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Multiple Point of Entry resolution strategy: a natural approach for decentralized retail banking groups

Executive Summary

Deciding between a Multiple Point of Entry (MPE) or Single Point of Entry (SPE) resolution scheme depends on each firm's particular characteristics.

- Banking groups vary significantly in their business models, corporate and legal structures, and their financial and operational interdependencies. For all these reasons, the optimal design of a resolution strategy should take into account the firm's particular characteristics. The way cross-border banks plan to die should be consistent with the way they lived.

- Choosing the optimal resolution strategy is not a binary decision. The SPE and MPE schemes are at the opposite ends of the spectrum and many resolution options may lie in between. Although the SPE resolution strategy seems at first sight the simplest approach – one strategy, one authority, one point of resolution, etc. – numerous impediments would arise should this resolution strategy be attempted in a decentralized retail bank context.

Cross-border retail banking groups fulfil all MPE pre-conditions

- Cross-border retail business models rely inherently on MPE when they meet the following preconditions:
    - They are structured by local subsidiaries.
    - Their client base is mainly local households and small and medium enterprises. Retail deposits are the main source of funding at subsidiary level, normally denominated in local currency and protected by the local deposit guarantee scheme.
    - Capital and liquidity are located in host countries with a stand-alone rating. Host subsidiaries manage their capital locally to support their own growth and are financially self-sufficient when needing to resort to the market.
    - There is no systematic intra-group support, either from the parent to the affiliate or in the opposite direction. This support is however not excluded under certain circumstances, but always as a voluntary business decision.

A hybrid approach (MPE + SPE) is possible, especially in the EU Banking Union context

- Recent progress towards Banking Union in Europe, and specially the designing of the Single Resolution Mechanism, may pave the way to implement a hybrid resolution approach in decentralized retail banks: i) an SPE scheme when dealing with subsidiaries in the Eurozone and ii) an MPE scheme when dealing with subsidiaries in third countries.

Operational MPE characteristics

- According to the FSB, “the MPE involves the application of resolution powers by two or more resolution authorities to multiple parts of the group when one or more parts of it have entered into resolution”. Very often, however, resolution will affect only one entity, to the extent that simultaneous crises in several subsidiaries are a rare event, especially in decentralized groups with natural barriers to contagion inside the group.

- The resolution process will always be led by local authorities. The role of home regulator will be more a “coordination figure”, and the role of host regulator will grow in relevance as the “executing figure” in cases where resolution affects only one subsidiary. Under an MPE model, coordination among resolution authorities is very important, but not as critical as under an SPE scheme, where trust of host towards home authorities is essential.

- Each subsidiary in the group that may be subject to a separate resolution action should have sufficient loss absorbency capacity individually and placed to the parent and third investors.

- Finally, shared services – IT and back office processes – should be organized on a stand-alone basis facilitating their continuity in case of resolution of any part of the group.

The decentralized model inherent to MPE implies benefits for global financial stability that far offset its costs

- From the point of view of the bank, stand-alone subsidiaries provide with a high degree of flexibility on the business strategy. From the point of view of global financial stability, the decentralized business model has proven its resilience during the financial crisis due to intrinsic firewalls between different parts of the group in case of a home or host financial crisis. Furthermore, stand-alone subsidiaries contribute to the development of local capital markets.

- The decentralized model has costs in terms of lower efficiency in capital and liquidity management and more loss absorbency capacity requirement (LAC) in the whole group, to the extent that potential synergies in the group are not exploited. These costs can be seen as a price to be paid for more prudent behaviour and a greater contribution to global and domestic financial stability.

- The MPE and SPE strategies respond to different business models. For each to work properly, it is important to align the incentives of all the stakeholders, including home and host authorities. In this note we argue that the MPE model is consistent with retail banking, deposit funding and stand-alone entities under the legal form of subsidiaries; although the SPE model is not analysed in this note, it seems more applicable to investment banks relying basically on wholesale funding and intra-group support.

1. Introduction: SPE and MPE

The FSB's guidance on developing effective resolution strategies[1] defines two stylised approaches for resolving significant financial institutions: the multiple-point-of-entry (MPE) and single-point-of-entry (SPE) and analyses the pre-conditions for applying them.

Under an SPE strategy, the resolution focuses on the entire group. After losses have occurred in any part of the group, a sole resolution process is initiated led by a sole home resolution authority. The assets of the whole group are then valued and the home resolution authority executes a global resolution plan. Thus, the implementation of the resolution tools such as a bail-in or mandatory debt-to-equity swap occurs at the parent level only and, therefore, losses in subsidiaries can be covered only through the holding company (by means of a downstream of new capital).

