



BANK OF ENGLAND

Speech

Resolution and future of finance

Speech given by

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Thank you very much for inviting me here today. The Bank of England has a long-standing interest in insolvency arrangements, including collaboration with INSOL. Drawing on techniques that the Bank had used in the 1930s and then again in the 1970s and '80s, around twenty years ago we articulated the 'London Approach' to creditors collaborating on restructuring firms that are financially distressed but could have a viable future. That was the background to our previous Governor, Eddie George, putting the Bank's name to the INSOL Lenders Principles on global corporate workouts.¹ Those principles focus on large international non-financial corporations. Today I want to update you on progress with the bigger and even more important challenge of ensuring that large global financial groups can be resolved in an orderly way without taxpayer solvency support.

Why resolution is so very important

I want to begin with why the work on bank resolution is so very very important.

First, we are not going to solve the deep problem of Too Big to Fail (TBTF) without effective, credible resolution regimes.

To date the international community is addressing TBTF via a combination of capital surcharges for the largest and most complex global firms, and an overhaul of resolution regimes. The first is designed to reduce the probability of failure; the second to provide society with the means to cope with the failure of systemically important financial institutions (now known as SIFIs) without taxpayer solvency support. Amongst Financial Stability Board members, this has informally been known as the 'bookends strategy'.²

Absent effective resolution regimes, we would be further from protecting society from the risks posed by the failure of large and complex firms. To reduce the probability of failure, capital requirements for SIFIs would end up being considerably higher – supplemented no doubt by more radical restructuring of banking than planned to date by any of the major countries.

While measures on capital resources and structure are vital complements to and enablers of resolution, personally I doubt that an alternative route without a resolution component would work in the end. As the years and decades passed, new types of financial intermediary would emerge operating outside of those capital and structural restrictions; or the restrictions themselves would eventually be relaxed or even lifted entirely as the spirit of the times evolved, as happened around the world in the past. Sooner or later, society would find itself regretting that it had not put in place the necessary resolution regime to cope with the failure of systemically important financial institutions.

¹ See INSOL International (2000), *Statement of Principles for a Global Approach to multi-creditor workouts*.

² That strategy was initially set out by the Financial Stability Board in 2010, *Reducing the moral hazard posed by systemically important financial institutions*, available at http://www.financialstabilityboard.org/publications/r_101111a.pdf

In short, there is no alternative to submitting banking and its investors to the disciplines of capitalism – failure as well as success. We cannot afford to have banking, so central to the allocation of capital in market economies, semi socialised. Moreover, we need to harness the energies of bond holders to monitoring and helping to contain the tendency to excess characteristic of bankers, over the generations, in the upswing of the credit cycle. That is not in and of itself a guarantee of stability, but I would rather give asset managers incentives to help the objectives of prudential supervisors than incentives to rely on a fiscal backstop.

Second, effective resolution regimes, capable of operating across national borders, are necessary for a healthy international monetary and financial system (IMFS). As Mervyn King has said, the large financial groups have been ‘international in life, but national in death’. Without effective cross-border resolution arrangements, domestic authorities are left with a clear incentive to take steps to cap the contingent exposure of local taxpayers, who are local voters. That is surely part of the backdrop to the series of measures taken by national and regional authorities to restrict the range of activities or structure of banking. Those measures need to be taken without the world slipping into a hard-to-reverse balkanisation of the international financial system. Were that to happen, the breakdown in cooperation between sovereign states could all too easily give encouragement to those around the world who would like to use protectionist measures to shield their countries from the winds of global trade. If the international monetary and financial system relies, as it has since at least the collapse of Bretton Woods forty odd years ago, on the private banking system to supply the cross-border liquidity needed to underpin expansion of world trade, then we must ensure that the international banking system is safe and sound. That cannot rest solely on prophylactic prudential supervision. It must include effective arrangements for cross-border resolution. That has been an architectural faultline in the IMFS for decades.³

