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18 September 2012

A practical process for implementing a bail-in resolution power - speech by Andrew Gracie

In this speech Andrew Gracie, Director, Special Resolution Unit, looks at how a resolution strategy that “bails in” creditors might work in practice in the context of the Recovery and Resolution Directive. He starts by noting that “bail in” is one of a number of potential resolution strategies set out in the Financial Stability Board’s Key Attributes of Effective Resolution Regimes for Financial Institutions and that some progress has already been made in implementing those Key Attributes. The publication of the proposed European Recovery and Resolution Directive (RRD) is a significant step in this direction. Andrew Gracie sees that in some cases - particularly for global systemically important financial Institutions (G-SIFIs) - the bail in tool might be used to deliver the objectives of the Key Attributes to resolve institutions in an orderly manner without taxpayer exposure to loss, while maintaining continuity of their core economic functions.

Andrew Gracie argues however, that “bail-in cannot, and should not, be used in isolation from other tools or powers.” “It cannot and should not be used simply to keep a loss-making business artificially alive.” Gracie says. “Rather, its role is to help keep a bank’s vital operations function, and avoid the disorder that would result from the bank suddenly ceasing to trade”.

While bail-in, like other resolution tools involves some interference with property rights, Andrew Gracie notes that “safeguards will apply which will ensure that no creditor is left worse off than they would have fared in a counterfactual insolvency.” He also sees it is important that bail-in follows the creditor hierarchy. More generally, he argues that “bail-in, like the other resolution tools, can only be used when it is necessary to do so in pursuit of clearly defined public interest objectives.”

He notes that well in advance of resolution it will be necessary to ensure that G-SIFIs have appropriate loss absorbency, to ensure that the G-SIFI has sufficient liabilities that could bear losses within resolution. Resolution requirements need to be enforceable cross-border, and Gracie points to cooperation across national authorities in drawing up G-SIFI resolution strategies and plans. He argues that the first line of defence is for the firm itself to take actions to restore its viability and recapitalise itself, noting that “The RRD provides supervisory authorities with a suite of early intervention tools”

Resolution tools, including bail-in, would only be used if efforts to avoid the firm reaching the point of non-viability are unsuccessful. The authorities would take a formal decision on which of the resolution powers at their disposal to use, but looking at the implementation of a bail-in in particular, Andrew Gracie suggests that a process could consist of four key steps: 1) stabilisation; 2) valuation and exchange; 3) relaunch; and 4) restructuring.

The stabilisation step might take place over a “resolution weekend”, with a range of operational measures taken to allow the resolution authorities to take control of the institution. Importantly, “communication with the market and other stakeholders would be carefully managed...to stabilise the position of the firm and provide retail investors and market counterparties with confidence.”

Immediately following the resolution weekend, “an intensive valuation period would commence in order to determine the extent of losses incurred or likely to be incurred by the firm and therefore the appropriate terms of the bail-in”. Creditors identified in announcements would be subject to write-downs which in aggregate covered all of the firm’s losses. Andrew Gracie agrees with a number of the RRD requirements in determining write-downs, though argues against the obligation that all creditors are treated equally within classes, given a need for the resolution authority “to retain some discretion to take account of any adverse impact on system stability”. Where bail-in is not viable and a firm needs to be wound-down instead, Andrew Gracie argues that “The ring fencing of particular functions provided by the ICB may be helpful”.

In the “relaunch step”, once creditors have been written-down as appropriate, equity would need to be assigned to the affected creditors as a quid pro quo. Andrew Gracie notes this could happen in one of two ways: issuing new shares or transferring existing de-listed shares from the wiped-out shareholders, though notes the RRD does not seem to contemplate the latter. A return to primary market debt and equity trading could follow and Andrew Gracie outlines the practical considerations that would arise, including possible ex-post adjustment mechanisms to distribute compensation value to bailed-in creditors.

Finally Andrew Gracie sets out the “Restructuring” step, noting that “a restructuring strategy should prevent disruption to the provision of critical economic functions while directly addressing the causes of the firm’s failure.” In all instances, culpable management would be replaced and the firm’s governance failures addressed. “The restructuring strategy should not focus on keeping the firm alive for the sake of continuity or on value preservation per se, but should instead have regard principally to the financial stability of the markets in which the firm operates.”

In conclusion, Andrew Gracie notes that “We are moving closer to an operational bail-in regime. A number of outstanding challenges remain, but these challenges are largely surmountable.” He sees that “The RRD proposals provide for a means of implementing bail-in in a coordinated and sensible manner”. He stresses again that bail-in should be considered one tool among several, noting that “As with other tools, it can ensure continuity of critical economic functions for as long as they remain critical.” “In this way”, he says. “the objectives of the Key Attributes can be met and the long-run stability of the system enhanced.”

Key Resources

<http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech600.pdf>

Full speech by Andrew Gracie