BANK OF ENGLAND

Speech

A practical process for implementing a bail-in resolution power

Speech given by

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At the British Bankers' Association, London

17 September 2012

Introduction

In November 2011, the leaders of the G20 endorsed the Financial Stability Board's international standards for resolution regimes, the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes). These standards form part of a global solution to a global problem—that of "too-big-to fail" and the avoidance of state-sponsored bail-out of the biggest international banks - or G-SIFIs[1] in the parlance of the FSB. They mandate the introduction of a set of resolution tools that should be available to all national authorities—tools that are expressly designed in the resolution of a G-SIFI to achieve the continuity of its critical economic functions, thereby avoiding systemic disruption, and in the process ensuring that public funds are not exposed to loss. The tools include the ability to transfer or sell assets and liabilities of G-SIFIs and to carry out a bail-in of creditors within resolution.

Some progress towards implementing the Key Attributes has been achieved across the G20. The passing of the Dodd-Frank Act in 2010 provides the US with a regime that is broadly compliant with the Key Attributes. The development of the Recovery and Resolution Directive (RRD) should leave Europe in a similar position. In the UK, the proposed RRD and anticipated legislation on non-bank resolution will significantly enhance the existing bank resolution framework under the UK Banking Act 2009.

As part of the implementation of the Key Attributes, supervisors and resolution authorities around the world are in the process of developing concrete resolution strategies for all G-SIFIs. These resolution strategies are designed to ensure that the failure of a G-SIFI should be orderly and should avoid exposing public funds to loss. Rather, the creditors of the failing banks should bear losses, as they would do in insolvency, but without the financial instability and disruption to critical functions that the sudden insolvency of a G-SIFI would otherwise cause.

In some cases, the preferred resolution strategy may be to expose creditors to loss by transferring critical parts of their business to solvent entities - a private sector purchaser or some form of bridge bank - leaving creditors behind in an administration. In other cases, in particular for G-SIFI's whose operations are too large, complex or interconnected to split without threatening the critical services that the bank provides, the bail-in power may be used to ensure creditors are exposed to losses without disrupting critical functions.

But bail-in cannot, and should not, be used in isolation from other tools and powers. Writing down and converting debt into equity may help to restore solvency, but on its own it cannot restore viability. And it cannot and should not be used simply to keep a loss-making business artificially alive. Rather, its role, similar to that of a corporate restructuring under Chapter 11 of the US Bankruptcy Code, is to help keep a bank's vital operations functioning, and avoid the disorder that would result from the bank suddenly ceasing

[1] 29 global systemically important financial institutions were identified by the FSB and Basel Committee on Banking Supervision in November 2011.

to trade, whilst it is reorganised, replacing management and restructuring the business as necessary. A credible bail-in, including the necessary restructuring, should enable the firm to access market liquidity.

Bail-in, like other resolution tools, involves some interference with property rights. But safeguards will apply which will ensure that no creditor is left worse off than they would have fared in a counterfactual insolvency. In keeping with that, it is important that bail-in follows the creditor hierarchy, secured claims are protected and netting arrangements are respected. And 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.

Bail-in in practice

The Bank of England, alongside other domestic and international authorities, has been working to ensure that bail-in can be implemented effectively. Applying it will involve overcoming legal, operational and financial challenges. But these challenges are surmountable and are being addressed — through legislation, through cross-border dialogue and resolution planning, and through changes to market practice. In the remainder of this presentation I shall set out in practical terms how a bail-in could work for a G-SIFI, highlighting some of the associated practical challenges along the way.

Pre-resolution

Well in advance of resolution, it will be necessary, to ensure that G-SIFIs have appropriate loss absorbency[2]. This would ensure that the G-SIFI has sufficient liabilities that could bear losses within resolution. Both the RRD and the UK's Independent Commission on Banking (ICB) recommend that such firms be required to hold loss absorbing capacity beyond their Basel 3 capital requirements. This is a regulatory requirement, nothing to do with the bail-in power itself.

