

## **Christine M Cumming: Early intervention and resolution**

Remarks by Ms Christine M Cumming, First Vice President of the Federal Reserve Bank of New York, on Early Intervention and Resolution, at the Transatlantic Corporate Governance Dialogue, Brussels, 25 October 2010.

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Let me thank the organizers for the opportunity to speak today about the supervision and resolution of financial institutions in danger of failing. Let me begin by noting that the views I'll express in these remarks represent my own views and not those of the Federal Reserve Bank of New York or the Federal Reserve System.

In any industry, it is important that unsuccessful firms fail. Business strategies fall short, franchises depreciate, management loses focus. Large or small, unsuccessful firms need to be cleared from the scene through merger, restructuring or liquidation.

This is no less true for the financial industry than for any other. And for all firms, society has an interest in ensuring that the process of failure does not destroy more value than necessary. As an economist, I see much innovation in national insolvency practices over time as designed to reduce the cost of insolvency and increase the value preserved in the insolvency process.

One of the vexing problems during the recent financial crisis was concern about the adequacy of means to resolve large financial firms and uncertainty about the externalities of placing a large financial firm into insolvency. The Lehman bankruptcy no doubt validated those apprehensions for many.

Some of the issues in resolving large, internationally active financial firms have been recognized for some time – the multiplicity of jurisdictions, differences in insolvency regimes across countries, complexities in unwinding certain books and the largely untested nature of national, much less international, resolution processes for such very large financial firms. Over the last 20 years, the international legal and supervisory communities have undertaken several efforts to address these issues.

In the wake of the financial crisis, the Basel Committee on Banking Supervision formed a Cross-Border Bank Resolution Group to identify what improvements could be made to the international resolution process and recommend actions to be taken. It published its recommendations in March 2010. The CBRG's report is admirable in its clear description of the problems encountered in the fall of 2008 and the concrete nature of its recommendations. I will be referring to them throughout my remarks. As the CBRG was completing its draft report, the Financial Stability Board asked a working group, the Cross Border Crisis Management Group, to advance the development of recovery and resolution plans for cross-border institutions as recommended by the CBRG.

I'd like to make three points today. The first is to highlight the importance of timely supervisory action in preserving the value in a financial firm. The second is to underscore the important innovation in supervisory practice represented by recovery planning. The third is to paint a picture, an admittedly optimistic picture, of the improvements in the international resolution process made possible by following the recommendations of the CBRG. I will conclude by returning to my starting point, to the importance and the scarcity of time in dealing with a troubled financial firm.

### **The important role time plays at a failing firm**

The seeds of any financial failure are generally planted years earlier. The cycle is familiar to us all – in good times, most business strategies thrive. Financial institutions commence an

activity that has high initial marginal returns; over time the activity attracts more competition, pricing goes down and risk appetite goes up. Overexpansion leads to an inevitable correction, with the losses incurred testifying to the long-term unsuccessful nature of the strategy.

U.S. banking, securities and finance companies in the early 1990s experienced the late stage of just such a cycle in which commercial real estate and leveraged buyout lending overexpanded. The result was that many large financial institutions had to be merged into others or unwound.

Banking supervisors responded to these problems by requiring banks with large, problematic exposures to implement a three-part program. First, the bank comprehensively identified its problem loans and assigned them to workout specialists. Second, the bank developed and executed a capital plan and strengthened its liquidity. Third and essential to raising new capital, the bank developed a new business plan demonstrating its ability to return to profitability.

This program worked, in large part because it was applied timely enough. Stylized facts about time's role on the value of a failing firm created urgency in implementing the program. Those stylized facts were:

- The value of the firm's assets and its business lines tends to decline with time as the firm's financial weakness becomes more apparent and market pricing of its assets takes on a "fire sale" character;
- The funding capacity of the firm declines as its troubles become more evident, counterparties cut lines and limit maturities and the quality of counterparties declines; and
- The value of the firm's franchise decays as customers migrate to other providers.

This three-part program of identifying all problems, replenishing capital and liquidity and recasting the business plan was designed around loan exposures, but continues to be relevant today. The challenges are to adapt such a program to the many financial institutions strongly oriented toward capital markets activities with the resulting volatile balance sheets and income streams and to apply the program timely.

