CNB CZECH NATIONAL BANK

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CZECH REPUBLIC

Czech National Bank's position on FSB public consultative document *Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines*

General principles applied in answers to the individual questions

- *The interest of financial groups cannot be superior to the interests of the individual countries.*
- *Supervision and crisis management of financial institutions are the responsibility of all countries in which such financial institutions operate.*
- *It is inadmissible to separate supervisory and crisis management powers from responsibility. An entity that holds responsibility must also have powers.*
- *The recommendations should not include any rigid trigger mechanisms for interventions by national authorities in a crisis situation.*
- *It is desirable that a certain harmonisation is achieved regarding the conditions for the use of tools and powers which national authorities have or will have at their disposal. At the same time, however, the national authorities must retain the possibility to react flexibly also to unexpected situations.*
- *The financing of resolution measures adopted by the individual countries is the responsibility of these particular countries. It is inadmissible that the recommendations contained in the consultative document imply detailed rules how to carry out this responsibility.*

Answers to questions asked in the consultative document

1. Comment is invited on whether Annex 1: Key Attributes of Effective Resolution Regimes appropriately covers the attributes that all jurisdictions' resolution regimes and the tools available under those regimes should have.
2. Is the overarching framework provided by Annex 1: Key Attributes of Effective Resolution specific enough, yet flexible enough to cover the differing circumstances of different types of jurisdictions and financial institutions?

CNB position: *In general we do not object the idea that all jurisdictions have a certain harmonised minimal set of resolution tools and powers and in some respects harmonised legal framework to carry out the resolution. The content of Annex 1 of the consultative document seems to be a useful contribution to the discussion currently under way at different forums, including the European Union. The Czech Republic has no experience with G-SIFI resolution, but – of the proposals provided in Annex 1 – we consider as very useful the concept of the host country's powers in the resolution of branches of foreign financial institutions established within its territory.*

We consider, however, that some proposals in this document are potentially problematic; in particular it is not possible at present to support the emphasis on minimising total impact in cross-border resolution. Such a procedure assumes (i) the introduction of a group interest concept into legislation of all relevant jurisdictions and (ii) burden-sharing agreements concluded among all relevant jurisdictions.

We also deem it necessary to emphasise that coordination role of a home country must never be interpreted as any decision-making power vis-à-vis host country authorities. We strongly refuse the concept where the host country is entitled to create its own resolution plans or take its own resolution measures only in the case of insufficiently effective cooperation of the home country or a CMG or upon agreement with the home state. Each country is responsible for financial stability within its territory and so it is its competence to require creation of resolution plans whenever it finds it justified. It does not mean, however, that such resolution plans should not be coordinated, where possible, within the financial group.

For the same reason we agree that all authorities should take into account the impacts of their measures in other jurisdictions, but we must refuse any imposition of the obligation on any country's authority not to adopt measures which they consider necessary only due to potential impacts on other jurisdictions. The individual countries can commit themselves to such a procedure only by a contract.

We do not support the proposals that directly or indirectly lead to the obligation to establish resolution funds. The ensuring of funds for financing the resolution is solely within the competence of each jurisdiction and we do not see sufficient reasons for harmonisation in this respect.

We consider it necessary to define plans for recovery or resolution measures and responsibility for their preparation based on the nature of such activities. Responsibility for planning recovery and resolution measures based on legal instruments available to the financial institution itself (sale of assets, subsidiaries, part or all of the business to another market participant, an increase in capital in the form of subscriptions of new shares or a conversion of convertible bonds etc.) must fall within the financial institution, not resolution authorities. On the other hand, resolution authorities must have instruments and procedures at hand available only to them, which they will be able to quickly and flexibly implement if standard solutions fail (receivership, bridge bank, bail-in, etc.).

We also believe that to request the other group members to continue providing necessary services to the institution in resolution should be possible only on condition of consent by both competent supervisors, as in the case of intra-group financial support.

3. Are the elements identified in Annex 2: Bail-in within Resolution: Elements for inclusion in the Key Attributes sufficiently specific to ensure that a bail-in regime is comprehensive, transparent and effective, while sufficiently general to be adaptable to the specific needs and legal frameworks of different jurisdictions?

CNB position: *We consider the elements identified in Annex 2 mostly as acceptable, but sufficient impact studies have not been conducted yet to prove a practical applicability of the bail-in concept and reveal its possible pitfalls. It is difficult to express an opinion on the tools, with which there is only very limited experience. Despite various considerations about their setting, the impact assessment of such a regime would be just a speculation.*

Even provided that the above impact studies confirm practical usability and legal feasibility of some of the proposed approaches, however, the consultative document should lead, at most, to non-binding recommendation addressed to the jurisdictions. The individual countries should have the

possibility to adopt their own solutions. This applies also to all other questions and answers to this consultative document.