On the contrary, an MPE resolution strategy involves the application of resolution powers by two or more resolution authorities to different parts of the group, and this is likely to result in a break-up of the group into two or more separate parts preserving essential functions without causing contagion to the rest.

Both schemes – SPE and MPE – are the opposite ends of a spectrum where many resolution options may lie in between. There is no binary choice between the two approaches. In practice, a combination might be necessary to accommodate the structure of a bank and the local regimes in the key jurisdictions where it operates.

A certain degree of flexibility is necessary in developing different resolution strategies for different banks' structures taking into account their business models, corporate and legal structures, and their financial and operational interdependencies. In this note we argue that the optimal resolution strategy for global retail banks based on a decentralized model is the MPE approach.

Section 2 of the note outlines why the case of decentralized retail banks fits in general better with the MPE resolution strategy. Section 3 outlines the main implications that a MPE strategy has on the resolution authorities and the overall group (parent + subsidiaries).

2. Decentralized retail banking and the MPE strategy

2.1 Decentralized retail banking groups meet all MPE pre-conditions

Decentralized retail business models rely inherently on the following MPE pre-conditions:

A. **They are structured by local subsidiaries.**

   Major internationally-active retail banks entered host countries financial systems through acquisitions of local subsidiaries and structured them through local or functional intermediate holding companies.

   The local resolution authority is the only one in charge of defining at local level the resolution point of entry, the minimum loss absorbency capacity, how the local critical functions are preserved, etc. On the contrary, the home authority does not have any responsibility for resolving subsidiaries outside its country. Thus, the existence of either a local subsidiary or intermediate holding companies paves the way to implementing an

[1] Financial Stability Board (July 2013), "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies"

efficient and timely resolution of a local subsidiary following the local resolution regime. That is to say, a banking group structured by local subsidiaries allows to implement multiple and independent resolution strategies led by local authorities, which are in fact a global MPE for the whole group and an SPE within any jurisdiction.

However Europe, in particular the Eurozone, could be the exception to this rule. To the extent that the Banking Union implies that the Eurozone will at the end of the process to be structured as one jurisdiction – with one supervisor, a common resolution legislation, one resolution authority, a single resolution fund, and ultimately, a single deposit guarantee scheme – ; it would make sense to envisage the SPE model as the optimal resolution strategy for the Eurozone's subsidiaries (for further details see Section 2.3).

B. The client base of decentralized retail banking groups is mainly local household and small and medium enterprises. Retail deposits, normally in local currency, constitute the main source of funding at subsidiary level, and are protected by the local deposit guarantee schemes (to which these subsidiaries contribute).

In global retail banks' subsidiaries, the client base is mainly focused on households and small and medium enterprises. This business model is especially relevant in emerging countries where subsidiaries finance their own growth relying predominantly on deposits denominated in local currency and other traditional sources. As the Basel Committee illustrated recently, the loan-to-deposit ratio and the non-core-funding ratio in emerging countries are well below of those of the developed ones: 0.8 and 0.2 versus 1.2 and 0.3, respectively[2].

SPE regimes fit better for banking groups that issue most of their debt out of a top company, as an investment bank. However, it would not work so easily for retail-oriented groups around the world which are funded to a very large extent from insured deposits.

Additionally, from the host authority perspective, the MPE strategy may ensure that local interest would be protected in case of resolution affecting a group. In fact, host authorities would necessarily lead the local resolution process in order to protect the local uninsured depositors and local deposit guarantee schemes (DGS). When local financial stability is at stake, host authorities would not as a rule rely on home authorities to take key decisions.

C. Retail subsidiaries of global banks often have a significant market-share and a leadership position in their host countries. Thus, host retail franchises usually become a key player in local economic development.

Foreign investments of global banks usually seek a local leadership position in each franchise. As a consequence, host subsidiaries have critical implications for local growth and financial stability. Local authorities are responsible for regulating and supervising subsidiaries of foreign banks, without prejudice of the responsibility of home authorities for consolidated supervision. In this function it is important that they ensure a level playing field with other significant local players. Their responsibilities as concerns foreign subsidiaries include the following:

- Local capital and liquidity buffers.
- Local resolution requirements.

[2] Basel Committee on Banking Supervision (October 2013), "Global liquidity: selected indicator".

- Local on-site inspections and reporting.

