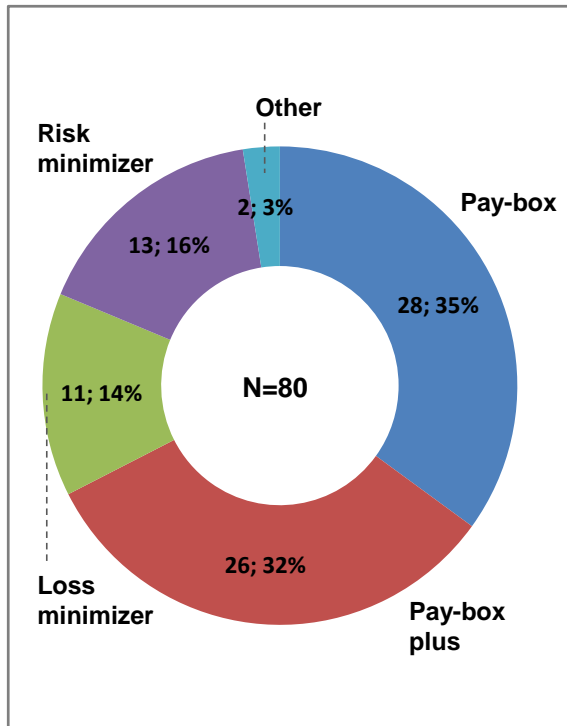
## Financial stability net structure



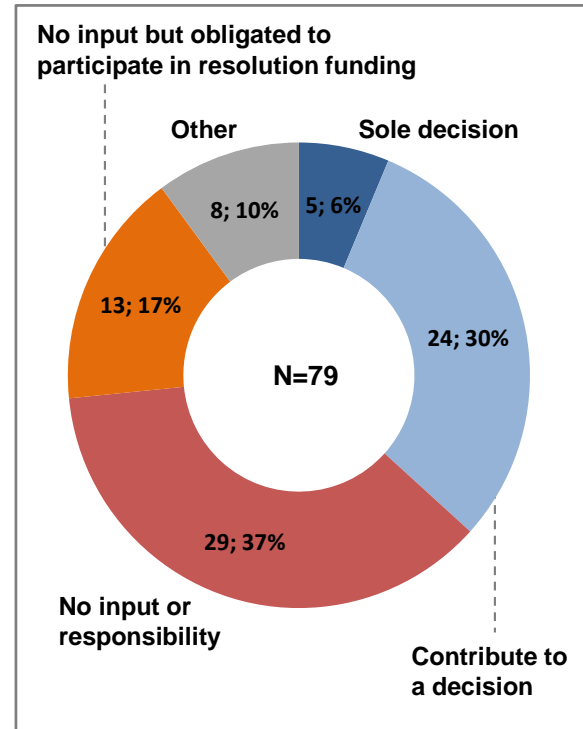


## Mandate of DIA and its role in resolution

### DIA mandate (declared)



### DIA input in the decision on resolution (declared)



Source: BFG's elaboration on the basis of IADI Annual Survey 2013

## Resolution toolkit

Lack of bail in

Bail in in the toolkit

**Pay out or bail out?**

**Funding?**

**Feasibility**

**Credibility**

Can other tools address the challenges? Compensate lack of bail in?

Other tools (resolution tool kit, bail-out options)

Structure of sector (sector size, TBTF)

Structure of funding (wholesale market, deposits share)

Other tools (resolution tool kit, bail-out options)

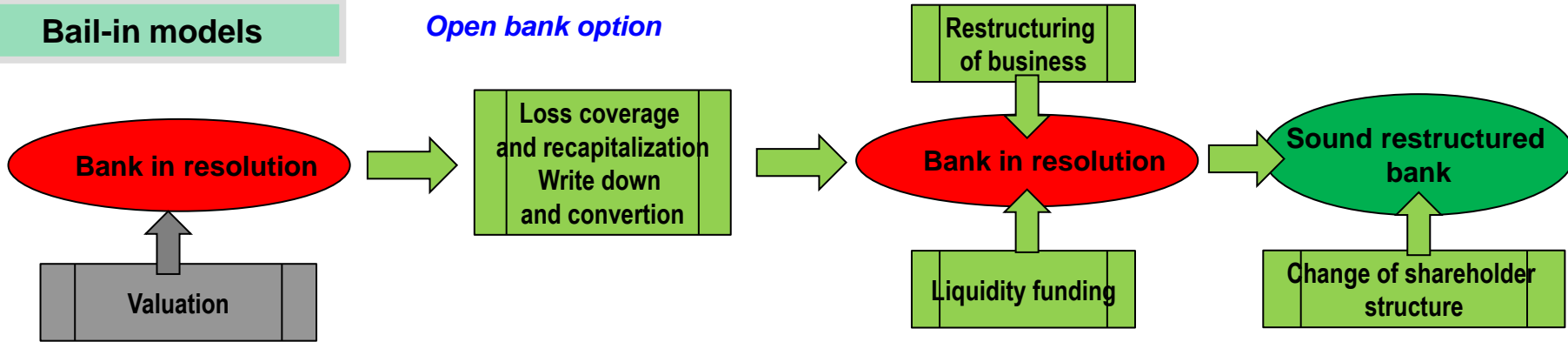
Willingness to use bail in

Likelihood of bail in selection. Role of DIA in selection process.

