Finance for Europe

Association for Financial Markets in Europe

Risk adjustment of contributions to resolution funds and DGS

17 March 2014

This note sets out AFME's views on the important issue of the calibration of the risk adjustment of contributions to resolution funds under the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Fund (SRF) under the Single Resolution Mechanism and deposit guarantee schemes (DGS) under the Deposit Guarantee Schemes Directive (DGSD).

The risk adjustment of contributions is the subject of Commission delegated acts under Article 94 of the BRRD and the risk adjustment of contributions to the SRF should be consistent with this. The risk adjustment of contributions to DGS is the subject of EBA guidelines under Article 11 of the DGSD and these should also approach the risk adjustment in a consistent manner.

Key principle

The risk adjustment of contributions to BRRD resolution funds, the SRF and DGS should be focused upon ensuring that **an institution's contributions reflect the risk of loss that it poses to the relevant fund**. This approach would maximise incentives for firms to reduce the risk that they pose to the fund and minimise moral hazard. Contributions based on any other principles are likely to create perverse incentives. For example, absent an appropriate adjustment, raising additional loss absorbing debt which does not class as own funds would increase contributions despite reducing the risk to the fund.

In order to assess the risk of loss to the fund, we propose that this should be calculated based upon an assessment of the following components:

(i) the probability that the institution fails and enters resolution (in respect of resolution funds) or that the DGS is triggered (in respect of DGS); and

(ii) the risk of loss to the fund in such event.

We consider how these factors should be assessed in the context of resolution funds and DGS below.

The risk adjustment should be conducted on an annual basis to ensure that it reflects changes that are made by firms to reduce the risk that they pose and to take account of changes in the market.

A. Risk adjustment of contributions to resolution funds

(i) Probability of entering resolution

The probability of an institution entering resolution should involve an assessment of:

a) the probability of failure of the institution; and

b) the likelihood that in the event of its failure it would be placed into resolution.

We suggest that the probability of failure of an institution should be based upon a supervisory assessment of a range of indicators including its capital adequacy (including leverage), asset quality and liquidity profile because it cannot be determined solely by reference to any particular ratio. This assessment should utilise existing indicators and supervisory processes rather than creating a new risk assessment process and be based upon consistent factors across the EU. The assessment should also take account of actions that could be taken by the group to avoid failure under the institution's recovery plan and avoid measures that would result in unpredictability and pro-cyclicality of contributions.

The assessment of the probability of failure should be given significant weight and provide incentives for banks to take steps to increase capital, conduct less risky business and ensure that they have adequate liquidity available. The risk assessment would therefore reinforce the objectives of prudential regulation.

The probability of entering resolution should reflect whether the particular institution would be placed into resolution under the relevant group resolution plan. For example, where the plan involves only one entity or certain entities in the group being placed into resolution, the fund is less likely to be used for those entities which are not planned to be placed into resolution.

It should also take account of the likely systemic (whether global or domestic) impact of the failure of the firm and whether it falls within the scope of the waivers or simplified obligations in Article 4 of the BRRD. However such assessment should not be limited to the impact of the failure of the institution alone, but should also recognise that the fund could be used for any bank and that the failure of a number of institutions which on their own might have a small impact on the financial system could together have a systemic impact and therefore require resolution. All banks should therefore contribute to the fund as they benefit from its potential use.

(ii) Risk of loss to the resolution fund

The risk of loss to a resolution fund should reflect the likelihood that a resolution of the institution would require the use of the resolution fund. In the vast majority of cases there should be no need for use of the fund to absorb losses, as these would be imposed upon shareholders and creditors of the group in accordance with the resolution framework and the group resolution plan. The risk of loss to the resolution fund should therefore take account of the recovery capability and resolution strategy of the institution and whether, in the event that the institution was placed into resolution, it is likely that the resolution fund would be used.

It should also reflect the resolvability of the institution and its loss absorbing capacity. The best way of assessing this would be based upon the level of liabilities that are not excluded from bail-in relative to the size of the balance sheet and potential losses. This would reflect the fact that the greater the level of "bail-in-able" liabilities, the greater the loss absorbency available and therefore the lower the likelihood that a resolution fund would be used for loss absorption. Use of resolution funds for liquidity purposes should not result in losses to the fund because funding would be provided on a secured basis against the bank's assets.

