

## 6 The medium-term agenda

The banking crisis and the unprecedented interventions by national and international authorities will affect both the structure of the financial system and the incentives within it. The full consequences will take time to emerge. But recent events have highlighted the need for a fundamental rethink internationally of the appropriate safeguards against systemic risk.

The long-standing focus on capital and, to a lesser extent, liquidity requirements for particular institutions has not delivered the right outcomes for the system as a whole, resulting in real costs for the wider economy. There needs to be a substantive discussion at a national and international level of the appropriate long-term responses. But some of the changes needed to improve the resilience of the system are already clear. These are discussed in this section, and summarised in **Table 6.A**.

*Macroprudential tools are needed to ensure banks are in a stronger position ahead of the next downturn.*

Recent events have demonstrated the tendency of the financial system to be procyclical, overexpanding in good times and contracting sharply in bad times. Many banks did not build up large enough capital buffers in benign times to ensure that they could maintain market confidence when conditions eventually reversed. As a result, large-scale injections of capital — often underwritten by the authorities — have been required into banks that had previously been considered adequately or well capitalised.

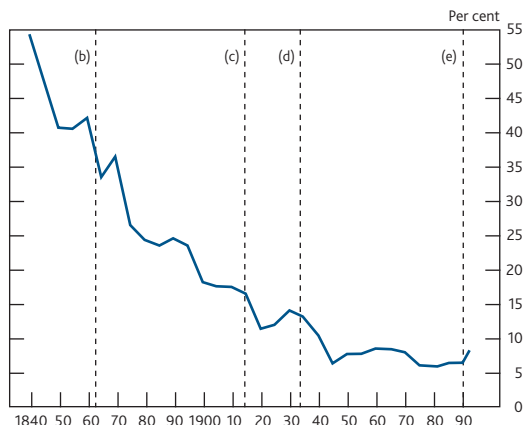
By historical standards, banks have operated with relatively low levels of capital in recent years. For example, long-run evidence shows that capital ratios for US banks have fallen significantly from levels of around 50% in the mid-19th century (**Chart 6.1**). The structure of banking systems, and the safety nets in place to support them, have changed dramatically over the period. While it is difficult to determine the optimum level of capital, recent events suggest that capital levels across the financial system as a whole have fallen too far.

Existing regulatory tools need to be adapted and new ones developed, to ensure that the financial system is better capitalised in advance of the next downturn and to address the build-up of risk through the cycle. A range of specific proposals have already been put forward. A leverage ratio — a minimum ratio of capital to total assets — would impose a constraint on the growth of banks' balance sheets relative to their stock of capital. A system of dynamic provisioning would force banks to build up reserves against future losses in good times, providing a resource which could be drawn on in bad times. These and other proposals are outlined in detail in **Box 6**. In addition, the requirement on banks under Pillar 2 of

**Table 6.A** Key actions to improve resilience

- Macroprudential tools are needed to guard against systemic risk and to ensure banks are in a stronger position ahead of the next downturn.
- Capital levels have been too low and need to rise; and capital needs to be of sufficient quality to deliver higher levels of resilience.
- Liquidity standards have been inadequate and should be strengthened to ensure that firms are sufficiently resilient to a range of shocks.
- The current UK legal framework for depositor protection and dealing with institutions in difficulties needs to be strengthened.
- International arrangements for managing crises at cross-border financial institutions should be developed further.
- Transparency should be improved through more informative disclosure, including the provision of more information on potential future balance sheet volatility, to strengthen market discipline.
- The scope for — and potential benefits of — developing centralised infrastructures for a broad array of over-the-counter instruments should be assessed.

**Chart 6.1** Long-run capital levels for US commercial banks 1840–1993<sup>(a)</sup>



Source: Berger, A, Herring, R and Szegö, G (1995), 'The role of capital in financial institutions', *Journal of Banking and Finance*, pages 393–430.

(a) Equity as a percentage of assets (ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets).

(b) National Banking Act 1863.

(c) Creation of Federal Reserve 1914.

(d) Creation of Federal Deposit Insurance Corporation 1933.

(e) Implementation of Basel risk-based capital requirements 1990.

Basel II to stress test their business for a downturn, which is in the process of being introduced, should also make a useful contribution.

*Inadequate levels of capital reflect underestimation of the risks that banks have been running...*

During this crisis, banks, market participants and the authorities have all underestimated the risks to which many banks and other financial institutions have been exposed.

