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EDITOR

Krystyna Kawerska

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Bankowy Fundusz Gwarancyjny
ul. Ks. Ignacego Jana Skorupki 4
00-546 Warszawa

SECRETARY

Ewa Teleżyńska
Telephone: 22 583 08 78
e-mail: ewa.telezynska@bfg.pl

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Miscellanea

Andrzej Dżuryk

Funding of Banks in Resolution

Abstract

The article presents the outcome of the research executed by the author, which formed the position of the European Financial Congress (EFC) in relation to the Financial Stability Board's consultative document on *Funding Strategy Elements of an Implementable Resolution Plan*. The position, was based on the opinions of stakeholders of Polish financial market, represented by banks, regulatory bodies, law firms and the academia.

The consultative document set out proposed guidance on the development of a plan for funding banks in resolution. The research revealed a wide array of challenges in the development of firm capabilities to facilitate the execution of the funding strategy in resolution. Additional issues were raised regarding relevant aspects for estimating liquidity needs in resolution process. There were indicated numerous obstacles to the mobilisation of assets that could be used as collateral for particularly private sector backstop sources of funding. All those blocking points could be removed by public sector support funding, subject to certain conditions. Moreover, there are a number of actions that could be taken by G-SIBs and authorities to support the development and implementation of resolution funding and there are also some other aspects of funding strategy which shall be also considered.

Key words: financial stability, financial stability board, resolution, BRRD, funding in resolution, G-SIB

* Andrzej Dżuryk, PhD, Adjunct at the Department of Banking, Faculty of Management, University of Gdansk and Director at Société Générale Corporate and Investment Banking Branch in Poland. The article solely presents author's opinions and shall not be interpreted as a position of respective institutions.

1. Introduction

The author tackled on the position[1] of the European Financial Congress (EFC)[2] in relation to the Financial Stability Board's[3] consultative document on Funding Strategy Elements of an Implementable Resolution Plan[4]. The position was based on opinions of stakeholders of the Polish financial market, collected in a research performed by EFC. A group of experts representing banks, regulatory bodies, law firms and the academia, were invited to participate in a survey. They received selected extracts of the consultation document and the consultation questions. The experts were guaranteed anonymity. There were over 20 replies. The replies were grouped and presented anonymously to experts who took part in the consultations. They were asked to mark opinions that should be included in the final position, as well as opinions they did not agree with. The experts could also adjust their primary positions under the influence of arguments presented by other participants, which they had not known previously. On the basis of the final responses received, the author developed the synthesis of Polish stakeholders' view, which became the position of European Financial Congress. The synthesis was presented by the author at the conference "*Zarządzanie Ryzykiem i Kapitałem w Bankach*" held by the National Bank of Poland[5].

The consultative document set out a proposed guidance on the development of a plan for funding in resolution that builds on the FSB's August 2016 *Guiding Principles on the temporary funding needed to support the orderly resolution of a global systemically important bank (G-SIB)*[6] and the existing supervisory and resolution guidance on liquidity risk management and resolution planning, respectively. It identified a set of key funding strategy elements covering:

- firm capabilities to support monitoring, reporting and estimating funding needs in resolution and to facilitate execution of the funding strategy;

1 *Position of the European Financial Congress in relation to the Financial Stability Board's consultative document on Funding Strategy Elements of an Implementable Resolution Plan*, European Financial Congress, January 2018, http://www.efcongress.com/sites/default/files/analizy/position_of_the_efc_funding_strategy_in_resolution.pdf [Accessed: 11.03.2018].

2 The purpose of regular debates held within the EFC Project is to ensure the financial security of the European Union and Poland (www.efcongress.com) [Accessed: 11.03.2018].

3 Financial Stability Board promotes global financial stability by coordinating the development of regulatory, supervisory and other financial sector policies and conducts outreach to non-member countries. It achieves cooperation and consistency through a three-stage process, including monitoring implementation of agreed policies, http://www.fsb.org/what-we-do/ [Accessed: 11.03.2018].

