Dubai Financial Services Authority

DISCUSSION PAPER 3

RECOVERY AND RESOLUTION FRAMEWORK FOR FINANCIAL INSTITUTIONS IN THE DIFC

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PREFACE

Why are we issuing this discussion paper (DP)?

The DFSA is considering developing a suitable recovery and resolution framework for financial institutions in the DIFC taking into account global developments including the Key Attributes of Effective Resolution Regimes for Financial Institutions adopted by the Financial Stability Board.

The potential future framework would augment our current early intervention powers. We would introduce new recovery and resolution powers in order to be able to stimulate recovery of distressed DIFC firms and, if need be, conduct or facilitate their resolution. The framework would be underpinned by the objectives of maintaining financial stability, ensuring continuity of critical economic functions and protection of depositors and client assets.

At this stage of our thinking, we are only looking at a framework for the resolution of deposit-taking institutions (i.e., banks) and their Islamic equivalents. Later work may look at Insurers and at Authorised Market Institutions.

The DFSA invites interested parties to provide their views and comments on the potential future framework and its various aspects described in this paper.

Who would be interested in this DP?

The persons to whom this DP may be of particular interest would include:

a) Authorised Firms carrying out either of the following Financial Services:

   i. Accepting Deposits; or

   ii. Managing a profit sharing investment account (unrestricted) (PSIAu);

b) applicants to be either of the above; and

c) advisers to any of the above.

Terminology

Where defined terms are used in this DP, they are identified by the capitalisation of the initial letter of a word or of each word in a phrase below or in the Glossary Module (GLO). When acronyms are used, they are defined in the Glossary section. In all other cases, the expressions used have their natural meaning.

What are the next steps?

If you wish to provide comments on any aspect of this DP, please email them to **consultation@dfsa.ae** by **25 November 2017**. Please identify the organisation you represent when providing your comments.

The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

Once we receive comments, we will review these and decide on our next steps. This might take the form of a Summary Response and, potentially, a Consultation Paper.

GLOSSARY

BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive (EU)
EU	European Union
FI	Financial institution
FMIs	Financial market infrastructures
FSB	Financial Stability Board
G-SIBs	Global systemically important banks
G-SIIs	Global systemically important insurers
IOSCO	International Organization of Securities Commissions
KA	Key Attribute
MPE	Multiple Point of Entry resolution strategy
NCWOL	No creditor worse off than in liquidation
SIFIs	Systemically important financial institutions
SPE	Single Point of Entry resolution strategy
TLAC	Total Loss-absorbing Capacity

INTRODUCTION

1. In the wake of the financial crisis of 2008/2009, a number of financial institutions (FIs), including banks, investment firms and insurers, experienced significant difficulties and were either rescued by sovereign governments or entered bankruptcy causing, or contributing to, widespread financial contagion. The crisis revealed a series of shortcomings such as:

   - there was little, if any, crisis preparedness by either financial institutions or public authorities;
   - public authorities lacked adequate powers and processes necessary to address the firms in crisis;
   - inadequacies were revealed in general corporate insolvency procedures, which were not suitable for handling bank failures, especially in a cross-border context where differences between jurisdictions tended to magnify the crisis;
   - the rescue of a failed bank on the basis that it is "too big to fail" was seen as unsatisfactory due to the moral hazard risk; and
   - an assumption that bank failures should be financed solely from the public purse was considered unacceptable due to the high negative impact on public finances.

2. These observations generated broad international consensus at the G-20 level on the importance of establishing effective recovery and resolution regimes for a range of FIs, in particular those that are considered systemically important for financial stability, including at a global level (SIFIs)[1]. There are currently 39 such institutions worldwide.[2] Thirteen of them are present in the DIFC, eleven banks and two insurers, with eleven operating through branches and two as DIFC incorporated companies, which are subsidiaries of groups headquartered in the UK – HSBC Group plc and the USA – AIG Inc.

