Resolution: Managing the failure of large financial institutions

Perspectives from • **Regulators** • **Industry** • **Academics**	• Resolving failing financial institutions quickly and saving core functions is crucial in a crisis • The Financial Stability Board is leading international efforts with its 'Key Attributes for Effective Resolution Regimes for Financial Institutions' • Resolution powers have been created in a number of jurisdictions, and implementation is now well under way

Details in Brief

Resolution is multifaceted. The FSB's *Key Attributes* sets out 12 principles and over 60 sub-principles that resolution regimes should adhere to.

Core among the aims of resolution regimes is to preserve systemically important functions performed by financial institutions. To make this possible, a resolution framework comprises a range of powers, legal techniques, and forms of cooperation agreements between firms and their often multiple supervisors.

Though there are outstanding questions about the precise point at which resolution will be 'triggered', a firm will enter resolution generally when it is close to, but not at, the point of balance sheet insolvency. At this point senior management will be replaced, and a 'resolution authority' will take control of the institution. Resolution authorities will have the power to restructure the balance sheet and the firm itself, to terminate contracts, to sell assets or whole sections of the firm, and so on. Such authorities may establish a 'bridge institution', which can continue to operate the firm in resolution. They may also establish an asset management firm to take control of 'bad' assets.

Bail-in

Critical functions

Crisis management group

Living will

Resolvability

Resolution authorities may also trigger a 'bail-in', whereby senior creditors have their debt claims converted to equity in order to fund the firm through resolution. Bail-in itself presents significant difficulties, but represents only one of many powers that resolution authorities will possess. The need for bail-in points to a more general funding problem associated with bail-in, as firms in resolution will need not just equity in order to operate, but significant amounts of liquidity, which may well have to be provided through official channels.

There are a number of key concepts which those dealing with resolution will need to attend to, such as 'resolvability', 'critical functions', 'bail-in', 'bridge institution', and more. Such concepts are likely to have an impact on the way we think about banks themselves, as regulatory requirements, and therefore business-relevant requirements, are attached to them.

For instance, banks will be subjected to 'resolvability assessments' by their 'crisis management groups' (CMGs – groups of supervisors responsible for dealing with firms in crisis situations). The FSB has advised that banks will be resolvable if their resolution plans are both "feasible" and "credible". There is a degree of uncertainty at present as to how such terms will be interpreted, and it may be that more experience of resolution is needed in order to set precedents. Until such experience is gained, there will be inevitable concern that regulators adopt an overly cautious approach. As an example of the potential impact of such a concept, the FSB's *Key Attributes*, suggest supervisors or resolution authorities should have powers to require changes to firms' business practices or structures in order to improve resolvability. Such changes could be required without an institution actually being in danger of entering resolution.

The Dodd-Frank Act in the **United States** requires banks to submit living wills depending on the size of the institution. A final rule requiring these plans by the end of 2012 was published in 2011. In the **UK**, the FSA consulted on Recovery and Resolution Plans in 2011, and published draft rules in May 2012, but is yet to detail its final proposals. The plans are likely to take in considerable detail from the Independent Commission on Banking's recommendations. In **Europe** the European Commission has stated that details of its Crisis Management Framework will be published in 2012, though they have been repeatedly delayed. In **Japan**, regulators are yet to provide detailed guidance on their expectations for such plans. Progress is thus patchy, which complicates cross-border coordination, as it is the divergence of national legal systems which considerably complicates cross-border resolution.

The Regulators

Regulators have consistently identified resolution as a fundamentally important part of the future of financial regulation, and crucial to overcoming the “too big to fail” problem. The FSB has coordinated international work, with regular input from a wide range of countries. The FSB has also stated that it sees resolution as providing “incentives for market-based solutions”. As an example of this, the UK’s FSA has stated that it would leave trigger points for initiating recovery plans down to firms, rather than mandate them. However, it was made clear that these should be set at “appropriate levels”, in order to prevent proactive regulatory intervention. A further example of such incentives can be seen with so-called ‘bail-in’ capital, whereby bank debt can be converted into equity when a trigger-point is breached. Regulators have been keen to stress that statutory bail-in regimes, which could be triggered by regulators, should not prevent firms from entering into private contractually-based bail-in agreements with higher trigger points than statutory bail-in would require, thus reducing the need for regulatory intervention.