4 *Funding Strategy Elements of an Implementable Resolution Plan*, Financial Stability Board, 30 November 2017, http://www.fsb.org/wp-content/uploads/301117-2.pdf [Accessed: 11.03.2018].

5 "*Zarządzanie Ryzykiem i Kapitałem w Bankach*" Conference, National Bank of Poland, Warsaw, 23 February 2018, http://zrk.projektekf.pl/ [Accessed: 11.03.2018].

6 *Guiding Principles on the temporary funding needed to support the orderly resolution of a global systemically important bank*, Financial Stability Board, 18 August 2016, http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D.pdf [Accessed: 11.03.2018].

- the development of a resolution funding plan by the authorities;
- the use of firm assets and private sources of funding;
- the access to temporary public sector backstop funding mechanisms and ordinary central bank facilities; and
- the information sharing and coordination between the authorities.

2. Challenges of the funding strategy

The funding strategy is a key element of a resolution plan. It must be formulated ex ante and will determine the plan's effectiveness. Action plans for stressed conditions must be developed and tested, especially for systemically important banks (SIBs). In practice, however, various difficulties may arise.

The major problem will be to determine liquidity needs in a contingency whose background and circumstances are unknown, on the basis of earlier contingencies observed in the market. The availability of the assumed sources of liquidity depends on many factors, and the financial needs may change very quickly and sometimes unexpectedly. Therefore, the funding strategy may not sufficiently account for all potential problems or it may address them in an inadequate manner. Moreover, in the case of markets where there were no bankruptcies of locally significant banks, it is difficult to estimate the feasibility of the recovery option.

The determination of an entity's liquidity needs in the resolution process depends on the adopted scenario, however this is the fundamental difficulty in modelling behavioural and market elements that constitutes the problem. The projected problems and shocks may turn out to be greater than those accounted for when determining the funding strategy, and an occurring extraordinary event ("black swan") would be an extremely negative scenario. As a result, the accumulated liquidity reserves may quickly run out and prove insufficient in relation to needs, as well as the assumed liquidity sources may be unavailable due to broader market problems. The inability to access market sources of funding in a crisis may result in a need to use extraordinary central bank facilities. The problem in this case may be the lack of adequate collateral in the form of high quality liquid assets (HQLA), which were used up in the recovery phase, due to the none-eligibility of certain types of assets as collateral and the aforementioned worse-than-expected market scenario (lower asset value and lower demand resulting in larger haircuts). The prerequisite for using extraordinary central bank facilities is stripping current owners of the entity of their rights in order to avoid moral hazard (what is not in line with current EU regulations). It appears to be an important aspect that the resolution authority and the central bank (as the lender of last resort) develop their own information policies. An appropriate information policy should prevent the occurrence of a panic (contagion effect) and of a run on bank deposits. The scale of this would be difficult to estimate and could result in an SIB with a robust liquidity situation losing liquidity. Such media activity should not be limited exclusively to traditional media, but should also include a broad offensive, including social media. If the negative

scenario unfolds the proper liquidity risk management as well as the meticulous monitoring of funding needs and reporting to the entity responsible for the bank resolution process will be the challenge.

Availability of the appropriate data and the coordination of information at the consolidated level are preconditions for reliable forecasting of future liquidity needs and designing adequate actions. In particular it pertains to current and intraday liquidity, as well as the rapid identification of other entities with similar profiles, which operate in the market. It allows to notify them and to impose increased monitoring and supervisory reporting obligations.