Time also plays an important role when a financial firm is subject to an insolvency process. Another stylized fact is that the market value of the assets and business lines often suffer a substantial markdown when a financial institution enters insolvency and may decay further thereafter. The Federal Deposit Insurance Corporation (FDIC), the resolution authority for banks in the United States, routinely experienced losses in resolving banks in the 1980s, when it was required to wait until the bank's book value had reached zero. That led to the provision in FDICIA 1991 that a bank can be declared insolvent when its tangible equity falls below 2 percent of assets.

### **A supervisory innovation: recovery planning**

The potential for rapid decay of asset and business line values unless assets and liabilities are transferred to a permanent owner quickly is a large part of what sets financial institutions apart from other companies entering insolvency. This difference motivates efforts to avert insolvency through supervisory action, as I described earlier. It also motivated U.S. banking supervisors in the early 1990s to ask some troubled banking companies not only to apply the three-part program but also to develop a meaningful contingency plan for reducing risk and raising capital if the first round of actions did not succeed. The supervisors incorporated the requirement to develop contingency plans in its supervisory agreements with those institutions.

The CBRG has recommended that all systemically important financial institutions develop recovery plans. I believe the development of such plans by healthy institutions and their discussion by a college of the firm's principal regulators constitute important innovations in the supervision of financial institutions. The Cross Border Crisis Management Group has provided momentum and a forum for discussion of progress and challenges as supervisors initiate discussion of recovery plans with firms. The discussions we have held in the United States involve the financial institution, its major U.S. regulators and the regulators of the foreign legal entities containing its principal business operations. Those discussions have included both the development of a global liquidity contingency plan and a plan to reduce the risk profile of or "derisk" the financial firm by winding down or selling business operations or financial assets. The intention is to have recovery plans, as well as resolution plans, in place by the end of 2011.

Recovery planning has several important benefits. The first is to bring about a discussion of the firm's response to very severe stress scenarios. In addition, the principal supervisors of the firm are present together with the firm to discuss the plan as it evolves, contributing to a common base of understanding of the firm among the supervisors.

The second benefit is the identification of impediments to the firm's recovery. In our discussions with U.S. institutions, four important impediments have surfaced and the same themes, all familiar concerns for supervisors and resolution authorities, have surfaced in other discussions led by members of the Cross Border Crisis Management Group. The difference this time is that the issues are being raised by the firms themselves.

The first is the availability of sufficient financial information by legal entity. It begins with simple housekeeping – records that accurately record the legal entities of both the firm and the customer involved in a financial transaction, an asset holding or a liability. Given the extensive consolidation of firms in the financial industry, the information systems of many firms are an accretion of systems, with issues of consistency, comprehensive aggregation of exposures and speed of information retrieval for analysis. For example, most firms in distress find it difficult to answer a crucial question: what market participants are most exposed to me and how will they react to my difficulties?

A second impediment is the complexity of unwinding certain books of business, where the business is originated in one location, recorded in another and risk-managed in a third. Derivative transactions are a prime example. The level of complexity related to how and where trades are marketed, booked, funded and risk-managed leads to high levels of connectedness within the firm, particularly as institutions book "back-to-back" intragroup trades to transfer the economics of a transaction to a central portfolio for risk management purposes.

The third impediment is the use of intragroup guarantees. Institutions sometimes use parent guarantees to support and cover particular transactions or the entire operations of separately capitalized subsidiaries in foreign countries. Guarantees of this sort allow firms to operate subsidiaries with less capital, but can distort the pricing and economics of the subsidiary's business activities and make the subsidiary more valuable to the current owner than to a potential buyer. In addition, the default of a guarantor may allow counterparties to terminate contracts and seize collateral even though official sector efforts are attempting to preserve the local operations.

The fourth impediment is the need to preserve global payment operations. The cash management, cash payments, securities settlement and custodial services that some firms offer to wholesale and retail clients are essential to the functioning of clients, the economy and the financial system, but such services have high switching costs for customers. These services often represent core business lines with stable profitability and thus valuable assets for financial firms, but they are also often entwined with other businesses in the firm. The fundamental nature of these activities and their importance to the financial and real

economies make them of special interest to the financial authorities reviewing recovery plans and developing resolution plans.

