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Bank Resolution Plans as a catalyst for global financial reform☆

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ABSTRACT

Bank Resolution Plans (Living Wills) should help with the resolution of systemically important financial institutions (SIFIs) in distress. They should be used to clarify and simplify the legal structure and make it commensurate with the functional business lines of the institution. Living Wills could also prove the right regulatory instrument to achieve two further innovations in the resolution of SIFIs with cross-border presence. First, they could incorporate burden sharing arrangements between countries enabling burden sharing on an institution by institution basis. However, there would remain problems arising from the incompatibility of the laws governing cross-border bank insolvencies. Many countries are currently introducing special laws covering the resolution of SIFIs. This creates a window of opportunity to use Living Wills to introduce a second innovation: a consistent legal regime for the resolution of SIFIs across the G20 countries.

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1. Introduction

The 2007–2009 financial crisis brought into sharp focus the massive costs associated with the bail out of complex systemically important financial institutions (SIFIs), which were perceived as too-big-to-fail. The too-big-to-fail doctrine has been reinforced, if anything, by governments' handling of the current financial crisis. As a result, the most significant regulatory reform proposals have focused on the question of how to curtail the too-big-to-fail problem. Namely, how can one reduce moral hazard and rein back expectations of future bail-outs of SIFIs?

Among the proposals that have been advanced so far Living Wills may prove a regulatory instrument of critical importance. Its further development might allow systemically important banks to fail or, at least, to be unwound in an orderly manner without imposing disproportionate costs on the taxpayer. The objective is to put in place, ex ante, conditions that would allow a wider range of options other than having the whole bank rescued (FSA, 2009). A Living Will is a recovery and resolution plan drawn up ex ante with the purpose of using it if a bank gets into difficulties. The G20 has requested Living Wills to be completed by the top 24 global banks and 6 insurance companies (Claessens et al., 2010).

In practice Living Wills will complement the new Basel III requirements to increase capital substantially, especially for large banks, forcing them to internalise the systemic externalities they generate (Basel Committee, 2010; Acharya, 2009). Higher holdings of core equity reduce the probability of failure of systemically important banks, while Living Wills reduce the impact of a possible systemic failure. Both elements can reinforce each other to reduce the too-big-to-fail problem.

In this article, we review some key elements of Living Wills and make policy recommendations for their further development. At the first stage, there should be discussions between a bank and its supervisors about forcing a bank to simplify its often opaque and very complicated structure, and winding down its operations in times of crisis. A bank will also have to make contingent funding and de-risking plans to recover its financial strength. At the second stage, credible resolution plans should be drawn up to keep a bank

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alive, if needed. In the case of international banks, these resolution plans could include a burden sharing mechanism for central banks (liquidity support) and ministries of finance (capital support). The burden sharing would then be agreed on an institution by institution basis. At the third stage the bank and the authorities should build a bankruptcy scenario which would highlight possible shortcomings in deposit guarantee schemes and inconsistencies between resolution and insolvency regimes. Relevant exercises would bring such inconsistencies to the forefront of attention. Thus, authorities (including lawmakers) would be forced to tackle the most critical inconsistencies. The cross-border resolution and insolvency procedure for international banks is currently a nightmare for depositors, creditors, and shareholders, but a paradise for insolvency lawyers. For this reason, all interested parties agree that further integration of national regimes should be at the top of the regulatory reform agenda.

Since Living Wills would be drawn up by banks and authorities, banks should be the principal actors in developing their own recovery plans. Supervisors will challenge banks on the credibility of the recovery plan. This is typically done by the core supervisory college comprising the home and key host supervisors of a bank (Financial Stability Forum, 2009). The resolution plan should be drawn up by the authorities (supervisors, central banks and ministries of finance) from the countries represented in the core supervisory college. As the Living Will should cover the whole bank, it is necessary to have one overall Living Will rather than a string of national Living Wills lumped together.

The main purpose of Living Wills is to achieve ex ante benefits. The drawing up of a Living Will should focus the minds of the institution's management and of the supervisors as to what they should expect in the event of an institution's failure. Thus, the drawing up of a Living Will could act as a catalyst for thinking and taking action, as in the wills of individuals. For example, in real life, a pater-familias, who starts to think about handing over his estate to his off-spring (and/or surviving partner) in case of his death and drafts a will, has to assess the structure and viability of the estate itself. On the structure side, the question he should be asking is: will my children understand the 'business' and make sense of it? Moreover, does the structure allow an orderly hand-over of the different parts of the estate to the various stakeholders (children and surviving partner)? If not, the structure should better be simplified. On the viability side, the question will concern the children's ability/willingness to accept the 'business'? Is a 'fair' distribution of the estate over my children feasible? If not, it is better to divest the loss-making parts upfront.