The Basel II capital rules introduced this year are more sophisticated than the original Basel Accord which was in place throughout the build-up to the current crisis. But some specific shortcomings of Basel II have been revealed by recent events, such as the treatment of trading book assets and the risks relating to off balance sheet exposures, and are now being addressed.

Structural changes, such as the growth in trading books and the wider adoption of mark-to-market accounting, have resulted in greater uncertainty about the net worth of some banks. Recent events have illustrated that banks can now incur losses much faster than they can recapitalise themselves in stressed market conditions. As such, banks may need to hold more capital in normal conditions so as to provide an adequate buffer against market volatility. If capital levels are to increase, this additional capital should be genuinely usable under stress. It must not simply become locked-in as part of a higher *minimum* expected level of capital.

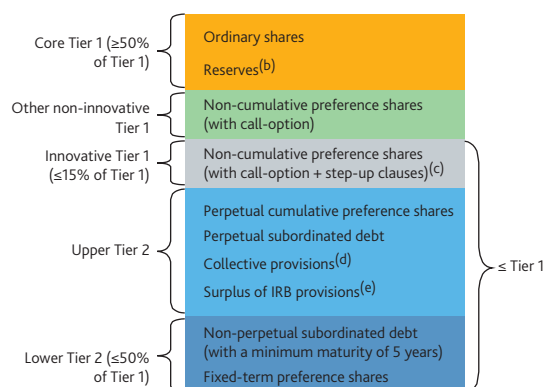
*...including systemic risks.*

Risks arising from system-wide interactions and market dynamics have received too little attention among firms and regulators. Firms' stress testing and contingency planning needs to factor in spillovers of asset sales on market prices and of lending contraction on aggregate credit conditions (as discussed in the October 2007 Report, pages 62–63). Macroeconomic stress tests, such as those required by the FSA, should help to calibrate the buffer necessary to insure against unexpected economic shocks. But it is not clear that firms currently have the capability to assess the potential impact of systemic risk on their balance sheets. They should consider how to adapt their stress-testing techniques and risk management practices in order to do so, and use the results in their capital planning.

*The quality of capital has been overestimated...*

Markets appear to have perceived the level of loss-absorbing capital held by banks as going-concerns to be lower than was previously thought. Supervisory regimes accept a range of hybrid debt-equity instruments in Tier 1, not just shareholders' funds (see Chart 6.2 and the discussion in Box 4 of the April 2008 Report, pages 40–41). But it appears that the market does not consistently treat these as loss-absorbing instruments. Instead, market participants recently have

**Chart 6.2** Key components of Tier 1 and Tier 2 capital and relevant regulatory limits under Pillar 1<sup>(a)</sup>



Source: General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms, FSA.

- (a) Limits are expressed in terms of Tier 1 which excludes Tier 1 innovative instruments and also deducts investments in own shares, intangible assets and other specific Tier 1 deductions.  
 (b) Includes non-repayable capital contributions and externally verified interim net profits after prudential filters (eg losses arising from valuation adjustments).  
 (c) A step-up clause allows an increase in the coupon rate beyond a specific date.  
 (d) Provisions that cannot be identified to specific transactions and correspond to portfolios under the standardised approach.  
 (e) The positive difference between the level of provisions and the level of expected losses associated with portfolios under the internal ratings based (IRB) approach.

focused on measures of 'core' Tier 1 capital.<sup>(1)</sup> If banks cannot both withhold payments on these hybrid instruments and be considered a going-concern by markets, they are holding less genuinely loss-absorbing capital than their Tier 1 ratios currently imply. That is one reason why, under the UK recapitalisation scheme, the majority of the capital injected will be provided in the form of common equity. The Basel Committee's current work on the appropriate treatment of different types of capital should provide guidance on appropriate definitions of regulatory capital.

