Speech

Resolution through the lens of corporate restructuring

Speech given by

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International Association of Deposit Insurers' conference, Russia

5 June 2012

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Corporate failures are a painful but routine feature of a market economy. They rarely give rise to government support. The UK Authorities, operating under the international standard of the G20 Financial Stability Board *Key Attributes of Effective Resolution Regimes for Financial Institutions*, aspire to make the process of resolving a failing bank similarly uncontroversial, with shareholders and creditors, rather than taxpayers, bearing the burden of the bank's failure. The establishment of effective resolution regimes and preparation of resolution plans for large international banks (often known as G-SIFIs[1]) can achieve this objective, and so prevent state-sponsored bail-out from being the necessary and inevitable response to the failure of large financial firms.

Corporate insolvency vs. bank insolvency

Corporate insolvency law is ill-equipped to handle the failure of a G-SIFI; the failure of a G-SIFI has very different economic consequences from the failure of a large non-financial corporate. Apart from their size and reach, G-SIFIs tend to bring together multiple functions that are critical to the functioning of the financial system and the broader economy. These functions can include retail and corporate deposit taking, payment and settlement services, and securities financing activities. Not only are these functions often vital, they are not easily substitutable. From the moment that these critical economic functions are interrupted, widespread financial market instability can rapidly ensue. When a big bank fails, the "slack" left behind cannot easily and painlessly be taken-up by the rest of the financial sector. Under corporate insolvency proceedings, dealings between a firm and its customers – the core of a financial firm's business – typically freeze, and a drawn out administration commences, taking time before any restructuring solution may be reached. Such proceedings are therefore ill-suited to G-SIFI resolution in the face of potentially damaging consequences for financial markets if a firm's critical functions are terminated.

The UK resolution regime

Prior to the recent financial crisis, the UK Authorities' only facility for dealing with bank failure was the existing corporate insolvency regime – there was neither a special resolution regime for deposit-taking banks (the lack of which was felt in dealing with the failure of Northern Rock), nor were resolution powers available for non-deposit-taking financial firms that were deemed systemic (eg Lehman Brothers). In the absence of a viable means of resolving financial firms, the Authorities were therefore left to deal with systemic failures through state-sponsored bail-outs, shifting the costs of bank failures onto the public.

In 2009, the UK instituted a Special Resolution Regime for deposit-taking institutions. This Regime provides the Authorities with the power to transfer parts of a bank to another institution, or to a publicly-owned "bridge

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

bank" until a private purchaser can be found. These powers have already proved valuable; for example, during the crisis they allowed the UK Authorities to transfer the retail and wholesale deposits, branches and a significant proportion of the residential mortgage portfolio of a UK building society, Dunfermline, to another UK building society, Nationwide. However, these transfer powers do not necessarily offer a fully effective solution in the face of the failure of a large, complex and international financial firm. The critical economic functions of a G-SIFI are intertwined legally, operationally and financially across jurisdictions and the firm's legal entities. As a result, it can be almost impossible to separate and transfer parts of a financial group to purchasers or a bridge in a short timeframe. For certain firms, therefore, a viable whole-group resolution alternative is required.

Preferred resolution regimes

The FSB's Key Attributes, endorsed by the G20 leaders in November 2011, include powers for a whole group solution. The Key Attributes focus on three core aspects of G-SIFI resolution: 1) the resolution toolkit; 2) resolution planning; and 3) cross-border cooperation. While the focus of this speech is on the resolution toolkit, it is worth mentioning that progress is being made on all three fronts, including extensive cross-border collaboration, both bilaterally (eg an ongoing dialogue between the Bank of England, UK Financial Services Authority, Federal Reserve Board, New York Federal Reserve and FDIC) and through firm-specific Crisis Management Groups.

As regards the resolution toolkit, the Key Attributes crucially mandate the introduction of a statutory bail-in resolution tool, alongside a number of other valuable resolution tools (including the power to establish a temporary bridge institution or a separate asset management vehicle (ie "bad bank"), and to transfer assets and liabilities to a third party purchaser). The bail-in tool will be a key aspect of the European Union framework for the recovery and resolution of banks, a proposal for which is expected to be released shortly.

The bail-in tool achieves the same effect as a partial transfer tool that leaves liabilities in administration – it allows for the recapitalisation of a G-SIFI without the need for an injection of public funds – but avoids the requirement to split a group structure or disrupt operational entities during the resolution period. The tool provides the Authorities with the power to write-down and / or convert into equity the creditors of a G-SIFI, at a point when the firm is no longer viable (or likely to become so) but before the firm is balance-sheet insolvent (this is the same trigger that applies to all resolution tools). The write-down should occur to the extent necessary to absorb losses and to ensure that the firm has enough regulatory capital to meet solvency requirements. Bail-in enables balance sheet losses to be borne by creditors of a G-SIFI in a manner that minimises contagion to the financial system and prevents massive value destruction. The application of the tool should respect the creditor hierarchy in liquidation to the extent possible.

