

Paul Tucker: Resolution – a progress report

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the Institute for Law and Finance Conference, Frankfurt, 3 May 2012.

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Thank you very much for inviting me to join this important conference. The EU have made a massive contribution to global planning for resolution regimes to address the fundamental problem of Too Big To Fail, inputting very significantly to the G20 Financial Stability Board's Key Attributes for Resolution Regimes. It comes as no surprise, therefore, that the EU is committed to implementing that International Standard, via a Directive.

As Chair of the FSB's Resolution Steering Group, I thought the most useful thing I could do this morning is to give a brief progress report, and also to air some emerging thoughts on how to operationalise the FSB's high policy.

Preliminaries: what this is about

For those who hesitate to grasp the nettle of implementing resolution regimes, I want to stress that the genie is out of the bottle. While myopia gripped the financial markets in the years leading up to the crisis, they are now seized of the risks on bank balance sheets. That will be reflected in the prices of the debt of those who bear that risk. If the risk in banking is not incorporated into the yields of bonds issued by banks themselves, then it will be reflected in higher sovereign borrowing costs. There is nowhere to hide. Quietly maintaining a policy of bailing out banks is not a free option for governments and their taxpayers. Anyone tempted to argue against pursuing the resolution policy agenda would effectively be wanting to increase the (contingent) burden on the taxpayer. That would be liable to increase the pressure for fiscal austerity.

As well as avoiding bailout by taxpayers, we must avoid liquidation – putting a failed bank through a standard bankruptcy procedure. That brings chaos. Resolution regimes are a way for the authorities to avoid the direct hit to the public finances while at the same time containing disorder in the financial system. That can lead to a much better financial system, with stronger market discipline and so less stability-threatening imprudence.

Contemplating this, some commentators are concerned that one particular resolution tool – commonly known as bail-in – entails losses for bond holders. That is a mistake. **All** resolution tools put losses on to debt holders and creditors. Because that is the only place they can go. Bail-in is just one technique for delivering that. Its distinguishing characteristic is that it applies losses up front based upon a valuation rather than at the end of a liquidation of assets. As such, it prospectively avoids an unnecessary destruction of value.

But there is no silver bullet. We need resolution tools that work in different contexts for different types of bank/dealer. That means having a rich set of tools but with a common trigger for going into resolution. I will say something first about the trigger, and then about different resolution tools and strategies.

The trigger for resolution

Not a few people worry about the trigger for putting a firm into resolution – not too early, not too late. It is obviously important to get that trigger right.

To my mind, the best way of thinking about it is that a firm should go into resolution when its time is up – when Recovery strategies are exhausted, and the firm just will not be able to

reverse its decline into insolvency or lack of viability. How to frame that thought more precisely? Every country has criteria for authorising/licensing a bank. A sensible trigger for resolution would be when a bank no longer meets the criteria for being authorised and, crucially, when there is no reasonable prospect of its doing so again. That does not give a damaging degree of flexibility to the authorities; it is a demanding test.

Some resolution strategies

In the banking field, many resolution tools entail separating out a distressed firm into different parts. Separating bad from good assets; and separating essential from non-essential functions. The good and critical functions are sold and transferred to another bank (often known as “Purchase & Assumption”); or to a bridge bank pending such a transfer. The rump goes into administration, run down and disposal.

That is achievable for relatively simple commercial banks operating in a single jurisdiction, and all of whose contracts are under the law of that jurisdiction. It is harder for so-called Systemically Important Financial Institutions (SIFIs), spanning many markets, jurisdictions, and currencies, with complex counterparty relationships. As one international colleague put it, the standard toolkit would face an “exponentially greater challenge”.

Top-down capital restructuring: bail-in

That is why resolution authorities in a number of countries are exploring how to execute “top-down” resolutions of complex groups, employing bail-in of debt issued by the holding company or top-level operating company. The US and UK have been working together very constructively in planning how to operationalise that strategy; and if we continue to make progress I hope that we will be able to say more about it over the next few months.

Imagine that a large, complex, global firm – just one legal entity for the moment – has 20 lines of business, each the same size, which is to say using the same amount of balance sheet and capital. Imagine it is 50 times levered. Now imagine that one of those lines of business is completely toxic, worthless. The firm is insolvent, bankrupt. Unless it can be resolved, it must cease trading and go into insolvent liquidation.