These prudential requirements in a context of global institutions are not new; but the concern for contagion and spill over effects has been exacerbated in this crisis The most difficult cases are when a subsidiary is systemic in the host country (D-SIFI) but the parent is not systemic in the home country, but these cases are quite unusual. The concern for contagion also applies to home authorities, some of which have adopted regulatory measures to avoid an excessive assumption of contingent claims abroad. Both home and host countries face incentives for an MPE model in case of deposit-funded banks in order to reduce contagion effects.

In essence, host resolution authorities would like to decide how and when the resolution would be activated in their jurisdiction: i) when the resolution of the local subsidiary is likely to occur (resolution trigger), ii) which local legal companies and subsidiaries should enter into resolution (resolution scope), iii) how local resolution should be done (resolution tools) and how their creditors would be affected, and, finally, iv) how much loss absorbency capacity the local subsidiary should have in advance to minimize and in the limit eliminate local tax-payer cost (minimum LAC).

D. Capital and liquidity are located in host countries with stand-alone rating. Host subsidiaries manage their capital locally to support their own growth and are financially self- sufficient when they need to resort to the market.

As mentioned before, global retail banks that structure their foreign activities following a subsidiary model have normally to comply with tougher local prudential requirements in terms of capital and liquidity compared with branch models, usually relying on wholesale banking, where capital and liquidity requirements are decided by the home supervisor. In addition to subsidiary versus branch differences, emerging countries have usually tougher prudential requirements compared to developed markets.

Additionally, their business model has been designed to be decentralized, so that subsidiaries are self-sufficient in their funding, which is often raised under their own name with stand-alone rating independent to their parent banks. In case of a local liquidity shortage, subsidiaries may tap the parent for assistance, albeit at market prices and on a voluntary basis as a principle.

In the case of subsidiaries in emerging markets, a decentralized capital and liquidity framework contributes to the development of local capital markets[3].

Although the debate is in its early stages and there are substantial differences in the approach in each jurisdiction (see figure 1), in the case of retail banks, we envisage a situation where each legal subsidiary in a global retail group would be required by the host authority to have sufficient loss absorbency capacity (LAC) to cover its likely losses in resolution.

The SPE and MPE models require a different distribution of the LAC. In the SPE strategy the financial group must hold sufficient LAC at its parent level for the whole group. However, MPE strategies require significant loss absorbing capacities in the subsidiaries. It is worth mentioning that, the MPE model reduces contagion within the bank, but entails less synergy in the distribution of the LAC than the SPE, and probably more LAC for the group as a whole, to the extent that the LAC in one subsidiary cannot be used to meet

[3] For example, in Peru, BBVA pioneered the first local issuance of senior notes in 2005, the first issuance of subordinated notes in local currency in 2007 and the first Mortgage Backed Securities also in 2007, opening the way to other local players

the needs of another. This is a price to be paid by the decentralized model for higher flexibility in the business model and a contribution to global financial stability.

Figure 1
Main loss absorbency characteristics under different proposals

	FSB	European Authorities	UK	US
	GCLAC (*)	MREL (**)	PLAC / SLAC (***)	Long-term unsecured debt
Nature	Pending	Equity, subordinated, senior unsecured debt, and other unsecured liabilities	Equity and subordinated (PLAC) and senior unsecured debt (SLAC)	Senior unsecured debt
Amount	Pending	Over total liabilities	Over total RWA	Pending
Location within the group	Pending	At group or individual level depending the resolution strategy	Individual level	Consolidated level (holding)

The FSB will publish the LAC proposal in mid-2014

(*) GCLAC - gone-concern loss-absorbing capacity
(**) MREL - minimum requirement of eligible liabilities
(***) PLAC - primary loss-absorbing capacity, and SLAC - secondary loss-absorbing capacity

Source: BBVA Research

E. Absence of systematic intra-group support.

Closely related to the decentralized financial model, a key additional element in the resolution of a decentralized group is that the possibility of providing financial support within the group is a private and voluntary management decision of each entity subjected to home regulation. In fact, the inexistence of financial support agreements and intra-group exposure between the parent and subsidiaries paves the way to apply an MPE scheme.

The US and Swiss authorities have recently stated that intra-group senior debt should be critical when designing an SPE resolution strategy of global cross-border banks[4]. Indeed, whether the loss-absorbing debt at sub-holding level is sold to the parent level (intra-group exposure) or to a third party is a key decision with important implications for the optimal resolution strategy of the whole group.