Regulators have pointed to a crucial difference between the objectives of special resolution regimes and the objectives of corporate insolvency proceedings. The former have a “public interest” objective, such as the maintenance of financial stability, while the latter are designed to achieve the best outcomes for creditors. Regulators have recognised the implications this may have for the creditor hierarchy in insolvency, and the FSB has accepted that the creditor hierarchy should be preserved in resolution.

The Basel Committee on Banking Supervision noted in July 2011 that the various new Special Resolution Regimes brought in after the crisis fail to address the difficulties of resolving whole financial groups, with particular shortcomings in the cross-border context. Even with the FSB’s new principles, however, the problem of resolving cross-border institutions looks set to remain. The FSB has stated that “there is no immediate prospect of [a] formal multilateral agreement addressing the set of issues raised in the resolution of financial institutions” and that binding mechanisms “will not be feasible” until existing proposals are already in place. In this respect, regulators have recognised the limits of international coordination, and appear to be taking a pragmatic approach to the short-term.

The Industry

The industry’s views have been laid out in responses to consultation papers and industry-led research. Interestingly, the FSB has acknowledged a “significant minority” of respondents to its 2011 consultation who pointed to an apparent lack of ambition in the FSB’s proposals. This group included a range of large, cross-border banks, as well as various banking associations, such as the British, French and German bankers’ associations. One internationally active bank was concerned that there will still be a “considerable danger that national self-interest may prevail over global interest in the resolution of a global SIFI.” Others noted that it is precisely the responsibility of the FSB and G20 to promote a more ambitious programme, and many called for an internationally binding treaty.

Construction and maintenance of resolution plans will require extensive work by firms, with consequences for governance, strategy, and structure. “Resolvability assessments” will require firms to convince the relevant resolution authorities that it is “feasible and credible” for those authorities to perform a resolution without severe systemic disruption or taxpayer loss. This will be a continuous and demanding process, which will be “intellectually stretching, logisticallv a6l239(w)-32(i)515(c)--324 T 87(o)-36(r)33(,)-30( )-369(2)-32( )-97(a)-18(o)-36(g)-29(c)-31(a)-29(b)-27m

The Academics

Richard Herring points out that the problems of cross-border resolution have been with us for many decades. To name but a few cases, Herstatt (1974), BCCI (1991), Barings (1996), LTCM (1998), Fortis (2007-8), Dexia (2008), the Icelandic system (2008), and of course, Lehman Brothers (2008), to which we can now add MF Global, are all illustrative of the difficulties of resolving failing institutions with cross-border operations. Unfortunately, despite this "long, troubling history", Herring argued as recently as 2011 that "no real progress has been made."

Schoenmaker and Osterloo investigated the cross-border externalities of firm failure in Europe in 2004, concluding that the extent of cross-border externalities is closely tied with the extent of cross-border banking business, but that national authorities tend to focus on national consequences rather than cross-border externalities. Schoenmaker notes that without a convergence of national interests there are few incentives for internalising these externalities. It is interesting to note in this regard the rise to prominence of concerns for systemic consequences and stability, which may prove to be the glue with which to join national interests in a world of cross-border banking. However, there is often a gap between agreement in principle and committed action in practice.

For Avgouleas, Goodhart and Schoenmaker, the problem of cross-border resolution is that there is a "gross incompatability" between global cross-border reality and national regulatory/legal attempts to respond. They point to a continuing divergence in insolvency regimes between jurisdictions, between those that operate "territorial" approach, whereby assets held in a particular country are ring-fenced, and those that operate a "universal" approach, whereby the group is treated as a whole, across borders. Banks which operate in multiple jurisdictions may as a result be subject to conflicting regimes, which may create conflict between regulators and insolvency practitioners. This marks a "glaring weakness" in the system. It is not clear that this weakness has been addressed by existing proposals, though many academics recognise that significant progress has been made in many other respects.

Outstanding Issues

Practical implementation of recovery and resolution regimes is now crucial, and 2012 may be the year in which several years of intellectual effort are transformed into practical reality. However, implementation often throws up difficulties, both expected and unexpected. Progress is likely to be regionally diverse. Both **US** and **UK** banks have