But, in this stylized example, only a single line of business is toxic; the other 19 are fine. In other words, the franchise has value. In the non-financial corporate sector, there are established tools for this. The remedy would be a negotiated reconstruction of the firm’s capital structure, writing off the equity and partially converting debt claims into new equity. In the US, that goes by the name of Chapter XI. In banking, which is subject to depositor and counterparty runs, there is not time for a process involving negotiations between the different classes of creditors and shareholders under the jurisdiction of the courts. And the public policy priority is the stability of the system, not only the welfare of creditors. An administrative agency needs to make and execute some rapid judgments. That is precisely what so-called bail-in via resolution is about. The essential difference from other resolution tools is, as I have said, that losses are applied ex ante, up front rather than at the end of a process of running down the assets associated with “non-critical” functions.

I have been making a simplifying assumption: one legal entity. Now imagine a cross-border group with subsidiaries in many jurisdictions and with a holding company. Under the provisions of the FSB Resolution Standard, recapitalisation through reconstruction of liabilities can also prospectively cut through a number of the long-standing impediments to resolution stemming from conflicts between home and host country insolvency laws; in other words, the cross-border problem. If the bail-in I have described were executed at the level of such a banking group’s holding company, there should in principle be no need to trigger default clauses in subsidiaries around the world that are not themselves affected by the problem causing the group’s losses. The bail-in changes the ownership of the group but it does not affect the balance sheets of the subsidiaries. Contrast Lehmann.

That doesn't mean there is nothing to do. Far from it. For example, firms (legal entities) issue bonds not only in their home county but in a host of other jurisdictions. We shall need the documentation of bond issues by banks and by their holding companies to make clear in terms that they may be bailed in or subjected to another type of resolution operation by the firm's home authorities; at the consequent change of ownership does not trigger "default" or "control" clauses. That should not be a high hurdle. It is equivalent to incorporating Collective Action Clauses (CACs) in sovereign bond documentation.

There is also a debate about which particular kinds of creditor claim should be subject to bail-in via resolution. Indeed, this is one of the key questions in the Commission's consultation. One thought on this. It seems to me that the approach to putting losses on to different types of creditor should probably be the same whatever the resolution tool used and, indeed, the same as in a standard insolvent liquidation. That would suggest that one way of addressing proposals to "exempt" some types of claim from bail in, and to establish a hierarchy amongst other types of claim subject to bail-in, would be to alter the creditor hierarchy in insolvency law. While that could be useful in the longer run, I don't think that is essential to make this resolution tool work. Moreover, operating on the capital structure of a holding company can cut through some of the complexity, since topco debt is structurally subordinated to the debt and other obligations of the bank operating companies it owns.

A final thought before moving on to a possible resolution strategy for a different type of SIFI. What I have been describing is not a matter of designing new instruments with terms that automatically trigger a pre-determined write down or conversion into equity, which would essentially be a putative form of "Tier 3" capital. Today's topic is rather the toolkit the authorities need, in a statutory resolution regime, to maintain order when all such instruments have converted, all other options are exhausted and liquidation beckons. But whether via contractual terms or under resolution, debt can add to a bank's loss absorbing capacity.

The resolution of deposit-funded international commercial banking groups

We should not assume a monolithic approach to resolution. It is not a case of one size fits all. What I have described could work for banking groups that issue plenty of debt. It would not work so easily for groups operating commercial banks around the world that are funded pretty well entirely from insured deposits. If they haven't issued bonds, then there would be no bond holders to bail in.

It has become fairly common to say that such groups should be resolved on a regional basis, ie broken up. Maybe. But, even if that is correct, it is obvious that "break it up" is an incomplete resolution plan. What happens to the broken-up parts? Under a "breakup" strategy, one needs a plan for each of the parts, both the distressed and the undistressed parts of the group. Under the FSB Standard (KA 11.8), it is clearly the responsibility of the home authorities of the group to ensure that a group wide resolution plan exists. There is no ducking that. It removes an ambiguity that has quietly haunted banking authorities for decades.

Imagine that some of such a group's regional/local commercial banks are smallish and simple, but that others are very large and complex. (Contrary to what is sometimes imagined, commercial banking can be complex!)

To the extent that the group's problems are in a bank(s) that is relatively small and simple, standard "Purchase & Assumption" techniques can be employed. Ie break up that bank into a good and bad bit; and effect a sale of the good and economically critical parts, aided by an injection of resources, in the usual way, by the Deposit Insurance Scheme, up to but not beyond what it would have had to pay out to insured depositors in a liquidation. The critical services are thereby maintained, and the DIS becomes a creditor in the administration and realisation of the rump. At the end of that process of realising the assets in the rump, the Deposit Insurer learns how much it has lost. I want to stress that the DI typically incurs losses but discovers how much ex post.

