MANAGING A BANK-SPECIFIC CRISIS: A UK PERSPECTIVE

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Introduction

The motivation for today's workshop really puts me – as a representative of the UK authorities – on the spot: the authorities are, so it is said, faced with new challenges; our roles and responsibilities are not clearly defined; and conflicts of interest may arise and hinder effective crisis solutions.

And I have to say that I agree – up to a point. Crisis management is indeed challenging, and has probably become rather more so in recent years. The complexity and 'connectedness' of the financial system, the speed with which events can unfold, the crucial role now played by collateral (and the ability to use it efficiently) all suggest that the problems we would face in handling a crisis would be greater than ever before.

But I'm less convinced that the challenges are (in form, at least) particularly new. After all, it was more than thirty years ago now, in September 1974, that the G10 central bank governors issued the so-called Basle Communique to reassure financial markets about the adequacy of euromarket lender of last resort arrangements, in the wake of the Herstatt collapse. So recognition of the importance of cooperation in handling crises in cross-border banks is not new. And it is reflected in the work of a number of the international financial fora which have emerged since that collapse.

UK domestic arrangements

Before I turn to the challenges of managing a crisis in an internationally active bank, though, I thought it might be helpful to remind you all of the current domestic arrangements in the UK – partly because they may not yet be widely understood, and partly because we firmly believe that robust national arrangements are an essential part of robust international crisis management.

We take a resolutely tripartite approach to crisis management in the UK: central bank, regulator and government (in the form of the Treasury) all have roles to play. But they are distinct roles, and need to be clearly understood by all parties so that there is no confusion 'on the day' about who is responsible for what.

And these roles need to be carried out co-operatively. The framework for this cooperation is provided by the tripartite Memorandum of Understanding, first drawn up in 1997 when responsibility for banking supervision moved from the Bank to the newly-established FSA. A revised MoU was published in March this year, at the time of the Budget.

As "the bankers' bank", maintenance of the stability of the financial system as a whole is naturally one of the Bank's two core purposes. We contribute to this by

- Ensuring the stability of the monetary system, acting in the markets to deal with fluctuations in liquidity
- Overseeing 'systemically significant' financial system infrastructure – in particular, core payment systems
- Maintaining a broad overview of the system as a whole
- In exceptional circumstances, undertaking official support operations in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system

The FSA is responsible for the authorisation and prudential supervision of financial firms; the supervision of financial markets and clearing/settlement systems; carrying out various actions in response to problem cases; and for regulatory policy in these areas. FSA in-crisis actions might include, for example, changing capital or other regulatory requirements; or the facilitation of a market solution – which might involve the introduction of new third party capital into a troubled firm.

For its part, the Treasury is responsible for the overall institutional structure of financial regulation, and for informing and accounting to Parliament for the management of serious problems in the financial system.

The principal forum for coordinating and agreeing action between the three authorities is the Tripartite Standing Committee: the Standing Committee on Financial Stability, to give it its full title. This is chaired by the Treasury and comprises senior representatives of the three authorities. It meets monthly at deputies level, and meetings can be called at other times by any of the participating authorities if they feel that there is an issue which needs to be addressed urgently.

In exceptional circumstances, for instance where a support operation is being considered, Standing Committee would meet at principals level: the Chancellor, the Governor and the Chairman (or senior alternates).

What would actually happen, were a bank-specific crisis to develop? The tripartite authorities have established a more detailed working level co-ordination procedure which would underpin these Standing Committee arrangements. These processes are designed to ensure that the authorities' response is orderly, that they gather and share relevant information quickly and that they act in a coordinated way. They have been developed in the light of experience from two simulation exercises, one in June 2004 and another in October 2005; and they will be regularly reviewed in the light of experience and periodic testing.

The over-arching guiding principle for the UK response to a financial crisis is that support operations or other exceptional interventions should only be undertaken "in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy.".

That's a hard test, but a sensible one: the authorities cannot and should not be expected to intervene with a support package every time a bank – even a large one – gets into difficulties. The cost of such an interventionist approach, in terms of market discipline and fiscal burden, would be substantial. And it would in all likelihood compromise the efficient provision of financial services and inhibit the exit of weak firms from the industry.

Ultimate responsibility for authorising support operations rests with the Chancellor. He would do so with advice (for which we would be accountable) from both the Bank and the FSA: the MoU requires *each* authority to assess the seriousness of the crisis and its potential implications, and to provide *separate* assessments to the Treasury together with their views on the options available to the Chancellor.