*... with insufficient account taken of systemically important institutions.*

Finally, the standard of resilience for some banks may have been set too low. Higher standards of resilience — not just for capital but also for liquidity — are appropriate for institutions that would impose a greater cost on the financial system as a whole if they were to fail. The Federal Reserve Bank of New York has already indicated that it will put in place more exacting expectations on capital, liquidity and risk management for the largest institutions that play a central role in intermediation and market functioning.<sup>(2)</sup>

*Liquidity standards need to support the necessary adjustments to banks' funding structures.*

Previous Reports have highlighted severe deficiencies in firms' liquidity risk management, including in identifying both on and off balance sheet liquidity risks, conducting sufficiently severe stress tests and maintaining adequate and fully operational contingency funding plans. Supervisors and regulators have stepped up their efforts, domestically and internationally, to ensure that liquidity risk is appropriately managed, given the critical role of liquidity in the banking sector and in the functioning of financial markets.<sup>(3)</sup>

Failures have required extensive intervention by the official sector to ensure that short and medium-term funding is available to banks. As discussed in Section 5, there should be a clear expectation that banks will move away from their current heavy dependence on official sector funding support over the longer term. Tougher liquidity standards should also reduce the financial system's procyclical tendencies — for example, by restricting banks' ability to expand their lending rapidly using potentially volatile sources of funding, such as some types of wholesale funding.

*Legislation will strengthen domestic crisis-handling arrangements...*

Recent events have demonstrated the need for the UK authorities to have more effective tools and systems for

(1) See the discussion of alternative measures of capital in Box 4 of the April 2008 Report, pages 40–41.

(2) Speech by Timothy Geithner, 'Reducing systemic risk in a dynamic financial system', 6 August 2008.

(3) See, for example, the Basel Committee of Banking Supervision (2008), *Principles of sound liquidity risk management and supervision*, September.

## Box 6 Countercyclical measures

The financial system has a tendency to be procyclical, overexpanding in good times and retrenching sharply in bad times, exacerbating the likelihood of financial instability and amplifying undesirable macroeconomic feedbacks. Banks' failure to build up sufficient buffers of capital and liquidity in good times to use in bad times is one aspect of this.

This *Report* discusses initiatives aimed at improving market discipline — such as better disclosure of stress-test results — as a way of mitigating procyclical tendencies. In addition, a variety of changes to regulatory capital requirements have been suggested internationally, to ensure that the financial system is more resilient in advance of a downturn. For example, restrictions on balance sheet growth could be achieved via simple rules linked to either a bank's level of debt or its asset growth. Ensuring banks have buffers to draw on in a crisis could be facilitated by provisioning against future defaults, or by having credible insurance that would provide recapitalisation when necessary. This box discusses examples of each of these in turn.

### Leverage ratio

One possibility is to adopt, in parallel with the Basel II standards, a backstop against capital levels falling too low in good times, such as a leverage ratio: a minimum ratio of capital to total assets. This would impose a relatively simple constraint on the growth of banks' balance sheets relative to their stock of capital. Some authorities — notably in the United States — already use a leverage ratio as an additional tool in their overall assessment of the resilience of their financial institutions. A proposal for a leverage ratio is being considered in Switzerland.

Careful consideration needs to be given to the consequences of the introduction of a leverage ratio. For example, to the extent the required ratio binds, it may provide banks with an incentive to invest in more risky assets. In addition, there is not one clear way to define a leverage ratio, particularly regarding accounting for off balance sheet assets such as lending commitments or potential future exposures on derivatives. If such contingent commitments were to be excluded, banks could circumvent leverage ratio rules through off balance sheet transactions and implicit commitments.

### Dynamic provisioning

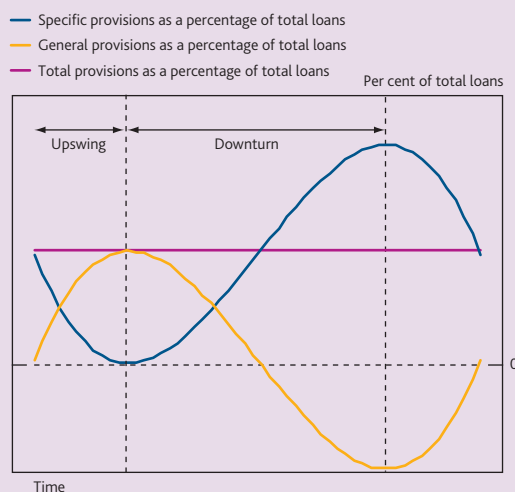
Another rules-based scheme, a form of which is in use in Spain,<sup>(1)</sup> is dynamic provisioning: a rule requiring banks to build up general loss reserves during good times according to a formula calibrated on loan growth and the rate of provisioning and losses experienced over the past. This framework would

be supplementary to current loan-loss recognition and capital requirements. Under current accounting rules, banks are permitted to hold allowances against losses only in respect of assets currently on their balance sheet, and to make impairments, or specific provisions, only on an incurred loss basis. Present accounting requirements therefore largely prohibit banks from building up reserves against future losses that they expect to incur but for which there is currently no or insufficient evidence of actual incurred loss.

