

COMMENTS

File: **EBA**

Subject: **EBA/DP/2012/2**

Date: **June 15th, 2012**

Question 5: *Do you believe the draft recovery template to be sufficiently comprehensive and cover all the aspects relevant for the purpose of recovery plan?*

Comment: To design a recovery plan when quantitative thresholds determining forced resolution are missing is like to build on sand. Without them, political pressure, inertia, natural tendency to avoid hard decisions and to cover up poor overseeing will drag Central Banks to opt first hand for a recovery action whatever the case might be.

Whenever banking is at stake, recovery and resolution are not two different directions away from the same starting point, as Discussion Paper presumes. Recovery starting point occurs very much before the resolution one. Consequently: (i) a “resolution frontier” shall be drawn based on qualitative and quantitative thresholds [see comment to Question 7, hereunder] beyond which immediate resolution shall be mandatory; (ii) and Central Banks shall not be empowered to decide differently. Only when “resolution frontier” is still distant recovery will be a feasible, reasonable and justifiable decision for a Central Bank to make – providing it is properly justified.

As in all decisions under uncertainty, a resolution decision is unavoidably subject to two different types of error:

- Type I error – to force a resolution while the Bank in stress is still recoverable;
- Type II error – to endeavour a recovery when the task is of no avail.

Usually, Central Banks abhor the stigma of incurring a Type I error that put in jeopardy shareholders, employees and other stakeholders - but not depositors. However, only a Type II error entails systemic risk, and we think this template, by ignoring Type II errors, does not take it in due consideration. On the other hand, no such dilemma stains a recovery decision – and, perhaps, that is why Central Banks are so keen on it. In our views, a recovery template shall be based on explicit resolution thresholds [see comment to Question 7, hereunder]. As it is, the template gives dangerous discretionary powers to Central Banks, whose accountability on the issue more often

than not appears to be wanting. In short, rules must be designed in such a way that Central Banks are obliged to explain thoroughly, comprehensively and publicly a recovery decision – but not a resolution one. Otherwise, the same picture keeps popping up: a lender-of-last-resort (Central Bank) nudging helpless taxpayers to become shareholders-of-last-resort.

Question 7: *How would you identify quantitative and qualitative recovery early warnings and triggers? What are the key metrics you would to develop early warnings and triggers?*

Comment: A “resolution frontier” is built on the following criteria (there is nothing new about them):

- Governance based on a clear Business Plan and sound control systems
- Compliance
- Accountability (through public disclosures)
- Capital adequacy.
- Balanced free cash flow

Governance and/or compliance failures demand some sort of judgement from the Supervisor. But, yes, they may be corrected long before causing the disruption of payment systems. That is to say, it makes sense to associate to any of these failures early qualitative warnings that trigger appropriate corrections the Supervisor shall monitor closely.

Public disclosures are more quantifiable, as long as adequate minimum standards are in place, but they do not preclude Supervisor’s judgement, too. And, similarly, these failures can be remedied before threatening payment systems.

On the contrary, the last two criteria are easily quantifiable and failures on these grounds have a strong possibility of causing payment systems distress. Moreover, it is not difficult to convert an unbalanced free cash flow to capital metrics. So, capital metrics it is.

Capital is inadequate whenever:

- (a)** It is not sufficient to accommodate risk exposure. Trigger: 80% of minimum capital requirements (with not so generous risk weights for a large array of exposures). Early warning: 100%: 100% of minimum capital requirements. Consequently, the breathing space for a recovery plan ranges between 100% (of minimum capital requirements) and 80% (*ditto*).

- (b) It is not sufficient to fund excessive overheads. Trigger: a recurrent-cost-to-recurrent-income ratio higher than 0.85 (where “recurrent” means “not exposed to market risks”). Early warning: a recurrent-cost-to-recurrent-income ratio higher than 0.60 (*ditto*). Consequently, the breathing space for a recovery plan ranges between 0.60 minimum capital requirements and 80% (*ditto*).
- (c) It is not sufficient to cover differences between assets valued at fair market prices and demandable liabilities in successive maturities.
- (d) It is not sufficient to fill the any treasury gap forecasted in the short term (“short term” meaning 1 (one) year horizon), Central Bank’s liquidity facilities notwithstanding.

Immediate resolution will be mandatory if, at least, two of the scenarios a) – d) occur simultaneously.

Question 13: *How do you assess the credibility of a recovery plan? Please comment on your experience.*

Comment: A recovery plan is credible as long as it manages to keep “resolution frontier” farther at bay. Which means: (i) the Bank fails no more than one of scenarios a) to d); (ii) there are reasonable prospects the failure will be effectively remedied in less than 2 (two) months time; (iii) there are reasonable prospects of effective improvement in all the four above mentioned capital adequacy criteria in less than 1 (one) year time. It is up to Central Bank to proof publicly that its prospects are “reasonable”, under current liquidity facilities.

Author: A. P. Machado