Fitch: Branch Resolution May Disrupt Credit Hierarchy [Endorsement Policy]

19 Aug 2014 5:25 AM (EDT)

Fitch Ratings-London-19 August 2014: The ability of a local regulator to resolve foreign bank branches can lead to unequal outcomes for same-ranked creditors, and complicates cross-border resolution, Fitch Ratings says. Branch resolution rules in many countries including the US and EU can create a "first mover" incentive that may make orderly cross-border resolution more challenging.

The resolution of the Cypriot branch of FBME (not rated), a Tanzania-based bank, on 21 July under the domestic bank resolution law is an example of a national regulator independently placing a foreign branch into resolution. The branch was put into resolution by the Cypriot authorities after being named by the US Treasury as a "foreign financial institution of money-laundering concern". We believe the prospect of branch resolution has wider significance, even though FBME's circumstances are specific to that bank.

The Bank Recovery and Resolution Directive will bring in a new requirement for all EU countries to be able to perform independent branch resolution for non-EU branches, from 2015. It envisages that this could be invoked if the bank's home depositors were preferred over EU depositors or creditors.

The US already has long-standing powers to resolve foreign branches/agencies locally. There is some precedent of the authorities using these powers, although cases are rare. A notable example was BCCI SA, where non-US creditors found it difficult to access the substantial surplus that arose from the state-run liquidations in New York and California. But the fact that the US authorities did not invoke branch resolution powers for Banco Espirito Santo, which had USD1.1bn of assets in its New York branch at end-2013, suggests that branch resolution remains a back-up tool rather than an automatic procedure.

In a ring-fenced branch resolution a branch is treated like a subsidiary, with local assets used to pay local liabilities. Creditors of a branch with a surplus of assets over liabilities could therefore be better off in a local resolution, especially if they are able to make an additional claim for any remaining shortfall in separate home-country proceedings. Branch ring-fencing could encourage regulators and investors to "rush for the exit" and hamper orderly resolution of a large international institution. This is one of many coordination challenges for authorities dealing with global institutions that are "too big to fail".

The Financial Stability Board (FSB) is working to ensure national authorities cooperate fully with each other, including by recognising foreign resolution actions and ensuring cross-border debt bail-in can be effective. But the FSB recognises that branch resolution might be appropriate if the "home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability."

We believe the widespread adoption of powers to resolve branches locally could increase the risk of a disorderly process. This would be the case even if branch resolution is a back-up tool in case international cooperation proves ineffective, as proposed in the UK.

Branch resolution could interfere with a single point of entry (SPE) resolution strategy, which many larger banks are working towards. SPE involves resolving a troubled banking group at the level of its ultimate parent, with the rest of the group's banking operations continuing without interruption.

The potential ring-fencing of creditors at branches is likely to have a greater impact where there are high levels of foreign branch assets, such as in the UK and New York. A branch is generally part of a company and not a separate legal entity, but the regulatory and legal positions of creditors are becoming more blurred for bank branches in different jurisdictions.

Contact:

Alan Adkins
Senior Director
Credit Policy
+44 20 3530 1702

Bridget Gandy
Managing Director
Financial Institutions
+44 20 3530 1095

Christopher Wolfe
Managing Director
Financial Institutions
+1-212-908-0771

Cynthia Chan
Senior Director
Fitch Wire
+44 20 3530 1655

Media Relations: Elaine Bailey, London, Tel: +44 203 530 1153, Email: elaine.bailey@fitchratings.com.

The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.