4. Is it 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?

CNB position: *We consider it appropriate that the scope of liabilities covered by statutory bail-in powers is as broad as possible, but it should be left to individual jurisdictions to set their own binding rules. See answer to question 3.*

5. What classes of debt or liabilities should be within the scope of statutory bail-in powers?

CNB position: *We consider it appropriate that one of the scenarios of necessary impact studies tests a situation where subject to bail-in will be all liabilities of unsecured and uninsured creditors except those listed below in the answer to question 6.*

6. What classes of debt or liabilities should be within the scope of statutory bail-in powers?

CNB position: *We believe that it is desirable that specific groups of debts are excluded from the application of the measure. In particular they should include insured client deposits and debts to funds, whose clients are consumers (e.g. pension funds, standard UCITS funds), if the extent to which they are authorised to take equity risk is exceeded. By contrast, we believe that in the case of debts to persons from the same consolidation group or persons with close links as defined in the Capital Requirements Directive (CRD) it is admissible that no protection applies to them.*

7. Will it be necessary that authorities monitor whether firms' balance sheet contain at all times a sufficient amount of liabilities covered by bail-in powers and that, if that is not the case, they consider requiring minimum level of bail-in debt? If so, how should the minimum amount be calibrated and what form should such a requirement take, e.g.:
(i) a certain percentage of risk-weighted assets in bail-inable liabilities, or
(ii) a limit on the degree of asset encumbrance (e.g., through use as collateral)?

CNB position: *We consider it useful to monitor – in addition to capital adequacy – also the level of those bail-inable liabilities that are not already at present considered as a part of financial institutions' capital base. The obligation to hold such additional bail-inable liabilities should be assessed also with regard to the institution's capital adequacy. If the equity capital is high, there is no reason to insist on holding additional bail-inable liabilities.*

8. What consequences for banks' funding and credit supply to the economy would you expect from the introduction of any such required minimum amount of bail-inable liabilities?

CNB position: *It is inappropriate to assess the impact of such a requirement separately. It should be evaluated as part of new regulations requiring banks to hold higher capital of better quality and more highly liquid assets. The requirements to maintain a certain amount of bail-inable liabilities will have similar effects.*

Nonetheless, the assessment of the whole package is also very difficult and there are different opinions among regulators, bankers and academics. It can be assumed that the implementation of the widely defined bail-in, as of higher capital and liquidity requirements, will lead to higher costs of bank financing (creditors will demand higher yield on their receivables from the SIFIs). At the same time a negative effect on credit supply to the private sector can be assumed. This effect may result in weaker long-term economic growth.

The positive aspects of the new regulations can balance the negative effects: better risk management, increased stability of banks, internalisation of some negative externalities, etc. Given the present knowledge of cumulative impacts of the currently discussed regulatory measures it is difficult to estimate the resulting balance, but – in view of the nature of the whole package – we think that a certain negative effect on economic growth is probable in the long run. At the same time we point out that overall behaviour impacts of new regulations are also difficult to estimate: e.g. if the management is led to very high responsibility for loss operations and shareholders are afraid of being squeezed out, risk aversion may rise above the optimal level. On the other hand, there may be pressure to offset the reduced return on equity by investing in more risky projects with higher yields.

Overall, it is therefore necessary, in our opinion, to consider very carefully whether the negative effects of new regulations are not too high relative to their benefits. It may seem from the perspective of roughly last five years that this need not be the case, but these issues must be viewed from the long-term perspective, and the assessment of potential benefits and costs of bail-in implementation is far from being unambiguous in the long run.

It is necessary to consider the effects of the requirement also in a crisis period, when it would be implemented. At turbulent times of a crisis, financial markets are extremely sensitive to any signs of uncompromising squeeze-out of the existing shareholders (and potentially some creditors). Such squeeze-out can seem correct at a certain moment and vis-à-vis a certain institution, but the impacts on the financial market may be very hard, as such action may lead to contagion on the financial market and the intensification of turbulence with potential negative effects on economic growth and financial stability. From this point of view it is important that the bail-in concept confers wide powers upon the supervisory authority, but at the same time leaves it the possibility to act appropriately and take into account the wider context of potential adverse effects on the financial markets.