3. The Financial Stability Board (FSB), a body created and mandated by the G-20, went on to formulate and publish in 2011 its *Key Attributes on Effective Resolution Regimes for Financial Institutions* (KAs)[3]. The KAs were later complemented with a number of additional guidelines on various aspects such as resolution planning; resolution funding, in particular temporary funding and total loss absorbing capacity (TLAC); client asset protection, cross-border co-operation and information sharing[4].

4. Other international standard setters also contributed to the formulation of the resolution

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1 SIFIs are defined as being capable of causing a severe systemic disruption at a global level (G-SIFIs), by reason of their size, nature, complexity, interconnectedness and substitutability. They include global banks (G-SIBs), insurers (G-SIIs), financial markets infrastructures (FMIs) and other non-bank non-insurance SIFIs (NBNI) such as asset managers and securities firms. If the domestic authorities in a jurisdiction consider that a failure of certain domestic firms (D-SIFI) would also be systemically significant or critical in the domestic context, they should extend the resolution regime to such entities.

2 There are currently 30 G-SIBs and 9 G-SIIs identified by the FSB. The list is updated annually.

3 http://www.fsb.org/wp-content/uploads/r_141015.pdf

4 Full list of the FSB standards on resolution is available on its website.

framework in addition to developing complementary standards focused on strengthening prudential standards, early intervention measures and supervisory practices covering their specific areas of expertise such as banking[5], insurance[6], Islamic institutions[7] and securities[8]. In particular, the revised BCBS *Guidelines for identifying and dealing with weak banks* were published in 2015[9]. Since the crisis, the DFSA has been engaged in the process of adapting our regime, where necessary and suitable, to meet some of these standards.

5. The FSB monitors the implementation of the KAs in its member jurisdictions[10]. The European Union implemented the KAs through the Bank Recovery and Resolution Directive (BRRD 2014/59/EU) and the USA through the Dodd Frank Act and the Federal Deposit Insurance Act. Other jurisdictions, such as Singapore, Hong Kong and Saudi Arabia, are also advanced in their implementation.

6. The status of the domestic resolution regimes now forms part of the International Monetary Fund and World Bank Financial Sector Assessment Programme, following the implementation of the Key Attributes Assessment Methodology for the Banking Sector in 2016[11]. The DFSA's regime is likely to be subject to this assessment in due course.

PROPOSALS FOR A RECOVERY AND RESOLUTION REGIME IN THE DIFC

7. In view of the global developments, we have reviewed our existing framework related to crisis preparedness and management applicable to FIs in the DIFC and are considering the possibility of implementing a suitable recovery and resolution regime.

8. While the aspects related to recovery are mainly related to strengthening our current supervisory powers in the area of early intervention and crisis preparedness (section I below), the resolution regime would introduce new self-contained functions and powers (sections II-VIII below). The key elements of the potential future regime are described broadly below.

I Early intervention and recovery

9. The DFSA currently has at its disposal a number of supervisory and enforcement powers, which may be, and indeed have been, used to improve the situation of distressed DIFC firms. Our experiences in applying these powers, coupled with a gap analysis we conducted against the recommendation of the BCBS *Guidelines for identifying and dealing with weak banks*, lead us to believe that some of our existing powers may require clarification or strengthening while some additional powers might also be necessary. Please note that while the existing early intervention powers set out in the Regulatory Law apply to all Authorised Firms, the recovery and resolution powers would apply only to the Authorised Firms covered by the future regime.

