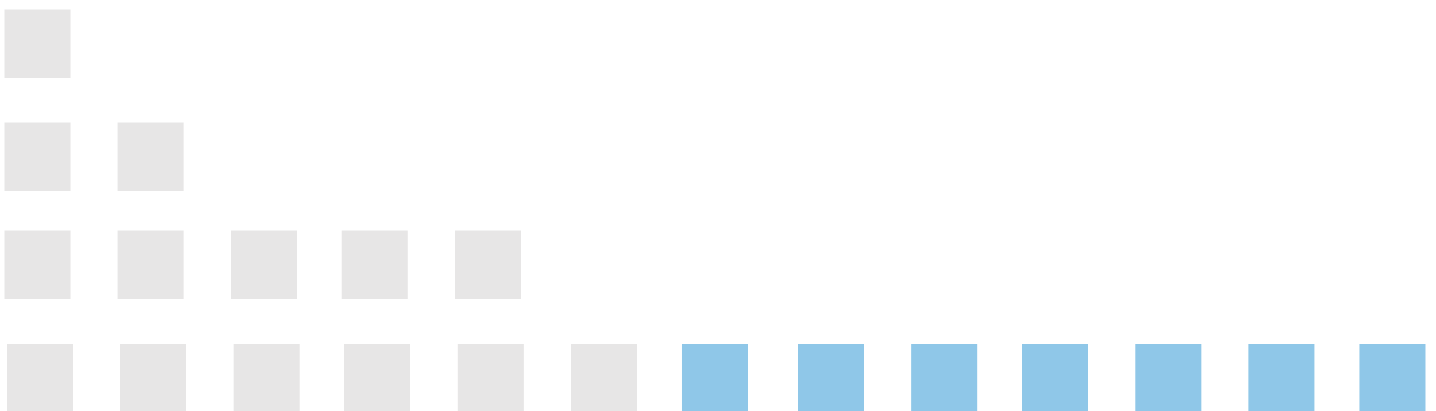
Gibraltar Resolution and
Compensation Unit

Bank Resolution

Introduction to Simplified Obligations



Briefing Note

August 2019

Introduction

The Gibraltar Financial Services Commission ('the GFSC') is the appointed Resolution Authority ('RA') for Gibraltar. The powers of the Gibraltar Financial Services Commission ('GFSC') as RA are delegated to the Financial Services Resolution and Compensation Committee ('the FSRCC'), which was established in 2016.

The FSRCC is responsible for resolution planning for Credit Institutions and certain Investment Firms as well as decision-making relating to the reorganisation of institutions experiencing financial difficulties. This is in line with the Financial Services (Recovery and Resolution) Regulations 2014 ('the Act') and internationally accepted principals in the area[1].

A resolution plan mainly describes how the failure of a firm will be managed to minimise its impact on the financial system, the economy at large and, if the firm provides social or economic critical services, continued operation of such services. For firms that are considered to be significant to the financial system, plans will assume, as a basic rule, that such firms will be placed into resolution in the event of failure. For institutions of lesser importance to the stability of the financial system, the FSRCC can, in accordance with the Act, decide to apply a simplified obligations ('SO') allowance in respect to resolution planning. SO's entail that certain exemptions can be made regarding the content and updating frequency of resolution plans.

Under SO's, resolution plans do not need to be as extensive or updated as often as full plans. As a result, information requirements imposed on firms concerned do not need to be as extensive as for firms managed via resolution. This helps to make the regulatory framework for resolution more proportional, especially for small firms. Decisions on simplified obligations can, at any time, be reviewed and amended where deemed appropriate. This document contains a description of the RCU's current approach to such exemptions and it's methodology for categorisation of firms.

Legal Basis

The Act allows for the RA to determine the following:

- the content and frequency of resolution plans;
- the information detail required from institutions; and
- the level of detail for the assessment of resolvability.

Simplified obligations in relation to the drafting of resolution plans shall apply where an institution's failure, and subsequent winding up under normal insolvency proceedings, would be likely not to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy. Although resolution actions will likely only be applied where the public interest test is met, resolution authorities are required to be conservative in their planning approach (and SO classification).