The elaboration and selection of indicators, which may trigger the resolution process due to the risk of financial liquidity is while capital adequacy and balance sheet liquidity ratios are acceptable, poses the challenge for the resolution authority .Especially under conditions when recovery options, in recovery plan, may be unavailable due to market situation or other temporary restrictions. The experience of the latest global financial crisis shows that a national legislator may introduce regulations that hinder or even prevent the implementation of measures, previously provided for in the funding strategy, by limiting the ability to use the assets held as collateral in the process of obtaining extraordinary liquidity. Legal risk is also related to the performance of various master agreements, including with respect to derivative transactions, which may cause problems with enforcement in individual jurisdictions and thus may prevent or hinder the effective and smooth implementation of the funding strategy. This risk may also be related to the insufficient development of legal institutions in some jurisdictions, which may lead to difficulties with the effective implementation of the funding strategy. Legal risk also stems from mismatches among agreements that stipulate mutual liabilities of the counterparties.

In the case of cross-border groups, the challenge may be caused by the differences resulting from diverging policies pursued by central banks, e.g. concerning assets purchase programmes. A considerable challenge may be posed by inconsistent expectations on the part of supervisory and resolution authorities with respect to the required liquidity levels and sources of liquidity funding. Potential difficulties may be related to the achievement of cross-border agreements concerning the allocation of costs of the resolution process to entities within a banking group. Both the BRR Directive (BRRD)[7] and the FSB guidance[8] have established a general frame-

[7] *Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC*, and *Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU*, and *Regulations (EU) No 1093/2010 and (EU) No 648/2012*, of the European Parliament and of the Council, Official Journal of the European Union, L 173/190, 12.6.2014, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=PL [Accessed: 11.03.2018].

[8] *Key Attributes of Effective Resolution Regimes for Financial Institutions, in particular Annex III 'Essential elements of recovery and resolution plans'*, Financial Stability Board, October 2011, http://www.financialstabilityboard.org/publications/r_111104cc.pdf, an update published in October 2014, http://www.financialstabilityboard.org/2014/10/r_141015/; *Recovery and Resolution Plan-*

work for determining the contributions of individual resolution authorities to the funding of the process. However, in practice, difficulties can be expected at the stage of negotiating specific agreements.

Other challenges and difficulties that may arise in the implementation of the funding strategy include:

- inconsistent auditing standards, which are prone to changes over time, especially with regard to estimating risk and provisioning;
- an effective debt collection mechanism in the resolution process and;
- the maintenance of adequate resources (human, IT, etc.) that enable the performance of tasks related to the implementation of the funding strategy.

3. Liquidity needs in resolution

An important element of the strategy for funding in resolution is the ability to use ordinary central bank facilities. A clarification of what is meant by ordinary and extraordinary central bank liquidity support would be useful. Central banks in individual countries use different solutions in this area. The proper differentiation between these facilities is necessary in order to correctly identify potential sources for covering liquidity needs for the purposes of resolution. Potential process participants should have *ex ante* clarity rather than in an emergency situation.

If a systemically important bank needs to be resolved, structural changes will occur in the banking sector in addition to a significant increase in sensitivity to counterparty risk and the interbank loans maturity shortening. These changes mainly consist in the shrinking of the whole interbank network while the role of banks playing key roles in this network is strengthened. It may cause difficulty in access to liquidity, depending on the bank's position in the interbank network. The multi-level structure of interbank markets must be accounted for, since it means that most banks do not lend to one another directly, but rather via intermediary banks.

When drawing up a resolution funding plan, the market liquidity risk should be considered. Under normal circumstances, the liquidation of assets at, or close to, market price does not usually pose large problems. In the event of an external or internal shock, market participants may partially withdraw, which may cause demand to drop and force the liquidation of assets at a price that significantly deviates negatively from the market one, thus increasing losses and causing a considerable gap between the funding plan and the actual possibilities of obtaining funding. In this context, increasing the liquidity cushion for systemically important banks should be considered. Perhaps increasing LCR and NSFR requirements would be a good solution. If problems occur, liquidity is more important than recapitalisation in the

ning: Making the Key Attributes Requirements Operational, Financial Stability Board, November 2012, http://www.fsb.org/wp-content/uploads/r_121102.pdf?page_moved=1 [Accessed: 11.03.2018].

pre-resolution stage and thus the priority should be to maintain short-term liquidity to "buy time" for introducing other measures.