10. For example, strengthening and clarifying certain aspects of our existing power to appoint managers under Article 88 of the Regulatory Law might be necessary. As to new

5 Basel Committee for Banking Supervision (BCBS) and the International Association of Deposit Insurers.
6 International Association of Insurance Supervisors.
7 Islamic Financial Services Board (IFSB).
8 International Organisation of Securities Commissions (IOSCO) and Committee on Payments and Market Infrastructures.
9 http://www.bis.org/bcbs/publ/d330.pdf
10 The FSB implementation monitoring website related to resolution can be accessed here.
11 http://www.fsb.org/wp-content/uploads/Key-Attributes-Assessment-Methodology-for-the-Banking-Sector.pdf

powers, a prominent example of a new power, which the FSB and the BCBS consider to be a pre-requisite of a successful early intervention, is the power of bank supervisors to require banks to conduct recovery planning and reflect on potential and plausible crisis scenarios and credible ways of addressing them in order to prevent firm failure.

II What objectives would the DFSA resolution regime try to achieve?

11. If the recovery of a FI is not possible, despite the activation of recovery measures by the firm and supervisory attempts to orchestrate recovery in line with the failing firm's recovery plan, the next stage of handling the stressed firm takes place in the context of the resolution or insolvency regime (please see section III for discussion on insolvency).

12. The objectives of the resolution regime recommended under the KAs are multiple, but broadly encompass: rendering feasible a resolution of a SIFI without causing severe disruption to the financial system; avoiding using public funds; protecting and ensuring continuation of critical economic functions; and protecting depositors and policyholders as well as ensuring the return of client assets.

13. Given the DIFC is a predominantly wholesale financial centre, the objectives of our regime would, largely, be narrower than those envisaged by the KAs. Therefore, the objectives of the DIFC regime would focus on:

    a) protecting and maintaining financial stability;

    b) ensuring continuation of critical economic functions exercised by the distressed FI; and

    c) protection of depositors, policyholders[12] and client assets.

14. Overall, when preparing for or conducting resolution, the DIFC resolution authority would consider each of these objectives in the selection and use of its tools, but they are not ranked in any particular order.

15. In relation to the objective of protection of client assets, as part of the work, we are also reviewing our existing provisions on client assets in order to bring them further in line, where necessary, with the KAs and the relevant IOSCO standards.

III. What would be the relationship between the resolution regime and the DIFC Insolvency Law?

16. The resolution regime under the KAs constitutes an exception to ordinary insolvency proceedings, which apply to all other financial institutions not covered by its scope. In this sense, the resolution regime is granted an exceptional status justified by reason of the overriding public policy objectives that the KAs try to achieve (as set out in section II above).

17. For illustration, the trigger points and the effects of the commencement of the proceedings may differ significantly in resolution and in ordinary insolvency. Under the KAs, resolution should be a pre-emptive action by a resolution authority, which should

[12] This does not imply the creation of a deposit guarantee scheme or a policyholder protection scheme in the DIFC.

commence before a firm is failing or likely to fail. This will be before it is balance sheet insolvent, with the aim of preventing this from materialising. This is not to say that parts of the business of the failing entity, in particular those deemed not to be critical, could not be separated and subject to ordinary insolvency. Conversely, ordinary insolvency proceedings in the DIFC, run by a court, would usually commence at the point when an entity is unable to pay its debts and effectively freeze all operations of the entity with a view to ultimately liquidating its assets and paying out its creditors.

18. In this sense, the DIFC resolution regime would also enjoy such special status against the DIFC Insolvency Law No. 3 of 2009. That said, the resolution authority could, at all times, determine that an intervention under the resolution regime is not warranted for lack of overriding public policy objectives. This would result in the firm or - as mentioned in the preceding paragraph - its part, being subject to the ordinary insolvency regime.

IV. The resolution authority in the DIFC

19. The KAs state that each jurisdiction should have a designated administrative authority (or authorities) with a clearly defined mandate, which will be responsible for carrying out the resolution process. To achieve that, the resolution authority must exercise the resolution powers under the resolution framework. In its dealings, the resolution authority should be guided by the objectives set out in the resolution regime.