The risk of loss to the fund in the event of failure should be given significant weight in the risk assessment. This would provide incentives for banks to increase their loss absorbing capacity and improve their resolvability. Absent an appropriate adjustment, banks could be disincentivised from raising additional loss absorbing capacity because they would perversely increase their contributions by issuing loss absorbing debt which does not class as own funds. It is also a key factor in assessing the risk to the fund.

(iii) Intra-group liabilities

It is also necessary to ensure that the assessment of contributions based upon the liabilities of each institution in a group does not result in double-counting of intra-group liabilities.

For example, if parent institution A issues €100m debt externally, it creates liabilities of €100m which would be included in A's contribution to the resolution fund. If A then lends this to its subsidiary B, it creates a liability of B to A of €100m. The intra-group liability of B to A would be reflected in the contribution of B to its resolution fund, resulting in the group paying twice for what on a consolidated basis would be a single liability of €100m.

We suggest that this is addressed by deducting intra-group liabilities from the assessment base of total liabilities less own funds and covered deposits.

B. Risk adjustment of contributions to DGS

(i) Probability that the DGS is triggered

The probability that the DGS is triggered should be based upon the probability that deposits become unavailable, which is the trigger for payout by the DGS. This should be based on the probability of failure of the institution, assessed in the same manner as considered above in respect of resolution funds, i.e. based on a supervisory assessment of the institution's capital adequacy (including leverage), asset quality and liquidity profile and adjusted to take account of actions that could be taken by the group to avoid failure under its recovery plan.

(ii) Risk of loss to the DGS

The risk of loss to the DGS should be based upon the proportion of liabilities that are subordinated to covered deposits, reflecting the seniority provided to covered deposits under the BRRD and that the DGS would not suffer any losses unless the institution incurred losses in excess of all such subordinate liabilities.

The risk assessment should reflect, as a secondary aspect, the fact that covered deposits are highly unlikely to become unavailable if the institution is placed into resolution, as a key objective of resolution is to maintain access to covered deposits. In this case, if the institution does not have a significant amount of liabilities subordinated to covered deposits, the DGS may be required to make a contribution under Article 99 of the BRRD based on the losses that covered depositors would have suffered. The value of the contribution is likely to be lower than the losses that the DGS would suffer in a liquidation of the institution and therefore if an institution is likely to be placed into resolution in the event of its failure, the risk of loss to the DGS should be lower.

Accordingly, the probability of entering resolution in the event of failure should also be reflected in the risk assessment of DGS contributions such that the greater the likelihood of being placed into resolution in the event of failure, the lower the risk of loss to the DGS. The probability of entering resolution in the event of failure should be assessed in the same manner as discussed above in respect of contributions to resolution funds.

C. Summary of proposed approach

The following tables summarise the approach suggested above. We suggest that these factors could helpfully be set out in a "scorecard" similar to the approach taken to the risk adjustment of contributions to the Deposit Insurance Fund in the US.[1]

1. Risk adjustment of contributions to resolution funds

Risk adjustment component	Method of assessment
Probability of failure	Supervisory scoring of: • Capital adequacy (including leverage); • Asset quality/risk; and • Liquidity assessment. It should also reflect the feasibility of recovery actions that could be implemented to avoid failure.
Probability of entering resolution in the event of failure	Assessment of: • the likely systemic (global or domestic) impact of the failure of the firm or a number of similar institutions; • whether or not the firm comes within the scope of waivers or simplified obligations under Article 4 of the BRRD; and • whether the institution would be placed into resolution under the group resolution plan.
Risk of loss to the fund	Assessment of: • the likelihood that, in the event that the institution was placed into resolution, it would require the use of the resolution fund, taking account of the recovery capability, loss absorbing capacity and resolution strategy of the institution; and • the level of liabilities that are not excluded from bail-in relative to the size of the balance sheet and potential losses.
Adjustment to remove double-counting of intra-group liabilities	Adjustment of the assessment base to remove intra-group liabilities.