The estimation of liquidity needs could involve an internal control system that should also address liquidity risk and, above all, ensure the proper and effective functioning of the liquidity risk management process. Combining this aspect with the public disclosure mechanism would enable market participants to reliably evaluate the bank's liquidity risk management system and its liquidity position during resolution. This could be supplemented with tools for the comprehensive measurement of liquidity risk in order to support the liquidity risk management process to enable the identification of heightened risk, emerging liquidity position weaknesses or an increase in liquidity needs. Another important issue with respect to the assessment of liquidity needs in the resolution process is the bank's appropriate organisational structure, i.e. a structure that corresponds to the bank's scale of operations and risk profile and that ensures the separation of functions between the units, which conduct transactions that affect liquidity risk and those responsible for monitoring and controlling liquidity risk.

Given the increasing popularity of factoring services provided by banks and of loans secured by assignment of receivables under contracts, the examination of the quality of assigned receivables, their maturity and the debtors' rights to offset these receivables may be of particular importance. Attention should also be paid to the liquidity needs related to the breach of clauses embedded into the funding obtained, e.g. concerning additional collateral or restrictions on creating security on assets. On the other hand, a positive solution would be for banks to have long-term contingency liquidity supply agreements, e.g. with other banks, although the question remains whether it would be effective in the resolution stage.

4. The collateral

The identification of assets that could be used as collateral in resolution itself does not appear to be a problem. However their use as collateral for private sources of funding may be the problem. Past experience demonstrates that these sources are often funded by banks (e.g. in Italy). Such a solution threatens systemic risk, since the difficulties faced by a large bank could be shifted to a group of banks or even to the entire banking sector, and thus it should be eliminated. During the implementation of a specific resolution strategy, it may turn out that owing to exceptional market difficulties, the private sector funding assumed, in the recovery plan, will not be available since certain types of assets are not eligible. It will be even more probable when concentration occur,s thus reducing the ability to dispose of the assets concerned. The limited availability of private sources means that the potential cost of conducting transactions (even collateralised) with private entities is difficult to estimate and test, which makes it difficult to assess the impact of these transactions on profitability and solvency under resolution conditions. This type of obstacle can be

removed by using support from the public sector institutions. In this case a question arises: in what scope and on what scale can this support be lent? Currently, we have no information on the terms and conditions of extraordinary liquidity support by the central bank, and the resolution plan cannot assume the use of its extraordinary facilities. Nevertheless, the entity subject to resolution may apply for such support after it meets certain conditions. This type of obstacle can be removed by informing banks about the types of collateral that are eligible for acceptance by the central bank in connection with extraordinary operations.

Owing to the fact that no assistance by the central bank can be extended on terms significantly deviating from the market ones, banks should have a sufficient amount of unencumbered assets that can serve as collateral, which will enable them to use the infrastructure made available to commercial banks by the lender of last resort.

Therefore, balance sheet items that may be used as collateral in transactions with the central bank need to be monitored on an ongoing basis. At systemically important banks, the leverage ratio should also be further reduced.

The main obstacle to use assets that could be employed as collateral for private sources of funding may be the fact that no current valuation of these assets performed using prudent methods is available. This valuation must then be conducted in a short time in circumstances where the value of assets recorded in the books of the entity subject to resolution may deviate significantly from their real value. Therefore, bank assets should be regularly valued by independent and credible experts, who are recognised on the market, applying a range of prudent valuation methods that are used by providers of private funding in order to convince them to accept the risk of investing their funds.

The need to predict behaviours of individual market participants in an unusual, stress situation may also cause considerable difficulty in using the assets. One cannot assume that the behaviours observed in the past will be repeated in the current contingency. Possible speculation in the market will also have an impact on securing funding sources (e.g. when FX structure is being adjusted). In a contingency, any estimates concerning the feasibility and implementation of corrective measures on a large scale and with significant effects such as the separation and sale of part of a bank may be erroneous to a considerable extent.