- If the loss-absorbing debt of the sub-holding company is sold to the parent, the effects of the intra-group bail-in would be material and may drive the parent into resolution[5]. Therefore, an SPE resolution strategy would be optimal.
- If the loss-absorbing debt of the subsidiary is sold to a third party, the parent and the rest of the group are isolated from the senior debt bail-in. Therefore, the absence of intra-group financial interdependencies between group entities would reduce the risk of contagion through the group. An MPE resolution strategy would be optimal in such cases.

In a nutshell, the nature and extent of intra-group exposures is tightly related to the resolution model. Under an MPE model, intra-group support should in principle be only occasional and at market prices, to preserve the financial independence of each subsidiary.

[4] Daniel K. Tarullo (October 18, 2013), "Towards building a more effective resolution regime: Progress and challenges" and FINMA (August 2013), "Resolution of global systemically important banks – position note".
[5] An important question in this regard is the seniority of intra-group positions. We assume here that intra-group potions would be subordinated to other liabilities vis-à-vis third parties regardless of the rank in which these positions are materialized. Those are complex issues currently unsolved.

2.2. SPE approach fits better with other business models

It is broadly agreed that the SPE is the best solution for the business models of globally active and highly integrated wholesale institutions with concentrated funding and risk management structures and a central booking policy with a systematic reliance on intra-group funding,.

The core SPE element is the centralized financial model where the parent bank covers almost the entire internal financing needs of each group. Therefore, senior or junior debt is mainly issued centrally. Within each group, funding is distributed to host subsidiaries in the form of intra-group positions.

Those intra-group positions play a key role in the SPE scheme. They would be the liabilities used by the resolution authorities to recapitalize failed subsidiaries and to implement the bail-in tool within the group.

One of the clearest centralized and wholesale business models is Switzerland's two big GSIFIs where FINMA stated in August 2013 that the SPE is the optimal resolution strategy[6].

2.3. Hybrid approach for the Eurozone

Although decentralized retail banks fit naturally in the MPE model, a hybrid approach could be the optimal resolution strategy in some cases. When thinking in a hybrid approach, we envisage a banking group where part of the subsidiaries would follow a MPE approach and others would follow an SPE approach. The key deciding factor to implement an SPE strategy in a decentralized bank is whether there is at least a supranational resolution authority, a common resolution regime, and a fully harmonized deposit guarantee scheme over part of the group.

In Europe, recent institutional developments have paved the way to implement a feasible SPE scheme when designing the resolution strategy of a banking group with presence in two or more Eurozone countries. In particular, advances in terms of a Single Rule Book, a Single Supervision Mechanism, and, especially, the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) under discussion are breaking down the national banking barriers.

As the resolution of Fortis/ABN AMRO highlighted, in times of distress it is harder for an individual country to internalise the broader impact of cross-border resolution on global financial stability, even in an integrated area like the Eurozone, sharing important elements of sovereignty like monetary policy. The banking union process, together with a common resolution legislation, will facilitate solving these types of crises in the future.

To the extent that the Eurozone moves towards a single jurisdiction in terms of banking resolution, the use of a MPE resolution strategy inside the area seems hardly beneficial, although it can still be used when dealing with third countries.

[6] FINMA (August 2013), "Resolution of global systemically important banks – position note".

3. MPE implications for banks and authorities

In this section we analyze the implications and main takeaways that institutions and authorities should take into account when developing a MPE strategy and resolution plan. The four main areas of interest are the following:

1. Activation the resolution process.
2. Cooperation among resolution authorities.
3. Loss-absorption capacity requirements: nature, location and side effects.
4. Shared services organized on a stand-alone basis.

3.1. Activation the resolution process

As a general principle, the resolution process of one bank (or group) is triggered when the bank simultaneously fulfils the following three preconditions: i) the bank does not comply (or is not likely to comply) with its prudential requirements, ii) there are neither private alternatives nor parent support for restoring the situation, and iii) the failure of the institution could entail financial stability damage. Thus, the conditions should permit timely entry into resolution before a bank is balance-sheet insolvent and before all equity has been fully absorbed[7].

