The Resolution of Systemically Important Financial Institutions

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Introduction

As events in the recent financial crisis showed, the failure of certain financial institutions (FIs) can have serious negative effects, not only within a domestic economy, but across borders as well, given the global nature of activities undertaken by the largest FIs. Over the past three decades, efforts to secure global financial stability have focused on enhancing the regulation and supervision of internationally active banks to reduce the likelihood that a systemically important financial institution (SIFI) will fail.[1]

Although effective regulation and supervision increase the resilience of the financial system, they do not eliminate the possibility of failure. The chaos that followed the collapse of Lehman Brothers in September 2008 underscored the importance of having a sound resolution regime in place.[2] In addition to avoiding situations where taxpayers are obliged to provide costly bailouts to support financial stability, orderly failure should be an option in order to maintain the efficiency of the system. A dynamic economy is underpinned, not only by a stable financial system, but also by the process that allows non-viable firms to exit so that resources can be reallocated to more efficient uses. Furthermore, firms that believe they will not be allowed to fail tend to take excessive risks, which introduces inefficiencies prior to non-viability. Hence, a policy framework to deal with SIFIs should include arrangements to allow these entities to fail "safely."[3]

Since the crisis, much work has been undertaken at both the international and domestic levels to develop robust resolution regimes. In Pittsburgh (2009) and Toronto (2010), the G-20 leaders asked the Financial Stability Board (FSB) to develop a regime for effective resolution as part of a broad-based policy framework to deal with SIFIs. The new standards established by the FSB (2011a), the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes) were endorsed by the G-20 leaders in November 2011.

Drawing on the failure of Lehman Brothers in order to illustrate the challenges involved, this report describes the need for a special resolution regime for FIs, especially those that are internationally active. It outlines how implementation of the Key Attributes, which build on proposals by the BCBS (2010) and the International Monetary Fund (IMF 2010), would address these challenges. Since most SIFIs operate across a number of jurisdictions, the Key Attributes take into account the necessity of cross-border co-operation for resolving them. The report discusses the key elements required in such models.

1 Systemically important financial institutions are financial institutions whose distress or failure can have significant adverse impacts on the financial system. The category primarily includes banks, but insurance companies and other FIs and financial market infrastructure are being considered for inclusion as well.

2 Resolution involves any action taken by a national authority, with or without private sector involvement, that is intended to address serious problems in an FI that imperil its viability (BCBS 2010).

3 In addition to establishing robust resolution regimes, certain jurisdictions are also enacting reforms to strengthen their financial infrastructure and to make the interconnections among SIFIs more transparent and easier to monitor. Ongoing policy discussions within international forums are focusing on the adoption of appropriate measures, such as changes to a firm's business practices, structure or organization, where necessary, as a complementary measure to improving the resolution regime.

The Need for Special Resolution Regimes

A resolution regime for FIs must take into account the special roles that they play in the economy. These are to intermediate the movement of funds from savers to borrowers and to provide services that facilitate transactions among participants in the financial system.

To perform the first function, FIs engage in "maturity transformation" by taking deposits and issuing short-term liquid instruments to fund longer-term investments. This transformation creates a situation in which the funding liabilities of FIs can be withdrawn on short notice, while the returns from the assets they hold are only realized over the longer term. Maturity transformation makes FIs vulnerable to simultaneous unexpected withdrawals (or runs), especially in periods of financial stress, when market participants can quickly lose confidence in an FI's ability to repay its liabilities.[4] The implication is that, should such a run cause an FI to fail, resolution of the FI must be undertaken swiftly and in a way that preserves confidence in the financial system.

Financial institutions also provide a range of critical services to the financial system, including, for example, supplying facilities for trading securities as well as such infrastructure-like functions as custodial, clearing, settlement and payment-processing services. These services are essential to the smooth functioning of the financial system; however, they also create interlinkages throughout the financial system through which a shock can propagate and amplify. To minimize disruption to the financial system, a resolution regime must allow for the continuation of such critical functions while minimizing the negative effects.

These imperatives for resolution (speed of implementation, preservation of confidence and continuation of critical services) present challenges for ordinary corporate bankruptcy procedures, which can be lengthy and have uncertain outcomes for stakeholders. Furthermore, such procedures tend to rely on asset liquidation (which is inefficient for resolving an FI) and on stays of payments (which will hamper the provision of critical services).[5] The need for special resolution regimes is most evident in the case of SIFIs, which tend to be highly interconnected throughout the financial system and play prominent roles in financial market infrastructures. Indeed, SIFIs present several unique challenges beyond those experienced in the resolution of smaller FIs. These challenges are vividly illustrated by the failure of Lehman Brothers in September 2008.[6]

Lessons from Lehman Brothers

The Lehman Brothers Group, a multinational financial services firm comprising 2,985 legal entities that operated in 50 countries, failed on 15 September 2008. Following the bankruptcy of the holding company, bankruptcy proceedings were initiated against subsidiaries in various jurisdictions. The collapse of this complex institution highlighted the need for a well-defined resolution regime that incorporates several specific elements to enable the orderly resolution of SIFIs: appropriate scope to resolve all SIFIs, pre-crisis planning, ability to provide liquidity support, and coordination across jurisdictions.

First, the impact of Lehman's failure showed that the *scope of a resolution regime* must capture all FIs that could be systemically important. Historically, the U.S. bank resolution regime was designed for commercial banks that raise retail deposits and have access to the financial safety net (deposit insurance and liquidity provided by the central bank). Hence, the only option for winding down SIFIs that were not classified as chartered banks or organized as bank holding companies (and thus not subject to the resolution authority of the Federal Deposit Insurance Corporation) was a corporate bankruptcy proceeding, which is not designed to address the challenges associated with SIFI failures.