**Risk of failure**

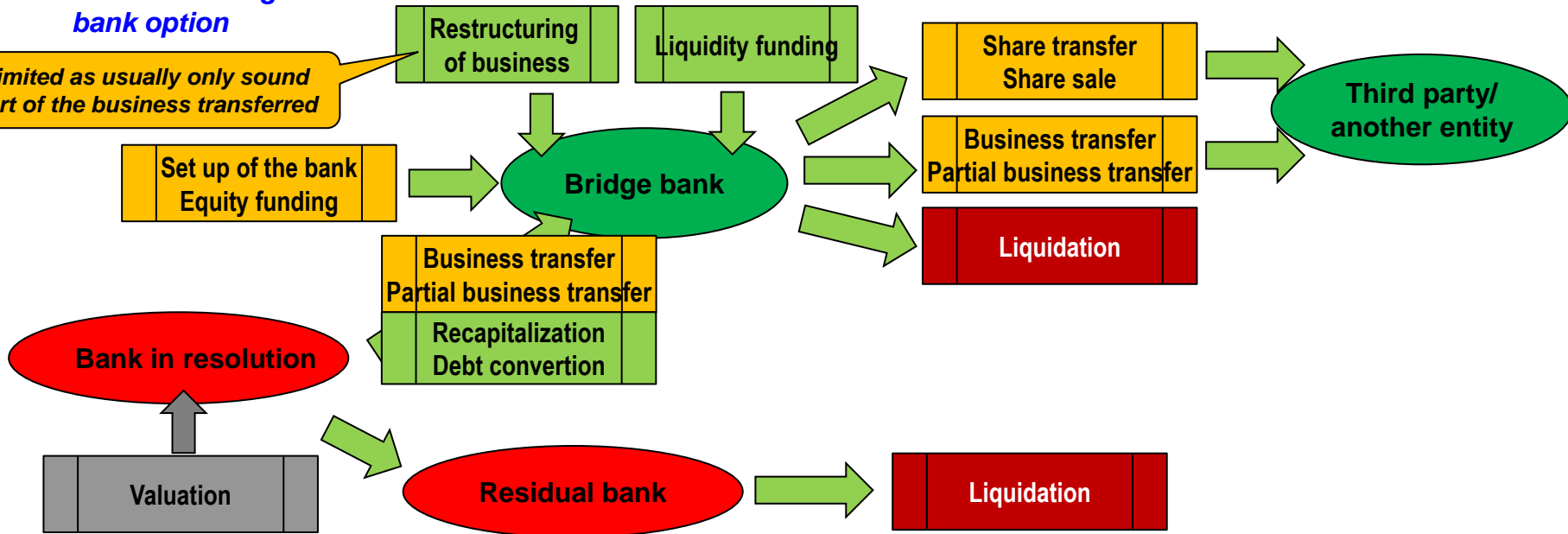
## Bail-in models

### Open bank option



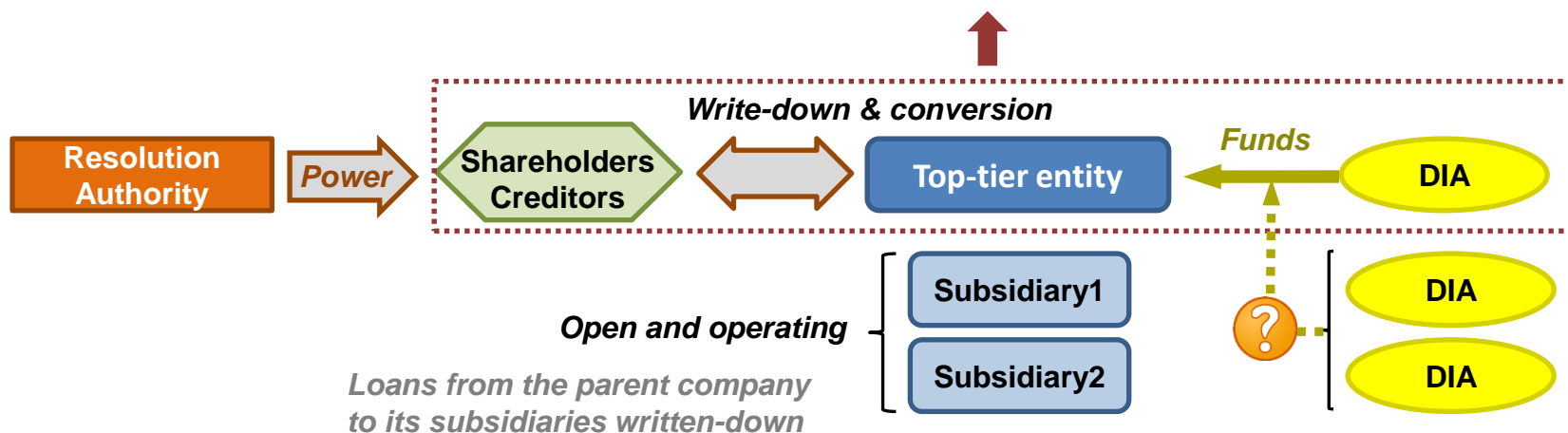
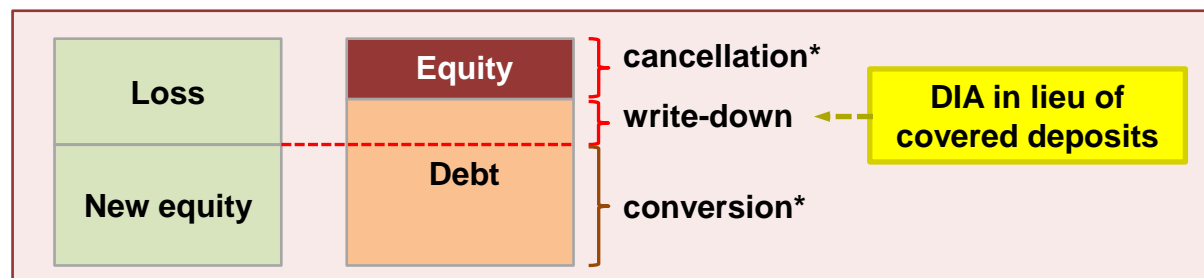
### Closed bank & bridge bank option

*Limited as usually only sound part of the business transferred*



## Resolution toolkit – bail-in models and strategies

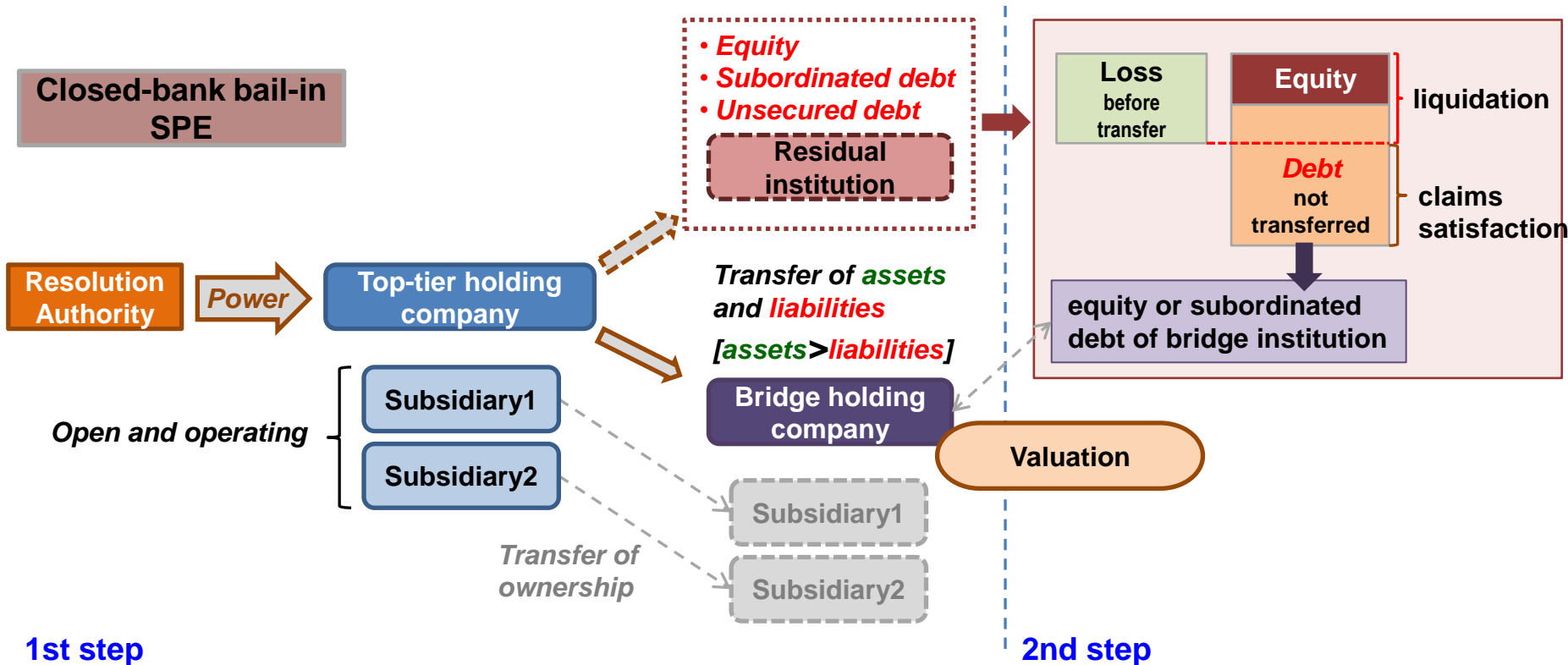
### Open-bank bail-in (SPE)



\*BoE model assumes that equity instruments are not canceled but transferred to the original creditors of the firm (instead of new issuance)