Any loss absorbency requirement would need to take account of cross-border enforceability. Hence the desirability of including some form of minimum requirement within the RRD. But any requirement would need to ensure that the relevant non-EEA liabilities of an EU bank could also be subject to bail-in.

As I have said, national authorities are also co-operating in drawing up resolution strategies and plans for G-SIFIs, using information provided by the firms themselves. They will also draw up firm-specific cross-border co-operation agreements setting out how they would co-operate to implement the plans in practice. This will help to establish a presumptive path for how the failure of a G-SIFI would be handled as it slid towards and into resolution.

[2] RRD Articles 39 and 40 would require authorities to ensure that firms maintain a minimum amount of liabilities eligible for bail-in. Although their proposal does not establish a common quantitative minimum amount, the Commission suggests that 10% of total liabilities might be an appropriate amount.

Should a firm encounter difficulties which potentially threaten its viability, the first line of defence is the actions that the firm itself may take or be required to take in an attempt to restore viability and recapitalise its balance sheet. During this “recovery” phase the firm might seek to reduce its balance sheet exposures and raise new capital, including through rights issues and divestments. The firm might attempt to restructure its outstanding liabilities through negotiations with creditors; and it might trigger the conversion into equity of contingent capital instruments (CoCos). The RRD provides supervisory authorities with a suite of early intervention tools—to supplement those already provided for in the European Capital Requirements Directives—to ensure, where necessary, that adequate action is taken.

However, notwithstanding the firm’s best efforts, its attempts at “recovery” might fail. Resolution tools, including bail-in, would only be used if efforts to avoid the firm reaching the point of non-viability are unsuccessful. That point is reached when the supervisory authority identifies that the institution was failing, or likely to fail, and that no other solution, absent the use of resolution tools, would restore the institution to viability within a reasonable timeframe. Additionally, resolution powers would only be used if it was necessary to employ them in order to meet clearly defined public interest objectives, for example the maintenance of financial stability and the protection of depositors[3].

Following the entry of the firm into resolution, the authorities would then take a formal decision on which of the resolution powers at their disposal to use. Bail-in is only one of the tools that could be used and strategies that could be followed but, given the attention it attracts in the RRD, I will concentrate on it today. Neither the Key Attributes nor the RRD set out in detail the process to be followed to put a bail-in into effect. But work which we at the Bank of England have conducted suggests that a process for implementing a bail-in could consist of four key steps: 1) stabilisation; 2) valuation and exchange; 3) relaunch; and 4) restructuring.

1. Stabilisation

The first stages of a bail-in should focus on stabilisation. Ideally a firm would enter resolution at close-of-business on a Friday evening, which would provide the authorities approximately 48 hours in which to stabilise the firm outside market hours. But this cannot be guaranteed. If a firm reached the point of non-viability during the middle of the week, it would be necessary to commence resolution proceedings at that point.

Many of the steps during the “resolution weekend” would be operational. It is likely the listing and exchange trading of the firm’s shares would be suspended or cancelled[4]. A formal change of control process would be

[3] Articles 26 and 27 of the RRD provide for this approach.
[4] Article 42(1) would require the cancellation or severe dilution of shares. This may need to be amended, to allow a share transfer to be effected (whilst having the same economic impact on existing shareholders).

required in order to affect the transfer. Debt instruments might also be suspended from listing or trading[5]. At this point, the resolution authorities would have the power to take control of the institution and exercise all the rights conferred upon the shareholders[6]. Communication with the market and other stakeholders would be carefully managed. The firm's entry into resolution would be announced publicly before major financial markets reopen (likely Sunday evening for the purposes of meeting Asian market openings), and dialogue with key stakeholders may be required during the resolution weekend itself. The authorities would make the following public announcements:

- First, that the authorities had found that the firm had reached the point of non-viability and had met the conditions for resolution;
- Second, the broad resolution strategy that was being executed, for example bail-in without splitting the group structure. Under such a resolution strategy, the authorities would state that through the write down and conversion of the firm's liabilities, solvency would be restored, and core functions would continue to be performed on a solvent, viable basis;
- Third, in order to make the previous statement credible the authorities would specify: a) the range of liabilities that would be completely written down without conversion (likely to be shareholders and potentially subordinated debt holders); and b) the range of liabilities that would be subject to potential write-down and / or fully or partial converted into equity through the use of the bail-in tool.
- Fourth, that the firm would be restructured but that all of the firm's core functions would continue without disruption, and that any insured depositors would be fully protected — as is always the case; and
- Fifth, the proposed timing for the announcement of the final terms for the bail-in, including the final extent of creditor write-downs, and rates of conversion to equity.