We also do not agree with a limitation allowing the host authority to make the bail-in at the subsidiary level only on condition that "no alternative group-wide solution would achieve a more favourable outcome from a host country perspective and from a cross-border financial stability perspective". Financial stability in other countries would thus be placed at the same level of importance as financial stability in the host state itself. If there exist two solutions of a problem situation, which are identical from the perspective of the host country's stability and one of them is at the same time more advantageous from the perspective of cross-border financial stability, such solution should obviously be chosen. If, however, one solution is more appropriate from the perspective of the host country's financial stability and the other from the perspective of cross-border stability, the host country's authority must see primarily to financial stability within its territory, for which it is responsible under the host country's legislation.

We further point out that in practice it will probably never be possible to determine accurately, what would be the result of an insolvency proceeding for each shareholder and creditor affected by the resolution.

9. How should a statutory duty to cooperate with home and host authorities be framed? What criteria should be relevant to the duty to cooperate?

CNB position: *The debate on a statutory duty to cooperate is problematic in our opinion. The cooperation between home and host authorities should take place on the basis of non-binding agreements on coordination of activities linked to the resolution of financial institutions. The CMGs should be interconnected as much as possible with other authorities and platforms (e.g. colleges of*

supervisors in the EU) to avoid duplicity. It is important to take into account the impact on other countries, but is must not prevent host jurisdictions to take effective measures to protect domestic market stability.

10. Does **Annex 3: Institution-specific Cross-border Cooperation Agreements** cover all the critical elements of institution-specific cross-border agreements and, if implemented, will the proposed agreements be sufficiently reliable to ensure effective cross-border cooperation? How can their effectiveness be enhanced?

CNB position: *We consider it necessary to complement Annex 3 for example by determining the moment of coming into effect of the cooperation agreements and by provisions on the release of any of the parties from such an agreement.*

Furthermore, it is not possible at present to support the emphasis on minimisation of total impact in cross-border resolution. Such a procedure assumes (i) the introduction of a group interest concept into legislation of all relevant jurisdictions and (ii) burden-sharing agreements concluded among all relevant jurisdictions. If the agreements are not legally binding, doubts can be cast on their effectiveness, but making them legally binding would be very difficult in our opinion.

11. Who (i.e., which authorities) will need to be parties to these agreements for them to be most effective?

CNB position: *It is appropriate to harmonise the parties to these agreements with the existing (or upcoming) similar forums, authorities and groups (in the EU for example MoU 2008, or Cross-Border Stability Groups, colleges of supervisors, European supervisory authorities). In general, we consider it more effective if the resolution is conducted by the supervisory authority. This reduces the number of CMG members and increases the effectiveness. The decision on institutional arrangements should be left to each country, however. The parties to the agreements must have sufficient powers and adequate legal protection.*

12. Does **Annex 4: Resolvability Assessments** appropriately cover the determinants of a firm's resolvability? Are there any additional factors to be considered in determining the resolvability of a firm?

13. Does Annex 4 identify the appropriate process to be followed by home and host authorities?

CNB position: *We consider the content of Annex 4 to be generally acceptable; however, resolvability assessments will always fall within the competence of competent authorities of concerned states, which have to choose themselves appropriate criteria and procedures. The FSB recommendations should constitute only non-binding instructions; besides it is clear that the list of factors will never be exhaustive.*

14. Does Annex 5: Recovery and Resolution Plans cover all critical elements of a recovery and resolution plan? What additional elements should be included? Are there elements that should not be included?

CNB position: *We consider the list of RRPs elements in Annex 5 to be overall sufficient; however, it will always fall within the competence of concerned states to specify binding RRPs elements. The states must have the right to choose elements other than those listed in the FSB recommendations. The FSB recommendations should constitute only non-binding guidance. For instance, a description of the legal and regulatory environment may be useless in some cases.*

The provision of intra-group financial support, including transfers of liquidity and assets within the group, mentioned as a possible part of recovery or resolution plans, must be admissible only under the condition of consent by both competent supervisors, i.e. the authority supervising the transferor of assets and the authority supervising the transferee.

We consider it necessary to define plans for recovery or resolution measures and responsibility for their preparation based on the nature of such measures. Responsibility for planning recovery and resolution measures based on legal instruments available to the financial institution itself (sale of assets, subsidiaries, part or all of the business to another market participant, an increase in capital in the form of subscriptions of new shares or a conversion of convertible bonds etc.) must fall within the responsibility of financial institution, not resolution authorities. On the other hand, resolution authorities must have instruments at hand available only to them, which they will be able to quickly and flexibly implement if standard solutions fail (receivership, bridge bank, bail-in, etc.).

We further disagree with necessarily involving top officials of supervisory or resolution authorities in RRPs assessments. These are activities with a high degree of technical detail, in which rather senior executive officers of supervisory or resolution authorities should participate. Moreover, a compulsory involvement of top officials might to unnecessarily politicize the supervisory process.