The problem of state aid interpretation, under European Commission law, and its costly consequences, may cause specific obstacle in employing public sector backstop funding. The problem related to the lack of definitions and procedures concerning possible temporary public sector backstop funding may be alleviated by making reasonable efforts to ensure that public sector funding is provided on an arm's length basis. The positive result of the private investor test would provide proof that the transaction was executed on an arm's length basis. This test should demonstrate that the bank's assets serving as collateral for public funding are sufficiently credible and reliably estimated so that they could serve as standard collateral for private funding.

A failure to implement a recovery plan for the bank, e.g. in the Polish jurisdiction, prevents the central bank from waiving the reserve requirement, thus without the implementation of the recovery plan, even the bank's highest-rated assets (HQLA) will not enable it to access obligatory reserve funds. Therefore, it is important to approve and implement as soon as possible the bank's recovery plan, which should be based on conservative assumptions and should be developed before resolution is initiated.

In essence, legal obstacles that may hinder or prevent the use of assets held as collateral for funding sources may be effectively removed only within the home jurisdiction, because uncontrolled bankruptcy of SIFI could trigger a systemic crisis in the country in question. However, legal obstacles cannot be effectively removed in relation to host jurisdictions, which in the face of a crisis will in the first place try to protect their own banking sector. In Poland, the regulatory authority has challenged the use of collateralised funding, i.e. mortgage bonds issued by mortgage banks, as a recovery option at the level of the parent undertaking (through a transfer of funds within a group of companies).

5. Support to funding plans

The development and implementation of funding plans must be accompanied by a range of risk mitigation and public relations measures. Risk mitigation activities involve primarily strengthening the debt collection process and the temporary suspension or significant limitation of lending, which should be restricted exclusively to loans secured on assets with a high recovery rate. At the same time, a communication plan and a consistent media message should be developed by preparing model messages and selecting channels for their transmission. These communications should be aimed at stabilising the bank's situation and lending credence both to the taken corrective measures and to the bank itself. This concerns both the bank's external communications and those with its employees in order to retain and convince them that the actions taken will enable it to survive temporary difficulties. Proper communications have a significant impact on the funding plan implemented and on the bank regaining liquidity.

Guidelines covering reporting structure and methods as well as other operational functioning aspects under resolution conditions should be developed. Supervisory reports are largely based on audited data, which are characterised by considerable delays, and thus a different reporting system is needed. It is critical that the information held by the resolution authority is credible and up-to-date. In order to avoid the interpretation uncertainties associated with nonstandard reporting, resolution authorities should make greater use of the standard reports drawn up by banks and submitted to the competent authorities, i.e. to the supervisory authority, resolution authority and central bank. This approach would not only guarantee access to reliable data, which was verified during its generation process in the earlier periods, but

would also ensure that these pieces of data are more frequently available from competent institutions that gather data from the banking sector. Moreover, in response to an individual request by the resolution authority the bank would be able to generate a standard statement much faster than in the case of non-standard processing, which is additionally associated with the risk that data will not be fully comparable across the sector. It should be ensured that the resolution authority can gain rapid access to the required pieces of data that are included in the reports and statements regularly being provided by banks to other supervisory institutions, as well as that a framework be established for open dialogue in the case of dedicated reports, which must be prepared on a case-by-case basis by the banks. The banks selected as possible candidates to acquire the institution in question should be informed of this fact as soon as possible, e.g. already at the recovery plan implementation stage, in order to conduct initial valuation and to shorten/facilitate the resolution phase (see Santander's acquisition of Banco Popular[9]).

Resolution authorities should be very sensitive to any measures proposed in resolution funding plans whose effectiveness depends on the legal environment in foreign jurisdictions, since even if such measures were possible earlier, it may turn out that they are no longer lawful in the jurisdiction at the time when they must be taken.