Third, across the world the operational independence of prudential supervisors⁴ from short-term politics depends on credible and effective resolution regimes. Unless we can handle the failure of banks and other financial firms in an orderly way, it is hard for governments to tie themselves to the mast of eschewing the temptations of ‘bailout’ using taxpayer’s money. That would give them an interest in the day-to-day operation of prudential supervision which, as experience in some countries shows, all too easily morphs into attempts to promote and protect ‘national’ champions; and to operate supervisory policy for short-term gain rather than in the interests of medium-term stability. In any countries where that persists, we should expect higher government bond yields than otherwise, reflecting the state’s contingent liability for the banking sector. Unless we deliver effective resolution regimes, public finances will be under more pressure.

³ This serious faultline in the international financial system was highlighted to the international community by a 2001 G10/Financial Stability Forum report explaining that officials did not then have the tools to manage the orderly wind down of a large and complex global financial institution (LCFI).

⁴ The Basel Committee on Banking Supervision’s *Core Principles for Effective Banking Supervision* (2012) require ‘the operational independence, accountability and governance of the supervisor [to be] prescribed in legislation and publicly disclosed, [with] no government or industry interference that compromises the operational independence of the supervisor.’

So, summing up why the resolution reforms are so important: if you believe in solving Too Big To Fail, in an international financial system that is not only free but also safe, in shielding taxpayers from the risks in banking, and in shielding banking from politics, you will be committed to making a success of resolution.

Thankfully, the extent of progress since the 2008/09 bailouts, while still incomplete and needing continuous political impetus, is good.

It has involved agreement on a global model for resolution regimes capable of handling the largest and most complicated firms; legislation in some, but not yet enough, jurisdictions to embed that regime; the development of high-level resolution strategies that can be applied to different types of global group; concrete steps towards agreement between countries on how to apply those strategies across borders to specific institutions; and plans for top-level reviews of the adequacy of the resolution plans for each Global SIFI. If that progress has not been faster, which is an understandable concern, it is for the good reason that the required reforms involve an agency of the State, the resolution authority, having powers that affect property rights. In democracies, that is rightly debated thoroughly to ensure that it has legitimacy and is subject to the right checks and balances.⁵ The key process is, of course, the vetting and passage of legislation. That process is well underway in the key jurisdictions.

Establishing the statutory regime

In November 2011, the G20 leaders endorsed the Financial Stability Board's *Key Attributes for Resolution* as an 'international standard'. That term of art means that all the jurisdictions of the G20 are committed to incorporate the Key Attributes (KAs) regime into their domestic legislation. The US has largely done so. The EU is very close to doing so, through its Recovery and Resolution Directive. Switzerland has largely done so. Between them, this will account for the home countries of 24 of the 28 globally systemic banks listed by the FSB and the Basel Supervisors Committee last year. It is unlikely that in future decades the West will account for such a large share of the world's unequivocally systemic firms. In both Asia and Latin America, a number of jurisdictions have made progress with putting the KA regime on to a statutory footing. But it is probably fair to say that not a few emerging-market countries are watching progress in the EU. Indeed, it is not an exaggeration to say that the EU's Directive is the keystone to breaking the back of the TBTF problem.

How? The toolkit for Resolution Authorities established by the KAs obviously includes the workhorse techniques for resolving standard commercial banks. Either: liquidation with prompt payout to insured depositors by the Deposit Guarantee Scheme (DGS), commonly known as Liquidation and Payout (L&P). Or: what the US call Purchase & Assumption (P&A) – selling to a third party the distressed bank's deposit book together with some cash injected by the DGS and perhaps some other good assets.

⁵ Eg, public interest pre-conditions for the use of resolution tools; compensation if creditors bear losses beyond what it is estimated they would incur in insolvency; an independent process for valuing potential compensation, etc.

