Global banks need global solutions when they fail

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During the financial crisis governments provided taxpayer support for banks, steadying the global financial system and helping to avoid a repeat of the Depression. Those bank rescues exposed governments and taxpayers to losses. And in the long term they will have made banking riskier if managers and creditors conclude that bailout is part of the fabric of the system.

To avoid that fate, the “too big to fail” problem must be cured. We believe it can be and that serious progress is being made. Evidence can be seen in the joint paper released by our organisations today, which outlines a resolution strategy for large and complex financial companies.

Alongside higher capital and liquidity requirements, the best chance of a durable solution will come from a process for resolving the largest international banks – so-called global systemically important financial institutions (GSifis) – in an orderly way when they fail. The failures of GSifis that confronted the US and UK in 2008 were unprecedented in scale, complexity and interconnectedness. They also outstripped the capabilities of the legal frameworks in place.

In the US, the Federal Deposit Insurance Corporation only had the power to put insured institutions into receivership; it could not wind down failing bank holding companies or other non-bank financial companies whose activities posed a systemic risk. With no bank resolution powers, the UK authorities’ options were even more limited when the crisis broke in 2007.

Since then, both the US and the UK have enacted significant legislative reforms that are the basis of new resolution frameworks. In the US, the Dodd-Frank act provides the FDIC with the power to resolve failed GSifis through an orderly liquidation process. In the UK, the 2009 Banking act will be supplemented by the planned EU recovery and resolution directive.

Over the past year, the FDIC and the Bank of England, in conjunction with the prudential regulators in our jurisdictions, have been working to develop contingency plans for the failure of globally systemic banks that have core operations in both the US and UK. Of the world’s 28 GSifis, 12 are headquartered in the US or UK. Because many of these institutions have operations that are concentrated in our two jurisdictions, we have a shared interest in ensuring that, when such a business fails, it can be resolved at no cost to taxpayers and without placing the financial system at risk. Importantly, a shared strategy will help us to avoid working at cross purposes or being blind to each other’s plans.

Our joint paper outlines a strategy we believe can accomplish our objectives. Under the plan, the resolution authority will take control of the parent of the GSifi group, apportion losses to the company’s shareholders and unsecured debtholders and remove senior management. In all likelihood, the organisation’s shareholders would lose all value.

The unsecured debtholders can expect that their claims would be written down to reflect any losses that shareholders could not cover. Sound subsidiaries (domestic and foreign) would be kept open and operating, thereby limiting contagion effects and cross-border complications. In both countries, whether during execution of the resolution or thereafter, restructuring measures may be taken, especially in the parts of the business responsible for the group’s distress. Those businesses could be shrunk, broken into smaller entities, or certain operations could be liquidated or closed. A portion of the surviving unsecured debt would be converted into equity, where needed, to provide capital to support the process.

We have engaged in an effort to understand how possible resolution structures might be treated under existing (and, for the UK, prospective) legal and policy frameworks. The process of cross-border dialogue that has facilitated the development of this strategy demonstrates more broadly how resolution planning can be made to work on a cross-border basis.

All countries share a very strong public interest in developing the capacity to resolve GSifis in a credible and effective way. A framework for applying a multilateral approach through crisis-management groups comprising relevant supervisors and resolution authorities is already in place for nearly all such businesses.

We believe that, for many GSifis, this strategy holds the best possibility of preserving stability while removing taxpayer support. It holds shareholders, creditors and management in a failed GSifi accountable for its losses.

Developing an effective strategy for the orderly failure of a systemic financial institution could hardly be more important. Today’s joint paper marks a significant step in that endeavour.