[1] A summary of the FDIC approach is available here: http://www.fdic.gov/news/news/financial/2011/fil11008.pdf

2. Risk adjustment of contributions to DGS

Risk adjustment component	Method of assessment
Probability of failure	Supervisory scoring of: • Capital adequacy (including leverage); • Asset quality/risk; and • Liquidity assessment. It should also reflect the feasibility of recovery actions that could be implemented to avoid failure.
Risk of loss to the fund	• The ratio of (i) liabilities that are subordinated to covered deposits to (ii) total liabilities. • Adjustment to reduce the risk of loss where the probability of entering resolution in the event of failure is higher, assessed on the basis of: o the likely systemic (global or domestic) impact of the failure of the firm or a number of similar institutions; o whether or not the firm comes within the scope of waivers or simplified obligations under Article 4 of the BRRD; and o whether the institution would be placed into resolution under the group resolution plan.

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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF Preliminary views on the Delegated and Implementing Acts on Contributions to Resolution Financing Arrangements under the BRRD and the SRM Regulation

The design of fund contributions is a key first step in the implementation of the crisis management framework aimed at fostering financial stability. Nevertheless, fund contributions, whether under the BRRD, SRMR or DGSD, will have a significant impact on the earnings of European financial institutions over the next decade.

In this context, the EBF members are ready to contribute to the debate on the way forward to calibrate accurate and balanced risk factors which will ensure that contributions reflect both the probability of failure and the drawdown on the funds that would be necessary in such case, while respecting different business models.

As a preliminary basis, the EBF members wish to put forward key principles that the ensuing delegated and implementing acts on the matter should respect:

Decisions must be based on correctly compiled and up-to date figures. Correct and up-to-date data is key to perform accurate simulation exercises and impact assessments. Failure to meet this pre-requisite could lead to competitive distortions and hinder the Single Market. We would also call upon the Commission to ensure that any individual bank data and indicators used in contribution calculations are harmonised and comparable and based on readily available and reliable figures. In this respect, the choice of indicators should be conducted with the ECB and the national supervisors to ensure that the individual bank data needed will be readily available.

We note that data referring to Basel III indicators is not available for all banks as of 31 December 2012. The Commission should therefore consider the possibility to move forward the reference date to 31 March (or 30 June 2014), when new COREP data will be available for all banks.

Principle of universality (no exceptions): All institutions should contribute in a proportionate way to their respective resolution financing arrangements on the basis that even small entities might trigger a systemic event, and that all entities benefit from the financial stability fostered by their existence.

The flat part and the risk adjusted part should be well balanced. Given the principle of universality (no exceptions), the flat part should account, in monetary terms, for at least 50% of the total monetary contribution. Nevertheless, the risk adjusted part should provide a sufficient differentiation in terms of contributions between banks based on their individual risk profiles. The decision of the weighting scheme and the calculation method for combining the flat and risk adjusted parts should be postponed until the final risk indicators are known and a proper impact assessment has been conducted. Banks need as much certainty as possible to calculate their contributions. As a general principle, the calculation and the ratio of the flat part vs. the risk adjusted part should be as predictable, simple and transparent as possible.

The contribution should be neutral with respect to a bank's business structure. No business model or resolution strategy should be unduly advantaged or penalised by the contribution method. Moreover, attention must be paid to avoid any duplication of contributions. The treatment of intragroup liabilities must be carefully considered to equally avoid that they are omitted or counted twice in the calculation of contributions.

The scope of the contribution basis must be clarified. A banking group's total contributions should cover all the institutions which are under the scope of the fund or financing arrangement in question, excluding insurance for conglomerates and unregulated entities. Regarding third countries, it must be clear that the scope only covers subsidiaries of the third-country parent within the Union. These considerations apply not only in relation to the Banking Union, but also in relation to the calculations under Article 99 in the BRRD. We note that there are several advantages and drawbacks to base the calculation of contributions on a consolidated or solo entity level. We outline these pros and cons in the appendix.

Furthermore, EBF Members note that the treatment of derivatives and repo transactions and other collateralised liabilities should be carefully assessed not to unduly increase the basis of the contributions or to deviate from established accounting and prudential standards.