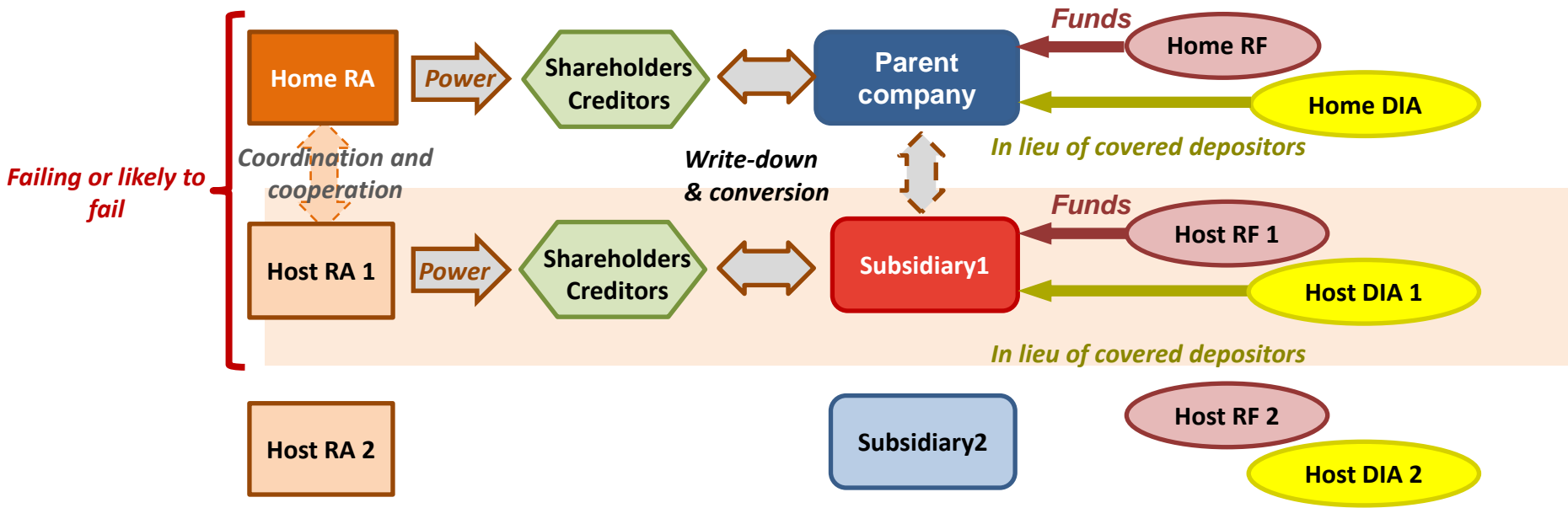
- One of the bail-in options laid down in BRRD
- Use of DIA funds depends on structure of financing of entity subject to bail-in
- Bail-in shall be accompanied by restructuring measures to address the causes of the failure.

## Resolution toolkit - bail-in models and strategies



FDIC proposal - group top-tier entity is a pure holding company and does not conduct any operational business activity financed by deposits

## Resolution strategies

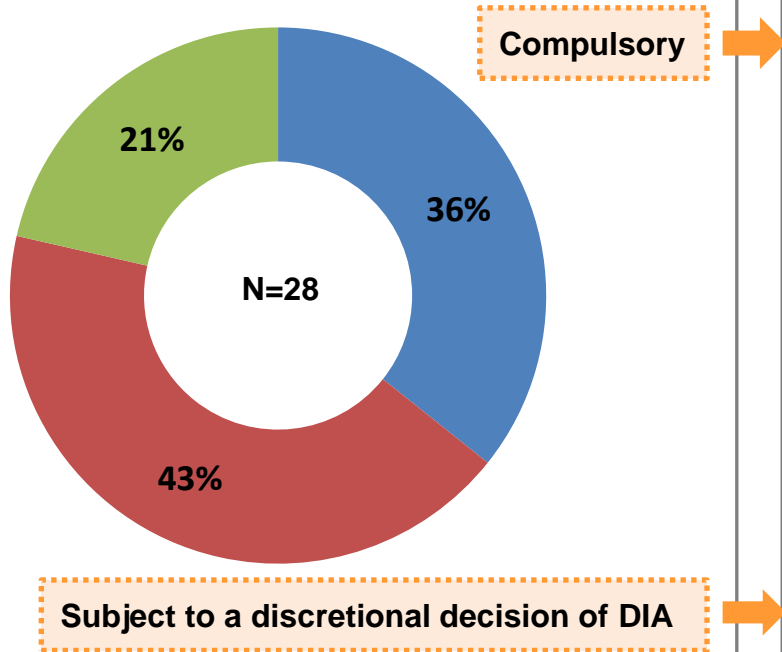


MPE      Open-bank bail-in

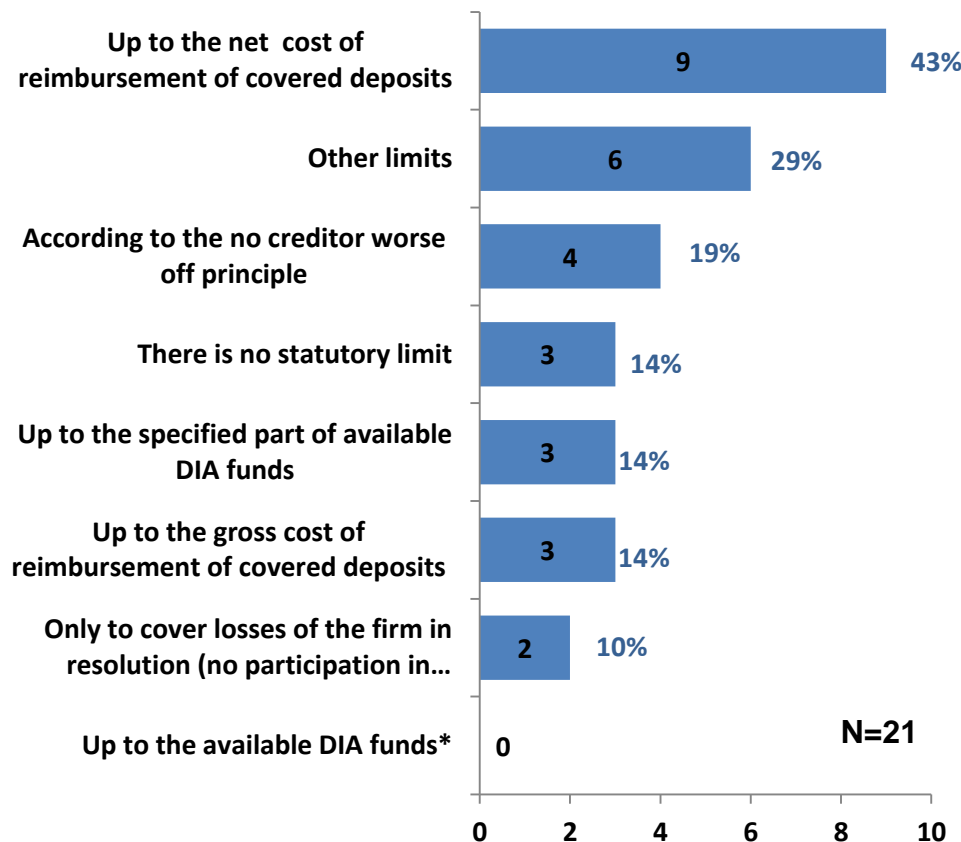
## Resolution funding model

### Role of DIA in funding resolution other than pay-box

It is **forbidden** to use DIA fund to finance measures other than reimbursement of covered deposits in liquidation (pay-box)



### Statutory limits for the use of DIA funds to finance resolution measures other than pay-box



## Resolution funding model

### FSB

**General rule**

DIA funds listed as a one of potential sources to provide temporary financing to facilitate the resolution (KA 6.3)

DIA **obliged** to contribute to financing resolution up to the net cost of pay out if resolution ensures depositors continue to have access to their deposits (BRRD; art. 109)

Limited list of activities that can be financed from financial arrangement (resolution fund) (BRRD; art. 101)

**Cross-border dimension**

Resolution plan for G-SIFI should identify all potential sources of resolution funding, including, where relevant, from national DIA and resolution funds.