At its simplest, P&A involves splitting the distressed bank into 'good' and, let's say, 'not so good' bits. The deposit book and cash might for a while be held in a Bridge Bank controlled by the Resolution Authority (RA), pending sale to a purchaser. But whether or not a Bridge Bank is employed as a holding position, the services to insured depositors are sustained. Meanwhile, the rump goes into administration, with the administrators selling what they can and winding down the rest.

Those techniques are tried and tested in the US, and are the basis for resolutions of regular commercial banks in many other countries. They do not involve taxpayer solvency support.

I am doubtful, however, whether those established techniques would work for a complex investment bank or a global commercial bank. Universal banks are typically run on an integrated basis, across functions and regions, so that capital can be reallocated easily as opportunities shift around. It would be a nightmare to execute over a weekend a split of any of these groups, with multiple entities across scores of countries, into those parts providing services that must be sustained at all costs and a remainder that could be wound down as part of a resolution. Moreover, this is not just a matter of critical versus not-so-critical services. Even if, contrary to my doubts, it were possible to execute that separation in the midst of a crisis, winding down a complex trading book would be hugely hazardous, with very nasty spillovers to the rest of the financial system.

Quite separately, P&A techniques might also fall short in handling the failure of medium-sized commercial banks in highly concentrated banking systems. Crudely, there may be few or even no potential buyers of the deposit book in such circumstances.

That is the background to the so-called 'bailin' technique which, within the official sector, takes its inspiration from the way insolvency practitioners effect a capital restructuring of distressed but viable non-financial firms – for example, Chapter XI in the US.

The critical difference from a standard corporate reconstruction is that for banks and dealers there is not time for a negotiation lasting a month or so under the control of a judge. In the wider public interest, swifter action is needed to stabilise banks, executing a resolution strategy designed to contain the impact on stability in the financial system as a whole. Bailin seeks to deliver that.

Such bailins do, of course, impose losses on creditors. But all – I repeat, all – resolution tools involve creditors and the Deposit Guarantee Scheme, as well as equity holders, taking losses. As this audience certainly knows, that is not an exotic proposition. The losses simply have to go somewhere.

There is, however, a difference between 'bailin' and other resolution tools. Under most traditional bank-resolution techniques – L&P or P&A – losses for uninsured creditors, including the DGS, are revealed only at the end of the administration of the rump, when all assets have been sold or run off. 'Bailin' works by

making an ex ante, up-front judgment of the scale of expected losses, and by reconstructing the capital structure accordingly, without the destruction of value entailed by winding down all portfolios associated with non-critical services. Following the creditor hierarchy that would apply in liquidation, the various layers – equity, subordinated debt, senior unsecured debt etc – are written down until the losses are covered. And then the last surviving layer(s) of debt are partially converted into equity to recapitalise the continuing parts of the business, which is thus under new ownership.

This has given rise to nothing short of a revolution in thinking about possible resolution strategies for SIFIs.

Resolution strategies

Last November the FSB issued draft Guidance on resolution strategies. Big picture, there are two basic strategies – *Single Point of Entry* and *Multiple Point of Entry*.

Single-Point-of-Entry Resolution

Single-point-of-entry resolution involves working downwards from the top company (Topco) in the group in an exercise that resolves the group as a whole, wherever its problems began. Think of it this way. Losses in subsidiaries are first transferred within the group to the Topco. If Topco is bankrupt as a result, the group needs resolving. Bailin can then be applied to the Topco's capital structure: writing off the equity and, most likely, subordinated debt; and writing down and partially converting into equity the senior (bonded) debt issued by Topco. Those bondholders become the new owners. If Topco is a pure holding company – its assets comprising only investments in its subsidiaries – a number of advantages follow. The creditors of the operating banks and dealers are left intact; what might be called the group's 'operating liabilities' are protected relative to the 'capital liabilities' of Topco. Cross-border problems in resolving different subsidiaries or branches can also be sidestepped.⁶ Any reorganisation of the operating companies to address the underlying causes of the group's failure can be made in an orderly fashion after the solvency position has been stabilised via the bailin.