Contributions should be raised on an annual basis based on audited year end data. EBF members do not believe that more frequent calculations and contributions are desirable, as not all banks produce interim accounting and reporting, and the administrative burden of contribution calculations should be limited for all concerned. Further, measurement based on year-end data should not prevent banks from accounting for the cost of their contribution to resolution funds through the year.[1]

Ensuring consistency with the Single Rulebook and guarding the level playing field between SRM, BRRD and DGSD. The Commission should ensure that the calculation methods for SRM, BRRD and DGSD contributions are aligned, so that the provisions of preamble (66) of the SRM are respected ("without creating distortions between banking sector structures of the Member States") and that transitional arrangements between BRRD and SRM do not provide Member States with perverse incentives to join, or to leave the SRM.

Pro-cyclicality of contributions should be minimised taking into account the overall commitments of banks to resolution financing and deposit insurance funds. High fixed annual costs push troubled banks closer to failure. SRM legislation requires contributions to be spread out "with due account to the phase of the business cycle and the impact that pro-cyclical contributions may have". A similar "prudential cap" to that for ex-post contributions will achieve this. Exemptions and deferrals for one institution should not place additional burden on other banks within the EU to make up the shortfall for the total industry contribution. Banks should "carry forward" their unpaid contributions in years when the cap is not met by adding them to their annual contribution the following year.

[1] We anticipate that a contribution to a resolution fund would fall within the scope of IFRIC 21 which clarifies that such a liability is recognised progressively if the activity that triggers the payment, as identified by the legislation, occurs over a period of time. It must be avoided that the total amount due over the entire period would have to be recognised up-front. To meet this requirement there will need to be clarity that the obligation to make a contribution to the resolution fund occurs over a period of time but that the measurement is against the year-end balance sheet. An express statement to this effect should be included in the relevant act.

The criteria for risk based contributions should reflect the relative risk and the cost to resolution funds for a bank in relation to its peers and follow the following principles:

- The risk profile methodology should be comprehensive, comparable, transparent and simple.
- Risk factors should be current regulatory benchmarks already available or in the course of being established.
- There should be no duplication of risk factors. Correlation between different risk factors should be avoided. Certain indicators will be already covered by the flat rate (like total assets/GDP).
- Any resolution fund contribution must not negatively impact other objectives such as an institution being incentivised to have sufficient MREL.

The following observations should be taken into account when assessing possible indicators for the prescribed criteria below to measure risk for the risk based part of the contribution:

a) the risk exposure of the institution, including the importance of its trading activities, its off-balance sheet exposures and its degree of leverage:

The risk exposure should be reflected through a range of indicators which focus on the quantity and quality of capital, liquidity and risk. Regulatory ratios combine the elements together. The leverage ratio by itself is not a sufficient indicator of the riskiness of the balance sheet (e.g. two banks with the same leverage ratio can have extremely different risk profiles when comparing credit risk, market risk, counterparty risk, etc.). Therefore, due consideration should also be given to total regulatory capital, the capital ratios CET1, RWA/total assets and bail-inable debt. The interrelationship of these measures needs to also be taken into consideration.

b) Stability and variety of funding and unencumbrance of assets:

We believe the Loan-to-Deposit (LTD) ratio does not take into account differences in business models across EU banks.[2] In addition, it would disproportionally penalise commercial banks and lending to the real economy. Therefore, we propose removing this indicator as a criterion to quantify the stability and variety of funding. We suggest replacing this indicator with the LCR and NSFR indicators in order to measure the stability and variety of funding in the short and long term.

EBF Members note that currently there is no commonly agreed definition or benchmark for asset encumbrance which could inform a risk based calculation in a comparable or meaningful manner.

c) Financial condition

The profitability of an institution is, we believe, unsuitable as a criterion for calculation of its contribution. This criterion does not say anything about what risks exist within an institution and how these are managed. The concept of financial condition is better captured by capital and liquidity indicators mentioned already above. The Commission may further look to find a measure that would capture a sustainable business model.

d) Probability that the institution enters into resolution:

We agree with the Commission's view that this parameter is already covered by other criteria such as capital and liquidity ratios.