As regards the activation of the resolution process it is worth to consider the following:

- Multiple points of entry. As mentioned previously, MPE subsidiaries are independent for each other, so local authorities would have all resolution powers to activate the resolution process independently in the subsidiaries under their jurisdiction. In other words, an MPE approach entails more than one point of entry and more than one national resolution authority.
- Only local triggers. As a consequence of this local authorities' independence, we envisage that the local resolution process should be triggered only when the local subsidiary or local sub-holding located under the resolution power of each authority has failed or is likely to fail and there is no support from the parent bank.
- No ring-fence measures. The absence of financial interconnections, which become one of the main MPE preconditions, implies that the activation of the resolution process in a host as a result of financial distress in the home or a third-country subsidiary is not necessary in order to protect domestic financial stability. The European crisis showed that, in some cases, host authorities have had concerns about the capital and liquidity situation of the EU parent institutions and, therefore they have proposed introducing several ring-fence measures such as resolution trigger events based on the parent's financial performance[8]. These triggers are unnecessary when there is no intra-group support. Thus, under an MPE model these ring-fence measures should be avoided.
- Under the PME model, resolution will normally be activated by one authority in one country, due to the absence of intra-group contagion. Only in the case of crises not specific to the bank, but of a systemic nature and resulting from cross-country correlations is the occurrence of simultaneous crises inside the

[7] See KA 3.1. Financial Stability Board (November 2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions."
[8] For example the Foreign Bank Organization proposal in the US.

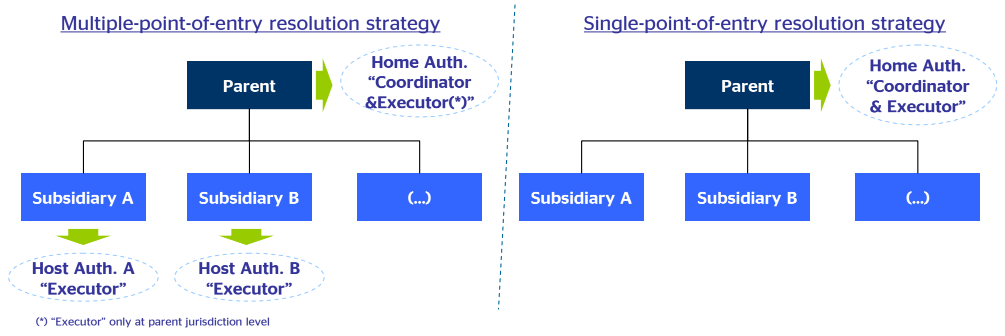
group likely; but also in these cases, the MPE acts as a natural firewall to spillover effects.

3.2. Cooperation among resolution authorities

The resolution process in an MPE banking group would be under the direction or control of two or more national authorities, each one responsible for the resolution process in its jurisdiction, and one of them (the home authority) in charge of overall coordination.

As a general principle, coordination between home and host authorities is important in both an SPE and MPE approach. However, under an MPE strategy, the coordination among resolution authorities should not be as critical as under an SPE scheme[9]. As shown Figure 2, under an MPE model, the ultimate responsibility for resolving any subsidiary lies in the host resolution authority. In fact, the role of home regulator will inevitably be more a "coordination figure," and the role of host regulator will grow in relevance as the "sole executing figure."

Figure 2
Home and host authorities' role under an SPE and MPE scheme



Source: BBVA Research

Against this backdrop, we envisage two different steps in cooperation and involvement among authorities under an MPE scheme.

- First, in the design of the high-level resolution strategy, home and host authorities should understand well the MPE approach of their counterpart and work together to develop a comprehensive resolution plan clearly delimiting the roles and duties of each authority. In this step, collaboration and coordination among host and home authorities is vital.
- Second, when the resolution strategy is implemented, as a difference with SPE, in a MPE model host and home authorities can act with relative independence, to the extent that the responsibility of each of them has been clarified ex ante. As compared to the SPE, where for example decisions on loss absorption have cross-border implications, the need of cooperation under a MPE is smaller.

A successful MPE strategy implementation will require the effective coordination of different resolution actions undertaken by home and host authorities. In this sense, specific cooperation

[9] The FDIC and the Bank of England highlighted the need for a tougher cooperation under the SPE when dealing with highly cross-border interconnected groups in their joint paper realized in December 2012

agreements (COAGs) should allow them to face the right incentives and meet their expectations. It is necessary to take into account four elements.

- First, as the FSB outlined, cross-border cooperation agreements (COAGs) within the Resolution Colleges and the Crisis Management Group are a key element of effective resolution regimes. Providing a clear definition of roles and duties for supervision authorities in both the design and the implementation of the resolution powers is crucial under both SPE and MPE schemes.
- Second, COAGs may be more flexible under an MPE model because the resolution strategy is applied locally, normally in only one country and the home authority does not have any power in relation to the local resolution implementation. In fact, each host authority has independent powers to execute the resolution in its jurisdiction.
- Third, the scope of host authorities to be considered in designing the resolution strategy is critical. Under an MPE, all subsidiaries that are systemically important in their local jurisdiction (domestic SIFIs) should contribute to effective crisis management planning, whilst, under an SPE scheme, the key subsidiaries are those that are systemic within the group.