Another important issue, related to the measures that must be taken by banks and resolution authorities, is transparent cooperation in the definition of critical functions with respect to institutions that play important roles in both resolution plans and recovery plans. Where a bank is the member of a cross-border group that applies a consistent methodology for determining critical functions within individual units. Uniform selection criteria and the list of critical functions by banks in cooperation with resolution authorities is of particular importance for ensuring proper approach and management not only with respect to the recovery or resolution process, but also at earlieractivity. Sets of critical functions related to the recovery and resolution processes may or may not overlap. On the other hand, banks should be given greater rights to inspect the resolution plans drawn up by resolution authorities (currently only a summary of key aspects of the plan is to be made available) if they are to adjust their contingency liquidity plans to resolution plans and ensure their feasibility. A more comprehensive dialogue on this subject should be initiated with resolution authorities. More attention must be paid to ensuring appropriate competences and resources (including the continuity of competent expert work) both on the part of the resolution authority and the bank subject to resolution.

Additionally, resolution authorities could consider a moratorium, which would affect the method of funding the process, and above all could temporarily reduce the bank's liquidity needs. The issue, whether it would be possible to suspend payments for a few days, is currently discussed in the EU as part of work on amending

[9] J. Aguado, F. Guarascio, *ECB triggers overnight Santander rescue of Spain's Banco Popular*, Reuters, 7 June 2017, https://www.reuters.com/article/us-popular-m-a-santander/ecb-triggers-overnight-santander-rescue-of-spains-banco-popular-idUSKBN18Y0IU [Accessed: 11.03.2018].

the BRR Directive. The question is whether the moratorium will be effective and how it will affect the credibility of the relevant market and the scale of disruption. Support for the development of the securitisation market would be helpful as well in order to enable broader access to this source of funding, which would also make the cost of obtaining funding from this source in contingency and during resolution more transparent.

Funding plans should involve pessimistic assumptions regarding possible loss of funds within the entity and within the entire group of companies at the consolidated level. The following questions must be answered: What is the tolerance of depositors in respect to bank problems? Does the deposit guarantee scheme provide sufficient security for those with deposits up to EUR 100,000? What will be the scale of the outflow among those depositors, who hold more than EUR 100,000 in the bank? This comment also applies to all other liabilities that are due shortly or are assigned to long-term liabilities under contractual provisions, but may become due shortly as a result of unfavourable conditions. In this context, market risk exposure and derivatives should also be discussed. The derivatives issued, especially American options, may be exercised by the buyer at any time. Buyers of such options may close their positions in a contingency. This may result in a need to conduct settlements on a greater scale than that suggested by internal bank models. Uncovered positions may additionally exacerbate the situation.

6. Other aspects to be considered

In the event of resolution of a cross-border group using the single point of entry formula, it may be necessary to maintain the liquidity of the entity operating in the host country. The question arises whether, if liquidity needs to be assisted by the public entities (central banks), it can be assumed that this task will be performed by the home country central bank. And what if support in the host country currency is necessary?

As concerns obtaining liquidity in the foreign currency, in addition to obtaining the foreign currency funding from the central bank, currency derivative contracts (FX swaps, CIRS) concluded with the central bank could be taken into account. In a contingency, access to these instruments in the market may be limited; if their availability is ensured by the central bank, this will allow liquidity needs in foreign currencies to be met by converting liquidity surpluses in the local currency.

As concerns the identification of obstacles in the transfer of liquid assets between entities covered by single consolidated supervision, liquidity requirements and large exposure limits should not constitute obstacles to the implementation of a resolution plan. Prudential limits should apply to normal circumstances and at the recovery plan stage. In the resolution process, saving the threatened entity should be the overarching goal, even at the expense of temporarily suspending prudential norms.

Communications with the sector should be structured by providing up-to-date information on threats to entities with similar liquidity risk profiles. This would reduce the effect of the affected entities being excluded from access to private sources of funding in the wholesale market and also mitigate the risk of spillover.

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