Dynamic provisioning would force banks to start to build up reserves against future losses when loans are originated. The effect of such a scheme, if it were properly calibrated, would be that the cumulative stock of these general provisions would rise when actual loan losses are low, providing a resource which could be drawn on in periods when actual losses are high. Banks would have less need to raise new capital in downturns, when the market appetite for new equity may be limited. And since drawdowns on these general provisions would be automatic, the market would view this less negatively than the need for capital raising.

Chart A provides a stylised illustration of how such a scheme would work. Specific provisions and impairments fall during upswings and then rise in downturns. General provisions, on the other hand, rise during upswings to build a stock of reserves that can be drawn down in downturns.

Chart A Dynamic provisioning



There would be challenges in the practical implementation of such a scheme, notably ensuring consistency with accounting rules. For example, the Bank of Spain was obliged to make changes to its dynamic provisioning rules upon the adoption by the European Union of the international accounting standards issued by the International Accounting Standards Board. As such, a provisioning scheme would have to make clear how regulatory requirements for provisioning differed from general accounting standards that apply to impairments.

A limitation of provisioning is that it typically relates only to average losses, rather than large losses which may occur with a small probability which is the basis for assessing minimum bank capital.<sup>(2)</sup> The scheme could, however, be elaborated to include an element of provision against losses linked to excessive growth of loans, thereby providing protection against the slippage in lending standards that tends to be a feature of prolonged upswings.

### Time-varying capital requirements

Another method to restrain excessive balance sheet growth in good times is to link banks' capital requirements to lending growth. Charles Goodhart and Avinash Persaud have suggested a simple countercyclical rule to achieve this that mechanically links capital requirements to growth in the value of each bank's assets.<sup>(3)</sup> Each bank would be allowed a certain amount of asset growth, related to factors such as the inflation target and the long-run economic growth rate. But banks that grew their assets by more than this allowance would be subject to increased capital requirements.

Further work on calibration would be needed to consider whether such a requirement restrained risk-taking effectively. There are clear drawbacks to such a simple, non risk-based rule; it could potentially penalise banks that grow their balance sheets through less risky assets, relative to their peers. More generally, focusing on specific indicators such as asset growth potentially ignores other important risk drivers, so the proposal would need to run parallel to Basel II. A different option would be to link capital requirements to asset growth in a less mechanical but more risk-based way through the implementation of Pillar 2.

### Capital insurance

An innovative proposal has been put forward by Anil Kashyap, Raghu Rajan (both University of Chicago) and Jeremy Stein (Harvard University).<sup>(4)</sup> Banks could choose between holding higher capital and buying capital insurance which would provide a capital infusion in the event of a systemic event. In essence, banks could buy — or be required by the regulator to purchase — catastrophe insurance. Capital insurance would work through a 'deep-pocket' insurer, such as a pension or sovereign wealth fund, which would place a sum aside in a 'lock box', invested in safe assets such as Treasury bills in return for receipt of premium and interest on the investment. In a payout, the bills would be transferred to the bank, thereby providing recapitalisation.

But this proposal has the potential to create new vulnerabilities, such as an overreliance on 'deep-pocket' insurers and the associated moral hazard. Moreover, it seems unlikely that such a scheme could deal with genuinely systemic events, since this is precisely when many institutions will be drawing on funds at the same time, potentially

exhausting the resources of the insurers. But it nonetheless merits further consideration and has some parallels with bonds which are used to transfer catastrophe (natural disaster) insurance risk from insurers, reinsurers and corporations to investors. Catastrophe bond risk capital outstanding was US\$13.8 billion at the end of 2007. 116 bonds were issued between 1997 and end-2007, comprising primarily of Standard & Poor's BB (or equivalent) rated issues.

### Summary

It is clear that more attention needs to be paid to countercyclical regulatory measures. Dynamic provisioning and *ex-ante* capital rules appear to be useful tools not only to ensure that the system has larger buffers to draw on, but also to restrain the tendency for excessive balance sheet expansion during upswings which exacerbates the severity of subsequent economic downturns. Further analysis of the effectiveness and calibration of the various options is required ahead of their implementation. The Financial Stability Forum has already set such work in train at an international level.