Generally, a resolution action shall be treated as in the public interest if:

(i) it is necessary for the achievement of, and is proportionate to one or more of the FSRCC's resolution objectives; and

(ii) winding up of the entity under normal insolvency proceedings would not meet those resolution objectives to the same extent.

FSRCC's resolution objectives are:

- to ensure the continuity of critical functions;
- to avoid significant adverse effects on financial stability in particular by preventing contagion;
- to protect public funds by minimising reliance on extraordinary public financial support;
- to protect depositors covered by the DGS; and
- to protect client funds and client assets.

When considering whether or not an institution is to be covered by the simplified obligations, the following criteria should be taken into account (the 'Criteria'):

- nature of the business;
- shareholding structure and its legal form;
- risk profile;
- size and legal status;
- interconnectedness to other institutions or to the financial system in general;
- scope and the complexity of the institution's activities;
- membership of an institutional protection system or other cooperative mutual solidarity systems;
- exercise of investment services or activities;
- and whether its failure and subsequent winding up under normal insolvency proceedings would be likely to have a significant negative effect on financial markets, on other institutions, on funding Conditions, or on the wider economy.

[1] Following the G20 endorsed Key Attributes for Effective Resolution Regimes of the Financial Stability Board (FSB) in 2011.

Link with Recovery Planning

While the Act requires the establishment of resolution plans by the RCU, the requirement to establish recovery plans is the responsibility of institutions' under the supervision of the Gibraltar Financial Services Commission. The purpose of recovery plans is to enable institutions to restore their financial position after a significant deterioration, and thus to ensure continued operations. Resolution plans are aimed at winding up institutions in a way that minimises the risks of financial instability if recovery has failed.

Although there is a close link between the assessment to be made by the GFSC and the RCU respectively in deciding which obligations will be applied to recovery plans and resolution plans, due to the different purposes of the plans it may be justified in certain cases for different conclusions to be reach in their assessments.

SO Resolution Plans

The SO resolution plans should consist of:

- General information about the firm.
- Relevant communication provisions.
- Identification of legal and practical obstacles to application of ordinary insolvency proceedings (if any).
- Conclusion of the resolvability assessment and measures to address or remove impediments to the application of normal insolvency proceedings.
- Financial position of the firm itself.

Firms that have been notified that their preferred resolution strategy does not involve the use of stabilisation powers, will be subject to the SO in respect of resolution planning. These firms will therefore not need to submit the more detailed resolution templates unless the RCU otherwise informs them.

The starting point for the resolution planning process is the bank's recovery plan. The RCU uses this information as a starting point for its own assessments of the bank's critical functions, the preferred resolution strategy and the bank's resolvability.

As the data templates are currently not required to be filled out for SO firms, the RCU may require institutions to provide additional information or support in order to draft the resolution plan, for example information on structure, critical functions or interconnections.

Assessment of SO Eligibility

The assessment of eligibility for simplified obligations is completed having regard to the impact that the failure of the institution could have on financial markets, on other institutions, on funding conditions, and on the wider economy, and taking account of the criteria set out in 6(1) of the Act (i.e. the Criteria included in the Legal Basis section of this document). Any assessment is currently deemed preliminary in nature and is subject to change if deemed appropriate.

A two-stage approach is taken by the RCU in its assessment[2]:

(i) Institutions that could potentially benefit from SO based on quantitative criteria measured on the basis of a set of quantitative indicators.

(ii) Selected institutions (from 'i' above) should be assessed to whether they also meet the set qualitative criteria. If however, it is clear that no further analysis is required (from 'i'), a qualitative assessment will not take place.

Quantitative assessment

The impact of the failure of an investment firm on financial markets, other institutions or funding conditions shall be primarily assessed on the basis of the size, interconnectedness, nature and complexity of the business.