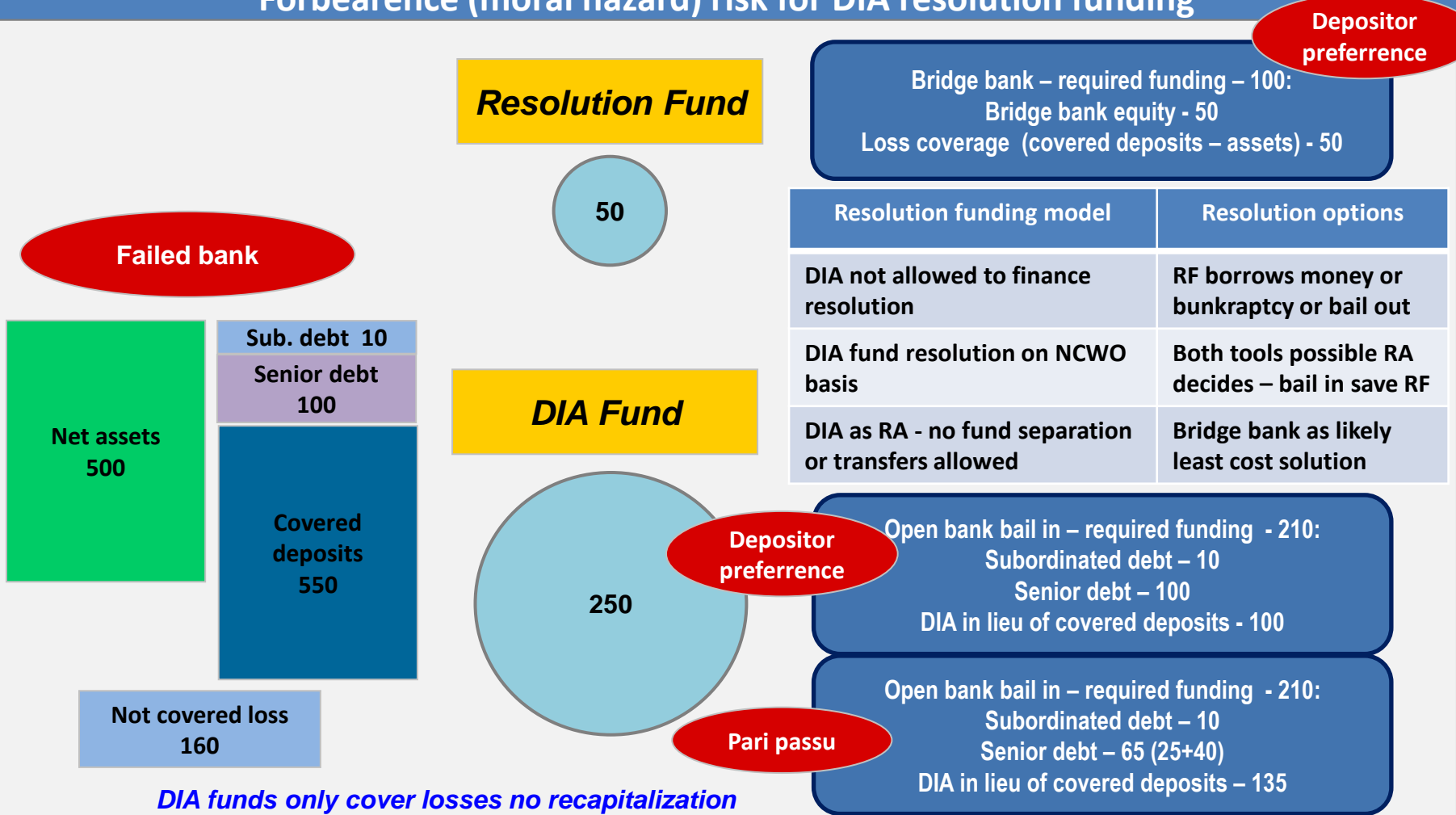
Where DIA funds are available to contribute to resolution, a mechanism **shall be found** to require DIA to contribute to resolution of holding company (RRP; p. 4.6)

In case of a group resolution resolution college shall draft a financing plan including inter-alia contributions that DIAs would be required to make (BRRD; art. 107)

- Basic issue – source of recapitalization
- Status of funding – liquidity (temporary) or solvency



## Resolution funding model Forbearance (moral hazard) risk for DIA resolution funding

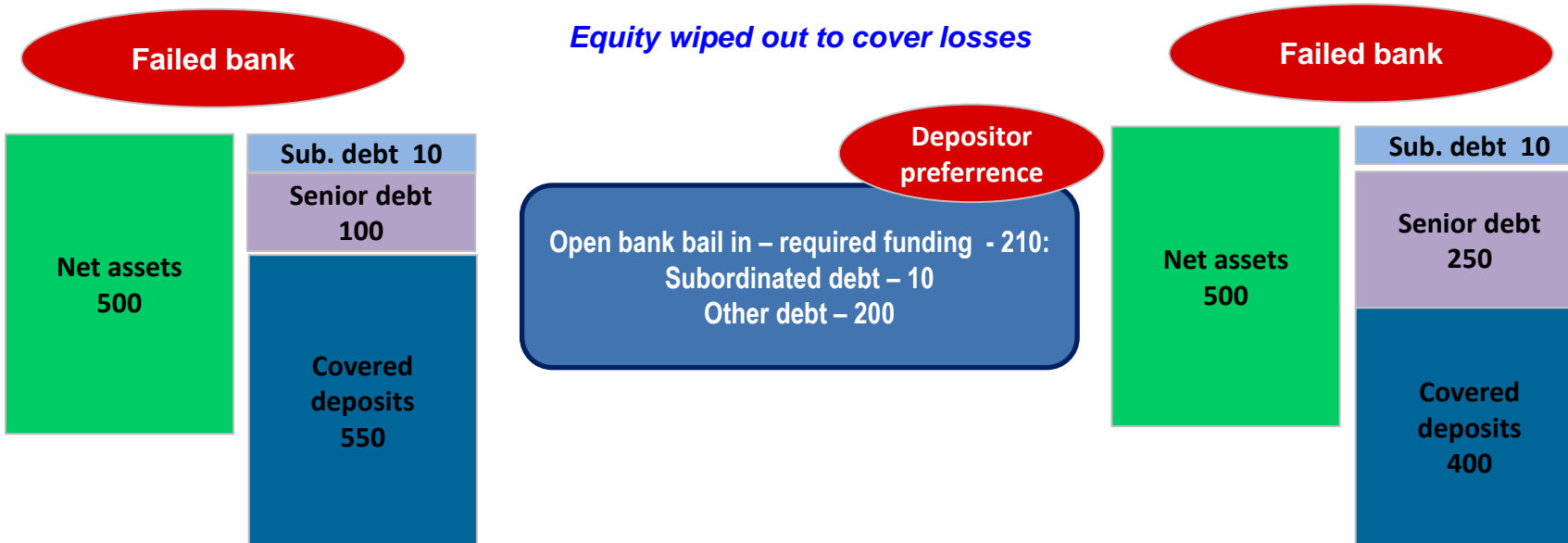


Depositor preference

Depositor preference

Pari passu

## Resolution funding model Bank funding structure

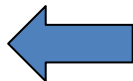


## Resolution (bail-in) risk

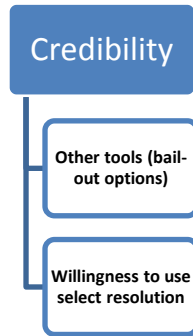
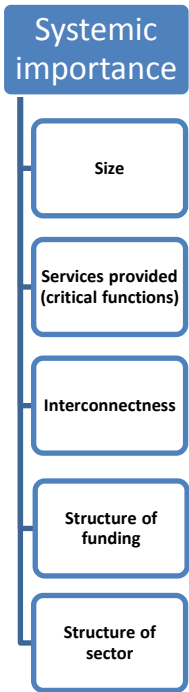
DIA does not contribute to resolution funding

DIA funds resolution

*Pay out or bail out?*



**Standard liquidation**



*Pay out or bail out?*



## Bail in specific risk

### Write down and conversion

### Business restructuring

#### Liquidity mngt & funding

- Deposits and funds withdrawal after memorandum
- Market confidence
- Cost of funding