The four impediments are all related to institutional complexity. A financial firm organized as a single legal entity would certainly face many complexities, but far fewer than organizations today. This clearly raises the issue of whether the extraordinary organizational complexity of financial firms today imposes social costs that are too burdensome, especially in resolution, relative to its benefits. The economists Dick Herring and Jacopo Carmassi earlier this year documented the reasons for the vast number of subsidiaries at large financial firms, reasons such as regulatory requirements, regulatory arbitrage and tax avoidance.

If such organizational complexity imposes a high social cost by impeding recovery plans and resolution, providing incentives to reduce complexity may be warranted. For example, collateralization or capital requirements on intragroup exposures or parent guarantees could internalize for the firm some of those social costs. Alternatively, more direct supervisory requirements may be necessary for addressing the improvement of information systems or the separability and preservation of critical payment systems.

But such measures have costs and I would argue increase the relative benefit of efforts to identify the no doubt very difficult changes necessary in both the private and the public sectors to reduce organizational complexity in financial firms. I note that the CBRG report not only has recommendations largely addressing the four impediments to recovery I described, but also a recommendation to simplify financial firm organizational structures.

A final benefit of recovery planning is that it is a prod to concrete action in the near term, when the institution is healthy and provides a ready-made menu of options when the firm is distressed. Moreover, the impediments to recovery are also impediments to resolution. If the recovery plan does not succeed in averting failure, but the firm has acted on the plan, it will enter resolution with better information systems, a reduced risk profile and perhaps fewer intragroup exposures than it otherwise would have.

## **Resolution planning**

As I mentioned at the outset, the financial crisis validated for many concerns about the adequacy of measures to resolve large financial firms without high costs and destructive externalities. The Lehman bankruptcy reminds us that every financial institution is resolvable, but at a cost. The major elements of cost are the considerable expense of insolvency, the substantial loss of value through any excess, “fire sale” markdown of the value of assets and business lines and the externalities of a large failure to other firms, their stakeholders and market participants in the form of knock-on and psychological effects. When the observation is made that a financial institution is not resolvable or is too big to fail, it represents a judgment that the financial costs and externalities of failure are unacceptable.

The desire to improve the resolution process for cross-border financial firms is widely shared, but how we should we judge progress? The success of private and public sector actions, such as those recommended by the CBRG, to improve the resolution of systemically important firms can perhaps be gauged by the extent to which resolution costs are reduced. We might further gauge progress against additional expectations, such as the absence of taxpayer support of the resolution process, the efficiency of the process (to the extent it is not captured in resolution costs) and the equitable and consistent treatment of stakeholders.

To improve the resolution process, the CBRG’s first recommendation is that national authorities have appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved. The recommendation specifically mentions power to create bridge financial institutions, transfer assets, liabilities and business operations to others and to resolve claims.

The FDIC has these powers for banks and thrifts as well as a great deal of experience in managing bank failures and has demonstrated the utility and flexibility of its tools. A positive development is that many countries are considering or have adopted legislation giving the financial resolution authority similar powers.

The U.S. Dodd-Frank Act passed in the summer broadens the scope of the FDIC's resolution powers, although in a carefully circumscribed manner. The Dodd-Frank Act allows the FDIC to resolve not only a bank, but a financial holding company of a banking organization or a nonbank financial institution, if the requisite recommendations and conditions are present, among them, that the failure is a threat to financial stability. When the FDIC is appointed receiver, it has available its full set of resolution powers, including the ability to create a bridge company for a nonbank financial institution.

The Dodd-Frank Act also strengthens the supervisory regime for systemically important financial firms. It empowers the newly formed Financial Stability Oversight Council (FSOC) to designate bank and nonbank firms as systemically important. The FSOC has just published an advanced notice of proposed rulemaking soliciting comments on the criteria for designating nonbank financial companies systemically important. Companies that are so designated will be subject to consolidated oversight from the Federal Reserve.