In contrast to corporates, the leverage and scale of maturity transformation on a bank's balance sheet can cause a bank to fail for liquidity reasons, while significant franchise value may still remain. But bail-in will not be used simply to temporarily resurrect a failing business. The bail-in tool would very likely be combined with restructuring measures to be implemented following resolution in order to restore the restructured firm to viability. Senior management may be replaced and the firm pared back to its core activities.

Bail-in tool as adopted from corporate debt restructuring solutions

Bail-in is an idea that has been adopted from corporate debt restructurings, an approach that is regularly used in the face of corporate failures. In advance of a corporate failure, corporate creditors are strongly incentivised to find a means of avoiding a drawn-out insolvency process. Corporate insolvency results in the destruction of franchise value, and lowers recoveries relative to the value that would be realised through the sale of business lines out of a going-concern group. Creditors can avoid a drawn-out insolvency process through a corporate debt restructuring, whether conducted through an out-of-court solution (eg negotiated debt-for-equity swaps) or a court-led reorganisation (eg Chapter 11 of the US Bankruptcy Code, or Schemes of Arrangement of the UK Companies Act[2]).

Negotiated out-of-court solutions tend to be preferred to court-let reorganisations insofar as they avoid time-consuming and costly recourse to the courts and the need to file for bankruptcy. A commonly adopted out-of-court solution – negotiated debt-for-equity swaps – involve a company's creditors agreeing to cancel some or all of the existing debt in exchange for an equity share in the restructured company.

Debt-for-equity swaps are not a new idea, originating as early as the Great Depression. More recently, the December 2008 restructuring of General Motors' financial services subsidiary, GMAC Financial Services, marked one of the largest debt-for-equity swaps in corporate history. GMAC offered bondholders a number of options for the terms of the swap (by making successive offers to the bondholders until sufficient uptake was reached) and eventually obtained an agreement from bondholders (representing around $21 billion of claims) to swap their existing bonds for equity[3]. Similarly in the UK (albeit on a smaller scale), West Bromwich Building Society undertook a voluntary debt restructuring in June 2009. In the face of diminished capital ratios, and the expectation that the building society would breach regulatory threshold conditions for continued operation, subordinated debt holders agreed to exchange their subordinated debt for a new capital instrument[4].

[2] Part 26 (Sections 895-901) of the Companies Act 2006
[3] GMAC was able to swap 59% of its GMAC notes and 39% of the notes of its subsidiary, ResCap. The company had aimed for a 75% participation rate on both offers, and had originally proposed swapping the existing debt for debt with a lower face value and preferred shares. However, due to low bondholder take-up for the first offer, the company was forced to extend the deadline for the debt swap four times, and to make its offer more attractive by increasing the annual share dividend to 9%.
[4] Subordinated debtholders agreed to exchange £182.5 million principal amount for a new instrument, Profit-Participating Deferred Shares, which qualified as core tier 1 capital.

Consensus agreements between creditors are often very difficult to achieve because individual creditors can hold a company (and other creditors) to ransom. Where a negotiated debt restructuring cannot be achieved, a similar outcome can be attained through court proceedings, notably a pre-packaged insolvency ("pre-pack") under Chapter 11 in the US or a Scheme of Arrangement in the UK. Under a pre-pack, a restructuring plan is developed in advance of a company declaring insolvency. Once this plan has been agreed by a requisite majority of creditors and has been approved in court, it will be binding on all creditors, including dissenting creditors. A pre-pack enables a company to transfer its business to a new creditor-owned company (in return for the new company agreeing to assume certain of the company's liabilities) immediately after the company has entered insolvency proceedings. The process therefore facilitates continuity of core businesses while liabilities are restructured, and avoids a drawn-out administration.

The restructuring of CIT Group (one of the largest US commercial finance companies) in 2009 marked the largest pre-pack and the fifth-largest bankruptcy in US history. CIT's restructuring plan included a solicitation for a pre-pack, which was supported by almost all bondholders participating in the solicitation. The pre-pack enabled CIT to exit bankruptcy in less than six weeks and reduce the company's outstanding liabilities by almost 30%[5].

Parallels between bail-in and corporate debt restructuring

Both bail-in and corporate debt restructuring return an institution to solvency by reducing the company's outstanding debt burden through the imposition of losses on certain creditors and/or by converting certain creditors into equity. Both processes seek to avoid the value-destructive process of insolvency and liquidation. Both maintain continuity of core functions provided by the institution and both processes respect the hierarchy of claims in insolvency law to the extent possible. Both are likely to involve the restructuring of the firm and replacement of senior management.

The design of G-SIFI resolution tools – as described by the FSB – also draw on a number of other features of the corporate debt restructuring process. Both the use of G-SIFI resolution tools and pre-packs under Chapter 11 are subject to similar creditor safeguards. Under a Chapter 11 pre-pack, a restructuring plan can be forced on dissenting creditor classes by the bankruptcy court through a "cram down", but the court will only approve such a plan if the dissenting impaired classes receive an amount not less than what they would have realised under Chapter 7 liquidation. Similarly, both the FSB Key Attributes and the UK's Special Resolution Regime ensure that no creditor will receive an amount less than they would have realised in liquidation (the "no creditor worse off than in liquidation" safeguard) when the resolution authority applies statutory powers over creditors (in the UK, this safeguard only applies under a partial transfer).