#### Legal risk

- Enforcement of payment and early termination rights suspension
- Annulment of decision
- Compensation payments
- Legal costs

#### Operational risk

- Valuation process (time and accuracy, principles of valuation)
- Liability identification and separation
- Time constrains
- External services continuity
- Cross border coordination

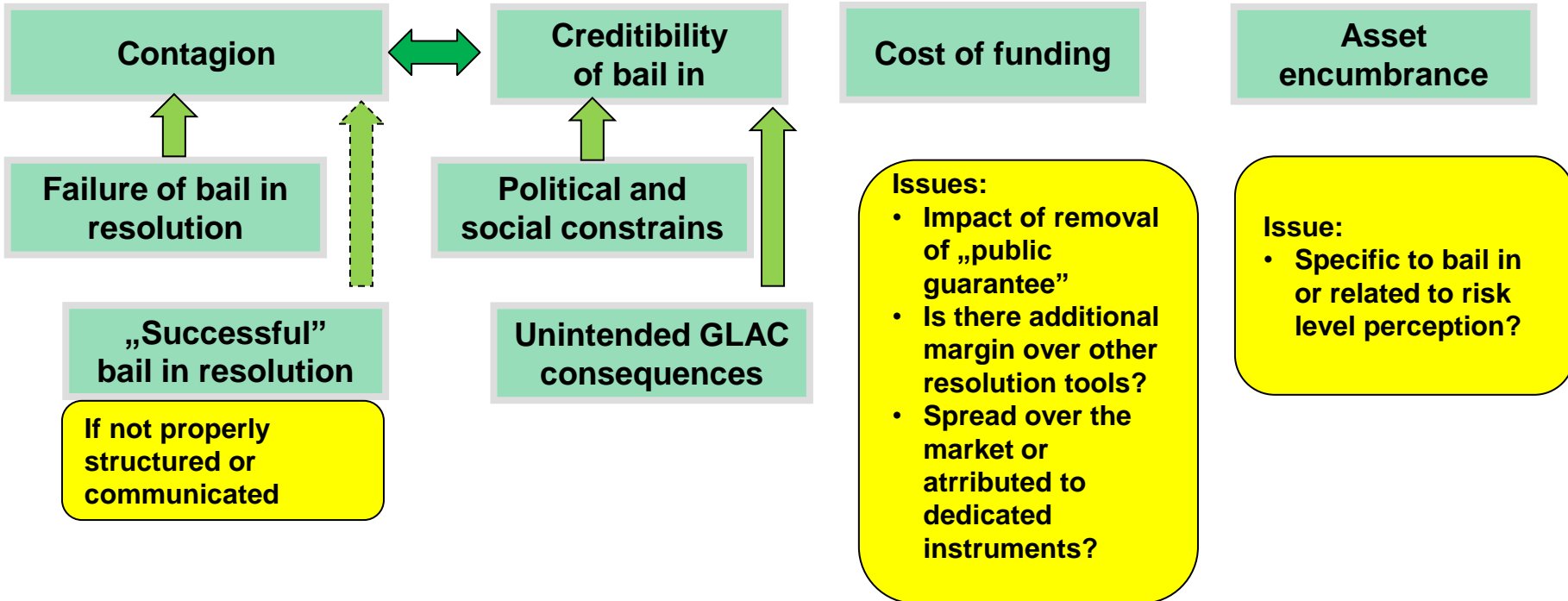
- Restructuring planning
- Restructuring execution
- Unintended shareholder structure
- Lack of shareholder support
- Cost of funding
- Market position v. risk appetite
- Risk position coverage costs

### Drained or insufficient LAC



## Risk of failure of resolution

## Bail-in implicit risk



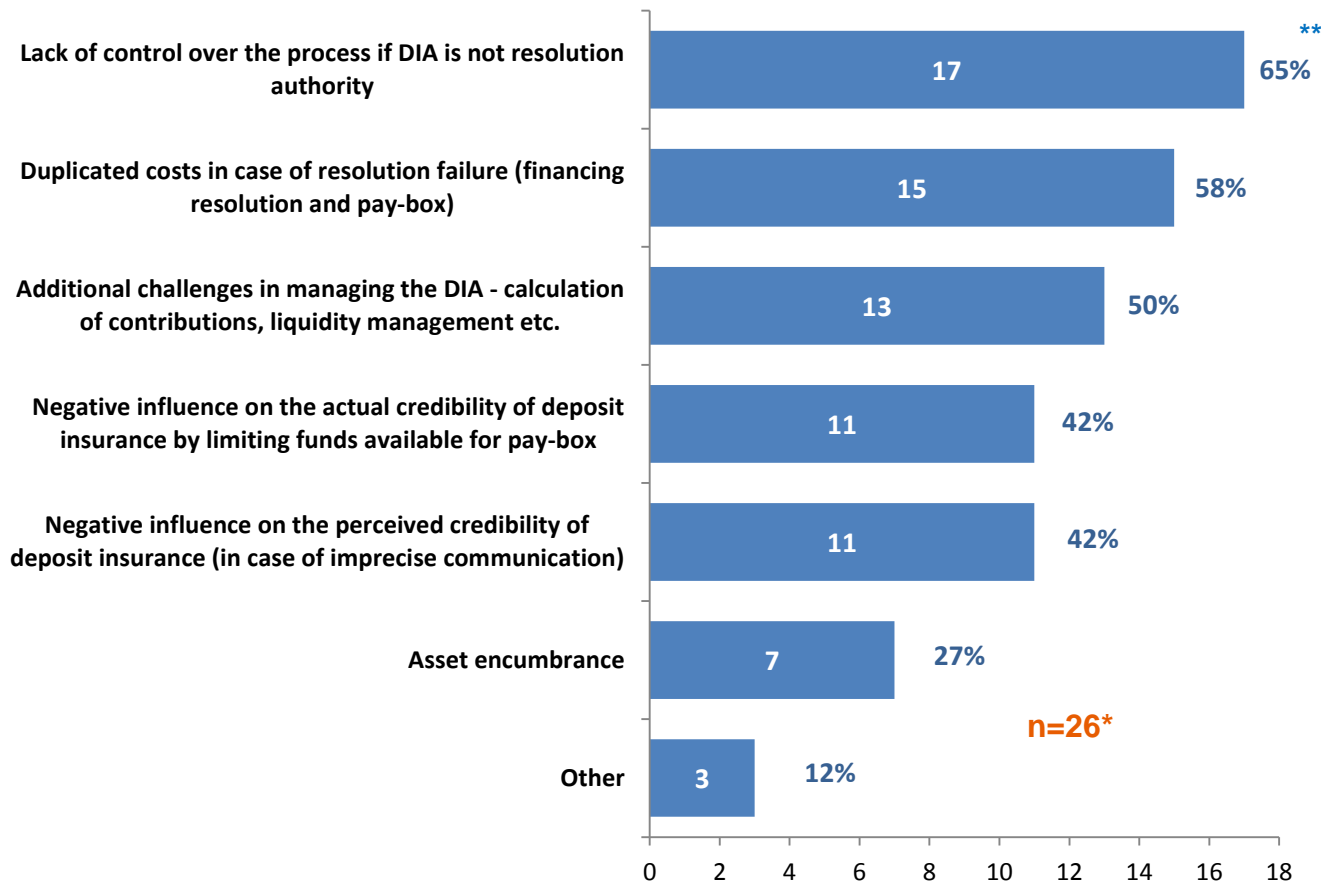
What risks relating to the participation of DIA funds in financing resolution, including bail-in, do you recognize?