The U.S. supervisory and resolution authorities have also begun the process of resolution planning, as recommended by the CBRG. That discussion is intended to be on a firm-by-firm basis among the supervisors and resolution authorities in the principal locations of the firm's activities.

The CBRG recommendations provide useful building blocks toward a stronger cross-jurisdiction national process: resolution tools, national coordination across jurisdictions, recovery planning, setting aside of impediments to recovery and resolution and simplification of organizational complexity. The CBRG also recommends that national authorities seek international convergence of resolution tools and measures.

How might we envision an effective cross-border resolution process developing from these building blocks? The report is very careful in talking about how the building blocks might integrate at the international level, noting the many problems and conflicts faced by national authorities in dealing with a troubled or insolvent organization located partially outside national borders. So let me extrapolate from the report, expressing strictly my own views and sketch out how the process set in train by the CBRG recommendations might evolve.

Let's focus on a single systemically important financial institution. The healthy dialogue among regulators and resolution authorities in the principal jurisdictions for a given firm and the firm-specific recovery and resolution plans developed could provide the basis for strong cooperation when the institution crosses from healthy to troubled. On the basis of that cooperation, the lead supervisor, with the participation of the resolution authority in the home country jurisdiction, could coordinate a program of early supervisory intervention encouraging a private restructuring utilizing the recovery plan. At the same time, the resolution authority in the home country, working with the home country lead supervisor, could begin taking the necessary steps to prepare for a possible resolution as a contingency. If the supervisory intervention does not produce a successful private restructuring and recovery, the home country resolution authority leads a coordinated resolution process.

Let me elaborate on a couple points. First, I believe that economists can be invaluable in helping financial supervisory and resolution authorities understand more fully where coordinated actions and cooperative solutions improve outcomes and where they do not, something I don't believe we now really know. The potential gains from cooperation will reflect the distribution of asset and liabilities (or net worth) across legal entities, assumptions about the rate of decay in the values of assets and business lines pre-entry and post-entry into insolvency, the length of time spent in each state and any one-time markdown on entering insolvency. With analysis or simulation, various decision rules can be explored about how a lead resolution authority could foster a cooperative, coordinated resolution using

tools such as bridge banks, transfers of assets and liabilities, sequencing of sales or liquidations and other techniques. An analysis can also explore how sensitive the decision rules are to timing, distribution of net worth across entities and decay or markdown factors.

In addition, one of the most important decisions for resolution authorities will be which legal entities within a systemically important firm to place into insolvency proceedings and which entities can and should be maintained for sale as going concerns. In his September 1 testimony before the Financial Crisis Inquiry Commission, my colleague, Tom Baxter, general counsel of the Federal Reserve Bank of New York, described how Lehman's broker-dealer was not placed into insolvency, remained a going concern temporarily funded by the central bank and was sold within days after Lehman's bankruptcy filing.

The work needed to understand how coordinated resolution might work and when it will work underscores for us that an immediate jump to a fully fledged international resolution process is not really feasible. This is in fact why doing the hard and painstaking work of resolution planning is so important. Resolution planning is a smaller version of the statistical simulation I described, more closely tied to the specifics of the individual institution's case, in which the financial authorities in the jurisdictions where the firm's major operations are located work through potential scenarios. Those scenarios will reflect the current structure of the firm and the normal range of the distribution of assets and liabilities across legal entities. Resolution planning is likely to contribute a great deal of insight into how a full-fledged international process could work, insight that we do not have today.

I have talked about early, coordinated supervisory intervention to activate a recovery plan for a systemically important firm and of a coordinated resolution process. Is there an opportunity between those two stages to intervene more forcefully, but not incur the potential asset markdowns and administrative costs of resolution? Considerable interest has been expressed in developing a "bail-in" mechanism to provide that intermediate step.

Let me comment by stressing that what I am expressing is strictly my own view. And let me start by saying that a bail-in mechanism cannot substitute for the national resolution tools and resolution planning called for by the CBRG. There must be a last stop where systemically firms can be resolved, because we will inevitably need it and we must work to make cross-border resolution possible at acceptable cost.

