

5. Resolution and fast-track capitalisation

Executive summary

- Failing institutions can be managed through a crisis and recapitalised without threatening the stability of the entire financial system or requiring government intervention and taxpayer support.
- Two mechanisms - “bail-in” and “contingent capital” - could be deployed to allow failing firms to continue in business rather than face liquidation.
- Both options would be implemented on the firm reaching a pre-defined trigger and would be far better solutions than liquidation, as both depositors and employees would be protected and the likelihood of contagion reduced.
- 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.

Current reform proposals are focused on strengthening bank capital and improving resolution regimes to ensure that taxpayers are not called on again to resolve any future crises in the financial sector. AFME believes that having in place clear, coordinated, cost-effective policies could help firms establish appropriate recovery and resolution plans to support these objectives. In this chapter, we set out some initial thoughts on the topic; our own work is at a relatively early stage and will be further developed in consultation with other interested parties, including investors.

The need for resolution authority

As noted in previous chapters, in a competitive market and economy, there is always a risk that financial firms will fail but a failure of an individual institution should not be viewed as a failure of the market or the financial system itself. That said, firm failures do bring many challenges so regulatory authorities should be granted resolution powers that allow them to manage such failures without bringing into question the viability of the entire financial system and resorting to taxpayer funds to rescue failing firms. All major jurisdictions may benefit from having in place resolution powers that apply to investment banks⁸.

One model is the stabilisation powers embodied in the UK Banking Act 2009 (and the US Dodd-Frank Act) for transfer to a private sector purchaser, bridge bank or temporary public sector ownership.

⁸ In Europe, resolution powers could be extended to the more broadly defined group ‘investment firms’ under MiFID, and the scope of firms to whom HM Treasury is considering making available the Special Administration Regime. As an aside, the proposed Special Administration Regime which aims to improve the efficiency of administration for investment firms is somewhat helpful but the absence of any resolution powers means that it will likely fail to ensure an orderly wind down or prevent systemic contagion.

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The key issues of a bail-in are:

- the mechanics of implementation;
- classifying the debt and securities that will be subject to the bail-in;
- the need to avoid acceleration of debt instruments or unwinding of financial contracts; and
- the possible need to provide liquidity for the recapitalised firm.

Typically, liquidation of a firm is very inefficient and destructive in the loss of enterprise value and jobs. The loss not only hits the firm in question, and other organisations with which it trades, but also multiplies among the wider economy that provides services to that firm and relies on its custom. This “loss multiplier” effect was one of the striking features of the recent crisis and a principal driver of the late 2008 market gridlock. Arguably, bail-in could have prevented this.

How firms and markets would react to a convincing bail-in framework must also be considered. A bail-in policy could positively influence market behaviour for certain classes of counterparties – for example, if certain customer and liability sectors (insured deposits, derivatives, repo) are protected they should be less prone to flight risk if rumours about a bank’s health start to circulate. This would lessen the chance of a repeat of the “accelerator” effect seen in the last crisis.

Bail-in would protect depositors and create an increase in capital that would be capable of absorbing losses far

greater than those seen in the recent crisis and would reduce systemic risk by avoiding costly and damaging liquidations. It may also reduce the impetus for overly-conservative capital requirements, which is being driven by the same desire to eliminate the need for publicly funded bailouts but has the undesirable effect of stifling economic growth.

Perhaps most importantly, as well as reducing the cost of big bank failures, and the likelihood of them occurring, bail-in would also improve confidence and certainty so would reduce the risk of contagion, which has a huge impact on markets and economies.

The impact of bail-in on the cost of funding needs to be further considered by member firms and buy-side firms. In particular it would be helpful to assess how that impact differs from the exercise of other resolution powers such as the state’s ability to establish a bridge bank, liquidate or sell a firm.

Recovery and resolution plans

Much attention has been focused on the idea that financial institutions should produce “living wills” – in essence recovery and resolution plans that would enable failing firms to exit the market with minimal systemic disruption. AFME supports this initiative. In our view, such plans should:

- allow a degree of flexibility to enable firms to adapt them to their particular

business model and operations;

- not be used as a means to impose arrangements that regulators require for other reasons (e.g. subsidiarisation requirements);
- put forward strategic actions as a generic “menu of options”, to allow for the unpredictability and complexity of any particular stress scenario;
- contain explicit details on the composition of the regulators’ Crisis Management Group (CMG) that would act in crisis situations; and
- detail an agreed approach and the protocols that would be used in creating a “common language” on how the CMG would deal with crisis situations.

Ideally, cross-border firms would be required to have only one resolution plan so that inconsistency and incompatibility of objectives and approaches can be avoided.

For recovery plans it would be worthwhile exploring the possibilities offered by a firm’s issuance of so called “contingent capital” – a self-operating security through which capital levels can be replenished in times of distress without direct regulatory involvement.

The authority to implement a bail-in could be included in the resolution powers of national regulators, with firms required to assist them in developing bail-in plans.

How contingent capital works

Historically used by the insurance sector to provision against one-time losses, contingent capital is issued in the form of notes convertible into equity upon the issuer's hitting a pre-defined trigger. It has recently been used by several AFME member firms to restore their capital levels post-crisis.

The benefits of contingent capital are:

- The improvement to a firm's capital levels would come well in advance of it falling below minimum regulatory capital requirements, while also serving as an amber warning to regulators and to the firm itself to de-risk, de-leverage or seek an M&A solution.
- It is self-operating and, with the exception of ensuring that from a prudential perspective the trigger is appropriately set, requires no regulatory involvement, although it is self-evident that regulatory authorities or central banks would have an interest in monitoring events and would need to be kept fully informed. Transparency and clarity to the market is increased and could help prevent a localised problem from spiralling into a systemic crisis.
- It could be designed to dovetail with the reinvigorated Basel 3 minimum capital requirements.

Despite the benefits, there is scepticism from some parts of the investing community who argue that, like hybrids, contingent capital is a gimmicky, complex, non-transparent security that avoids raising core equity. Some fixed income investors assert that contingent capital's equity features make the asset class ineligible for fixed income mandates. Another concern is that rating agencies would not rate contingent capital because it is not debt, and it should be excluded from fixed income indices. A further concern is that this new type of security may not be suited to some of the potential issuers and would make sense only if considerable amounts of contingent capital could be placed with investors.

Although it does bring challenges, appropriately structured contingent capital could be a highly effective recovery tool that would ensure firm-specific issues are addressed well before they become a systemic crisis.

Self-evident from these proposals is that where a well-considered resolution and recovery regime is in place there should be no need for taxpayers to support failing institutions, nor for a significant pre-capitalised fund to provide liquidity or capital during the resolution or recovery phases.

Further reading:

Institute of International Finance, "Preserving Values in Failing Firms," Submission to the FSB (2 September 2010)

British Bankers Association, "Resolution and Unsecured Creditors" (24 August 2010), www.bba.org.uk

Paul Tucker, Deputy Governor, Financial Stability, Bank of England, Speech delivered at the European's Commission on Crisis Management, Brussels (19 March 2010) <http://www.bankofengland.co.uk/publications/speeches/2010/speech431.pdf>

JP Morgan Credit Research Note, "The Ins and Outs of Bail-Ins, Regime Change for Bank Senior Debt?" (6 September 2010)

Significant regulatory initiatives:

Basel Committee on Banking Supervision, Consultative Document "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability," (1 October 2010) <http://www.bis.org/publ/bcbs174.pdf?noframes=1>

European Commission, Directorate General Internal Market and Services, "Roundtable on Debt Write Down as a Resolution Tool," (10 September 2010)

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