Remarks

One response „other” excluded from the graph because of the commentary „no response due to absence of legislation”

Only one respondent with answer „other” has specified the character of risk:

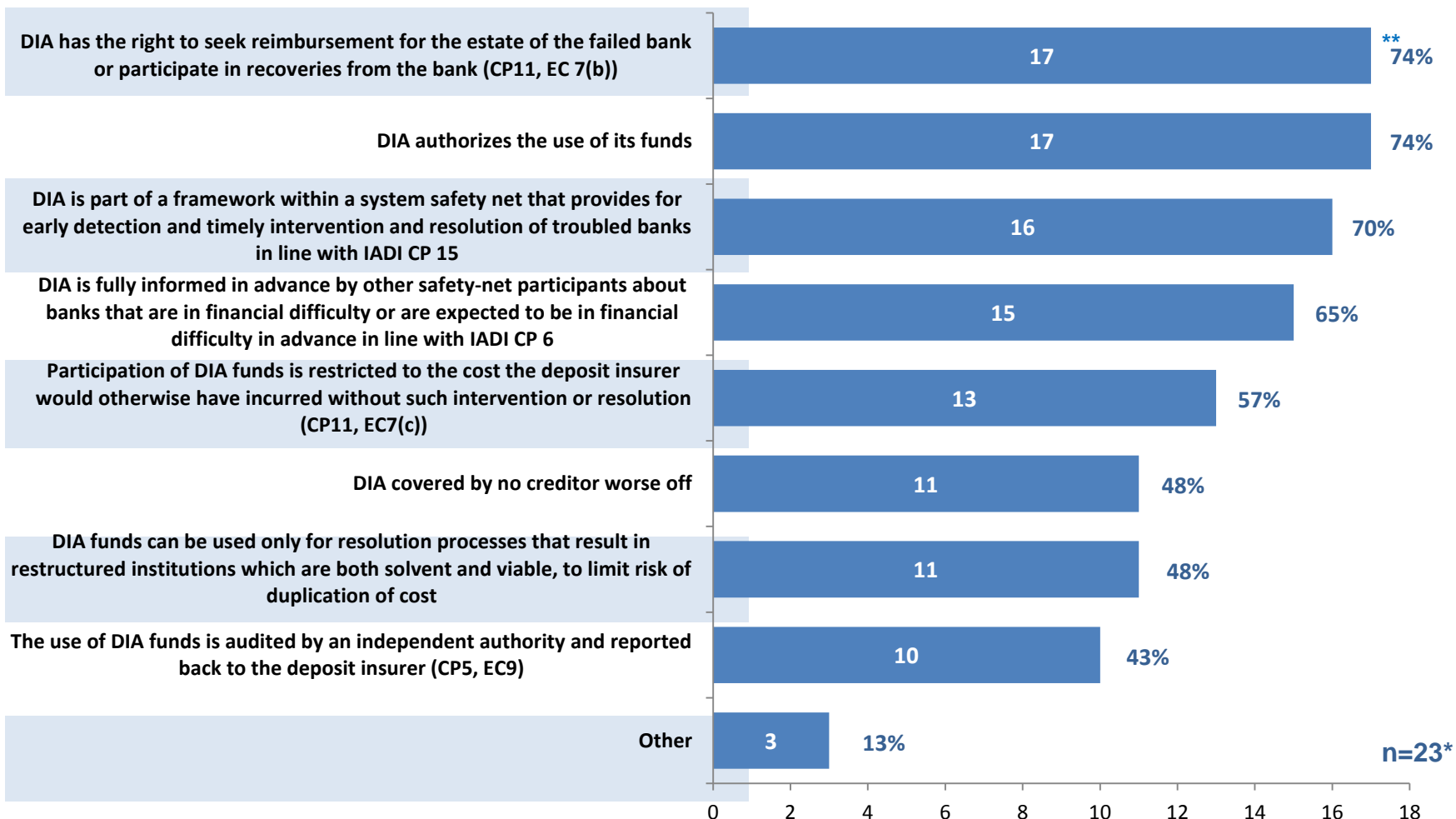
„The use of funds, which were originally build up for deposit protection, for resolution cases (especially in the "too-big-to-fail-case" of systemic important banks!)”



\* n – number of participants who answered the question (at least one option marked)

\*\* percentages calculated in relation to number of participants who answered the question (n)

## If contribution of DIA is compulsory what are the safeguards to protect DIA's interests?



Remarks – next slide

\* n – number of participants who answered the question (at least one option marked)

\*\* percentages calculated in relation to number of participants who answered the question (n)

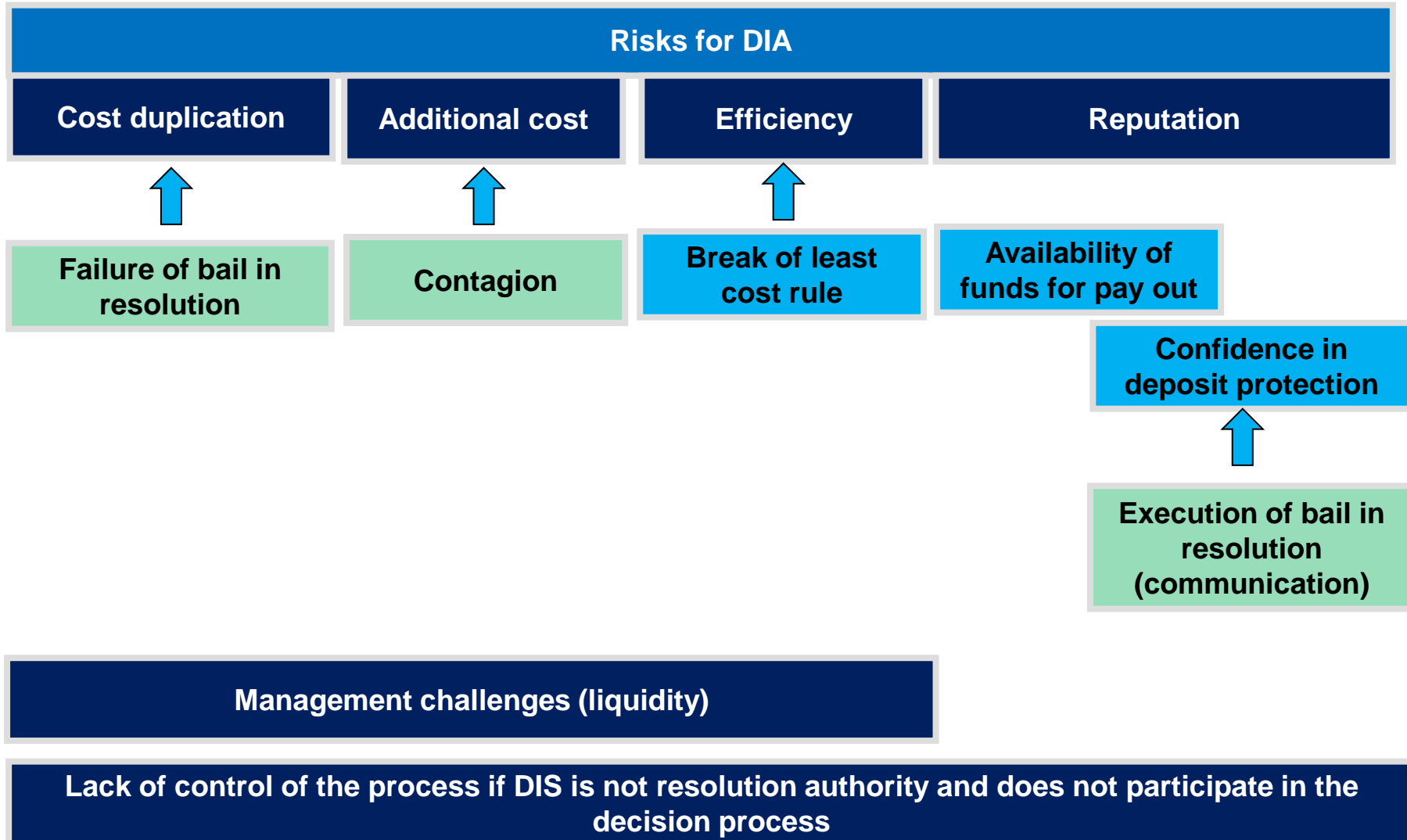
If contribution of DIA is compulsory what are the safeguards to protect DIA's interests?