Where can bail-in fit? I've described a process in which supervisors deal first with a troubled financial firm by encouraging its board of directors and management to activate its recovery plan and develop a private restructuring. In my personal view, the possibility of a restructuring prior to insolvency with potentially more forceful outside supervisory or contractual intervention is interesting and deserves more study. Given the number and range of stakeholders in a large financial company, such a mechanism could help solve a coordination problem that can be costly in terms of time and sub-optimal in terms of ensuring the equitable treatment of stakeholders for a financial company on the threshold of, or in, distress.

However, bail-in is not yet a well-defined concept in the international policy discussion; I'm not sure how my description of a mechanism resonates with the overall discussion. Right now, the common theme of a set of bail-in concepts is putting in place a statutory or contractual trigger that would convert a firm's debt into equity, thereby immediately strengthening the firm's capital base. Short-term debt and liabilities would likely be excluded.

To move the bail-in mechanism from concept to a meaningful proposal, the official community needs to develop one or more specific proposals that can be vetted, debated and improved. In that spirit, let me list some areas in which a bail-in proposal needs to be more specific. A proposal needs to make clear:

- The nature of the trigger. Is it contractual or supervisory? Is it rule-based and if supervisory, rule-based or discretionary?

- The desired capital structure before a bail-in. Consonant with the work in Basel on capital and liquidity requirements, how much bail-in eligible debt should the firm have? To answer that requires specifying goals for the capital structure of the restructured firm. It is probably crucial that the post-bail-in capital structure provide enough loss-bearing capacity to make regeneration of the company's prospects credible.
- Estimates of the market capacity to purchase bail-in eligible instruments relative to the amounts of such instruments that would be needed and the price sensitivity of markets to volume and financial institution credit quality.
- Funding of the restructuring firm.
- The reactions of rating agencies and of customers either influenced by rating agency actions or subject to bylaws or guidelines.
- Legal authority and enforceability across jurisdictions. The appropriate legal authorization not only needs to exist in each home country jurisdiction, but we also need proposed legal mechanisms to ensure that:
  - Supervisors in other countries will not treat the triggering of bail-in as an insolvency event;
  - Supervisors in other countries will coordinate with the home country in exercising any supervisory trigger in their jurisdiction; and
  - The company's debt conversion will be honored in all jurisdictions (through choice of law or other legal foundation).

I'll conclude with the timing of the trigger. A key question is when such a mechanism has the greatest chance of success. In my personal view, it seems unlikely that the proverbial "one minute to midnight" is the right moment for action – by then most firms would face a severe shortage of liquidity and serious constraints in the ability to undertake new business. Timing that is too early brings with it a host of repercussions and risks, of course.

If I interpret a bail-in mechanism against the three-part supervisory program for troubled firms that I described at the beginning, conversion of debt to equity stakes is a mechanism to replenish capital, a critical element, but just one of the three key elements. The comparison suggests that the conversion of debt to equity by itself may not be sufficient and a fully developed proposal for a bail-in mechanism will need to include thorough identification and workout of problem assets and positions, as well as a revamped business plan that demonstrates the ability of the financial firm to return to profitability.

### **A return to the issue of time**

Let me conclude by returning to the theme of time. Long-standing supervisory practice aims to intercept problems before they threaten the viability of a financial institution and to promote action by the firm's directors and management while the firm still has the opportunity to recover. But supervisors will not always execute timely, successfully and in all necessary cases and financial firms will not always be able to turn around a deteriorating situation and avert failure; certainly the experience of the financial crisis are sobering in that respect. That underscores the need to develop with alacrity and diligence meaningful recovery and resolution planning for systemically important firms and continue to build a strong international resolution process.

Recovery planning by firms helps to increase the margin of time available for firms by shortening reaction time when distress occurs and reducing the impediments to recovery and resolution when firms are healthy. Similarly, resolution planning gives financial authorities a better starting position and more ability to move swiftly and decisively in a financial firm

failure. Taken together, augmented resolution powers, recovery and resolution planning and better identification of systemic risks can move us substantially forward in dealing with failing systemically important institutions.

Thank you for the opportunity to share these views with you.