Multiple-Point-of-Entry Resolution

Multiple-point-of-entry resolution is what it says on the tin. Rather than resolving the group as a single whole, it would be split up into its parts. That is quite probably appealing for those global groups comprising a bundle of regional, on-the-ground commercial and retail banks, operated as separate businesses financially in distinct legal structures but with shared operational and central services.

Of course, just saying 'break up the group along regional lines' does not amount to a resolution strategy. What happens to those regional parts? Healthy parts might be sold or be maintained as a residual group

⁶ See FDIC and Bank of England (2012), *Resolving Globally Active, Systemically Important Financial Institutions*.

shorn of their distressed sister companies. Those distressed parts would need to be resolved, either via P&A or via bailin of the local subsidiary (if it had issued bonds to the market). I want to stress that last point because 'bailin' as a resolution tool should not become synonymous with top-down SPE resolutions: an MPE resolution could involve the bailin resolution-tool being applied to some parts of the group.

For those groups comprising a series of regional subgroups in a hub-and-spokes structure, there may be intermediate holding companies for each region. The preference of some of the regional authorities might be for a SPE resolution of 'their' subgroup. In other words, a MPE resolution strategy can incorporate SPE resolution being planned for some parts of the group.

The precise approach applied to the different regional/local subsidiaries would be a matter for the relevant host authorities. But it should not be a mad scramble. Under the FSB KAs, the home authority for the group has the important role of ensuring that the operation is well co-ordinated and not competitive.

Preconditions for SPE and MPE resolutions

There is obviously a lot to be said about how to apply the two headline strategic options for resolving SIFIs. The FSB plans to finalise its Guidance on implementation before the summer holidays and so decently ahead of the Summit of G20 Leaders in September. I think that will need to include in particular:

- groups having enough loss-absorbing capacity, and at the right locations in their corporate structure;
- resolution authorities being able to enforce a write-down or conversion of bonds issued in foreign jurisdictions;
- as much clarity as possible about the relative treatment of different categories of creditor;
- regulatory measures to guard against contagion in a world where bank creditors take losses;
- legal, operational and financial structures that are aligned with the preferred resolution strategy for a group and with sustaining its most essential financial services;
- effective co-ordination between home and host authorities;
- fall back plans, and frameworks for escalating preparations for resolution as a group's condition deteriorates.

Enabling effective resolution: removing barriers and structuring financial groups for resolution

For most if not all SIFIs, steps will need to be taken in order to ensure that the preferred resolution strategy can be implemented.

Sufficient loss-absorbing capacity, and its terms

Perhaps the most obvious prerequisite is that SIFIs should have sufficient bonded debt in issue for losses exceeding their equity base to be absorbed through the process of resolution. This is gone-concern loss-absorbing capacity (LAC).

This gone-concern LAC could be senior unsecured bonds or subordinated bonds.⁷

Bonds issued outside the issuing firm's home jurisdiction are going to need to include legally robust clauses under which holders unequivocally accept that the home Resolution Authority can apply the bailin tool (and other resolution tools) to their investment. If that cannot be achieved, gone concern LAC is going to have to be issued from each firm's country of domicile.

There should not be cross-default clauses in other liabilities, including elsewhere in the group that could be triggered by bailing in these bonds.⁸

Beyond the terms of bond issues, the authorities are going to need to decide how much loss-absorbing capacity SIFIs need to have in issue. In Europe, the draft resolution directive provides a framework for that. But a global discussion is needed.

My own provisional view is that the minimum for bonded debt might need to be equivalent to the sum of the firm's regulatory equity requirement plus a margin (X) less any surplus equity. That would mean that bailin could be used to cover losses beyond a firm's required equity base up to an amount X and then to recapitalise back to the *ab initio* equity standard.

⁷ For groups with a pure holding company, senior debt issued from holdco is structurally subordinated to claims on the group's operating banks and dealers.