Remarks

Respondents who has chosen „other” specified in supplementary text:

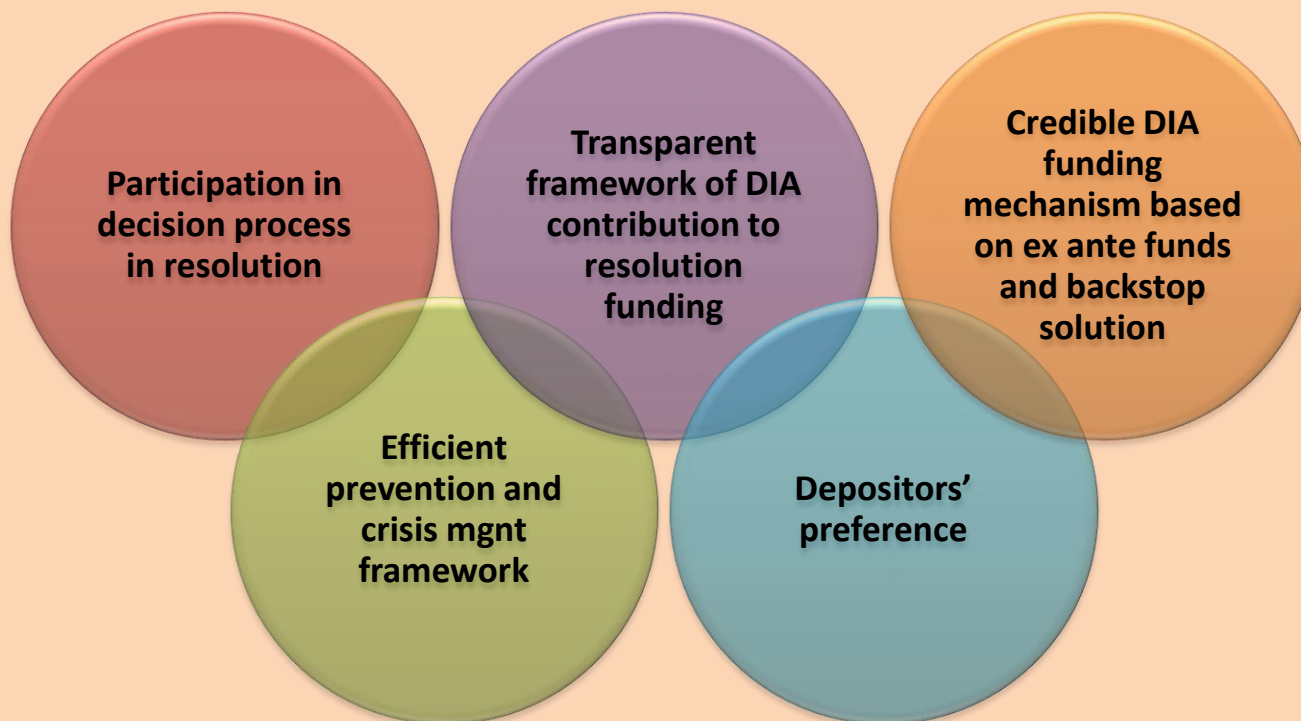
- *„Strictly separates systems and funds! No "link" between resolution and deposit protection!”*,
- *„Covered deposits are benefitting from depositor preference”*,
- *„Ultimately, there needs to be alignment between responsibility for conducting resolution and funding of resolution. The resolution authority needs to be accountable for funding the cost of resolution”*.