Qualitative assessment

Where an investment firm is not regarded as an institution the failure of which would be likely to have a significant negative effect on financial markets, other institutions and funding conditions, the impact of its failure shall be assessed having regard to the following qualitative considerations:

- the extent to which the investment firm performs critical functions;
- whether the firm's shareholding structure is highly concentrated or highly dispersed, or whether that structure is sufficiently transparent insofar as it could negatively impact the availability or timely implementation of the institution's recovery or resolution actions;
- whether the firm is a member of an institutional protection scheme;
- whether the majority of the investment firm's clients are retail or professional;
- the extent to which money and financial instruments held by the investment firm on its clients' behalf would not be fully protected by an investor compensation scheme; and
- whether the investment firm's business model is complex, including the scale of investment activities.

[2] The impact of the failure of a credit institution shall be assessed on a regular basis and following engagement with the GFSC.

MREL under SO

In order to ensure effective and credible application of the bail-in resolution tool (to impose losses on banks' creditors in case of a banking crisis), banks resolution firms are subject to the Minimum Requirement for own funds and Eligible Liabilities ('MREL') which is earmarked for bail-in in a crisis. Firms that form part of the Bank Resolution regime are required to comply with MREL at all times by holding easily 'bail-inable' instruments, so as to ensure that losses are absorbed and banks can be recapitalised once they get into a financial difficulty, and are then subsequently placed in a resolution.

In a resolution, losses and recapitalisation requirements are to be borne by the institution's own shareholders and investors. In order to ensure that this can occur, institutions must have sufficient capital and liabilities. This is especially important to enable effective use of the bail-in resolution tool, maintain critical functions, avoid the need for recourse to taxpayers' money and restore the institution's capital position after resolution. MREL is therefore crucial in underpinning institutions' resolvability.

MREL is calculated on the basis of two key components:

- The **loss absorption amount** ('LAA'), based on the capital requirements of the current balance sheet, including regulatory capital requirements, the combined buffer requirements, and additional pillar 2 requirements (bank specific) set by the supervisor. The RA can also adjust this based on a risk assessment of the entity (through SREP[3]).
  LAA will equal the sum of (where applicable) the institution's Pillar 1 ('P1'), Pillar 2 ('P2') and any relevant Capital Buffer Ratios ('CBR') expressed as a percentage of risk-weighted assets.
  Therefore, LAA will be set as follows:
  Risk Weighted Assets X (P1+P2+CBR)

- The **recapitalisation amount** ('RCA'), which aims at covering the capital requirements of the failing institution post-resolution, taking into account potential divestments and other resolution actions under the preferred resolution strategy (the RA will be set to nil if it considers it will be put into liquidation i.e. firms with SO obligations and that will likely to subject to modified insolvency and not bank resolution tools).

In summary, institutions for which liquidation is the likely resolution strategy will have no RCA requirements. Where the preferred strategy is liquidation, MREL will be set at the level of the LAA (i.e. in line with current capital requirements).

MREL Eligible Liabilities

The RCU (acting as the operational unit of the FSRCC) expects firms subject to Bail-In strategies to meet MREL at all times. Banks can use their available shares and other capital instruments, as well as certain debt instruments, provided they meet regulatory requirements.

Eligible liabilities should satisfy the following conditions:

- The instrument is issued and paid up.
- The liability is not owed to, secured by or guaranteed by the institution itself.
- The purchase of the instrument was not funded directly or indirectly by the institution.
- The liability has a remaining maturity of at least one year (where the liability confers upon its owner a right to early reimbursement, the maturity of that liability shall be the first date where such a right arises).
- The liability does not arise from a derivative.
- The liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy.

MREL Transitional Period

The RCU will work closely with firms throughout 2019 and beyond on the challenges and possible solutions relating to the implementation of MREL (implementation date: Jan 2022).

MREL Reporting Templates

Although MREL targets must be met by firms at all times (from 2022), the responsibility around supervision of MREL amongst firms has yet to be confirmed. The consequences of a breach will be assessed on a case-by-case basis and tailored to accommodate the nature of the breach.

Looking forward

The RCU will continue to closely follow ongoing UK, European and international regulatory developments. In particular, the RCU will monitor the adoption of pending changes to the European recovery and resolution framework. Therefore, the approach outlined in this document is subject to future potential revisions.

[3] SREP is the Supervisory Review and Evaluation Process measure the risks for each institution assessed by the supervision unit of the GFSC.