⁸ The trigger for statutory resolution would be, broadly, that the conditions for the group being authorised as a bank or dealer were no longer met and there was no reasonable prospect of repair. It should be underlined that what is described here is nothing to do with so-called 'contractual bailin', which has been a source of confusing distraction over the past year or so. 'Contractual bailin' typically refers to bonds that convert into equity or write down under a trigger established purely in the contract documentation. But if the trigger is the firm's capital ratio dipping below a high threshold, the bond is in fact for recovery not for handling abject distress. If, at the other end of the spectrum, the trigger is falling below a low capital ratio, there can be no assurance that the firm would survive in the markets long enough for the bond to be triggered before the firm had to go into statutory resolution. And if the suggestion were that the contractual trigger should give the regulators discretion, most Resolution Authorities would want to avoid writing down or converting bonds outside the statutory resolution process, since that provides protections for creditors, and gives the RA protections and powers for the achievement of a clear statutory objective established by the legislature. Bailin is not about a specific type of bond – a so-called 'bailin bond' – but about the application of a statutory resolution power to bonds of any kind within a statutory resolution. 'Bailin' is a verb not a noun. Orderly resolution will not be achieved by drafting term sheets.

In summary, the authorities are going to need to establish minimum standards for the amount of bonded debt – or gone-concern LAC – SIFIs have in issue, with a requirement that they are capable of being bailed-in by the RA of the jurisdiction in which the issuing entity is domiciled.

Containing contagion (1): holders of bank bonds

The purpose of resolution regimes is to contain disorderly disruption of the financial system. Equally, in order to avoid taxpayers providing solvency support, losses must fall to creditors. It is therefore important to ensure that the imposition of losses on creditors does not itself cause systemic distress through contagion. That will depend heavily on who within the financial system holds bank bonds.

It would be impractical to identify individual holders of bonds on the eve of resolution, applying case-by-case discretion. This needs to be addressed through regulatory policy. Most obviously, regulators need to ensure that banks do not hold each other's bonds, except for example in small amounts as part of market-making.

Secondly, regulators are going to need to ensure that some investors, for example life-insurance companies, do not have concentrated exposures to bonds issued by single banks or to banking sectors.

Looking back on the 2007-2009 part of the crisis, those precepts should have been in place anyway. In the UK, it was alarming that many medium-sized domestic banks had been allowed to hold each other's bonds in what were purportedly 'liquidity' portfolios.⁹

Contagion (2): the creditor hierarchy and depositor preference

Preparations for bailin, and even more the recent reconstruction of Cypriot banks, have heightened awareness of the prospect of creditors of distressed banks losing money, prompting calls for clarity about the relative standing of different types of creditor. Who stands where in the creditor hierarchy affects the loss they incur in the event of default, and therefore their behaviour before default, including the return they demand to compensate for risk and whether they flee at the first signs of the firm weakening.

Insured depositors are insured, pure and simple – they are covered by the relevant Deposit Guarantee Scheme. The details of the resolution regime do not affect that.¹⁰ Nor does preference for insured deposits affect those depositors directly. Rather, it affects the exposure to loss of the DGS and thus the share of the losses having to be covered by the surviving parts of the industry.¹¹

⁹ See Tucker, P. M. W. (2009), *The crisis management menu*, "Too little attention was paid to core liquidity holdings: a treasury portfolio comprising the [Floating Rate Notes] issued by other banks does not leave a distressed bank with many options in the face of system-wide stress."

¹⁰ Of course, if the DGS is bankrupt and a country's government is bankrupt, the DGS may not be able to pay out. That is very serious, but it cannot be solved by the design of bank resolution regime.

¹¹ See Tucker, P. M. W. (2012), *The role of deposit insurance in building a safer financial system*.