  Thus, enhancing coordination and communication between the Crisis Management Group and the Supervisory Colleges is necessary in crisis preparedness[10].
- And fourth, effective information-sharing is essential for planning and carrying out resolution. The ability to exchange information between resolution authorities is fundamental in coordinating the effective planning, preparation and implementation of resolution. Nevertheless, the MPE requirements for the information will be different from an SPE strategy. In fact, local empowerment and local involvement throughout the resolution process is higher being inherent to the decentralized decision-taking, whereas information exchange is again less critical than in the SPE.

3.3. Loss-absorption capacity requirements: nature, location and side effects

The objective behind the minimum loss-absorption capacity requirement (LAC) is to ensure that there is an appropriate level of capital and unsecured liabilities for the relevant group to be resolvable, minimizing (and in the limit eliminating) the tax-payer cost. This requires that the application of the LAC within a group reflects the group resolution strategy and, therefore, is tailored to the group business model and resolution plan.

For MPE groups, this implies that each legal entity or sub-holding in the group that may be subject to a separate resolution action should have sufficient LAC individually to cover its likely losses in resolution and those of subsidiaries below it for which a separate resolution is not planned. On the contrary, requiring such groups to comply with a consolidated LAC would not be appropriate because liabilities in a subsidiary would not be used to absorb losses either at parent or at third subsidiary level.

[10] See Principie 7 of the BIS's consultative document on "Good Practice Principles for Supervisory Colleges" (January 2014).

Despite being an individual requirement set by local authorities, the LAC's nature and hierarchy of claims in case of MPE resolution should ideally be consistent among different jurisdictions. We use the word "consistency", not "harmonization", because domestic conditions and circumstances often compel regulators to adapt the local framework out of global financial stability considerations. Two examples:

- Equity and subordinated debt should always assume losses; however, the rest of the liabilities should be adapted to the local idiosyncrasy of each jurisdiction, and be flexible enough to exclude creditors where it would cause domestic systemic issues or would jeopardize the incipient development of capital markets. This is especially relevant in emerging countries where loan-to-deposit ratios and non-core funding ratios are well below those in developed ones[11].
- Another example concerns the degree of harmonization of resolution legislation required under the SPE/MPE models. Under an SPE, the hierarchy of claims harmonization is critical to ensure intra-group and cross-border inter-creditor fairness (for instance as regards the treatment of intra-group positions external creditors, or how the structural subordination of home versus host creditors is defined). That is not the case under an MPE scheme where further degree of flexibility could be possible.

We have outlined previously that the LAC should be required at individual level and mainly in the form of equity and unsecured debt. In fact, the individual LAC requirement should be placed at parent level in equity terms and at third-investor level in debt terms (subordinated and senior). This requirement is consistent with the absence of intra-group exposures, which is one of the key MPE pre-conditions. The LAC characteristics mentioned above have the following effects:

- First, the total LAC amount at consolidated level placed to third investors is higher under an MPE approach than under an SPE one. Therefore, MPE banks would have higher costs in terms of lower economies of scale in funding activity and lower capital and liquidity management optimization.
- Second, in most emerging countries the LAC requirement would, in practice, imply higher capital requirements due to the lack of development of their local capital markets. Subsidiaries in emerging countries would not be able to issue a significant amount of the new bail-in debt, and therefore, they would be forced to cover the LAC requirement with pure equity, increasing the total capital amount.
- Third, on the contrary, at parent level, an MPE scheme would imply that capital surcharges to cover future capital shortfalls in host counties are not necessary.

3.4. Shared services organized on a stand-alone basis: Operational subsidiarisation

As mentioned before, MPE groups usually organize themselves into well-defined regional and functional subgroups. In this sense, an MPE approach does not only apply to bank units, but also to shared services, such as IT or back-office processes. Thus, critical shared services of

[11] As the Basel Committee illustrated recently (October 2013, "Global liquidity: selected indicator") loan-to-deposit ratios and non-core funding ratios in emerging countries are well below the developed ones: 0.8 and 0.2 versus 1.2 and 0.3, respectively

MPE banks must be organised in a way that would permit the group to maintain critical services when other parts of the group enter into resolution. This is what has been termed as "effective operational subsidiarisation."