That may sound distinctly un-cooperative, but the process for preparing these assessments would be less like a competitive examination than this appears. For example,

- we would share information freely, so that the assessments would be based on a common information set
- we have worked together to develop a common framework for assessing the severity of a crisis, to ensure that we are covering similar ground and using a common language to talk about the impact

- we are adopting a common template for assembling the analysis and presenting the assessment to the Treasury.

If so much is similar, what is separate about the assessments? First, as the MoU notes, the Bank and FSA have distinct responsibilities and expertise. So we might attach weight to different factors, or attach different weight to the same factors, in offering our separate advice. FSA, for example, has a consumer protection objective; the Bank does not. And second, more importantly, systemic assessment is not and never can be a purely mechanical exercise: it depends crucially on judgments. Information will inevitably be incomplete and potentially also unreliable; and future actions or events will be uncertain. So reasonable, well-informed people could arrive at different conclusions even on the same evidence.

To me, one of the strengths of this process is that it forces these uncertainties and ambiguities into the open, and creates an environment in which they will be considered from different perspectives before the big decisions are taken. So they should be better decisions. And it is likely to be clearer, after the event, why they were taken and whether the advice was reasonable, given what was known at the time.

This is perhaps a good point for me to mention a couple of recent practical developments which support these UK arrangements.

The first is the factbooks project, which many of you will be aware of. I've already emphasised the importance of information sharing between the tripartite authorities (and particularly between Bank and FSA) to support crisis management decisions and actions. We know from experience, though, that getting hold of the right information quickly can be quite a challenge. So the idea of assembling key information in advance, and being open about what additional information might need to be called for 'on the day', has obvious attractions. That is what factbooks are all about: they are a tool for mobilising and sharing information quickly between the Tripartite authorities. Despite a fair amount of international discussion – and even some trialling under the auspices of the FSF – the idea has been slow to become a reality, in part because there always seem to be more pressing jobs to do. But we're now embarked on a project (led by FSA) to do just that, in the UK, and hope to have basic factbooks for the larger firms in place by next spring.

The second development I want to mention is the Bank's new money market arrangements and, specifically, the standing facilities associated with them. These facilities offer participants the unlimited capacity to borrow from the Bank against eligible collateral, usually at a penalty rate of interest, and so make the provision of emergency liquidity much more straightforward. Following major operational or financial disruption, we can reduce the penalty – if necessary, to the point at which we are lending at Bank Rate. Banks accounting for some 95% of the banking system's sterling liabilities have signed up for access to these facilities, materially enhancing our capacity to provide rapid liquidity assistance when it is needed. That should reduce the risk of a short-term liquidity problem developing into a full-blown crisis.

For completeness, I should also mention that there are separate – but broadly similar – arrangements for handling operational emergencies in which the Government's Emergency Response machinery comes into action. These give a rather greater role to the Treasury than does the TCP, reflecting their participation in key Governmental crisis management groups. As with the TCP, though, it is Standing Committee which is responsible for strategic decision taking.

Mapping UK arrangements to international crises

So how do these domestic arrangements work, if the bank in difficulties has overseas operations (or, indeed, is based abroad but operates also in the UK)?

Our approach here is to operate on a basis of 'like with like' cross-border interactions and to rely on our domestic processes to join things up. That builds on the normal day to day relationships, and – as with our domestic arrangements – should avoid duplication and delay. So ELA coordination, for example, would generally be a matter for central bank to central bank contacts; regulatory issues would be handled by the FSA; and for fiscal and other inter-governmental aspects the relevant finance ministries would normally take the lead (based of course on the agreed tripartite strategy in each case).

One of the first thing one notices on looking at other countries is that they each have their own domestic financial structures – and mapping between the UK tripartite authorities and our overseas counterparts is not always straightforward. There will generally be natural counterparts to the Treasury and Bank of England, but the organisation of supervision is much less uniform. While a unified national financial regulator, separate from the central bank, is becoming a more common structure, many variants exist and dispersed responsibilities for supervision, often with some degree of direct central bank involvement, remain common. But cross-border supervisory channels of communication – particularly within the EU – are well-established now, so in practice this is unlikely to be a major problem. A bigger challenge, perhaps, is simply the number of authorities which might have a material interest in problems affecting a major international bank.

And alongside these different structures, there are many differences in roles, powers and responsibilities; and more or less well articulated processes and approaches to crisis management.