20. The DIFC legal framework does not have a designated resolution authority with specific resolution objectives and powers assigned to it. The DFSA, as a single integrated regulator and supervisory authority, has *de facto* acted as the resolution authority in previous insolvencies of DFSA Authorised Firms, using the supervisory and enforcement powers at our disposal. Given the current DIFC organisation, it is our view that the DFSA would be the most suited body to carry out the resolution authority role in respect of Authorised Firms. Having said that, the exercise of the powers, or assistance with their application, could be outsourced to a third party.

21. We would envisage that the new function would be clearly set out in legislation with appropriate transparency, accountability, processes and safeguards as prescribed by the KAs. As recommended by the KAs, and to the extent it is possible in an organisation of the DFSA's size, attention would also be given to functional separation between our on-going supervisory functions and those performing resolution functions in order to address any potential or actual conflicts of interest. Having said that, both supervisory and resolution functions would closely cooperate on crisis preparedness matters.

V. What Authorised Firms would be covered by the regime?

22. The resolution regime designed in the KAs is intended to apply to all types of SIFIs including banks, insurers and FMIs, which are found systemic at a global level. Home authorities may extend the resolution regime to an entity whose failure would be systemic in the domestic context (D-SIFI). For example, the EU's Bank Recovery and Resolution Directive (BRRD) applies to all EU banks, credit institutions and large investment firms, although not all the powers are available in all circumstances.

23. The potential DFSA resolution regime would likely cover Authorised Firms, whether operating as DIFC companies or branches of foreign FIs, which conduct deposit taking activities; that is, firms in prudential Categories 1 and 5. Some parts of the regime might apply to firms in prudential Category 2. This would include firms that have not been

identified as G-SIFIs at the global level, for example, when there is a domestic or regional financial stability consideration for the DIFC.

24. We intend to prioritise the work by focusing on developing a suitable regime for banks in the first place (for this reason sections VI-VIII refer primarily to banks). This is helped by the fact that the global resolution standards are complete for these institutions. At a later stage, as and when the standards for insurers and Islamic institutions are finalised, we would consider the need and parameters for specific resolution frameworks for these entities. It is unlikely that the AMIs in the DIFC would be covered bearing in mind the types of activities they currently conduct[13].

25. Furthermore, the KAs recommend that, in order to remove barriers to resolution through lack of operational continuity, the resolution regime should cover other entities, which provide services to FIs such as IT. Ensuring the continuation of provision of these services is considered crucial for the stabilisation of the failing entity, since, for example, lack of operational continuity might destabilise an already financially stable 'new' bank.

26. Ensuring continuity from entities which are not part of the same corporate group as the distressed entity, are unregulated and/or are located in other jurisdictions may prove difficult, mostly for reasons of lack of jurisdiction over such entities. When deciding how this point should be addressed in the DIFC, the DFSA will consider the typical practices of the DIFC entities, as far as the provision of these services is concerned, and the extent to which this KA objective could be achieved through the resolution regime or through other means.

VI. What powers should the resolution authority be equipped with?

27. To achieve the resolution objectives, the KAs recommend that the resolution authority should be equipped with wide-ranging powers and tools. Their use would be discretionary and adapted to the circumstances of the specific case at hand while being protected by a number of safeguards (please see section VIII below). Broadly speaking, there are three key groups of powers allocated to the resolution authorities under the KAs:

- **Crisis preparedness** – banks, in co-operation with the resolution authority, are required to draw up recovery and resolution plans on how to deal with situations which might lead to their financial stress or failure. The resolution authority then can test the resolvability of an entity in line with the resolution plan. If obstacles to resolvability are identified during the process, the resolution authority could require a bank to take appropriate measures, including changes to corporate and legal structures, to ensure that it can be resolved with the available tools;

- **Resolution** – where a bank is determined to have reached, or be likely to reach in the near future, a point of non-viability (PONV), the resolution authority should be able to trigger the resolution process and employ a credible set of resolution tools (the resolution triggers are discussed in section VII below). The tools aim to ensure that the failing bank's critical functions are preserved. This helps maintain financial stability, while shareholders and unsecured and uninsured creditors of the bank (e.g. depositors whose funds are in excess of levels protected by deposit

[13] Although the FSB tends to consider most FMIs as systemic, at least in the domestic context, its focus is on central clearing counterparties engaged in over-the-counter derivatives clearing given their increasing systemic risk concentration following the post-crisis reforms.

guarantee schemes) bear an appropriate part of the losses, which reduces the need to bail out the bank with public funds. The non-critical parts are separated and can be wound-up in ordinary insolvency proceedings.