Amongst uninsured creditors, the position of bond holders will depend on whether they are issued from a (pure) holding company, in which case they have a structurally subordinated claim on the underlying business assets, or by operating companies that also have lots of other unsecured creditors. The exposure to loss of bonds issued by operating companies are, therefore, affected by whether or not they incorporate subordination clauses. For every bank group, all of that will be clear.

The big issue, therefore, is about uninsured deposits. Should they rank alongside senior unsecured bonds or should they be preferred?

In the US, all deposits are preferred. There is now an active debate in the EU about whether or not it should introduce depositor preference and, if so, whether that should be for all or only some uninsured deposits? Whatever the conclusion reached by the political authorities, it is important that the creditor hierarchy is the same under bailin, other resolution tools, and liquidation. Otherwise, pricing each piece of debt would depend upon time-varying assessments of the probabilities of the various resolution tools being applied in the event of a firm's bankruptcy.

On the substance of the issue, I can see a case for both insured and some uninsured depositors being preferred. That would help to provide some protection, beyond the DGS, for users of the monetary services that banks provide via overnight and short-term deposits; it could provide a small degree of protection against runs; and there could be an element of social justice in insulating, say, small firms and charities from the first line of loss.

But, I say 'some' uninsured deposits because I am doubtful whether very large, wholesale deposits placed at term maturities (eg billions of pounds for six months or more) should be preferred. They are not monetary deposits, in the sense of being transaction balances; and they are not placed by households or small firms or charities. Moreover, if they were to be preferred, it would be likely that a chunk of bonded finance would over time morph into borrowing-instruments that had the legal *form* of 'deposits'. That would increase the cost of any residual bond issuance.

Finally, whatever types of deposit end up being preferred, there should be no discrimination on grounds of location or nationality. The chosen creditor hierarchy should apply the same way to all branches of a bank throughout the world. The Financial Stability Board Key Attributes are clear about that.¹²

I do not need to remind this audience that depositor preference would not be a guarantee against the relevant uninsured deposits (or the DGS) ever taking losses. But they would be exposed to loss only after bonds, as well as equity, had been wiped out. The greater the gone-concern LAC requirement for bond issuance, the lower the probability of any preferred deposits incurring loss.

¹² FSB Key Attributes paragraph 7.4: "National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. The treatment of creditors and ranking in insolvency should be transparent and properly disclosed to depositors, insurance policy holders and other creditors."

Group structure: having LAC in the right place, and operational dependencies

It will have been apparent from my earlier description of high-level resolution strategies that where and how a group maintains its LAC will vary somewhat according to whether the preferred resolution strategy is SPE or MPE.

For SPE resolutions, sufficient loss-absorbing capacity must be at the topco. But more than that, there has to be a mechanism for transferring losses from operating subsidiaries, wherever they are in the world, to the topco. One way of doing that would be for Topco to guarantee the performance of the obligations of its systemically significant and other key operating subsidiaries. But that could not be a complete solution as it would leave the hosts of the group's foreign subsidiaries with exposure to Topco being unwilling or unable to pay when it mattered. For that reason, the LAC of Topco needs to be passed down to the 'systemic' or otherwise key operating subsidiaries, forming LAC in the subsidiaries themselves. This should probably be in the form of *subordinated* debt issued to the Topco with write down triggers that would enable losses exceeding the subsidiary's equity base to be pushed up to the Topco. By transmitting the losses to Topco, the operating company is recapitalised. If Topco itself is bankrupt as a result, it can be resolved in a top-down bailin by the group's home resolution authority of its own debt. That is the model set out in the paper FDIC/Bank of England issued last December.¹³

For MPE resolutions, there needs to be sufficient LAC in *each* of the key subsidiaries that are manifestly relevant to global financial stability. Some of the gone-concern LAC should be issued externally, so that bailin can effect a transfer of ownership. Beyond that, the host authorities of other subsidiaries may want to require sufficient externally issued gone-concern LAC, in order to be confident of being able to execute a local resolution if the subsidiary they host is systemic locally, ie a domestic SIFI.