[2] For example; the loans percentage of loans over the total assets of one European investment bank is 23 %%, that it is not represents the whole balance sheet.

e) Extent to which the institution has previously benefitted from extraordinary public financial support:

EBF Members question the validity of this criterion as a necessary indicator of structural weakness for a bank. If public support measures have been imposed, then they must have been considered to be in the public interest. If this is the case, there should be no need to penalise such banks with additional contributions. Should this criterion be retained, further details on this indicator must be specified i.e. the kind of capital aids (or separate capital/ guarantees/ liquidity support or resolution financing). These will have to be further quantified in terms of the time that has elapsed and the public monies received.

Furthermore, counterbalancing public support and its own restructuring measures need to be considered, i.e. the criteria that a company has received state-aid in the past should not play any role in the risk contribution to the SRF, if the bank has been subjected to severe restructuring plans and/or paid back public support loans from its own resources. There is no reason to assume that banks that have received state-aid and have been required to restructure with far-reaching consequences and/or have already re-paid the public support are more risky. The contrary could be argued.

However, if state aid is used as a factor the EBF advocates assigning a lower weighting to this factor. Furthermore, EBF Members do not believe that the use of public support in the past should be considered. Only the use of public support and resolution financing going forward from the transposition of the BRRD and SRM should be considered.

f) Complexity and resolvability of an institution

Complexity and resolvability are important indicators in the framework used by authorities to define systemically important banks. However, the size or/and interbank exposures criteria, although they may be simple and transparent indicators, do not reflect the complexity and resolvability of a banking group.

Furthermore, the new regulatory framework has several general as well as national optional requirements targeting systemically important banks with the aim of minimising systemic risk. Hence, including a benchmark based on these kinds of measures would create an additional burden to mitigate a risk that is already well considered in the new regulatory framework.

The assessment of the complexity and resolvability of the structure of an institution is in nature more qualitative, which should be conducted by the resolution authority, solely and exclusively, after the resolvability assessment has been completed. The EBF therefore recommends taking into account the absence/existence of obstacles to resolvability (cf. art 15 or 16 of BRRD) (including the availability of bail-inable debt (MREL) as a binary indicator which decreases/increases the contribution respectively.

g) Importance of an institution to the stability of the financial system or economy:

Merely using size to approximate systemic importance is not appropriate. In addition, we note that size already lies at the basis of the flat contribution. Therefore, the use of Total Assets / GDP should be avoided. Furthermore, systemically Important Institutions (global or domestic) will be subject to higher capital requirements that should mitigate risk. Thus, any “double counting” of their status should be avoided. Furthermore, we believe that this indicator should take into account the framework currently being developed by the EBA with regards to the definition of a synthetic score to identify Other Systemically Important Institutions (O-SIIs) or in the case of the Banking Union the SSM criteria to identify significant banks subject to the direct prudential supervision of the ECB in the euro area. The proposed criteria (Total Assets / GDP, Exposure to Credit Institutions and other financial corporations / Total Assets) would then already be captured and need not be reassessed.

The EBF suggests to deal with financial interlinking on the liabilities side. The purpose cannot be to give a negative incentive to banks offering funding to other financial institutions. The re-opening of the interbank market should be an objective of European public policy.

h) the fact that the institution is part of an IPS.

Membership of an institutional protection scheme should not, on its own, be recognised as a criterion for a reduced contribution. What would have to be taken into account/examined is whether an institution is so big that it may stretch the institutional protection scheme to the limits of its capacity. In addition, the systemic risk resulting from interconnectedness via joint liability networks should be included in the methodology for calculating contributions. An approach that only looks at the risk exposure of a single institution within a group of interconnected institutions would be short-sighted.

The relative weighing of this criterion should be lower. Also, for level playing field purposes, mutual solidarity mechanisms provided by law or deposit guarantee funds having early intervention powers should also be recognised as equivalent to institutional protection schemes.

i) Possible additional indicator to capture the expected intervention of the Fund: Ratio of bail-in-able funds available in excess of the minimum requirement for own funds and eligible liabilities.

Due to the lack of a final framework for the calculation and definition of the MREL, it is still too early to evaluate the impact of this indicator. EBF Members however see merit in assessing the loss absorbing capacity, i.e. the bail-inable liabilities including the amount of uncovered and covered deposits (DGS funding) that reduces the need for resolution funding in the gone concern. This measure will inform on the likely amount a bank will call on fund resources in the event it is wound up (loss given default approach). This benchmark should complement the probability of default approach (i.e. excess capital and liquidity an institution has to avert a going concern crisis that reduces systemic risk).

