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# Early Corrective Action and Bank Crisis Resolution

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# Scope of bank crisis management




Bank crisis management comprises an array of official & private responses that extends beyond the insolvency proceedings that are the only tool typically available to deal with corporate bankruptcy in other industries.

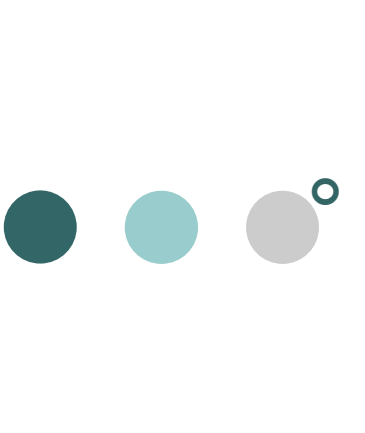
As regards the official responses, when confronted with failed or failing banks, public authorities have at their disposal:

- (1) The lender of last resort role of the central bank
- (2) Deposit insurance schemes
- (3) Government policies of implicit protection of depositors, banks (TBTF etc) or the payment system
- (4) Insolvency laws (*lex specialis vs lex generalis*)
- (5) Prompt corrective action, early intervention, preventive measures (including supervision) and contingency planning (living wills)

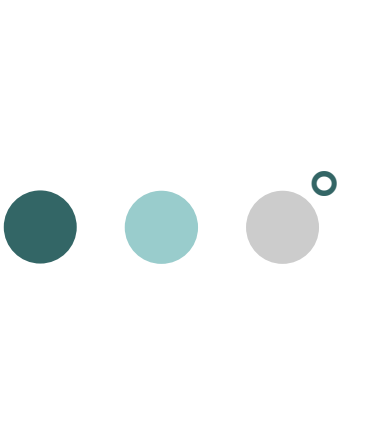
# An ounce of prevention...

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- Supervision and crisis management are a seamless process: Supervision of a healthy institution can quickly turn into the supervision of an unsound institution, which inevitably will lead – if conditions further deteriorate - to crisis management. Linking the intensity of supervision to some trigger ratios related to the level of capitalization and other indicators of liquidity and sound banking is a sensible approach that should be adopted at the national level and harmonised at the international level.
  - Discretionary powers to discipline banks are not sufficient. The need for legal certainty and transparency suggests the need to adopt some mandatory trigger ratio for intervention that, no doubt, will focus the minds of bank managers, and will influence their incentive structure. Early intervention mechanisms (such as PCA rules) are only effective if they are enshrined in the law, in particular the mandate to initiate early closure when the bank still has capital.
  - Since early intervention reduces costs to taxpayers, a special regime, like the SRR in the UK is highly desirable


# The Banking Act 2009 and the Special Resolution Regime

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- The SRR is the most relevant part of the Banking Act 2009. The SRR provides three stabilisation options:
    - private sector purchase (Bank of England)
    - bridge bank (Bank of England)
    - temporary public ownership (Treasury)
  - The Act also contains procedures for the administration of a bank and for bank insolvency but these are included to support the SRR rather than to stand alone.
  - On 7th October 2008 the government introduced the Banking Bill to the House of Commons (Bill 147). It was enacted on 20th February 2009

# Salient features of the 2009 Act


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- The purpose of the SRR is to “address the situation where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties” (Section 1). According to section 2(1) “bank” means a UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits
  - The SRR has five objectives (section 4), These are: to protect & enhance the stability of UK financial systems; to protect and enhance public confidence; to protect depositors; to protect public funds; to avoid interference with property rights in contravention of the Human Rights Act 1998 Ensuring the continuity of banking services is not set out as an objective but is clearly one of the overall aims of the legislation. This idea of preserving banking functions rather than individual banks has quite rightly found a considerable amount of support, both in the UK and elsewhere in recent times

# Roles of the Authorities in the SRR




The FSA is responsible for the instigation of the SRR on the basis of two general conditions (Section 7). Where the FSA reaches the conclusion that 'a bank has failed (or is likely to fail) to meet a threshold condition' and, taking the relevant circumstances into account, it is not reasonably likely that action will be taken by the bank to enable it to satisfy the threshold conditions, it must notify the Bank of England. The Bank of England is responsible for two of the stabilisation options (private sector purchase and bridge bank), while the Treasury is responsible for the third option: temporary public ownership.

# 1. Private Sector Purchase



This gives the Bank of England the legal power to 'direct and accelerate a transfer of part or all of a failing bank's business to a private sector purchaser' (Section 11). There is no court involvement – this is a purely administrative action by the Bank of England. The Bank of England can transfer property or shares to another body and this can be done on a pre-emptive basis provided the FSA has decided that a threshold condition is likely to be breached. There is no need to wait until a breach of a threshold condition has actually occurred. This means that in practice it is now possible in the UK for a bank which is still balance sheet solvent to be the subject of the SRR.

## 2. Bridge Bank



The Act introduces the concept of a 'bridge bank' into the UK for the first time (section 12) This power is also given to the Bank of England to transfer all or part of the business of troubled bank to a 'bridge bank' (which is a company wholly owned by the Bank of England) which will continue to be operated as a bank until a private sector purchaser can be found or, if that is not possible, be wound up or taken into temporary public ownership. Finding a suitable private sector purchaser is the primary objective of this procedure.