Now imagine that the commercial bank subsidiary in question is big and complex. The realisation of the assets via a standard rump-administration is liable to destroy a lot of value, increasing the Deposit Insurer's losses. And in any case that strategy may not be consistent with maintaining stability (or containing disorder). A way of cutting through that would be to bail in the Deposit Insurer. Rather than the Deposit Insurer waiting until the end of the process of a potentially destructive realisation of the assets, it would hear up front how much it had lost. In the scenarios I have described, its losses should be smaller that way. That approach could, if necessary, be applied in different regions to different distressed subsidiaries of the group.

In the world of real banks, the firms have uninsured as well as insured deposit liabilities, and they typically combine deposit taking with some bond issuance. That means that, after equity and subordinated debt holders were extinguished, losses would be shared amongst the DIS and those bonds etc that could be bailed-in. Whether they got bailed-in together or in sequence (bonds first) would depend on whether a jurisdiction operated depositor preference in its insolvency regime.

But I must stress that in no way does any of this dilute the protection assured to insured deposits.

It does transfer losses to the surviving parts of the local banking system. But so do other resolution techniques, and liquidation would entail much bigger losses for the Deposit Insurer and thus for other banks.

There is much work to be done on planning how to operationalise that kind of resolution strategy, but it is worth doing.

The FSB work programme

This brings me, briefly, to the FSB work programme for 2012 and into 2013. There will be a preliminary peer review of the extent to which jurisdictions' resolution regimes comply with the FSB Standard. That will be followed by more exacting examinations, led by the IMF and World Bank, once an Assessment Methodology for the Resolution Key Attributes is complete.

Meanwhile, authorities are enjoined to produce assessments of resolvability of Global SIFIs and the obstacles in their way; firm-specific agreements for co-operation amongst home and host resolution agencies and supervisors; and resolution plans by the end of this year. Each of those requires a conception of a high-level resolution strategy for individual firms agreed amongst top officials of home and key host authorities. And the development of those strategies will inform the information that the authorities need from firms.

I have sketched in very general terms two broad kinds of resolution strategy, potentially appropriate for different types of global SIFI. In other cases, where a business is rotten through and through, a more "traditional" break-up of a group may be needed, perhaps using a "bad bank" in some cases. Planning for that will not be easy, and so for those extreme cases there is a special need somehow to ensure continuity in the provision of absolutely critical services to the economy. In the UK, that is one way that ring-fencing fits into resolution planning.

Implications for supervision

All this has important implications for prudential supervisors.

In the first place, supervisors get some allies: debtholders. The prospect of taking losses will incentivise bondholders (and fellow banks) to monitor the risks taken by banks – pricing or rationing accordingly. This is market discipline: an extra line of defence. Risk being priced into bank bonds will not, as some suggest or threaten, kill the market. It would be uncertainty

about the regime governing what happens in the event of distress that would kill the market because that kind of uncertainty could not be priced.

Supervisors won't be idle though. Resolution needs preparation. Hence the international agreement that firms should prepare Recovery Plans and contribute to Resolution Plans. To be clear, while the firms will own the Recovery Plans, the authorities will design and own the Resolution Plans. It has to be that way.

To a much greater extent than ever before, supervisors will need to work backwards from the end game, working with resolution authorities. That work is commencing around the world through dedicated Crisis Management Groups. In this context, Living Wills are effectively, in US parlance, a "pre-pack". What I mean by that is that firms and regulators can do a lot of detailed planning for how they would, for example, execute a bail in of their debtholders. That will focus minds. Including on who holds bank paper. This is, therefore, relevant to supervisors of insurance companies – a function that the Bank of England Prudential Regulation Authority will combine with bank supervision.

But I must stress that none of what I have said entails supervisors diluting efforts to reduce the probability of failure, and to ensure plans are in place to enable recovery.

Conclusion: the FSB's planned Peer Reviews

The nations of the G20 have signed up to the FSB's Standard on resolution regimes. But, of course, we need to keep each other honest. That is why the FSB has proposed a Peer Review process, involving top officials, to ensure that this is working. The Bank of England is 100% behind this. Not only would we like an opportunity to vet the existence of viable resolution plans for the current SIFIs from the US, Germany, France, Switzerland and, no doubt, other countries down the road. We also really want other countries to be able to confront us with harsh reality if we don't deliver on having viable resolution plans for UK SIFIs over the next few years.

To all of this, the EU Directive will be crucial in giving us all the tools we need. I really do believe that, with Dodd Frank already in place, it will help set the tone for the world.