[5] CIT reduced its liabilities by $10.5 billion via debt forgiveness (from $35bn total liabilities). Senior bondholders were granted 91% of the equity of the newly formed company, with the remaining equity granted to subordinated debt holders (all previously issued stock was cancelled).

As mentioned, both G-SIFI resolution tools and pre-packs seek to maintain as close to "business as usual" as possible in the immediate term through preventing temporary disruption of provision of the firms' core services. If counterparties or clients stop doing business with a firm while it is being resolved or restructured, significant franchise value may be destroyed and it may become more difficult credibly to resurrect at least part of the business as a going concern[6]. Therefore, corporate debt restructurings are often employed in conjunction with measures designed to prevent counterparties or contractors from reneging on existing financial arrangements during the restructuring process. This is achieved through the implementation of statutory or contractual "standstills". Standstills can either been adopted de facto, through the use of voluntary agreements or coordinating committees, or through the intervention of the courts as part of the Chapter 11 restructuring process[7]. Similarly, for G-SIFI resolution the Key Attributes (Annex IV) mandate the adoption of resolution regimes which provide Authorities with the power to prevent the early termination of financial contracts through the use of a "temporary stay" at the point of entry into resolution. Both the stay and the standstill provide an important means of ensuring continuity of economic functions while minimising disruption through the resolution or restructuring process.

In addition, both cross-border resolution and corporate debt restructuring involve multiple vested stakeholders and are confronted by the common challenge of ensuring that a plan is not frustrated by one or more parties refusing to cooperate, or that a plan is ineffectual in one or more regions in which a firm operates. In order to circumvent such challenges, corporate debt restructurings can make use of Collective Action Clauses (CACs) that include specific contractual provisions designed to help facilitate a restructuring; these clauses avoid the need either to obtain unanimous approval from all stakeholders or to enter a court process in order to achieve a comprehensive debt restructuring. Similarly, in order to facilitate effective cross-border G-SIFI resolution through the bail-in of debt contracts in multiple jurisdictions, it is envisaged that debt contracts may in the future include cross-border enforceability clauses. These clauses would enable a home resolution authority to bail-in debt that is governed by a law other than the law of the home jurisdiction, thus avoiding the requirement to seek recognition of resolution actions in foreign courts. An alternative way around this cross-border challenge is to use a bridge bank mechanism, transferring assets of the bank to a new company, while leaving securities issued by the holding company (whether foreign or domestic) in receivership. This approach is envisaged in the FDIC single receivership model. However, under this model the bail-in process may take longer because the new company would need to be listed and therefore extensive listing requirements would need to be met.

[6] As highlighted by the Key Attributes (Annex IV) "the termination of large volumes of financial contracts upon entry into resolution could...frustrate(s) the implementation of resolution measures aimed at achieving continuity".
[7] Southern Cross, one of the UK's largest care home operators, agreed a standstill on its contractual obligations during its July 2011 restructuring. The company made use of two coordinating committees to achieve the standstills, and the standstills adopted were de facto. There are multiple examples of US firms that have employed a court-instructed or voluntary standstill agreement through the restructuring process. These include Mirant Corporation and Calpine Corporation.

Modifications to the corporate debt restructuring tool

While the bail-in tool draws heavily on the corporate debt restructuring process, the process of G-SIFI resolution cannot adopt an identical model. Unlike corporate failures, G-SIFIs are vulnerable to rapid depositor and counterparty runs – as a G-SIFI starts to fail, there will not be enough time to commence lengthy negotiations between different classes of creditors and shareholders. Unlike corporate failures, G-SIFI failures can result in severe disruption to the rest of the financial system and the broader economy, which often spans multiple legal jurisdictions – these externalities will not be taken into account during private negotiations between shareholders and creditors.

The bail-in tool therefore adopts a modified version of the corporate debt restructuring process – one that is appropriate to G-SIFI failure. The bail-in tool would speed-up the corporate restructuring process, thereby allowing the resolution to take place over a single weekend. Bail-in is an administrative debt restructuring conducted by a resolution authority (it does not require the consent of a majority of creditors or a court sanction) with the objective of achieving the best public outcome, rather than simply the best private one (although resolution should also help to preserve value for creditors). Finally, home and host resolution authorities seek to coordinate G-SIFI resolution across multiple legal jurisdictions, achieved through bilateral and multilateral cross-border resolution planning and implementation.

Concluding remarks

While the failure of a G-SIFI will never be costless or painless, it is possible to make it less devastating. The introduction of a statutory bail-in resolution tool should be viewed as an extension of the corporate debt restructuring process to G-SIFI resolution. Both bail-in and corporate debt restructuring return a firm to solvency by writing-down or converting liabilities. Both tools offer creditors similar safeguards and avoid the value-destructive process of a drawn-out insolvency. This similarity has informed the resolution policy making process, and should give G-SIFI creditors and other stakeholders increased comfort around the tools and objectives of G-SIFI resolution regimes. The introduction of the bail-in tool will therefore be a key step in implementing the FSB Key Attributes within national regulatory frameworks.