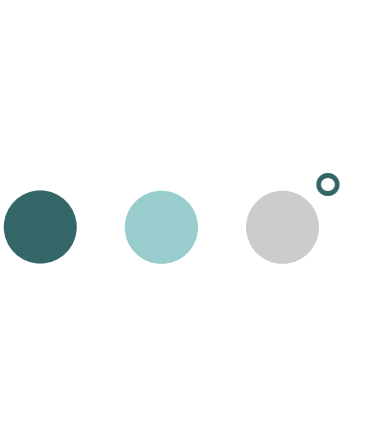
### 3. Temporary public ownership

- The temporary nationalisation of a failing bank (Section 13) is done by HM Treasury rather than the Bank of England. It is described as 'temporary public ownership' thereby signalling that the government has no intention of operating state owned banks on a permanent basis. This power is likely only to be used where there is no realistic prospect of a private sector purchaser being interested in purchasing either the whole or part of a financially distressed bank.
- This is meant to be used only in the situation where the tools available to the Bank of England have already been fully explored and found not to be appropriate. In fact it can only be used where two conditions are satisfied. The first is that it is necessary to place a failing bank into temporary public ownership to resolve or reduce a serious threat to the stability of the financial systems of the UK. The second that it is necessary to protect the public interest. Before concluding that these conditions are satisfied the Treasury must consult with the Bank of England and the FSA

# Bank insolvency procedure

- This, unlike the others, is a court based procedure. All three of the Tripartite Authorities can apply to the court for a bank insolvency order to be made<sup>[1]</sup>. If the court is satisfied that one or more of the grounds set out in the Act have been established<sup>[2]</sup> a winding up order will be made and a liquidator will be appointed. The rationale for this procedure is to ensure that the process of compensating depositors will be expedited and the liquidator is to work with the Financial Sector Compensation Scheme to achieve this.
- <sup>[1]</sup> For details of which authority can apply see section 96 (2) and (3).
- <sup>[2]</sup> Section 96(1). Ground A – a bank is unable, or likely to become unable, to pay its debts; Ground B – a winding up would be in the public interest; Ground C – the winding up would be fair.

# SRR and LOLR



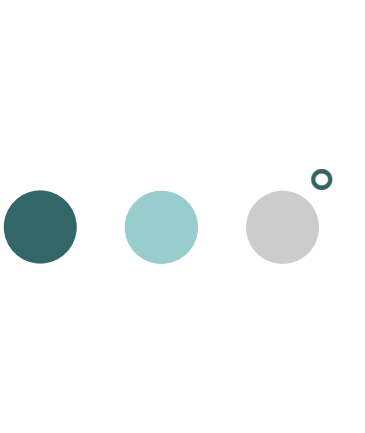
Section 1(1) provides that the purpose of the SRR for banks is to address the situation where all or part of the business of bank has encountered, or is likely to encounter, financial difficulties. The interface between the provision of lender of last resort assistance and the Bank of England's role in the SRR is of particular importance and potentially problematic.

- The Bank of England has responsibility for exercising a 'stabilisation power' where the FSA is satisfied that two conditions are met. Condition one is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41 (1) of the Financial Services and Markets Act 2000 and condition two is that having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by in respect of the bank that will enable the bank to satisfy the threshold conditions. Should the FSA consider that these two conditions are satisfied with respect to a bank it is required to consult with both the Bank of England and the Treasury.

# SRR and LOLR


- If a bank is considering approaching the Bank of England for LOLR assistance, it will be aware of the possible risks involved. In my opinion, the Bank of England should not have availed itself to be the authority in charge of two of the key stabilisation options in the new SRR.
- Dealing with troubled banks is a 'micro' task, and a difficult one, with heavy legal consequences, not to mention the possible adverse reputational effect for an institution that is in charge of monetary policy.
- Little to win, lots to lose if things go wrong is what the Bank of England should expect from its SRR powers.

# The Dunfermline Building Society Case



The first exercise of the SRR is in relation to a building society rather than a bank. On Saturday the 28th of March 2009 the FSA determined that the Dunfermline Building Society was likely to fail to meet the threshold conditions necessary for it to remain open for business, and that it was not reasonably likely that its management would be able to take action which would enable it to satisfy these conditions. The FSA immediately informed the Bank of England which organised an auction over that weekend. This resulted in Nationwide, the country's largest building society, acquiring or all of DBS's retail and wholesale deposit, its branches and its originated residential mortgages. DBS's social housing portfolio was transferred into a bridge bank wholly owned and operated by the Bank of England (The assets and liabilities in the bridge bank were subsequently purchased by Nationwide Building Society in a competitive auction). The remainder of its business was put into administration by court order under the special administration procedure contained in the Act (This part of the business included commercial loans, acquired residential mortgages, subordinated debt and Treasury assets). The Treasury did consider whether it would be appropriate to provide DBS with a capital injection but it was felt that the potential scale of future losses meant that this would not provide value for money and would not provide a sustainable and lasting solution.

