Paul Tucker: Developing an EU cross-border crisis management framework

Remarks by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the Eurofi Financial Forum, Brussels, 30 September 2010.

*   *   *

Thank you very much for inviting me to join you here today.

It is terrific that the EU, and the Commission in particular, have been taking resolution really seriously as part of the programme for reforming the financial system. This is a domestic issue, an EU-wide issue, and a global issue.

In introducing this session of the conference I've got five points, and I'm going to try to be quite crisp on those five points once I have made an introductory comment about resolution regimes in general.

It may be helpful to say a few words about what resolution is. Resolution is what happens when we are in the "last chance saloon". That is to say when supervision, however enhanced, has not prevented distress. When higher capital and liquidity requirements have proved insufficient. When any Cocos or other instruments have been converted or written down but have proved insufficient to absorb the distressed firm's losses, and so the institution is still teetering on the edge of failure. That is we are talking about the point at which all the usual remedies have been exhausted, and the authorities face a desperate choice between taxpayer bailout or chaotic liquidation unless special resolution tools are available. All those other, essential measures are about reducing the probability of distress. Resolution is about coping when, notwithstanding those measures, we do face severe distress in a financial institution.

The trigger for putting a financial firm into resolution should essentially be when the criteria for the authorisation of the bank (or dealer, or whatever) are no longer met, there is no reasonable prospect that they are going to be met in the future. Which in practice, actually means that the institution is effectively insolvent or what amounts to insolvency. Effective resolution regimes are designed to manage these situations. They are about making the private sector pay rather than making the taxpayer pay through the mediation of a public sector bailout when, because of the firm's provision of critical services, we cannot afford simply to put it through a standard corporate bankruptcy procedure.

Against that background, I would make five points.

First of all I would say that it is absolutely essential that each of the EU member states, and indeed all the countries in the world, should have a national resolution regime for conventional commercial banks. Not to have such a regime is a great mistake. It can indeed be a disaster, as the UK very sadly demonstrated through the Northern Rock problem, with spillovers to confidence beyond our borders.

Why do I start with this? Essentially because, at present, very few countries of the EU – including until 18 months or so ago the UK – have a national resolution regime for conventional commercial banks. This is a real gap in the infrastructure for the financial system. One of the most important things the EU can do in the period ahead is to say to all of the member states "You really must have the elementary regime that exists on the other side of the Atlantic".

That benchmark system enables us, the authorities, to take a distressed bank and transfer the deposits to another viable bank, transfer or sell the good assets, and put the bad assets into receivership or run off. Plainly this requires safeguards if it interferes with property rights.

So that's the first proposition. I'll now go on to talk about globally important, systemically important financial institutions (so-called SIFIs), where the issues are much harder, way more important and much more topical. But we should not lose sight of that vital first step. It is the foundation stone; and one that will help us to speak a common language on resolution.

The *second* proposition is that we must, as a global community and as a European community, develop tools to be able to resolve the largest, most complex cross-border systemically important financial institutions. This is absolutely at the core of the work to address the problem of Too Big To Fail. And unless we make real progress with this problem, we won't bring back into our financial system the market discipline on which capitalism relies. The goal, of course, is to be able to resolve distressed giant institutions, complex institutions, without taxpayer solvency support, but also without disastrous disruptions to the flow of essential financial services to our economies. I would say two substantive things about the tools needed to make this feasible.

First of all, as the crisis around the world has demonstrated, we need to extend the basic resolution toolkit I was talking about beyond commercial banks to bank holding companies and to affiliated companies; in other words, to *groups*. And we must extend the scope of the basic resolution regime to *non-bank* financial institutions and groups in circumstances where their distress could prove systemic. This is essentially what the Dodd-Frank Act does in the United States. It makes it possible for the FDIC to manage and run down a SIFI from a bridge company. This could work well in some circumstances; for example, where there are buyers for parts of the business in the wings, as with Lehman. This is, therefore, a resolution instrument which we should seriously contemplate adopting in Europe. I am not certain that it would definitely work in all circumstances; eg if there were no buyers in prospect, the state ends up running the group, which could be quite a thing, with a risk that staff and counterparties may drift away. But even in those circumstances it would surely be preferable to a normal liquidation.