(1) More details on the Spanish approach can be found in Banco de España, *Financial Stability Report* (05/2005), Box III.1; and Jiménez, G and Saurina, J (2006), 'Credit cycles, credit risk, and prudential regulation', *International Journal of Central Banking*, Vol. 2, No. 2, June, pages 65–98.

(2) Under the Internal Ratings Based approach in Basel II, capital against credit risk in the banking book is assessed at a 99.9% level of confidence over a one-year period.

(3) Goodhart, C and Persaud, A (2008), 'A party pooper's guide to financial stability', *Financial Times*, 4 June 2008.

(4) Kashyap, A, Rajan, R and Stein, J (2008), 'Rethinking capital regulation', conference draft for Federal Reserve Bank of Kansas symposium, Jackson Hole, Wyoming, 21–23 August 2008.

**Table 6.B** Elements of the Banking Bill 2008

- Establishes a **special resolution regime (SRR)** to provide the Authorities with tools to deal with banks that encounter, or are likely to encounter, financial difficulties.

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- Establishes a new **bank insolvency procedure**, based on existing liquidation provisions, to provide for the orderly winding up of a failed bank and to facilitate rapid Financial Services Compensation Scheme (FSCS) payments to eligible claimants or a transfer of such accounts to another institution.

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- Establishes a new **bank administration procedure** for use where there has been a partial transfer of business from a failing bank.

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- Includes powers to enable the introduction of pre-funding for the FSCS; allows the FSCS to contribute to costs arising from the use of the SRR; and allows the National Loans Fund to make loans to the FSCS.

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- Gives the Bank of England a statutory role in the oversight of **interbank payment systems**.

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- Replaces existing provisions about **banknotes in Scotland and Northern Ireland**; empowers the Treasury to make regulations about banknotes, including a requirement on note-issuing banks to have backing assets; and permits the Bank of England to make rules about the treatment, holding or issuing of banknotes.

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- Includes provisions relating to the **governance of the Bank of England**, including a new statutory financial stability objective and the establishment of a Financial Stability Committee as a subcommittee of the Bank's Court of Directors.

Source: The Banking Bill 2008.

dealing with failing banks. This is the main purpose of the Banking Bill laid before Parliament in early October (see **Table 6.B**). The proposals were designed to reduce the likelihood of a bank failing, to lower the impact on the wider financial system in the event of a failure, to ensure effective compensation arrangements for depositors in those circumstances, to strengthen the Bank of England's role in financial stability and oversight of payment systems and to improve co-ordination between the UK authorities.

The special resolution regime (SRR) is central to these proposals (Box 7). This regime would provide powers and tools to be used when voluntary actions by the firm and normal regulatory powers are insufficient to handle a failing bank in an orderly way. The recent severe institutional distress in the United Kingdom — including Northern Rock and Bradford & Bingley — has illustrated the need for a permanent and transparent regime to manage the risks to financial stability, protect public finances and depositors, and ensure the continuity of key banking and payment arrangements.

*...and international crisis management needs also to be strengthened...*

The complexities of cross-border crisis management have long been recognised. But recent events have highlighted weaknesses which increase the need for joint work to improve co-operation between authorities in these cases.

For example, there has been a long-standing recognition of the complications that arise from the resolution of a bank with significant foreign branches or subsidiaries. But this did not prevent poor co-ordination during recent events, such as those surrounding the failure of Lehman Brothers and the handling of distress among the largest Icelandic banks. The sequential announcements by national governments of deposit guarantees and changes to deposit insurance arrangements highlighted other areas where greater international co-ordination would have been desirable. Recent events also demonstrated, however, how effective co-ordinated action can be at times of system-wide stress: for example, the co-ordinated interest rate cuts on 8 October; the provision of dollar liquidity by central banks in September and October (see **Table 3.A**); and the adoption of comprehensive national measures to support banking systems (see Box 5 on pages 31–33).

The Financial Stability Forum (FSF) is developing a practical checklist of issues and actions that need to be considered to manage a distressed cross-border institution and a set of principles for international crisis management, drawing on the experience of the current crisis.<sup>(1)</sup> International work is also

(1) The mandate is set out in the FSF (2008) *Report on Enhancing Market and Institutional Resilience*, April ([www.fsforum.org/publications/r\\_0804.pdf](http://www.fsforum.org/publications/r_0804.pdf)).

under way to develop a better understanding of the different mandates of individual authorities in different countries and the different regimes for crisis management and bank insolvency. In the European Union in particular, there is work to develop firm-specific contingency plans in groups of relevant authorities (known as cross-border stability groups). A better understanding of the complexities of resolving such firms may call for changes in the legal and operational structures of cross-border groups.

