

'This newsletter is translated from the Japanese edition distributed on July 23rd.
Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

From the US to Emerging economies via China: Financial Crisis Express is finally departing?, etc.

Global Risk Watch Vol.40
30 July 2018

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«index»

1. # From the US to Emerging economies via China: Financial Crisis Express is finally departing? (Tsuyoshi Oyama)
 2. # Feasibility of resolution plans (Shiro Katsufuji)
 3. # Is China strengthen its efforts to prop up the business environment? (Toshikazu Kumagai)
 4. Seminars, Conferences & Publications
- =====

2. Overview of Development in Financial Regulations (Trends & Topics)

Feasibility of resolution plans (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Both Global regulations and domestic regulators are starting to require practical feasibility of resolution plans from large-scale financial institutions. The Financial Stability Board (FSB) issued two documents in June, namely “Principles on Bail-in Execution” and “Funding Strategy Elements of an Implementable Resolution Plan.” These documents advocate for financial institutions to create a framework that of implementing their resolution plans – preventing said plans from remaining merely armchair theory.

Taking a lesson from the global financial crisis, where a tremendous amount of taxpayers’ money propped up losses by financial institutions, the global regulatory regime has been working on a scheme that executes orderly liquidation at the cost of shareholders and creditors (called a “bail-in”). By publishing documents such as “Key Attributes of Effective Resolution Regimes for Financial Institutions (2011)” and “Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet (2015),” the FSB has built a structure that obliges large financial institutions to absorb losses with their TLAC including their own capital and senior debt. In accordance with the texts, domestic regulators and financial institutions issued bonds to secure TLAC and developed recovery and resolution plans. In Europe, mid- and small-sized institutions successfully went through resolution under the required framework, proving the effectiveness of the post-crisis resolution regime.

However, none of the global systemically important banks (G-SIBs) have gone under since the crisis. Insolvency of a global financial institution would be extremely challenging given its complex organizational and business

structures. The existing supervision standards for resolution planning merely require the description of a minimum framework to implement resolution, but practical procedures are not required. Consequently, resolution plans appeared more developed on paper, but left doubts as to their feasibility.

The June document “Principles on Bail-in Execution” requires institutions to clarify pragmatic items in resolution beforehand, such as a specified range of capital and debt for bail-in, an asset evaluation framework with regulators for resolution, and the governance structure at the time of insolvency. The “Funding Strategy Elements of an Implementable Resolution Plan” demands regular monitoring of liquidity necessary for resolution, and securing private market flow as primary funding source while limiting central bank facilities as secondary. These rules call for more practical resolution procedures and in-depth monitoring and reporting by financial institutions.

Recovery planning is also expected to ensure further feasibility. Supervisors are encouraging financial institutions to strive for more implementable recovery plans. For instance, the Prudential Regulation Authority (PRA) in the UK issued a supervisory statement “Recovery planning” in December 2017, ordering to develop “Playbooks” that are easy to understand for management.

Since the FSB’s 2011 publication, large-scale financial institutions have completed documentation for recovery and resolution planning. The next step will be to prepare realistic enough plans for management teams and regulators based on which they can execute recovery or resolution. Financial institutions will be required to include the plans in risk appetite framework and stress testing as an organic component, in addition to documenting them as an independent regulatory matter.

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