At the fourth and final stage, Living Wills may help to persuade banks to restructure their business (namely, simplify and hive off parts of the business) and encourage supervisors to enforce desirable restructurings when banks do not act voluntarily.

Of course, the ex post effect could be less strong due to time inconsistency (Kydland and Prescott, 1977). The burial of an individual may be handled according to the script of that individual's will. However, in case of multiple deaths (for example, due to a tower inferno, earth-quake or war), authorities need to act swiftly and ignore individual wishes (namely, wills). Accordingly, in the 2007–2009 financial crisis, authorities across the world ignored soft arrangements, such as Memoranda of Understanding (MoUs), and acted as they saw fit to rescue the financial system, often using unconventional tools.

The article is organised as follows. In Section 2, we examine the disciplining effects of Living Wills. How can the complex structure of banks be simplified? Section 3 reviews the resolution plans. In particular, we consider the possibility of arranging burden sharing on an institution by institution basis. In Section 4, we discuss the inconsistencies between insolvency regimes and we investigate the possibility of a standard insolvency model for systemically important financial institutions. The final section concludes.

2. Reducing complexity

The corporate structure of a bank can be extremely complex with a myriad of legal entities (Kuritzkes et al., 2003; Schoenmaker and Oosterloo, 2008). In practice, separate subsidiaries are often set up to exploit tax loopholes and regulatory arbitrage opportunities. In addition, banks may use the limited liability of various (off balance sheet) legal entities to ring-fence certain risks. At the same time, the different legal entities are interwoven through multiple intra-group transactions and common operational platforms. The result is a complex structure, which is difficult to understand, and impossible to unwind at short notice during times of stress. Basically, banks try to have the best of both worlds: exploiting the benefits of the legal structure (regulatory and tax arbitrage, etc.) and taking advantage of the synergies attached to operating as an integrated group (intra-group transactions, common IT platform, etc.). Faced with a complex and opaque structure, authorities have little choice but to rescue the whole bank, if needed, to minimize the systemic consequences. However, in doing so, they also reinforce the 'too-big-to-fail' effect and increase moral hazard.

One of the goals of a Living Will is to make contingency plans for times of stress. In these plans, banks should develop scenarios under which certain, less important, parts can be sold, or put into liquidation. The systemically important parts may then be rescued, although the choice of the resolution tool may be left to be made ex post (Huertas, 2010). This is only possible with a straightforward legal structure, in which the different parts are easily identified and separated. The development of Living Wills may thus lead to a simplification of legal structure. Supervisors have the power to enforce restructuring. Following the failure of the Bank of Credit and Commerce International (BCCI), new rules[1] were introduced that allow supervisors to prohibit structures that impede effective supervision. On this basis, supervisors can enforce a transparent and coherent structure. The simplification of structures – in tandem with tight limits on intra-group transactions – may ultimately lead to separately capitalized and ring-fenced subsidiaries (Arner and Norton, 2009; Cerutti et al., 2010). Standalone subsidiaries will have their own management, IT systems, payment platform, risk management, internal controls, etc. Nonetheless, if this approach is adopted not only the front-office but also the back-office would have to be split up. The operational efficiency of banking groups is primarily realised by running a single banking platform in the back-office. In the scenario of stand-alone subsidiaries, the question may be asked: what are the remaining synergies of being part of a single group? Furthermore, ring-fencing may lead to fragmentation of international capital flows, the one area where multinational banks have made a truly welfare enhancing contribution to the global economy (Lipsky, 2010).

Simplification of corporate structures will help supervisors to get a better overview of, and a more effective handle on, large banking groups. However, markets tend to regard the strength of a banking group as a whole, ignoring the legal structure. As witnessed in the case of Lehman Brothers in 2008 and earlier of Drexel Burnham Lambert in 1990, solvent subsidiaries of a banking group

[1] The Basel Committee on Banking Supervision issued guidelines 'Minimum standards for the supervision of international banking groups and their cross-border establishments' in 1992, which were further refined 'The supervision of cross-border banking' in 1996. In the EU, the post-BCCI Directive (95/26/EC) deals with corporate structures.

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