*...while ensuring that market discipline is maintained...*

Market discipline did not prevent a build-up in risks. One reason may be that firms lack clear incentives to produce and disclose accurate and comparable information on the risks facing their businesses. Recent surveys of financial statements suggest that disclosures on the use of fair value, on exposures to structured finance and on approaches to risk management have improved.<sup>(1)</sup> But Pillar 3 of Basel II needs to ensure that counterparties and other market participants have the information they need to assess the risks to individual firms' businesses and to the wider financial system. For example, greater disclosure of the potential effects on balance sheets of different outcomes, including the variation or margin of error around those outcomes, would be beneficial. Uncertainty about such effects has been acute during the present crisis and has contributed materially to funding problems.

The consistent and timely disclosure of exposures following international standards is a key step in restoring market confidence in financial institutions. Although fair values have proved difficult to determine in illiquid markets over recent months, that should not mean abandoning the underlying principles. Indeed, events during the crisis have illustrated that market participants are themselves making these fair value adjustments when evaluating the solvency of a firm. It is better if those market judgements are well informed and based on authoritative application of fair value principles to the underlying balance sheet exposures. That is not to say the methods for applying these principles could not be improved. Recent joint guidance from the US Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) — supported by the International Accounting Standards Board (IASB) — on the valuation of financial instruments when markets are dislocated, is welcome.<sup>(2)</sup>

Other stakeholders in financial institutions also need to play their part. Failings of strategies and risk management within financial firms suggest that shareholder groups have not

(1) For example, PWC (2008), *Accounting for change: transparency in the midst of turmoil*; and Committee of European Banking Supervisors (2008), *CEBS report on banks' transparency on activities and products affected by the recent market turmoil*, June.

(2) IASB (2008), 'IASB staff position on SEC-FASB clarification on fair value accounting', 2 October 2008; and SEC/FASB (2008), 'SEC Office of Chief Accountant and FASB staff, clarifications on fair value accounting', 30 September 2008, 2008-234.

provided as rigorous an oversight role of the financial institutions that they own as they could have done.

*...and market infrastructures develop where necessary.*

Recent market events have also highlighted weaknesses in the post-trade infrastructure for over-the-counter (OTC) products in general, and credit default swaps in particular. Among the actions being discussed to strengthen this infrastructure are the potential benefits of a clearing house or a central counterparty (see Box 2 on pages 21–23). A debate is needed on whether such centralised arrangements are required for a broader array of OTC instruments and if so what form they should take — recognising that the establishment of a sufficiently robust central counterparty may not always be feasible. Even where it is not, standardisation and centralisation of many post-trade functions could bring considerable benefits.

## Box 7

### Banking Bill: overview of the special resolution regime

Until the Banking (Special Provisions) Act (BSPA) was passed in February 2008, the United Kingdom relied on normal corporate insolvency law to wind up failed banks. Such reliance could put financial stability at risk, by undermining the ability of the authorities to take rapid action to resolve a failing bank in the public interest. A number of the resolution provisions in the BSPA expire after one year. So a Banking Bill was laid before Parliament on 7 October,<sup>(1)</sup> which proposes a series of permanent powers and tools be given to the Tripartite Authorities and the Financial Services Compensation Scheme (FSCS) to reduce the potential for, and impact of, future bank failures. A key component of these proposals is the special resolution regime (SRR), which is designed to provide the Tripartite Authorities with a range of tools to deploy flexibly, in order to control the resolution of failing banks in a manner that supports the public interest. The objectives of the SRR — detailed in the bullet points below — set out how it will support the public interest.

Before the Banking Bill is passed, the UK authorities will consult on draft secondary legislation which will set out in more detail the structures and processes that will govern the application of these bank resolution tools, including the safeguards that will apply. This should give greater certainty and confidence to the banking industry and to markets more generally that the SRR is a necessary and proportionate way of resolving failing banks in future.