The main features and pre-requisites of the operational subsidiarisation are the following:

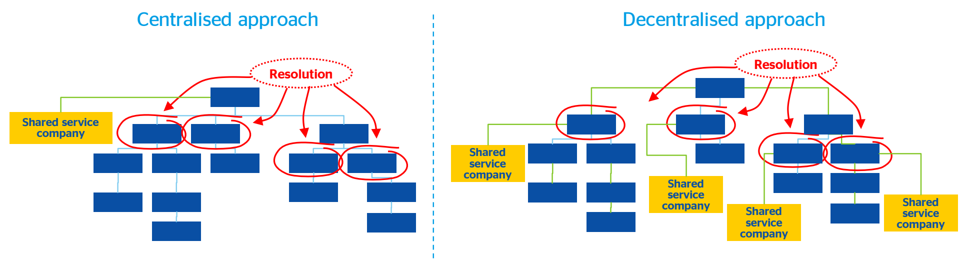
- Shared services should be provided from a separate legal company.
- The financial viability of the shared service company should be driven by services provided rather than by corporate contributions from the parent; and should be supported by a robust and audited transfer pricing policy.
- The shared service company should be sufficiently funded ex-ante.
- Robust service level agreements (SLAs) between group entities are a requirement.
- IT service companies should be able to produce specific legal entity data.

Benefits of the operational subsidiarisation are significant, ranging from a more effective resolution – securing operational segregation – to a more efficient service – cost optimisation.

As shown Figure 3, operational subsidiarisation in MPE banks may be structured in two ways: i) a centralised approach based on either branches or subsidiaries, and ii) a decentralised approach. When choosing between the two approaches, banks need to strike a pragmatic balance between the wishes of the regulators – decentralised – and the need to maintain an economically viable business model – centralised.

Figure 3

Operational subsidiarisation structure approaches: centralised vs. decentralised



Source: BBVA Research

4. MPE benefits in decentralized retail banks outweigh its costs

We argue that MPE is the natural resolution strategy for decentralized retail banks. In the following section we describe the main pros and cons of the MPE strategy in decentralized retail banks from a double perspective: the bank vs other stakeholders and the home vs host authorities.

The bank's perspective

The decentralized business model carried out by global retail banks – inherent to MPE resolution strategies – provides the following benefits to the bank:

- Firstly, it allows for a fair assessment of the risks involved in the financial activity. The decentralized model has a medium- / long-term orientation, avoiding short-termism and allowing for a proper evaluation of risks. Broadly considered, this business model provides adequate tools to account for the risks each subsidiary undertakes. As a result of this, its corporate structure avoids risk undervaluation related to cross subsidies inside the group. Furthermore, this approach ensures the sustainability of each subsidiary on a stand-alone basis.
- Secondly, the decentralized model does not exclude a sharing of a risk culture inside the group, in particular as regards credit and liquidity risk management. Subsidiaries share i) corporate liquidity and credit risk identification, measurement and control methodologies, ii) liquidity and credit management best practices , iii) access to a conditional corporate emergency liquidity facility that is constrained for idiosyncratic operational risk events or exceptional one-off market disruptions and iv) a common human resources management culture. Moreover, the need for building pools of liquidity constitutes a guarantee against sudden reversals in market liquidity conditions.
- Thirdly, the decentralized liquidity and capital management model creates natural firewalls in the event of a crisis. This model generates inbuilt limits to contagion.
- Finally, accountability and transparency are enhanced by a subsidiary model by reducing complexity. These factors anchor agents' expectations and lower risk perception in financial markets.

Nevertheless, there is a cost attached to this resilience in terms of lower economies of scale in funding activity, lower capital and liquidity management optimization, and more loss absorbency capacity requirement (LAC) placed to third parties in the whole group. This potential cost in terms of lower efficiency in the subsidiary model could be considered a price to be paid for more flexibility in the business model and a greater contribution for global financial stability when it comes to resolution.

The host and home authorities' perspective

A key consideration for home or host authorities in weighing the merits of the MPE or SPE resolution approach will be their implications for local growth and financial stability, as well as the incentives for all stakeholders, including the authorities themselves, to act in the benefit of global financial stability. Thus, while certain features of the two schemes are relevant only for host countries, other features have different implications for home and host and hence entail different preferences.