However, the inverse relationship between the amount of contributions the bank has to pay and the amount of its bail-in-able liabilities should be carefully analysed. Banks should not be disincentivised from building bail-in-able liabilities in excess of the minimum required: as these liabilities (other than own funds) are not excluded in the calculation of the flat part contribution, they would in fact increase the amount of contribution which must be paid to the fund. This is to ensure consistency in relation to the objectives of the BRRD and the SRM for institutions to become more resilient and safer.

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Appendix -Pros and Cons of different calculation scope for resolution financing

APPROACH	PROS	CONS
Consolidated approach	• The assessment is transparent: Most data and risk indicators are public. • Reflects the consolidated supervisory approach adopted by the ECB. • Allows one single calculation for the contributions of a group and enhances administrative simplification. • The adoption of a consolidated basis does not preclude the payment of the overall contribution into different national compartments by the institutions within a group. • Avoids the distortions introduced by use of National GAAP on solo contributions.	• Contributions are based on total liabilities that include those of third countries which would not benefit from the resolution fund, or may give rise to other contributions. • Not neutral with regards to the resolution strategy. Global decentralized banks are penalized to a greater extent. • Consolidation can include also non-credit entities of the group with external (3rd parties) funding which could unreasonably increase the contribution. • Incentives for intragroup funding which might increase group interdependency (reduce resolvability). • Need of additional mechanism for distribution of the payments to the national resolution funds • No distinction among the different business models/risk profiles of the respective group entities and thus it might lead to the situation, that the amount of funds in the respective national resolution funds would not correspond to the risk profile of the entities.
Sub-consolidated (Eurozone) approach	• Aligned with the concept of a Banking Union in the Eurozone (SSM, SRM, Single Rulebook, etc...). • Avoids the intragroup issue in the Eurozone. • The adoption of a sub-consolidated basis does not preclude the payment of the overall contribution into different national compartments by the institutions within a group. • Avoids the distortions introduced by use of National GAAP on solo contributions vs consolidated IFRS accounting views.	• It is not consistent with BRRD as it introduces arbitrary distinctions within the Single Market: group's contributions would be different depending on its individual entity's geographical location –within the European Union– the intra-group position would be excluded from the contribution base within SRM but included if outside SRM (within European Union). • Operational complexity (IT systems and procedures are not designed at present to carry out a new sub-consolidated approach). Costs of adaptation should be assessed. Realistic deadlines needed to comply with the new requirement (not just banks but also for Commission and ECB). • The calculation will have to be revised as countries join the euro-zone/banking union. • Intragroup liabilities towards non-SRM EU banks (subject to BRRD contributions) are not excluded which give rise to double contributions. • Some risk indicators may not be available as waived at solo entity level. Further work will be needed to develop benchmarks at a sub-consolidated level for the risk adjusted part. • Distribution to national compartments in transition will be complex. Need to find a solution to the transition period in terms of the methodology for allocating to national compartments each sub-consolidated contribution. • Includes non-regulated entities of groups.
Individual approach	• Aligned with the BRRD articles: no legal issue. • Resolution is conducted per legal point of entry in MPE approach. • Necessary balance sheet data would be readily available and a breakdown of solo entity level data could facilitate the calculation for individual shares to national compartments. • Solves the third country issue which are excluded.	• Not neutral with regards to the resolution strategy: SPE banks would be more penalised than MPE banks due to non-deduction of intragroup liabilities. For banking groups managed on a consolidated basis and which benefit from waivers at solo entity level, data and risk indicators may not be public for some institutions thereby increasing their administrative burden and disregarding risk diversification benefits.

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	• Consistent with MREL assessment (Entities within one group can have intentionally different business models (diversification) and thus different risk profiles and consequently different MRELs). • No difficulties to allocate contributions to national compartments of the SRF during the transition period. • Individual approach with exclusion of intragroup funding is more relevant than consolidated one with inclusion of external funding of non-credit entities.	• The use of national GAAPs may give raise to significant deviations among banks in different jurisdictions.