A key objective of regulation of the financial services industry is to reduce the risk that deposit-taking institutions experience troubles which bring them close to failure. But no regulatory regime can (or indeed should) prevent deposit-taking institutions from failing. It is important, for financial stability, that any such failures are orderly. That is the role of the SRR. The proposals in the Banking Bill include that the SRR applies to banks and building societies that are incorporated in the United Kingdom. The Banking Bill also allows the authorities to extend the SRR powers to credit unions in the United Kingdom, if considered appropriate.

#### Key elements of the SRR

The SRR would be triggered by the FSA, in consultation with the Bank and HM Treasury. The FSA's decision to trigger the SRR would be made upon it determining that the deposit-taking institution had failed (or was likely to fail) to meet its Threshold Conditions, and that it was not reasonably likely that action would be taken to enable the institution to satisfy these Threshold Conditions on an appropriate timescale.<sup>(2)</sup> In consultation with the FSA and HMT, the Bank

would determine which SRR tool was most appropriate for resolving the institution. It is possible that the Bank might choose to deploy a combination of SRR tools at the same time or sequentially. If the Bank's preferred resolution approach required the use of funds for which the Chancellor of the Exchequer is responsible, then that would require the Chancellor's authorisation.

In determining which SRR tool would be most appropriate to resolve a failing deposit-taking institution, the Bank would need to balance the following objectives that are set out in the primary legislation:

- to protect and enhance the stability of the financial systems of the United Kingdom;
- to protect and enhance public confidence in the stability of the banking systems in the United Kingdom;
- to protect depositors;
- to protect public funds; and
- to avoid interfering with property rights in contravention of the European Convention on Human Rights.

Some of the measures that can support the resolution of a bank were available to the Tripartite Authorities even before the BSPA became law — notably public sector guarantees, liquidity support or capital injections. Indeed, all three of these were important elements of the Government's announcement on 8 October regarding financial support to the banking industry. The Banking Bill establishes a SRR that comprises four resolution tools:

- (i) the ability to direct an accelerated transfer of part or all of a bank's business or shares to a private sector purchaser;
- (ii) the ability to direct an accelerated transfer of part or all of a bank's business to a bridge bank;
- (iii) temporary public sector ownership; and
- (iv) a bank insolvency procedure, which imposes a priority on the liquidator to facilitate the payout or transfer of the accounts of depositors insured by the FSCS.

These tools would allow the orderly resolution of a bank that gets into serious difficulties and that is judged not likely to recover. Application of the regime as soon as a regulatory decision has been taken that the bank is failing and not likely to recover, rather than waiting for the bank to fail to make payments, also means that the bank's franchise value can be better preserved. This, in turn, usually means there is more residual value to distribute to creditors (and, ultimately, to shareholders) than if the failed bank were liquidated immediately with a fire-sale of its assets.

Since February 2008, under the wide-ranging powers of the BSPA, the authorities have had the flexibility to implement a

number of different resolution tools, while offering few of the safeguards that are a feature of the Banking Bill. Once the Banking Bill is passed, the range of tools will be more clearly specified, as will be the safeguards, and there will be greater clarity in the processes to ensure that the appropriate tool is chosen in each circumstance. These measures are likely to reduce the probability of needing to use the temporary public sector ownership tool. The remainder of this box explains in more detail these various resolution tools, including some of the main safeguards that the authorities expect to deploy when resolving banks in future.

### Individual SRR tools

#### (i) transfer to private sector purchaser

It is proposed that the Bank of England be given the power to effect the transfer of part or all of a failing bank's business to a willing private sector purchaser either by the transfer of the bank's shares, or of its property, rights and liabilities. The tool would allow for a property transfer of the business of a bank without the protracted court process required under Part 7 of the Financial Services and Markets Act 2000.

#### (ii) transfer to a bridge bank

In addition, it is proposed that the Bank of England be able to transfer part or all of a failing bank's business to a bridge bank. This is a bank controlled and owned by the Bank of England, which is designed to operate for a limited period until it is sold to the private sector. A bridge bank helps to ensure continuity of the banking services for its customers: households and companies would have continuing access to deposit and current accounts and to overdraft and loan facilities. It also creates the time to identify potential private sector purchasers and permit them to undertake due diligence before submitting their bid to acquire ownership of the bank's business. Proceeds from the sale of the bridge bank will accrue back to the creditors and thereafter the shareholders of the failed bank via a Bank Resolution Fund.