The KAs recommend that the resolution authority tools should include a power to:

- replace senior management with a special manager under the resolution authority's control;
- impose temporary stay on early termination rights (e.g. under derivatives and securities financing transactions);
- sell or merge the failing bank's business with another bank while overriding shareholder rights;
- set up a temporary bridge bank to continue operating its critical functions;
- require group companies to provide services to the entity in resolution in order to ensure continuity of essential services;
- separate good assets from bad ones; and
- convert to shares or write down the bank's debt such as TLAC and other eligible instruments (bail–in).

- **Cross border-cooperation** – under the KAs a resolution action of a SIFI can only succeed if co-operation is effective between home and host resolution authorities in a jurisdiction where the entity is also present. To this end, host authorities should enter into appropriate arrangements on information sharing, recovery and resolution planning (aka Cross-Border Cooperation Agreements) and where relevant participate in the Crisis Management Groups set-up for the G-SIFs. More importantly, host authorities are expected to recognise, and not hinder, subject to certain exceptions, resolution actions of the home resolution authority.

28. In terms of crisis preparedness, we would envisage that DIFC-based banks, irrespective of their legal form, would be required to engage actively with us in relation to resolution planning, which would allow us to ascertain the viability of the plans and test the resolvability of the DIFC entities.

29. As far as resolution powers are concerned, the types of powers to be used would largely depend on whether an entity is a branch (i.e. is not legally separate from the parent), or a DIFC-incorporated entity such as subsidiary or entity headquartered in the DIFC. At present, bank branches dominate the DIFC banking landscape, with 28 of them against five subsidiaries.

Branches

30. In practice, the resolution powers that the DFSA would need to facilitate resolution of branches of foreign banks would generally be limited, since the host authority of a branch would be expected to rely on and co-operate with the home resolution authority.

31. In the ideal situation, anticipated in the KAs, the home resolution authority would trigger and manage the resolution process for the parent entity and its branches. It would

normally consolidate assets and liabilities at the parent level and carry out the resolution actions, such as recapitalisation through bail-in with potential use of central bank emergency liquidity assistance to support the new entity. Once the parent entity is stabilised, the balance sheet of the branches is re-established.

32. Importantly, from the perspective of the host authorities of the branches, the KAs recommend that foreign branches and their creditors are not discriminated against and are treated on par with domestic operations. If this is indeed the case, and no actions to the detriment of the DIFC or the DIFC depositors are being taken (actions may also include inaction), it would mean that the DFSA's powers to recognise and support the actions of the home resolution authorities would generally suffice. This would include the power to support stays on early termination rights and bail-in, where relevant.

DIFC-incorporated companies

33. The DFSA is currently considering which of the resolution powers listed in the KA could be practicable in the DIFC context. At present, the powers would primarily apply to subsidiaries of international banking groups. To some extent their practical use would depend on the type of resolution strategies adopted for the entity by the home resolution authority, whether a Single Point of Entry (SPE) or a Multiple Point of Entry (MPE)[14].

34. More importantly however, a number of powers may not effectively be exercised in the DIFC, since those resolution actions would require access to resolution funding sources. For example, a bridge bank could require temporary financial support in addition to bail-in, as well as emergency liquidity assistance, until it can secure its own stable sources of liquidity. This could prove difficult in the DIFC context where, at present, public or private resolution funding does not appear to be viable or available.

