AFME outlines ways to rescue failing banks without taxpayer financing

The Association for Financial Markets in Europe (AFME) has today published the most comprehensive discussion paper yet to examine how a failing financial institution can be managed through crisis and recapitalised without requiring capital support from governments and taxpayers.

The paper, "The Systemic Safety Net: Pulling failing firms back from the edge", focuses on two mechanisms - “bail-in” and “contingent capital” - that allow failing firms to continue in business rather than face liquidation.

- **Bail-in**: Implemented when a firm hits a pre-defined trigger, this would recapitalise a firm as a going concern by converting selected tranches of unsecured debt to common equity. No shareholder or creditor consultation would be needed so this could happen very quickly - over a weekend, for example.

- **Contingent capital**: Used historically by the insurance sector to provision against one-time losses, this is issued in the form of notes convertible into equity upon the issuer’s hitting a pre-defined trigger. The trigger itself would be activated well in advance of a firm falling below minimum regulatory capital requirements. It requires no regulatory involvement, so increases transparency and may help prevent a localised problem spiralling into a systemic crisis.

Either option would be far better option than liquidation, protecting depositors and employees and reducing the likelihood of contagion. In each case, the bank’s shareholders would bear the loss through devaluation or dilution of their equity. Critically, neither option requires capital support from taxpayers or a pre-capitalised fund for providing liquidity.

Mark Austen, acting CEO of AFME commented:

“There will always be the risk of firms failing but we need to ensure that they do not destabilise the wider economy or need taxpayers’ funds to refinance them. Taxpayers should never again be the first to be called upon for help when there is a banking crisis.

“A well considered resolution and recovery scheme, using bail-in or contingent capital, could not only mitigate against contagion but also pull a firm back from the brink of insolvency so that liquidation can be avoided."
“If such a regime had been in place two years ago, Lehman Brothers might not have needed to be liquidated and the destructive consequences of that liquidation could have been avoided.”

Details of how each mechanism would work and the challenges that implementing either would bring are set out in AFME’s paper, which is distributed today to senior regulators and other interested parties across Europe.

The paper has been written by a group of senior experts from major banks and law firms and AFME’s in-house experts. It forms part of a wider piece of work considering the control of systemic risk in the financial system, due to be published in the autumn.

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Notes:

1. The Systemic Safety Net: Pulling failing firms back from the edge is published today on the AFME website.

2. AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website, www.AFME.eu.