The Bank of England may exercise the transfer powers to transfer just part of a failing bank's business to a private sector purchaser or bridge bank. One reason for choosing such a partial transfer might be if a private sector purchaser would be willing to buy only part of a failing bank. A better price might be obtained from the sale of just the higher-quality assets and liabilities. Another advantage of a partial transfer to a bridge bank is that the potential commitment of public funds might be less than in a whole bank transfer.

If there is a partial property transfer to a private sector purchaser or bridge bank, then the Banking Bill proposes a number of safeguards to protect the creditors left in the failing bank. Among other things, these safeguards protect netting and set-off rights; place certain restrictions on the transfer of

assets and liabilities; and require the Treasury to have regard to ensuring that any creditors in the failed bank do not receive less favourable treatment than they would have received if the whole bank had instead entered liquidation. The recent transfers of the deposit books of Bradford & Bingley (to Abbey National), and of Heritable and of Kaupthing Singer & Friedlander's Kaupthing Edge (to ING Direct), underscore the importance of partial transfers as part of the authorities' bank resolution toolkit.

It is likely that after the partial transfer the remainder of the failing bank will be insolvent. In this event, it would enter a special bank administration procedure to allow for the realisation of the failing bank's non-transferred assets. Among other things, the bank administration procedure modifies the normal duties of an insolvency administrator to require it to co-operate with the bridge bank or the private sector purchaser until such time that they can run the purchased business effectively, without the assistance of the failing bank. This may be necessary where the insolvent bank retains some of the systems and contractual arrangements required to run the business that has been transferred.

#### (iii) temporary public ownership

The temporary public ownership power would allow the Treasury to transfer the shares of a failing bank to a nominee of the Treasury. It is envisaged that this tool would be used in cases where significant amounts of public sector funds are required to stabilise the failing bank or where long-term restructuring of the bank is necessary. Enactment of the BSPA allowed the Tripartite Authorities to adopt this tool when resolving Northern Rock.

#### (iv) bank insolvency procedure

In some circumstances, closure of a bank may be the right policy option. Therefore, the authorities are working with the banking and payments industries to speed up the FSCS payout procedures to insured depositors. To deliver this, the Banking Bill also proposes a new insolvency procedure for banks: the bank insolvency procedure (BIP). The BIP is based on existing liquidation procedures, with the main alteration being that the liquidator's primary objective would be to assist the FSCS either in paying compensation speedily to protected depositors or in transferring accounts to another bank or building society.

### Conclusion

To date, the BSPA has been used on four occasions, demonstrating the importance of having legislation to deal with banks outside the normal insolvency procedure. The BSPA powers have been used in a number of different ways: Northern Rock was put into temporary public ownership; Bradford & Bingley saw a transfer of its deposit book and

branches to Abbey National, but with the remainder of the business being placed in temporary public ownership; while the resolution of Heritable and Kaupthing Singer & Friedlander involved a transfer of elements of their deposit books to ING with the remainder of the businesses being placed into administration. These examples, combined with lessons from abroad, demonstrate the importance of the authorities having the flexibility to adapt their approach to resolution to reflect the circumstances of the particular bank and the market conditions at the time. The Banking Bill introduces a number

of resolution options to give the authorities the flexibility to meet the objectives of the regime. In addition to the Bill and secondary legislation, a forthcoming Code of Practice will explain the processes around the implementation of the tools, to ensure that the most appropriate ones are used in a timely way and subject to appropriate safeguards.

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(1) Available at <http://services.parliament.uk/bills/2007-08/banking.html>.

(2) The Threshold Conditions are set out in Schedule 6 to the Financial Services and Markets Act 2000.

## Conclusion

The period since the previous *Report* has been associated with exceptional financial instability. While the roots of this turbulence were established during the credit boom, weaknesses in banks' balance sheets were amplified by rising macroeconomic and counterparty risk. That led to a freezing of funding markets, failures of financial firms and a widespread perception that banking systems, in the United Kingdom and globally, were undercapitalised.

The system-wide measures put in place by the authorities in the United Kingdom and internationally aim to tackle these structural balance sheet weaknesses at source and in size. Nonetheless, the very scale of government and central bank interventions during the present crisis will pose difficult transitional issues for banks as they seek to repair their balance sheets over the medium term. And, looking further ahead, the events of the past year or so clearly highlight the need for a fundamental overhaul of the regulatory safeguards used to mitigate systemic risk within the financial system.