The second tool that many of us believe really should be considered, and which the Financial Stability Board is likely to urge countries in the G20 to consider seriously, is to be able to write down, or haircut, claims of unsecured, uninsured creditors and impose a partial conversion from debt to equity in conditions of distress *while leaving the non-toxic parts of the bank or dealer as an otherwise viable concern*. This is a technique sometimes called Bail-in, although that term is also used for a purely contractual route for recapitalising banks which is rather different in some crucial respects (both operationally and in terms of policy). Reduced to its bare essentials, it involves the following. You take the distressed bank or dealer, and examine whether it is rotten all the way through, or whether – as can easily be the case for highly-levered firms – its financial problems are concentrated in specific parts of the business. In other words, is there a viable underlying franchise once the toxic parts are written off? That will sometimes be the case, although by no means always. When it is, you also make an estimate of the firm's loss. Sometimes that may not be possible due to chaos in the firm or the breadth of its problems. But if you think about the SIFI failures during this financial crisis, there are some instances where supervisors could, perhaps, have made estimates of the losses before the final curtain came down because they were on notice of accumulating stress. Having made a conservative estimate of the loss, it must be absorbed by the firm's capital structure, respecting the ranking of priority that would apply in liquidation. So you start by writing off the equity to the extent that that is needed. If the loss is bigger than the equity, you also write off the subordinated debt. If there is still some loss left, then you write down the claims of uninsured, unsecured creditors in one way or another; the scope of this would need to be made clear in the statutory framework for resolutions. The loss is then covered. But it is still necessary to recapitalise to the bank, so you convert some of the residual claims of the unsecured, uninsured creditors into equity. How much? Whatever the microprudential regulatory authority concludes is needed to provide adequate capitalisation for the bank or dealer going forward.

This is a technique that will work only in circumstances where the size of the loss could be estimated in the run up to the resolution and where the underlying franchise of the business remains basically viable. But it has the promise of being able to take an essentially viable business with a toxic part, write-off the toxic part and reconstruct the capital structure of the bank or dealer so as to be able to maintain the business as a going concern. For those of you familiar with Chapter 11 in the United States for non-financial corporates, this amounts to applying those techniques in a very accelerated way and under the discretion of the resolution authorities rather than through a negotiation mediated by a judge. As I have described it, it is a resolution tool. There is no good reason of public policy why resolution should always involve closing the firm, provided that shareholders, uninsured creditors, the board and management pay the appropriate price.

Whichever combination of tools is incorporated into resolution regimes, we should expect them to induce changes over time in behaviour of banks and their creditors. There might, for example, be greater incentives to lend to banks against security or at short maturities. As we reintroduce the disciplines of capitalism back into the heart of the financial system, we might have to think carefully about regulatory policies on the encumbrance of assets and on the maturity structure of liabilities.

The *third* point I would make is that even if we were equipped with a decent set of tools for the domestic context, we must be able to cope with the *cross-border* element of a financial firm failure. Within the EU, this should not be the hardest thing in the world and I hope that the Commission will be able to develop proposals that will lead the way for the rest of the international community in identifying how we can do this. Because within the EU we can enter into more or less binding commitments under the terms of rules and legislation that comes out of the process here in Brussels, without infringing on national sovereignty.

The *fourth* point I would make is that the EU, as well as leading the way in addressing that problem regionally, must take a very close interest in the arrangements for *global* resolution, because pretty well every single one of Europe's largest financial institutions operates on a global scale and, furthermore, the largest global institutions headquartered outside the EU all have sizable and complex businesses within the EU. In the run up to the G20 meeting of Finance Ministers and Governors in October and then the Leaders summit in November, our community and the political community will have to think about the extent to which sovereignty in this area could be pooled or whether, instead, to come up with a middle road which at least removes obstacles to co-operation. I suspect it is unrealistic at this stage of global financial development and co-operation for there to be a multilateral binding treaty that would put a single country in the sole and unqualified lead in the resolution of a global financial institution. But that doesn't mean that there is nothing useful to do. We could do things along the following lines.

First of all, in our national and EU legislation, we could all remove impediments for one country to co-operate with other countries in the event of a resolution. This sounds quite straightforward but actually it would be quite a step because, of course, all of us are answerable to our national parliaments. But nor do I think it is realistic for countries to engage in or embark on what one might think of as unilateral disarmament, where a country that acts as host to financial institutions says to the home countries "I will let you lead in the resolution of all banks in all circumstances, notwithstanding whether you take account of the interests of my country". So countries probably need to reserve some powers for themselves but should eliminate from their regimes any automatic triggers that can cut across sensible resolution led by a firm's home country.

The other step that we could sensibly take, I suspect, is for there to be *much* closer planning on a bilateral basis between host and home countries in respect of particular banks. I mean at the level of entering into more or less binding agreements on who would do what in the event of distress. That, again, sounds easy, but actually it would be embarking on quite a change from where we are right now.

And that brings me to my *fifth and final* point, which is that even if we were to put in place nationally, in the EU or globally the best possible statutory frameworks for resolution of international banks and dealers, it would work only if there is also a great deal of planning by the regulatory and resolution authorities case by case. This is what has become known as the preparation of Recovery and Resolution Plans, colloquially Living Wills. What a robust resolution plan looks like depends on the statutory resolution regimes that we have. At the moment we shouldn't kid ourselves as to how much progress can be made. In an environment where few countries have viable resolution regimes on statute, there are going to be few viable resolution plans for the largest institutions in the world. So the first step needs to be statutory change, in which the EU can take a lead. And thereafter the financial authorities would need to do very serious planning, so that we could in earnest put these institutions through our improved resolution regimes if we needed to, *without* taxpayer solvency support.

That is a formidable agenda. But it is within reach, and the EU can be part of the leadership.