BANK OF ENGLAND

News release

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The Crisis Management Menu - Speech by Paul Tucker

In a speech opening a conference on 'Crisis Management at a Cross Roads' in Brussels today, Paul Tucker - Deputy Governor for Financial Stability and a member of the Monetary Policy Committee - reviews the various components of a crisis management package for financial institutions. That includes central bank liquidity insurance for viable firms and markets; firm recovery plans and contingent capital; resolution plans for winding down failed institutions; and official-sector support operations, including Capital of Last Resort. A thread that runs through the discussion is how to preserve the core financial services provided to the economy through periods of extreme stress without bailing out equity holders or uninsured wholesale creditors.

Liquidity insurance and market maker of last resort. Paul Tucker notes that the lender of last resort role of central banks was one area where frameworks existed ahead of the crisis, but inevitably had to be refined as events unfolded, specifically in lending against a wide range of collateral. In putting this on a permanent footing, he says that it has been important to set ". terms so as to avoid subsidising or encouraging imprudent liquidity management by firms in normal circumstances". In addition to providing liquidity insurance for firms, the crisis has also prompted arguments that central banks should be prepared to act more directly to preserve market liquidity - effectively standing ready to act as a Market Maker of Last Resort. But this is not straightforward. Acting as a buyer does not automatically enhance liquidity, and it involves increased credit risk being taken on by the central bank.

Recovery plans and contingent capital. Paul Tucker goes on to explain that routine liquidity insurance will not always suffice. The crisis has brought into relief the need for contingency planning in times of stress and the need for firms to take a leading role in producing recovery plans. Two key components of the recovery plans are contingency funding plans and de-risking plans. He adds that contingent capital - debt which converts into common equity in times of stress and is genuinely loss absorbing - might also provide a useful form of "catastrophe insurance", especially if widely issued and held.

Resolution of bank failures. Paul Tucker says, "If recovery plans prove wanting, then distressed banks need to be 'resolved' - laid to rest, but without undermining crucial economic services." Authorities need specific and extensive powers to resolve failed banks in an orderly way. The Bank of England has recently been given such powers, becoming the Special Resolution Authority in the UK. But any resolution requires detailed information from the firm. Paul Tucker agrees with the FSA's view that the authorities will need to be assured that firms are able to provide the necessary data to assess resolution options and to execute the authorities' chosen strategy. He goes on to explain that resolutions become even more complicated with cross-border banks: for example, because of differences in insolvency and resolution laws. He explains that over the coming months, facilitated by the G20-sponsored Financial Stability Board, authorities around the world, together with the largest banks, will be producing recovery and resolution plans. That is likely to flush out issues for debate on the regulation of the system.

Support operations and Capital of Last Resort. During the crisis governments have gone beyond guaranteeing retail deposits via insurance schemes to also guarantee uninsured wholesale creditors. Paul Tucker believes that, for the future, principles need to be developed around these Capital of Last Resort operations because they raise issues of fairness and incentives. He advocates a debate on how the costs of official Capital of Last Resort could be recovered from the banking system, either in advance or through a levy on surviving banks.

Concluding, Paul Tucker draws together the themes of his speech on crisis management with the international and domestic decisions on the structure and regulation of the financial system. He says, "The weaker a recovery plan and the greater the obstacles in the way of its effective resolution, the more capital (and liquidity) a bank is going to have to hold." He adds, "Whether our community can find ways of distributing the costs of official sector support operations back to the system and its uninsured creditors rather than to the general taxpayer. If we can achieve that, market discipline would be enhanced. ... The goal of re regulation - of redrawing the rules of the game for the financial system - should not be to reintroduce the wisdom of the state into micro decisions about how to run businesses. But rather to put market discipline at the heart of a market economy. An effective framework for crisis management drawing on the lessons of this crisis can take us in that direction."

Notes to Editors

Paul Tucker chairs the Financial Stability Board Working Group on the Principles for Cross-Border Co-operation on Crisis Management.

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech410.pdf