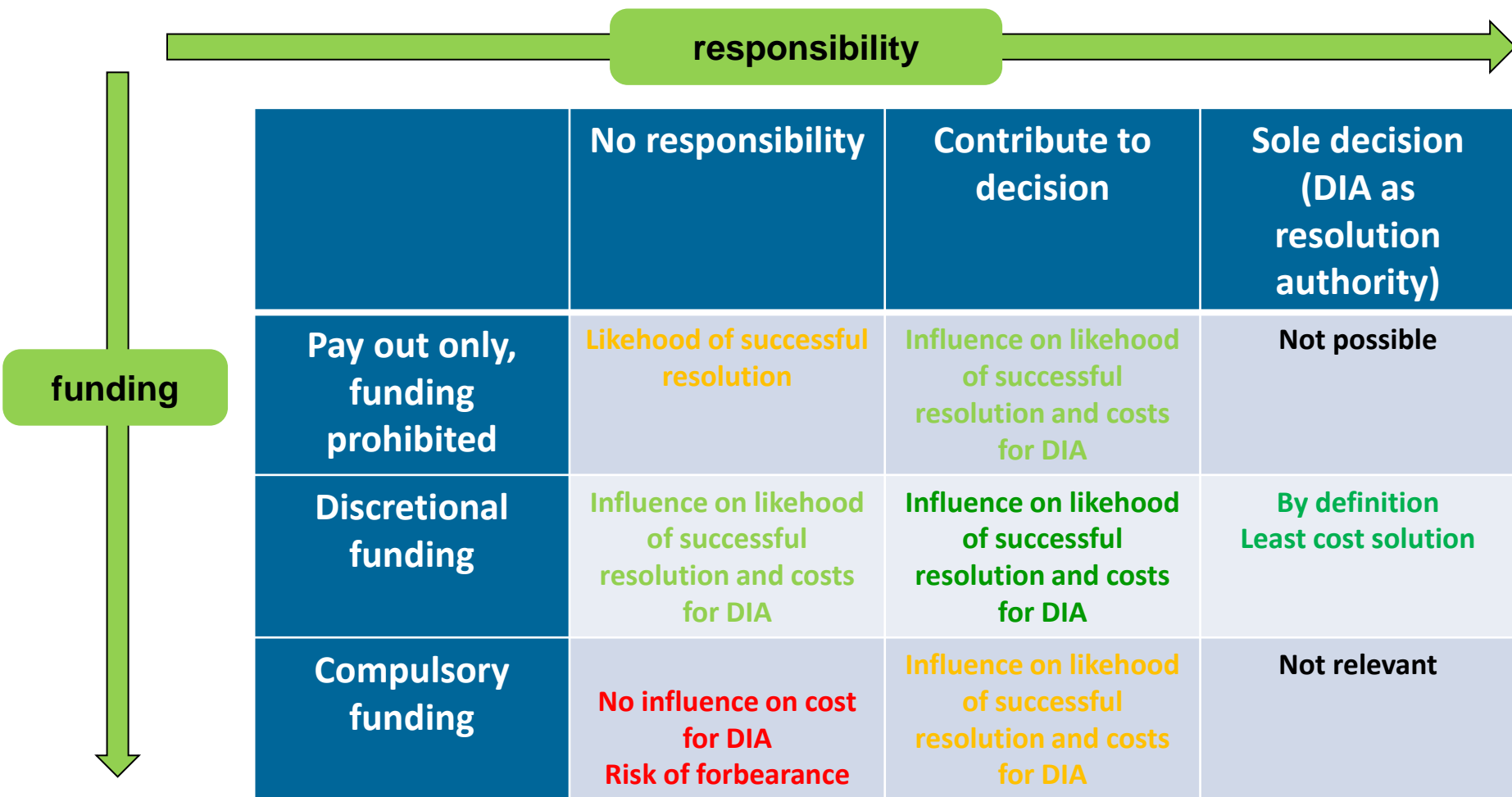
## Safeguards for DIA

### Strong legal framework

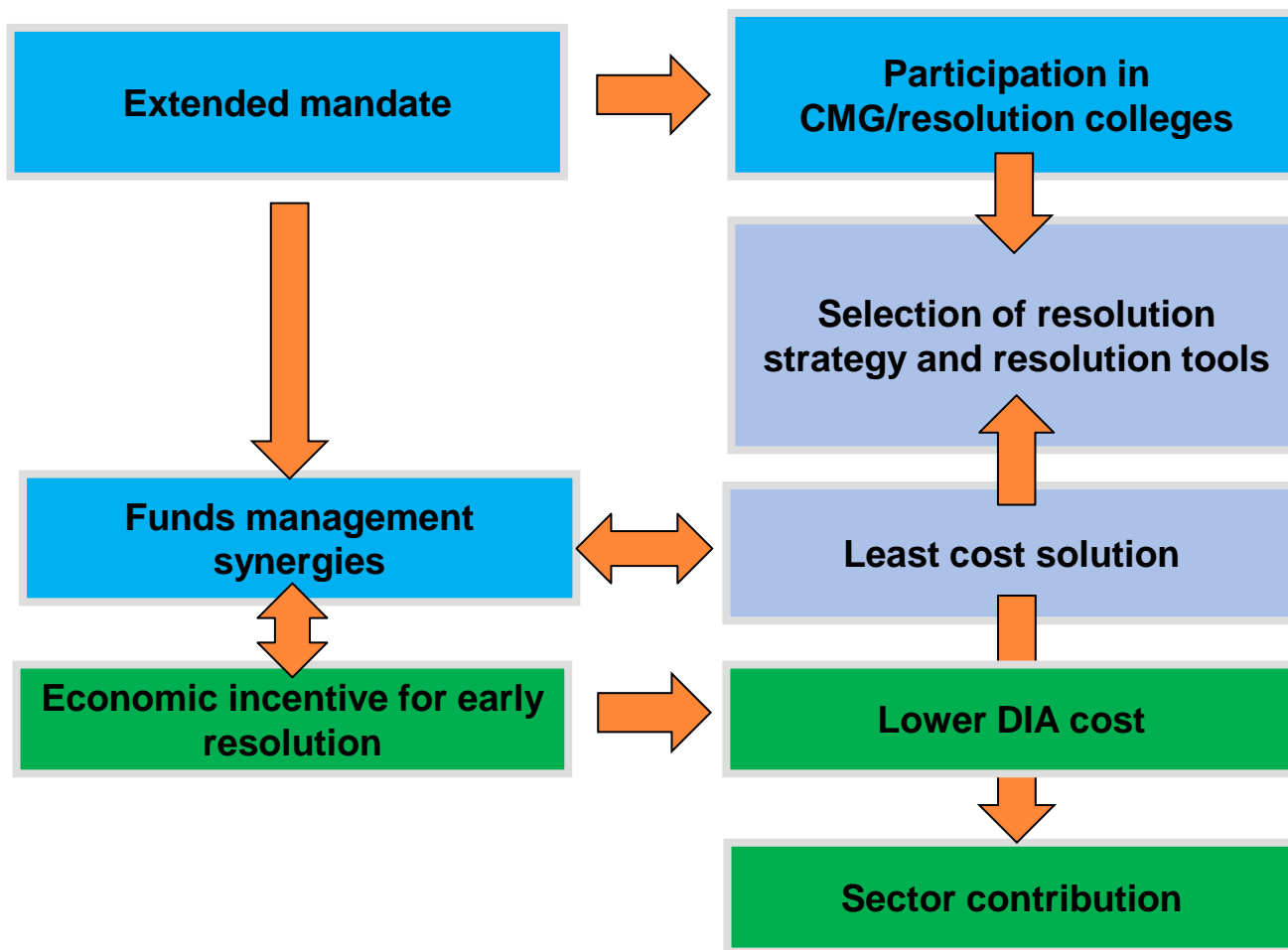




## DIA participation in decision process in resolution



## DIA participation in decision process in resolution



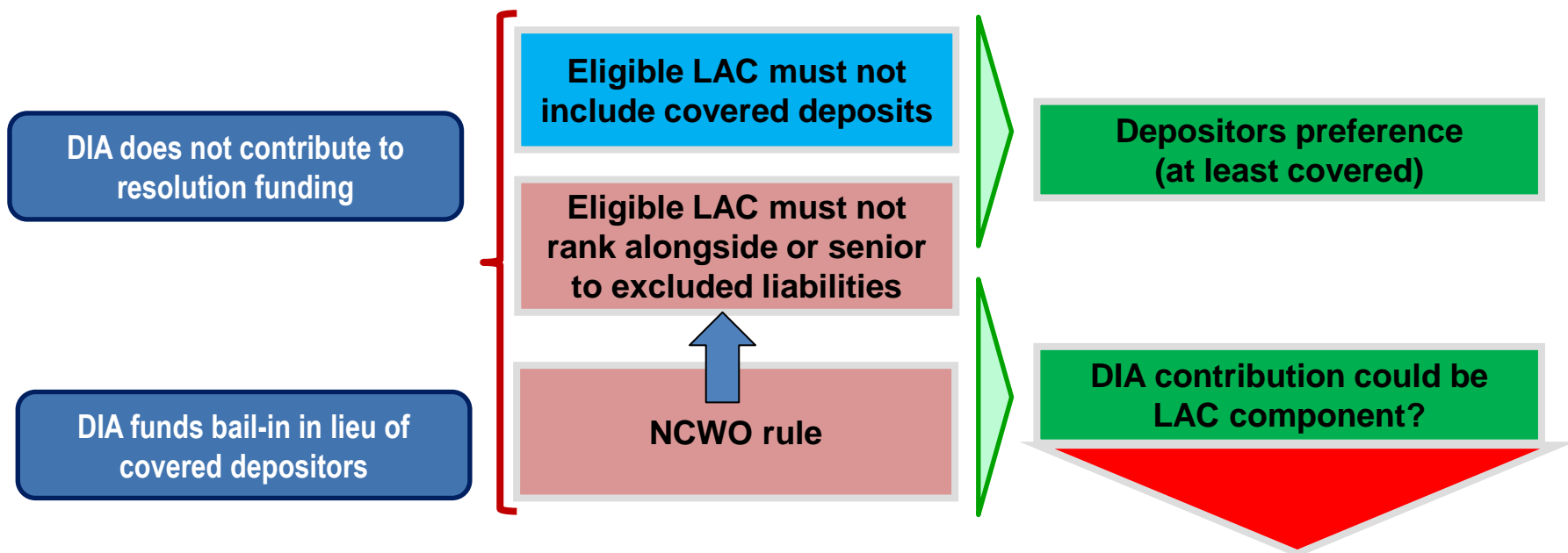
### Transparent framework of DIA contribution to resolution funding

#### CP - Principle 9

##### USES OF FUNDS

- If DIA not the resolution authority, it has the option to authorize the use of its funds for resolution other than liquidation and pay-out,
- DIA informed and involved in the resolution decision-making process,
- Use of DIA funds only up to the net cost of pay-out of insured depositors,
- DIA funds not used for the recapitalization of resolved entity,
- Use of DIA funds subject to an independent audit,
- All resolution actions and decisions using DIA funds subject to ex-post review.

## Depositors preference LAC relevance for DIA



**DIA contribution cannot be sole LAC builder if it would not be able to recapitalize  
DIA contribution as LAC component can de incentivize for other sources of LAC (other liabilities) if DIA funds are material**

**What if DIA contribution based on underlying amounts callable on demand or matured shorter after 1 year (LAC eligibility criteria)?**

### LAC relevance for DIA

#### **FSB working documents:**

**It would not appear appropriate for DGS contributions to count towards GLAC adequacy for G-SIBs unless it could be demonstrated that, in the event a G-SIB enters resolution, the DGS would be able to materially contribute to the loss absorption requirements of the firm. If use of DGS funds in resolution would present a significant cost to public funds (for example, where there are only small or no ex-ante funds available), and if it is unclear that industry could be levied to recoup the costs of the DGS contribution in a timely manner without causing widespread contagion to the financial sector, it would not be appropriate for DGS contributions to count towards GLAC adequacy.**



*THANK YOU*

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