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Separability of Banks During Crisis – Guidance on Separability for Transfer

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Table of Contents

NATIONAL RESOLUTION SYMPOSIUM 2023

INTRODUCTION

Separability during resolution is an issue where a transfer strategy is employed

- A transfer strategy is defined in European regulation (BRRD) as the transfer of:
    - shares or other instruments of ownership issued by an institution under resolution; or
    - all or any assets, rights or liabilities of an institution under resolution
- A number of resolution tools can be used to effect a transfer:
    - Sale of business tool (Share or asset deal)
    - Bridge institution tool (Share or asset deal)
    - Asset separation tool (Asset deal only)
- Separability is thus an important element in a number of circumstances
- The Single Resolution Board (SRB; resolution authority for the Eurozone) says separability is a concept relevant for all resolution strategies. However, it is particularly relevant where either the preferred resolution strategy or a variant of it envisages a transfer tool

In the EU, several documents were published on separability analyses

1. **SRB Expectations for Banks**
   - Published in April 2020 (final version)
   - Principle 7.2 specifically deals with separability issues

2. **SRB Operational Guidance**
   - Published in October 2021
   - Document entitled "Operational Guidance for Banks on Separability for Transfer Tools"

3. **EBA Transferability Guidelines**
   - Published in September 2022
   - Guideline for institutions and resolution authorities to complement the resolvability assessment for transfer strategies (Transferability Guidelines)

SEPARABILITY ASSESSMENTS

The SRB Expectations for Banks set out the first set of requirements

- Consider implementing measures to arrive at operationally independent material legal entities to support the resolution strategy
- Limit complex practices related to how trading or hedging operations are marketed, booked, funded and risk-managed
- Reduce the complexity and size of the trading book if this is necessary to apply resolution tools
- Ensure that legal and operational structures are not too complex and interconnected. Where necessary, banks are expected to take measures to reduce the complexity and/or to simplify the legal entity structure
- Align the legal corporate structures of the group with core business lines and critical functions
- Put in place a legal entity structure and intragroup funding arrangements which facilitate the implementation of the resolution strategy

Expectations are further detailed in operational guidance on separability

Perimeter Identification	• Institutions to propose transfer perimeter, composition of it and main arguments for proposal • Transfer perimeter should be as small as possible but represent a clear set of businesses attractive to a third party, preserve the continuity of critical functions and can be structured in legally, financially and operationally sound way
Interconnectedness	• Assessment of interconnectedness between transfer perimeter and other parts of the institution in resolution • Assessment of financial, legal, operational and business interconnectedness and decide on most efficient way to address it (remove, reduce, maintain)
Market interest and capacity	• Provide and assess a list of potential buyers and their suitability • Assessment of strategic fit of the transfer perimeter, business-related indications of appetite for transaction (e.g., recent M&A activities in the past 2 years) and financial strength (free capital and/or market access to raise additional capital if needed)
Information capabilities	• Self-assessment of preparedness in terms of information capabilities for transfer perimeter • Ensure MIS capabilities as well as the provision of valuation-related data for the transfer perimeter • Support the drawing up of due diligence and marketing materials

The guidelines issued by the EBA in September 2022 are much more high-level

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- The EBA guidelines are primarily addressed to resolution authorities as they are responsible for implementing the resolution plan – the SRB puts much of the onus of the work on banks rather than authorities
  - The EBA states that resolution authorities have to undertake most of the work with institutions asked to "**support**" the process by providing information
  - The SRB expects banks to perform most of the work (e.g., by developing separation analysis reports) to "**underpin**" the SRB's own analysis

- The EBA guidelines remain necessarily vague in a number of areas as many of the concrete actions will depend on the circumstances of a resolution (e.g., the definition of a transfer perimeter, the business plan for these operations, etc.)

The separability analysis should focus on an assessment of interconnections

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- The SRB expects banks to identify all interconnections between the transfer perimeter and other parts of the institution under resolution
  - Financial interconnections
  - Legal interconnections (including tax)
  - Operational interconnections
  - Business interconnections

- Following the interconnectedness analysis, banks are asked to identify potential barriers or constraints to a smooth transfer implementation

- For all barriers or constraints identified, there should be an evaluation of existing or planned mitigation actions

- The SRB also requires banks to establish a historical financial analysis of the proposed transfer perimeter as part of a draft business plan, with a detailed description of all costs entailed by the transfer and its implementation (focussing in particular on the costs of removing, mitigating or maintaining interconnections)

Four types of interconnectedness to be analysed

	Examples
Financial	• Intra-group funding and loans, commitments, guarantees, comfort letters • Securities financing transactions, covered bonds, on-B/S netting agreements • Back-to-back transactions • Cross-collateralisation agreements • Profit and loss transfer agreements
Operational	• Shared Service Centres • IT systems • Infrastructure (e.g., buildings) • Key personnel active in several entities • Membership and usage of financial market infrastructure (FMIs)
Legal	• Default, cross-default, close-out netting or similar clauses that would allow early termination of contracts • SLAs, agreements with third parties that could be terminated upon a change of control • Employee contracts, litigation, tax linkages
Business	• Cross-organisational unit links (with synergies, cross-selling) • Franchise impact

Methodology for analysis of interconnectedness

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	Methodology
Financial	• Analysis of intercompany items to identify intra-group funding and lending connections as well as commitments, guarantees and comfort letters • Analysis of business model to identify back-to-back transactions, profit & loss transfer agreements and other potential types of financial interconnectedness
Operational	• Analysis of critical shared services to identify relevant service providers and operational intra-group linkages • Analysis of shared services to include both specialised subsidiaries (e.g., for IT) and services provided by centralised functions and/or centres of competence as well as third parties
Legal	• Analysis of contracts (for products and services, but also employee contracts) in order to identify clauses leading to interconnectedness • Analysis of SLAs in connection with shared services to review any clauses (e.g., early termination) that could become barriers to resolution (particularly to a transfer)
Business	• Analysis of business model to identify any business linkages between business lines / activities