To a greater extent than with SPE, a MPE resolution can be impeded by financial connections between different parts of the group, whether arising from intergroup loans or from business lines, such as global payment services, that are integrated but spread across different legal entities. In supporting MPE as a preferred strategy, the home and key host resolution authorities will have to satisfy themselves robustly that such interlinkages would not impede resolution via splitting up the group. In practice, that will mean reducing intragroup exposures.

Operational dependencies between different parts of the group are another priority where MPE is the preferred strategy. For example, some global commercial banking groups seek to exploit economies of scale and scope by drawing on centralised operational services (in particular related to IT and processing). MPE does not work unless those arrangements can survive the breakup of the group. At the very least, that entails service-level agreements and transitional support arrangements being effected via

¹³ See FDIC and Bank of England (2012), *Resolving Globally Active, Systemically Important, Financial Institutions*.

enforceable contracts. Any separate group-service companies need to maintain sufficient capital and liquidity to continue to support the principal operating companies before they are wound down or sold to third parties. And it would probably be useful to have governance arrangements that give some form of control rights to the operating companies over the service companies during that transition.

In broad summary, it will be apparent that, even once the statutory resolution regime is in place in all key jurisdictions, many financial groups are going to need to restructure themselves in order to achieve resolvability – financially, legally, organisationally. Indeed, a group's choice of financial and operational structure will influence which of a SPE or MPE resolution strategy is preferred by the home and key host authorities. These will be *bespoke* restructurings – and will be on top of the plans for systematic structural reforms of banking around the world (Vickers, Volcker, Liikanen, and so on).

Cross-border co-operation

The final precondition for success I want to highlight is, of course, effective cross-border co-operation.

For a SPE strategy, successful implementation will depend on the home authority providing assurances to the key host authorities so that they refrain from taking independent action. Instead the host authorities would rely on the home authority to give effect to a group-wide resolution and, where necessary under the law, would take local action to help the home authority. Host authorities are going to need to be clear about the assurances they need – ahead of time and during the execution of the groupwide resolution.

For a MPE strategy, the successful implementation will require effective coordination of the different resolution actions undertaken by home and host authorities. Each key host authority needs to be open about its plans. The home authority needs to reciprocate, ensuring a joined-up, collaborative approach with no surprises.

For both SPE and MPE resolutions, the FSB has stipulated that firm-specific cooperation agreements (COAGs) must be agreed amongst home and host authorities. The FDIC/Bank of England joint paper last year is by no means the only example of intensified co-operation preparing the way for those COAGs. Over recent months there has been marked convergence in how the world's key authorities plan to approach resolution. This will become more apparent as more jurisdictions, including crucially the member states of the EU, legislate the KAs into their local statutory regimes.¹⁴

¹⁴ See for example the testimony on cross-border resolution to the US Senate of Mike Gibson, Director of Banking Supervision and Regulation at the Federal Reserve Board, on 15 May. Available online at: <http://www.federalreserve.gov/newsevents/testimony/gibson20130515a.htm>.

Preferred paths, and fall backs

My exposition of how the resolution work programme will be taken forward has made it clear that, as I at least envisage it, for each SIFI there will be a *preferred* path. There are two points to make about this.

First, I favour the term ‘preferred path’ over ‘presumptive path’ because I am concerned that too many people – perhaps particularly amongst asset managers – slip into thinking, and even demanding, that a ‘presumptive’ path should offer certainty, with no room for the RA to exercise any discretion in the public interest. I think that that is unrealistic. Take the case of a bank with plenty of bonds in issue, but also tiny amounts owed to each of hundreds of trade creditors or to hundreds or even thousands of market counterparties. In an emergency, it would not be remotely sensible operationally for the RA to have to pin down each and every tiny trade-credit or wholesale obligation on a Friday evening/Saturday morning so that they could be bailed in, becoming part owners of the bank, alongside the bondholders. Precious time would be lost. The RAs need a degree of carefully constrained discretion to ensure that complex resolutions can be implemented in the real world.