How does one bring this disparate set of players and contexts together to deliver effective cross-jurisdiction crisis management? One important feature of this complicated landscape, which helps to tie it together into a coherent whole, is the growing network of Memoranda of Understanding which set out the various authorities' commitments to share information and to work together to handle crises.

It's perhaps not surprising that the EU has led the way here, building on the precedent of the supervisory arrangements which support the single market in banking services. The most recent EU MoU embraces supervisors, central banks and finance ministries and is a significant advance on previous understandings. But the EU is not alone: there are other important regional agreements, often reflecting particular features of their financial systems which make such agreements self-evidently necessary: the Nordics, for example; and Australia and New Zealand.

Further progress in this area is plainly desirable, and it's certainly not being neglected. Indeed, the UK authorities and the FSF are jointly hosting an international workshop in London in mid-November to take stock of current arrangements and to consider ways of taking this strand of work forward.

One practical way of building on the MoUs and other cooperation agreements is to make information sharing part of a continuing dialogue, not just part of the crisis management machinery. So I see considerable attractions in the notion of so-called 'interest groups': groups comprising authorities linked by a shared interest in an internationally active firm, which is systemically important within their jurisdiction. The idea is a close cousin to that of colleges of supervisors, though the constituency for interest groups is probably both broader (in that it would need to include central banks) and narrower (in that practicality probably dictates some threshold below which a host country would not normally be invited to participate directly).

Regular dialogue within such a group – perhaps also, on occasion, directly with the firm concerned – could do much to increase the relevant authorities' awareness and understanding of the issues they might face in handling a crisis in that firm. It could also constitute the core of a forum within which possible courses of action could be discussed, if a crisis were to arise.

Some fundamental issues

But these steps should not disguise the fact that the effective handling of financial crises faces (and has long faced) some challenging obstacles beyond the basic sharing of information.

There is much talk these days, for example, of burden sharing: do we know how the costs of supporting an internationally-active bank would be apportioned? That's certainly an issue, but for me is some way down the track. There are formidable and more immediate issues about how – and by whom – decisions should be taken; what the criteria for action by the authorities should be; which authorities should be expected to act, and in which capacities, to avert or minimise the impact of a crisis; even, what measures are realistically available to the authorities in handling a major crisis.

Underlying these issues is, I think, a more fundamental conundrum. The business and structural realities of modern international banking, and the supervisory approach which accompanies them, pay little regard to national boundaries. Large banks now manage their liquidity and capital on a regional or even global basis, and their risk management and IT systems have developed accordingly. That's sensible, if the goal is to achieve efficient, broadly diversified banks which can deliver financial services as cheaply as possible

Yet legal and fiscal realities – both of which inevitably intrude on crisis management – remain resolutely national in their scope and instincts. A single bank may in fact comprise a large family of entities in different countries, both branches and subsidiaries, and so be subject to no single overriding jurisdiction. How could it be closed in an orderly way? How, indeed, could it be kept going, in these litigious times, where a single creditor in any one of these jurisdictions could unravel a carefully-assembled rescue or restructuring plan?

The bottom line is that we may be paying a hidden price for efficient banking: crises – if and when they occur – may as a result be more difficult to deal with.

I would not for a moment seek to argue that the tide of international banking should be rolled back, and that we should somehow re-instate a parochial, national approach to supervisory matters. That would be unthinkable. But what can we do, to strengthen the authorities' capability to deal with troubled banks?

Our crisis management capability can of course be improved, and that is being actively pursued. But I think that it is likely to be a slow process – particularly if the legal and fiscal issues are to be tackled effectively.

The other important strand is that of crisis avoidance: making as sure as we can that the chances of incurring these extra costs are as low as possible. A stable macroeconomic environment, supported by effective monetary and fiscal policies, is an important part of that. So too is early identification of potential problems, and prompt response to them. Regular risk assessment work – such as the Bank publishes periodically in the Financial Stability Report – is part of that. It helps us to spot vulnerabilities early, and to mitigate them before they have become the germ of a crisis. So too is stress testing, both by banks and by the authorities. And of course the steady improvements which have been made to supervisory processes and techniques over the years, and the development of more robust financial system infrastructure, also help to increase the shock-resilience of the financial system.

So it's a varied strategy, combining both vigilance and prompt action to minimise the risks that crises will occur with longer-term work to overcome some of the long-standing obstacles to effective crisis management. Both are necessary. And if we neglect either of them, perhaps the price we will eventually pay – in a more costly crisis – will outweigh the benefits we currently enjoy from having allowed commercial and investment banking to evolve into the efficient cross-border business it is today.

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