CHALLENGES WITH ASSESSMENTS

Challenges can take two different forms

Formal challenges	• Inability to comply with "form" (text) of the requirements • Requirements perceived to be overly theoretical and/or non-sensical (especially in a resolution planning scenario) • Challenges considered immaterial • Challenges not mitigated as part of separation analysis as mitigation is not deemed necessary
"Substance" challenges	• Inability to comply with "substance" (intention) of the requirements • Requirements seen as being sensible, even in the context of resolution planning (as opposed to actual resolution) • Challenges considered material • Challenges should be mitigated and institutions are required to analyse possibilities for mitigation

Formal challenges arise from the specificity of SRB requirements

- There is a detailed list of data items that should be made available in a virtual data room at short notice – while all items on the list make sense where the whole institution is sold in a share deal (although some items may be deemed "overkill"), none would be specifically applicable to an asset deal / partial transfer

- The items listed as being necessary in a VDR for the transfer perimeter are not necessarily readily available (nor could they be produced at short notice). It is unclear how much preparation / mitigation would be required by institutions

- The requirement for a financial analysis of the transfer perimeter and a business plan appears excessive given that the cause of the problem that led to resolution is not known at the planning stage (also contradicts the need to only assess the ability to create carve-out financials stated elsewhere in the guidance). In addition, a business plan may be drawn up by the acquiror (and is certainly dependent on it!)

There are further formal challenges relating to the specific wording used

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- While the SRB states that the transfer perimeter should be "as small as possible", regulation contains the "sale of business" tool, which suggests the possibility for a share deal for the whole institution.

- Where institutions in resolution are relatively small, this is seen as a viable resolution strategy, so although transfer is the preferred resolution strategy, the separability analysis required appears to be excessive and not necessary as no separation will take place

- It is unclear whether an institution can state that it has no experience with a transfer of assets (which is possible if it has only acquired businesses in the past or sold only very small portfolios) as the guidance states "importantly the institution should describe any previous experience with the proposed type of transaction"

- As the transfer in this case is part of a resolution plan, it is likely that institutions have no experience, especially since they have never sold themselves in a share deal!

"Substance" separability challenges can depend on the type of deal or acquiror

- In a share deal for an entire legal entity, separability often becomes a non-issue (unless individual legal entities are sold off separately and interconnections between them need to be managed)

- Interconnections are much more relevant in the context of asset deals or partial transfers, i.e., where the transfer perimeter only contains part of an institution

- Where acquirors operate in the same market as the institution in resolution, many interconnections become irrelevant, as the business is likely to get integrated into that of the acquiror (e.g., shared service centres for finance, reporting, etc., FMI access)

- Where acquirors operate in different markets (e.g., where an institution is acquired by a foreign buyer), the operations of the acquired institutions may be critical for the acquiror as he is also acquiring the market access and the local market expertise

There are “substance” challenges related to addressing market interest and capacity

- Recovery options will normally include the sale of certain portfolios and/or businesses, often where these represent separate legal entities (e.g., a subsidiary)

- When establishing the impact of recovery options, banks need to analyse the potential market for their portfolios and/or businesses, taking into account market capacity and willingness to acquire

- The challenge in resolution planning will be that the transfer perimeter is likely to be much larger than the portfolios and/or businesses included in recovery options

- The market analysis, therefore, will likely have to be undertaken again to gauge capacity and interest for the “new” transfer perimeter

Most other “substance” challenges relate directly to the need for mitigating actions

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- Existing interconnections may make the separation of individual legal entities and, particularly, business lines difficult or impossible
  - Shared services, particularly for IT services, may be provided by one entity for other entities of the group
  - IT systems will be shared by several business lines (e.g., use of the core banking system)
  - Infrastructure, particularly branches, will be shared by several business lines

- Information systems cannot provide all the information required within a reasonably short time frame
  - Production of financials is linked to month-end (or quarter-end) closing processes, which may take several weeks to complete
  - Financial and regulatory calculations are not conducted for a potential transfer perimeter

MITITGATING MEASURES

The SRB only touches on limited aspects of mitigating actions in its guidance

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- SRB guidance is focussed on contracts (i.e., legal interconnectedness):
  - Removal of interconnections:
    - Cancellation of contracts
    - Establishment of new contracts (example: transitional SLAs)
  - Mitigation of interconnections;
    - Substitution of contracts (example: resolution-resilient clauses)
    - Modification of contracts (example: re-design of IT infrastructure → how is this a contract?)

- In many cases, mitigating actions do not appear feasible during resolution planning, as they interfere with ”business as usual”:
  - Division of branches into retail and corporate
  - Making all legal entities self-sufficient without relying on shared services
  - Establishment of model validation, internal audit, other central functions in all legal entities / business lines or aligning responsibilities of central functions with business lines / entities

Mitigation activities must be undertaken by all banks for MIS / data capabilities

- Production of financial information
  - Out-of-cycle, i.e., not just at month-end-closing
  - For different perimeters, especially the transfer perimeter (carve-out financials)

- Timeliness of producing financial information is key – banks have to work on speeding up their closing process and make it more flexible
  - Particular challenge for larger groups with operations in multiple countries
  - Challenging for groups with heterogeneous systems landscape

- Compilation of information to be included in a virtual data room (or organisation of information internally available) is critical as documents are typically "owned" by disparate departments in an institution

- Scope of remediation actions critically depends on responsible resolution authority and their specific guidance / requirements

QUESTIONS ?

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THANK YOU