But there is a second, bigger point. The *preferred* path is not guaranteed by Heaven to work. For example, resolution of a group (or sub-group) by a top-down bailin would not work where, in the particular circumstances of its distress, the group’s problems proved to be so pervasive, so toxic and its business controls and information systems so hopeless, so chaotic that it was impossible to make a reasonable ex ante estimate of expected losses. In that absolutely disastrous but not unthinkable circumstance, the RA would need a fall-back plan.

In the UK, the government’s plan for ring-fencing provides the basis for just such a back-up strategy. Under the proposals, essential payment services and insured deposits would be provided by a ring-fenced bank (RFB), capitalised separately and with no direct financial links to the group’s other businesses. If that succeeds in making the RFB super-resolvable, it should be easier for the UK authorities to retreat to maintaining at least the most basic payments services if a preferred strategy of top-down resolution of a whole group could not be executed. The introduction of ring-fenced domestic retail banks is, therefore, consistent with the broader international agenda on resolution.

For each SIFI, the global authorities probably need not only a preferred resolution strategy for the group as a whole, but also a fall back. For example, are the clearing services provided by broker-dealers so important that they need to be maintained come what may?

Recovery plans and preparing for resolution

A final point.

There is great emphasis on recovery and resolution plans, RRP. As familiarly used, Recovery is a binary process – either it works, the firm survives and, thankfully, there is no resolution; or, alternatively, the best-laid and executed recovery plan fails, the firm fails, and it enters resolution.

But this is too crude a way of thinking about Recovery.

Of course Recovery is primarily about delivering recovery. That is what we all want. But it is not all. The period in which recovery is being attempted also provides a window for the firm and the resolution authorities to prepare in case recovery cannot in the event be achieved.

For the firm, there can be time to adjust its balance sheet to make resolution easier. This might involve discreet steps to reduce trading, derivative portfolios and counterparty credit exposures. In parallel, Resolution Authorities should ensure that they are themselves as ready as can be. That might include engaging advisers needed to help determine the firm's losses, and so the size of debt write-down and conversion that might be needed to recapitalise it; preparing options for winding down or transferring critical functions; and lining up replacement management and directors to run the firm following the resolution. This should be the bread and butter of preparing for any resolution. For a Purchase and Assumption transaction, the US FDIC typically start preparations around 90 days out.

To make escalated preparation practical, supervisors and resolution authorities need to agree a framework for graduated intervention as a firm deteriorates. In the UK, the Prudential Regulatory Authority's Proactive Intervention Framework is intended to provide a basis for just that.¹⁵

Conclusion

There is absolutely no question that effective, credible resolution regimes and plans are essential to overcoming the biggest problem in the international financial system: 'Too Big to Fail'.

Only with a credible mechanism to put losses to a failed bank's creditors can we harness the forces of market discipline and take tax payers off the hook. Only with powers and plans to resolve cross-border banking groups can we arrest the risk of national regulators progressively putting up barriers to cross-border finance.

A lot of progress has been made over the past few years. For most Global SIFs it is fairly apparent whether, at least with their current structures, they are best suited to single-point-of-entry or multiple-point-of-entry resolution. Once home and key host authorities have determined a preferred resolution strategy, we need to ensure that minimum levels of gone-concern loss-absorbing capacity are maintained in the right parts of

¹⁵ See Table A on the PRA's Proactive Intervention Framework in Bank of England (2013), *The Prudential Regulatory Authority's approach to banking supervision*.

each group; and that any necessary changes to group structure are made. Behind the scenes discussions on individual firms are underway in official-sector Crisis Management Groups or at more senior levels. Those planning discussions will need to intensify as more key jurisdictions put the necessary statutory regime in place.

The crucial next step is for a EU resolution directive compliant with the FSB Key Attributes to be passed. With the stakes so high, it is the moment to press ahead. This can transform international finance for the better.