15. Does Annex 5 appropriately cover the conditions under which RRPs should be prepared at subsidiary level?

CNB position: *We strongly refuse the concept when the host country is entitled to create its own resolution plans or take its own resolution measures only if the group resolution plan is insufficient or upon agreement with the authority of the home country. Each country is responsible for financial stability in its territory. The host country must have the option of creating all plans as deemed appropriate, upon its own initiative and at its sole discretion. We can of course agree with cross-border coordination.*

16. Are there other major potential business obstacles to effective resolution that need to be addressed that are not covered in Annex 6?

17. Are the proposed steps to address the obstacles to effective resolution appropriate? What other alternative actions could be taken?

18. What are the alternatives to existing guarantee / internal risk-transfer structures?

19. How should the proposals set out in Annex 6in these areas best be incorporated within the overall policy framework? What would be required to put those in place?

CNB position: *We consider the procedures identified in Annex 6 to be overall sufficient; however, individual jurisdictions may identify other obstacles to resolvability and choose other procedures to improve it. The submitted proposals are undoubtedly justified, but the list cannot be deemed final. It also depends on the type of institution, type of activities, organisational structure. Different measures can be suitable for different groups. At the same time, we would like to point out that the above recommendation can be considered an example of an ideal situation, but reaching it might be very costly and in some cases not feasible.*

20. Comment is invited on the proposed milestones for G-SIFIs.

CNB position: *We consider the proposed schedule to be unrealistic; these are very complex activities requiring time for conducting necessary analyses and a subsequent preparation, including*

building up material and staff resources. If the proposals are submitted to G20 in autumn 2011, it cannot be assumed realistically that the first draft recovery plans in line with these proposals will be available in December 2011. The schedule must be thus adjusted, taking into account other parts of this public consultation (e.g. necessity of impact studies in relation to bail-in). This of course does not affect the fact that supervisory authorities and authorities responsible for financial system stability should already today monitor significant institutions and prevent negative impacts of their failure.

21. Does the existence of differences in statutory creditor rankings impede effective cross-border resolutions? If so, which differences, in particular, impede effective cross-border resolutions?

22. Is a greater convergence of the statutory ranking of creditors across jurisdictions desirable and feasible? Should convergence be in the direction of depositor preference or should it be in the direction of an elimination of preferences? Is a harmonised definition of deposits and insured deposits desirable and feasible?

23. Is there a risk of arbitrage in giving a preference to all depositors or should a possible preference be restricted to certain categories of depositors, e.g., retail deposits? What should be the treatment of (a) deposits from large corporates; (b) deposits from other financial firms, including banks, assets managers and hedge banks[1], insurers and pension funds; (c) the (subrogated) claims of the deposit guarantee schemes (especially in jurisdictions where these schemes are financed by the banking industry)?

24. What are the costs and benefits that emerge from the depositor preference? Do the benefits outweigh the costs? Or are risks and costs greater?

25. What other measures could be contemplated to mitigate the impediments to effective cross-border resolution if such impediments arise from differences in ranking across jurisdictions? How could the transparency and predictability of the treatment of creditor claims in a cross-border context be improved?

CNB position: *We believe that the issues of the creditor ranking and depositor preference are significant mainly for the application of bail-in. As we note in the reply to the relevant part of the Consultation Document, sufficient impact studies have not been conducted yet to prove a practical applicability of the bail-in concept and reveal its possible pitfalls. We consider it useful to discuss suitable adjustments in respect of the creditor hierarchy and depositor preference only on the basis of such studies. Anyway, labelling some liabilities as potentially usable for bail-in will mean lower demand for these instruments and higher costs of obtaining them for institutions; differences in the hierarchy of creditors in different jurisdictions may result in unequal conditions. Currently we do not deem it feasible to achieve highly unified legislation globally.*

26. Please give your views on the suggested stay on early termination rights. What could be the potential adverse outcomes on the failing firm and its counterparties of such a short stay? What measures could be implemented to mitigate these adverse outcomes? How is this affected by the length of the stay?

CNB position: *Although this is a harsh interference with contractual freedom, we believe that this is a potentially useful power of resolution authorities. However, impact studies need to be compiled and simulations of alternatives included, which can be expected when this tool is applied, including*

[1] The Consultation Document uses the terms „hedge banks“, its authors might have meant „hedge funds“.

partial transfers of assets and liabilities and their impacts on the residual entity. Such decisions cannot be made based only on replies from a public consultation.