# *Societas Europaeae* and *lex specialis*



Given the differences in bankruptcy laws in the Members States of the EU and the difficulties of involved in the resolution of cross-border banking crises, large banking institutions and financial conglomerates should be incorporated as *Societas Europaeae*\* (like Nordea proposed) and a specific insolvency regime should apply to them. Systemic risk route.

\* A “Societas Europaeae” (SE) or European Company is a public-limited company set up in the territory of the EU under the European Company Statute, which consists a Regulation (Council Regulation 2001/2157/EC of 8.10.2001 on the Statute for a European Company) and a Directive (Directive 2001/86/EC of 8.10.2001 supplementing the Statute for a European company with regard to the involvement of employees

# Systemically significant financial institutions



- Like with territorial waters in fishing disputes amongst countries, where you draw the line of regulation, protection and government assistance is likely to lead to disagreements. This is an unresolved issue of paramount importance, because the crisis has shown the profound systemic risk implications of some non-banks. The definition of a systemically significant financial institution is not an easy task: size, structure, interconnectedness are all factors to consider. Furthermore, it is a dynamic definition; any published list is likely to lead to moral hazard incentives, unless there is a proper pricing of the implicit government guarantee. Almost all systemically significant financial institutions have a cross border dimension, thus calling for across-border solution, supra-nationally and/or internationally.

# Competition

- Christine Lagarde (FT Nov 17, 2009)  
'Competition must be as much of a concern as stability and security as the G-20 rewrites the principles of global financial regulation'
- 'We need to make sure we do not create institutions that have a competitive advantage' (voicing concerns that some institutions have become too powerful in a market that has been consolidated by banking failures and industry mergers, with massive government assistance).

# Living wills

- The Queen's Speech on 18 November 2009 introduced the Financial Services Bill.
- A most interesting feature of the bill is the imposition of 'living wills' for systemically significant financial institutions.
- The bill expands the remit of the Financial Services Compensation Scheme, addresses the issue of bankers' compensation, creates a new Consumer Financial Education Body, increases the enforcement and regulatory powers of the FSA, including *inter alia* the ability to place restrictions on short selling and to require disclosure of short selling, and the ability to seek information from entities that it does not directly regulate, such as hedge funds, establishes a new statutory Council for Financial Stability, to replace the Standing Committee, chaired by the Chancellor and comprising the Treasury, the Bank of England and the FSA & grants an explicit financial stability objective for the FSA.


# Living wills

- The FSA ito require firms to produce Recovery and Resolution Plans (RRPs) Living wills or RRP can facilitate an *orderly resolution* (as opposed to a chaotic one) and can act as a complement to early intervention procedures, as well as a mechanism for ex ante burden sharing. RRP provide firm specific contingency planning and help ensure that institutions have robust recovery (capital and liquidity) plans to deal with periods of stress without recourse to support from taxpayers' money.
- Living wills also address the issue of multi-level governance since they can combine the national, the European and the international dimensions. By preparing an institution's own funeral, a living will can help avoid the chaos that would surely ensue in the event of insolvency, given the tangled web of counterparties and derivative contracts of many banks nowadays. If troubled institutions expect governmental assistance, bank managers will have little incentive to pre-arrange an orderly resolution and market discipline will be distorted.

# Living wills

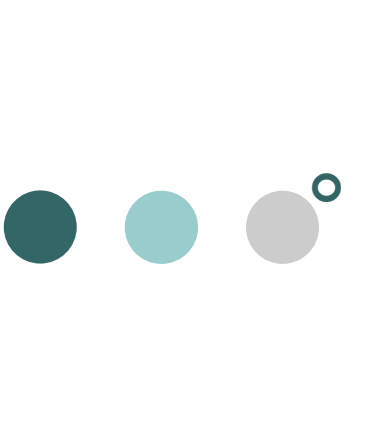
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- The contingent resolution plan, which has been likened by Thomas Huertas to the plan electric utilities develop in order to disconnect a power plant from the grid without bringing down the grid and with minimal disruption to consumers, would provide the information the authorities need to proceed to carry out an orderly resolution, in particular with regard to how to 'unplug' the bank from the payment, clearing and settlement infrastructures.

# Living wills



Critics of living wills - many predictably from the banking industry - claim that they might imply a return to a world of national markets in order to make things simpler for the authorities. Others claim that such wills may refrain a bank from entering into new lines of business or expand its operations. However, dealing with the too-big-to-fail problem or too-interconnected-to-fail problem by reducing the advantage of being big (or complex) can be construed as an advantage.

# Concluding observation



Cross border resolution of financial crises remains the number one unresolved policy issue, and presents complex and difficult challenges. Yet, as Einstein famously remarked: “We can’t solve problems by using the same kind of thinking we used when we created them.” We must find ways to resolve the problems posed by large cross-border systemically relevant financial institutions. Capitalism, it has been rightly said, relies on the lure of wealth (privatization of gains) and the discipline imposed by the fear of bankruptcy (privatization of losses). It is imperative to reinstate a credible fear of bankruptcy for systemically significant financial institutions to reconnect the incentives of bankers with the interests of society.