The aim of these announcements would be to stabilise the position of the firm and provide retail investors and market counterparties with confidence.

2. Valuation and exchange

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. This process would build on preliminary valuation work conducted prior to the resolution.

The creditors identified in the announcement at the resolution weekend would be subject to write-downs which in aggregate covered all of the firm's losses. These write-downs would be determined in a manner

[5] Article 48(2)(b)
[6] Article 56(1)(b)

that: first, respects the creditor hierarchy[7]; second, stands up to proportionality requirements in order to minimise the risk of compensation claims[8]; and third, is clear and transparent to creditors[9]. These are all requirements of the RRD which we support.

The obligation that creditors are treated equally within classes[10] we do not. It is important for the resolution authority in deciding which liabilities to include within the scope of the bail-in to retain some discretion, especially within the senior creditor class, to take account of any potential adverse impact on system stability of bailing in particular liabilities or types of liability.

The authorities, in this case the prudential supervisor, would then determine the amount of capital that would be necessary to help restore the firm to viability. This quantum would likely be larger than the normal minimum prudential capital requirements in order to ensure market confidence. This recapitalisation requirement would be met through converting eligible liabilities into equity, again subject to the safeguards and requirements outlined above.

It is important to note that the valuation conducted for the purposes of determining the quantum of write-downs and conversions into equity should be separate from the independent valuation of a counterfactual insolvency, which would be conducted to determine whether and if so how much compensation creditors may be due. The valuation basis for the former should be closer to a fair value; and for the latter, liquidation value based on certain assumptions about the liquidation process would be more appropriate; although we do not consider it necessary to specify in advance the precise methodology to be employed. There may need to be some technical amendments to the RRD in order to secure this[11]. But the difference between the two valuations would serve to show the value destruction avoided by the bail-in, let alone any wider systemic impact averted.

Valuation for the purpose of determining the extent of losses should be conducted on a broadly fair value basis, and the haircut on creditors should be large enough to ensure that the firm can be recapitalised and does not lapse back into resolution. Where junior creditors or shareholders have borne losses on the bail-in which are greater than the counterfactual insolvency, they could be compensated through ex post adjustment mechanisms in the capital stack.

The extent of losses at the firm pre-resolution, and the degree to which those losses were easily identifiable and isolated, would have implications for the timing of the valuation process. If losses were isolated within a

[7] Article 29(1) (b) establishes the principle the creditors should bear losses in accordance with the priority of their claims and Article 29(1) (e) the principle that creditors of the same class are treated in an equitable (but not necessarily equal) manner.
[8] Article 65 provides for a "No Creditor Worse Off" protection for shareholders and creditors subject to the bail-in and partial transfer powers. Authorities are required by Article 27(2) (c) to demonstrate that action is necessary in the public interest.
[9] Article 75
[10] Article 43 would require that creditors in the same creditor class bear losses equally in a resolution bail-in. This provision applies uniquely to the bail-in tool.
[11] Specifically, Article 65 requiring a valuation for the purposes of determining the amount, if any, of compensation required under the "no creditor worse off" safeguard should be decoupled from the provisions in Article 30 for making a valuation to inform the choice of resolution actions to be taken.

business unit or legal entity, and limited to a single asset class, it should be possible to conduct an effective valuation rapidly. If losses were pervasive and difficult to identify or isolate, or the assets were complex and hard to value, it may take several months before exchange could be enacted[12]. In fact there may be cases where losses and problems in a firm are so thorough-going that a bail-in is not viable and a firm needs to be wound down instead, bridging the systemic functions that need to be preserved. The ring fencing of particular functions provided by the ICB may be helpful in such cases.