35. A tool which could prove useful, to some extent, is bail-in of unsecured instruments designed to absorb losses, such as TLAC. These financial instruments are currently in the process of being issued by a number of G-SIBs. In this context, it might be necessary to require that DIFC banks disclose to their depositors and creditors the possibility that their deposits and claims could be subject to bail-in.

36. Based on the above, we would expect that our potential future resolution powers would be specifically tailored to the DIFC situation and be heavily complemented by our careful prudential supervisory approach as well as international cooperation with home resolution authorities of the SIFIs to which these powers would apply.

VII. Resolution triggers

37. Under the KAs, the resolution authority has the power to trigger a resolution when certain parameters are identified, that is when a firm is no longer viable or is likely to be no longer viable with no reasonable prospect of recovery (PONV).

38. A potential future DFSA regime would provide for parameters that the DFSA, in its discretion, would consider to determine whether a bank has reached a PONV. The

[14] Under a SPE resolution strategy, responsibility for the resolution process rests with the home resolution authority, who would treat the FI as a single integrated entity with the necessary tools applied at the top level of the group. Under a MPE resolution strategy, several resolution authorities (home and host) act independently from each other but in a co-ordinated manner in respect of the entities in their respective jurisdictions.

PONV parameters in the DIFC regime, which should be sufficiently measurable, might include a mix of prudential indicators, as well as factors such as whether the bank is able to secure funding or recapitalise, or whether there is a heightened risk to the DIFC depositors and creditors.

39. The triggers would lead to activation of the resolution powers. At this stage, strong cross-border co-operation with other resolution authorities is of paramount importance. This decision would be subject to the DFSA being satisfied that use of the powers is necessary and proportionate; that other viable solutions do not exist; and that there is overriding public policy interest, which would justify the resolution rather than the ordinary insolvency route.

VIII What safeguards to protect creditors should the regime contain?

40. The KAs require that the resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class (e.g. prioritising claims of third party depositors ahead of the claims or deposits of the failing firm's head office). The resolution authority must be transparent about the reasons for such departures. The reasons could include containing impact of the firm's failure on financial stability or maximising the value for the benefit of creditors as a whole, rather than particular classes or individual creditors.

41. Although in most cases the resolution would achieve a better result for all creditors, there may be instances where this would not be the case. To address that, the KAs state that a resolution framework should incorporate safeguards to protect the interests of stakeholders affected by the resolution measures by providing for appropriate mechanisms to seek judicial redress. Such redress is based on the principle that no creditor should be worse off under resolution than it would have been had the bank been wound up under the applicable insolvency law ('no creditor worse off than in liquidation', NCWOL). Please note that other types of claims that could constrain the resolution authority in implementing resolution actions, or lead to reversal of such actions, are not in line with the KAs[15].

42. The envisaged DIFC resolution regime would need to incorporate the safeguards described above, although this might prove difficult given the current absence of funding. For this reason, the DFSA has not yet formed a final view as to the potential redress framework. The regime would need to strike a balance between protecting the legitimate interests of certain stakeholders under the NCWOL principle while enabling the resolution authority to intervene, often under severe time constraints, which are characteristic of bank failures.

IMPLEMENTATION

43. The proposed policy changes would be effected primarily through amendments to the existing legislative framework – the Regulatory Law, DIFC Law No. 1 of 2004 supported by necessary Rulebook changes, which may be included in a separate module. The DFSA would also envisage suitable amendments to the Regulatory Policy and Process

[15] *The legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their powers in good faith' (KA 5.5.).*

Sourcebook.

44. We would intend to consult on the legislative amendments, after considering the feedback on the proposals in this paper.

Questions for discussion:

1. **Do you have any comments on, or concerns related to, the issues discussed in the paper in relation to the potential recovery and resolution regime?**
2. **Please could you comment on any expected impact of the proposed changes on your DIFC activities?**