In normal times, one would anticipate that a centralized business model (aligned with SPE) could provide host country borrowers with easier access to foreign credit. Intuitively, the structure that has fewer restrictions on intra-group transactions should make the provision of credit to subsidiaries easier. However, excess of capital flows for foreign banks may exacerbate bubbles in host countries. The recent crisis showed that countries that experience huge increases in asset prices fuelled by net capital inflows from banks suffered particularly badly. In particular, high external interbank debt and maturity and currency mismatches contributed to foreign rollover risk[12].

An additional clear example is the comparison between the role of foreign subsidiaries in Central and Eastern Europe (based on centralized model that relies on a systematic support from the parent) and in Latin America (where most foreign subsidiaries operated under a decentralized model). The credit boom and the sudden stop in the first case contrast with the resilience in Latin America. There is abundant literature that attributes this difference, to a certain extent, to the different business models of foreign banks[13].

Additionally, MPE subsidiaries could foster local financial markets' development in host countries because these subsidiaries are more likely to rely on local savings and local financial market developments.

The dilemma appears in stressed times or when a financial turnover is on the horizon. In those scenarios, home and host regulators may have opposite preferences regarding the optimal group structure: decentralized versus centralized or, what is the same, MPE versus SPE. Thus, the key is the financial strength of each county.

- On one hand, home authorities would prefer a decentralized-MPE approach with stricter firewalls across parts of the group, especially when their banks expand into countries with weak economies and a risky business environment.
- Additionally, host authorities might also prefer the MPE model if conditions in their country are better than those in the home country or in a third host country, in order to protect the local subsidiaries from the problems of the parent or any part of the group. For example, under an SPE approach, the failure of a subsidiary would trigger the bail-in of intra-group debt and may lead the parent to experience material financial distress. This situation would imply that a third host authority would consider that the parent is at risk of no longer being able to be a source of strength for the subsidiary located in their country, driving it into a pre-planning resolution stage. Under a SPE model, contagion may spread among the whole group.
- Host authorities will prefer the SPE model when they have a very high degree of confidence on the home resolution authorities. In the absence of this, they may prefer an MPE model, especially for retail banks with a significant share of local deposits.
- On the other hand, countries with underdeveloped financial systems and weak economies may prefer global banks with an SPE resolution strategy that can facilitate support from the parent bank.

It is important to keep in mind that resolution strategies should be consistent along the business cycle and across countries, and designed in a way that is not contingent on the position in the cycle, either at home or in the host countries. In other words, resolution strategies as well as business strategies of global banks should be designed to operate for the good and especially for the bad times.

[12] Bank of England (October 2013), "The role of external balance sheets in the financial crisis".
[13] See for example: S. Fernandez de Lis (April 2013),; Cull and Martinez Pería (2012), and Fiechter et al (2011).

5. Conclusions

The MPE is the natural resolution strategy for decentralized retail banks. Their business model, their corporate and legal structure, and their financial and operational independence are consistent with the MPE's pre-conditions outlined by the FSB in July 2013.

However Europe could be an exception to this rule. To the extent that the Banking Union implies that Europe will at the end be structured as one jurisdiction from a financial point of view, it would make sense to envisage the SPE model as the optimal scheme for the Eurozone's subsidiaries. Banks operating both in the Eurozone and abroad can opt for an hybrid resolution strategy, SPE for the former and MPE for the latter.

From an operational point of view, the MPE implies three main characteristics:

- First, the resolution process will always be led by local authorities.
- Second, the resolution process in a subsidiary should be triggered only when it has failed or is likely to fail, there are no private alternatives to restore the situation – the parent does not support it --, and the failure of the institution could entail local financial stability damage.
- And third, each subsidiary in the group that may be subject to a separate resolution action should have sufficient loss absorbency capacity individually and placed to the parent and third investors.

The banking model approach, and therefore their inherent resolution strategy, is a voluntary decision of each bank. Despite the efficiency cost in terms of capital and liquidity, the decentralized retail banking model provides a more prudent behaviour, a fair risk assessment, and enhanced transparency and accountability whilst sharing the group's best practices (e.g., IT, risk management, etc.).

From an institutional perspective, in the case of retail banks host authorities would probably tilt towards an MPE resolution strategy in order to preserve their local markets and protect domestic depositors. Healthy retail subsidiaries that operate independently of the parent bank will be able to better withstand the failure of the parent or other subsidiaries within an MPE resolution strategy. Furthermore, the SPE model requires a degree of trust of host towards home authorities that is difficult to envisage in case of banks funded by local deposits.

In case of home authorities, the MPE model constitutes also for them an inherent firewall against contagion risk and, additionally, enhances the market discipline and sets proper incentives inside the group.

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