3. Relaunch

Once the valuation had been completed, and creditors written-down as appropriate, equity would need to be assigned to the affected creditors as a quid pro quo for their recapitalisation. This could happen in one of two ways: issuing new shares or transferring existing de-listed shares from the wiped-out shareholders. There may be some operational advantages in the latter option, although the RRD does not seem to contemplate it[13]. Once the written-down debt instruments and equity have been assigned to the bailed-in creditors, primary market equity and debt trading should resume.

During this process, a number of practical considerations would likely arise[14] including any regulatory change-of-control approvals. Equity stakes that could not be transferred directly to creditors would need to be distributed in the market.

As mentioned, ex-post adjustment mechanisms would also likely be required as a means of distributing compensation value to bailed-in creditors. The specific application of such instruments would be case-specific and should be determined during the valuation process.

4. Restructuring

As described, recapitalisation via bail-in should be accompanied by a concrete and effective restructuring strategy as mandated by the RRD[15]. Such 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, this restructuring would replace culpable management and address the firm's governance failures. 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.

[12] For this reason, it should be clarified in the RRD that the requirement in Article 30(1) to conduct a preliminary valuation before resolution is taken should not prevent authorities from taking the initial steps described above to stabilise the firm before a bail-in is formally executed.
[13] As noted above, Article 42(1) would require the cancellation or severe dilution of shares.
[14] Article 49(3) provides for authorities to require that there are no procedural impediments to the conversion of liabilities to ordinary shares by virtue of their instruments of incorporation or statutes, including pre-emption rights and requirements to authorise increases in share capital. The RRD provides for amendments to Company Law Directives and the Shareholders Rights Directive to allow this.
[15] Article 47

The extent of the problems at the firm pre-resolution would determine the scale of the restructuring required. If the problems pre-resolution were isolated and contained to individual business lines – eg a “rogue trader” or sector-specific asset losses – and identifiable, it is conceivable that the extent and scope of the restructuring required would be limited. Such a restructuring would focus on unwinding selected loss-generating business lines and/or removing problem assets from the banks’ balance sheet. Following resolution and agreement of a restructuring plan, authorities should be able to exit the firm rapidly, privatisation or relisting should occur quickly, and counterparty relationships should remain intact.

On the other hand, in the scenario in which deep losses were experienced across multiple business lines, and the losses themselves were difficult to identify, value or isolate, much of the group would be rendered non-viable. The restructuring would need to be extensive and, at the extreme, may require the controlled and solvent unwind of the entire group.

The appropriate timeframe for the development and implementation of a restructuring plan would be case-specific. It may range from a matter of months in the simplest cases where problems are contained and easily isolated or longer in more complex scenarios[16].

The public authorities may need to be significantly involved in the restructuring process, particularly if the restructuring were extensive and critical business lines needed to be exited or unwound. The role of the public authorities should move from active intervention to supervisory oversight once a formal restructuring plan has been agreed and once new management has been installed.

Implications

As described above, we are moving closer to an operational bail-in regime. A number of outstanding challenges remain, but these challenges are largely surmountable. Inevitably, many details still need to be worked out, but many are case-specific and should not be set in stone within an industry-wide bail-in framework.

The RRD, in line with the FSB Key Attributes, offers a pan European resolution toolkit that includes bail-in. The RRD proposals provide for a means of implementing bail-in in a coordinated and sensible manner. We look forward to working with our European counterparts to see the proposed RRD translated into law.

Before closing, I would like to stress once again that bail-in should be considered one tool among several that ensures a bank can be resolved by assigning losses to shareholders and creditors rather than public funds. As with other tools, it can ensure continuity of critical economic functions for as long as they remain

[16] Article 47(1) indicates that the business reorganisation plan may be required to be produced within one month of the resolution. There may need to be some flexibility around this to allow for complex cases.

critical. In this way, the objectives of the Key Attributes can be met and the long-run stability of the system enhanced.