It should be also noted that the proposed measures may collide with the settlement finality principles under Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems.

27. What specific event would be an appropriate starting point for the period of suspension? Should the stay apply automatically upon entry into resolution? Or should resolution authorities have the discretionary right to impose a stay?

CNB position: *An automatic suspension of the right seems to be more appropriate; the resolution authority should have an option of deciding that the suspension of the early termination right is not necessary in a given case. Nevertheless, the choice between the discretionary and automatic mechanisms should remain within the competence of individual jurisdictions.*

28. What specific provisions in financial contracts should the suspension apply to? Are there any early terminations rights that the suspension should not apply to?

CNB position: *We believe that until the specific features of temporary suspension of rights are better specified (e.g. as regards the maximum duration), we cannot specifically comment what contractual provisions it should apply to. However, we agree with the idea that the stay should not prevent early termination for reasons of failure to pay or deliver other performance (, under any contract made between the parties (i.e. the duty to meet margin calls; to transfer the coupon, etc.; if a party breaches the duty under one contract, the counterparty should retain a right to early terminate other contracts).*

We also believe that the counterparty should have a right to terminate transactions in accordance with the 'credit event upon merger' provisions – i.e. if rights and obligations from a contract are transferred and the transferee fails to comply with the negotiated criteria, the counterparty should have an option to act according to the contract and terminate the transactions. In this context, we would like to note that rights and obligations arising from some contracts (e.g. TBMA/ISMA Global Master Repurchase Agreement) cannot be transferred without the other party's consent, and this limitation should also be addressed.

Also solved should be the stay or non-stay of the right not to comply with the obligations arising from a contract if not complied with by the counterparty or if a pre-negotiated event occurred in this counterparty (including insolvency and similar proceedings). We believe that this right should also be retained but this might at the same time result in deeper problems of a financial institution. Therefore, a deeper analysis of this issue would be appropriate.

The proposal in the Consultation Document as well as the input obtained in this consultation should be used solely as a starting point for necessary analyses and variant impact studies, see reply to Question 26.

29. What should be an appropriate period of time during which the authorities could delay the immediate operation of contractual early termination rights?

CNB position: *This decision should remain within the competence of individual jurisdictions. Situations of various complexities may require various periods of time of suspension of rights with a certain upper limit but also with a possibility of extending the period in justified cases. A necessary*

condition would be assessing the impact of this measure on financial markets, costs of obtaining etc.

30. What should be the scope of the temporary stay? Should it apply to all counterparties or should certain counterparties, e.g., Central Counterparties (CCPs) and FMIs, be exempted?

CNB position: *This question cannot be answered without conducting simulations of the introduction of this measure and assessing their results. One of the variants examined in these simulations should undoubtedly examine the impacts of the introduction of this measure if its effects on central counterparties and financial market infrastructure entities are excluded. Further, it is advisable to consider the situation where the resolved institution uses various financial market infrastructures in various jurisdictions and the suspension of rights is not effective in all these jurisdictions.*

31. Do you agree with the proposed conditions for a stay on early termination rights? What additional safeguards or assurances would be necessary, if any?

CNB position: *Decisions about suitable protective measures should remain within the competence of individual jurisdictions, however, they should be known to creditors in advance. As in the case of the introduction of the bail-in power, a certain transition period is also necessary for this power so that financial institutions and their counterparties could respond reasonably to the new regulation.*

The formulation of the protection measure referred to in the Consultation Document[2]*, page 73, paragraph 5(viii) is very vague, it is necessary to make its content more specific.*

32. With respect to the cross-border issues for the stay and transfer, what are the most appropriate mechanisms for ensuring cross-border effectiveness?

CNB position: *The contractual mechanism seems to be most appropriate and market-conforming; as a subsidiary option, the courts mechanism could also be taken into consideration.*

33. In relation to the contractual approach to cross-border issues, are there additional or alternative considerations other than those described above that should be covered by the contractual provision in order to ensure its effectiveness?

CNB position: *Also for this question we believe that it is necessary to conduct simulations of this procedure and its consequences for contracts governed by laws of various jurisdictions. The aspects mentioned in the Consultation Document seem to be a good starting point for these simulations.*

34. Where there is no physical presence of a financial institution in question in a jurisdiction but there are contracts that are subject to the law of that jurisdiction as the governing law, what kind of mechanism could be considered to give effect to the stay?

CNB position: *We believe that this issue is well covered by the contractual mechanism.*

[2] „Such legal authority would be implemented so as to avoid compromising the safe and orderly operations of regulated exchanges, Central Counterparties (CCPs) and financial market infrastructures (FMIs).“