Second, the firm's collapse emphasized the importance of *pre-crisis planning* in minimizing spillovers to other financial market participants, preserving franchise value by ensuring that viable entities continue to have access to critical operations and identifying data required to efficiently wind down the firm.[7] For example, thousands of failed trades might have been avoided if there had been contingency plans in place to permit Lehman's prime-brokerage clients to have access to the collateral held for them by Lehman as their custodian. More broadly, an effective resolution plan might have helped authorities to anticipate and avoid the systemic impact of a disorderly windup of the Lehman holding company.

A third issue that became apparent was the necessity for resolution authorities to have *access to temporary liquidity*. U.S. authorities provided liquidity support to Lehman's U.S. broker-dealer arm, facilitating its orderly resolution through an acquisition by Barclays Capital. In the United Kingdom, however, the lack of public sector liquidity support left Lehman's U.K. affiliates illiquid

4 In many countries, deposit insurance exists to prevent runs by retail depositors; however, runs by wholesale depositors or investors unwilling to roll over short-term funding can be just as destabilizing.

5 The liquidation value of an FI's assets tends to be lower than its fair value, since asset purchasers cannot typically realize on the value of lending relationships, or the "soft" information incorporated in bank loans.

6 See Čihák and Nier (2009); BCBS (2010); and Claessens et al. (2010) for more detailed discussions of recent FI failures, including Lehman's.

7 Lehman's U.S. administrators estimate that at least US$75 billion of value was lost because of the lack of preparation for bankruptcy (Claessens et al. 2010).

because cash that was centrally managed at the parent company became unavailable when the parent filed for bankruptcy.[8] As a result, the resolution of the U.S. broker-dealer was much more orderly than that of the U.K. subsidiaries.

Finally, Lehman's failure highlighted the need for *cross-border coordination*. Lehman was structured such that business lines were lodged in different legal entities around the world. Furthermore, the company maintained a fragmented data system across jurisdictions, so that when various entities were spun off (the U.S. broker-dealer to Barclays, investment banking operations in Asia and continental Europe to Nomura, and the asset-management division in a management buyout), insolvency officials from different jurisdictions had no access to data from these operations. The lack of cross-border co-operation made it difficult to salvage value from Lehman's business lines that were still viable when the company failed.

The Financial Stability Board's Key Attributes

Once they have been implemented, the Key Attributes (FSB 2011a) will contribute to more effective resolution of SIFIs primarily by requiring that every FSB member have a resolution regime that can effect the orderly resolution of each FI within its national borders. The adoption of the FSB's Key Attributes by all members is also a necessary step toward achieving the cross-border co-operation needed to successfully resolve SIFIs.

The Key Attributes define the scope of a resolution regime to include any FI whose failure could be systemically significant. Each jurisdiction is required to have a designated administrative authority responsible for leading and exercising resolution powers, with the objectives of pursuing financial stability, ensuring continuity of important financial services, protecting depositors and avoiding unnecessary destruction of value. Some of the authority's key powers should include the ability to override the rights of shareholders, replace management, operate a bridge institution and enforce losses on senior unsecured creditors (bail-in), where warranted.[9] Recognizing the need for preplanning, the FSB requires an appropriate resolution plan for global SIFIs, whose feasibility would be regularly assessed by regulatory authorities.

The Key Attributes also require that the authorities have the powers and facilities to enable them to meet the need for resolution funding without relying on public ownership or bailout funds. However, temporary public funding may still be needed during a crisis—for example, when private funds are not available or are insufficient to restructure large FIs. Thus, resolution regimes should include provisions to recover from shareholders, creditors and the financial industry the costs of providing such funding, as well as any losses incurred during resolution.

Finally, the Key Attributes empower and encourage domestic authorities to achieve a co-operative solution with foreign authorities in resolving a cross-border FI. As a first step, domestic legislation should not contain provisions for automatic actions (which may preclude the possibility of a coordinated resolution strategy) based on insolvency procedures in the foreign jurisdiction. In addition, there should be ongoing information sharing, particularly in relation to resolution and recovery planning.

Cross-Border Resolution

Cross-border co-operation is a critical element of a robust resolution regime. Existing resolution frameworks are established by national law and, without international co-operation, are enforceable only vis-à-vis the legal entities operating within their own jurisdiction. This has been described in the literature as a *territorial* approach to international co-operation. A disadvantage it poses is that the lack of coordination can increase resolution costs. For example, actions taken by one jurisdiction can impose costs on others by damaging the critical functions of other entities in the group through the loss of liquidity or of access to important infrastructure. A more fundamental disadvantage is that territoriality inhibits financial integration and can lead to fragmented, stand-alone banking units that do not benefit from cross-border economies of scale and scope. At the other extreme would be a *universal* approach, whereby resolution proceedings initiated against a financial group as a whole would be undertaken by a global resolution authority. The universal approach would have the potential to minimize resolution losses in a crisis and, in normal times, could provide efficiencies through financial integration.

The requirement by a global resolution authority that national authorities surrender some of their sovereignty is politically challenging. International work has therefore focused on advancing an *intermediate* approach to co-operation (BCBS 2010; IMF 2010). The objective of such an approach is simple. While acknowledging that individual jurisdictions will act in their own self-interest, it aims to create an environment in which the benefits of co-operating outweigh the benefits of acting unilaterally. Such an environment increases the likelihood that

8 The situation was further complicated in the United Kingdom by the lack of debtor-in-possession (DIP) financing, a special form of financing available in the United States for companies in distress. DIP lenders often receive a "super priority" lien that puts them ahead of even the first lien holders. This offers an incentive for stakeholders to continue to provide credit to a firm during resolution.

9 A bridge institution is one that is temporarily established and operated to acquire some or all of the assets and liabilities of a failed institution until final resolution can be completed.

jurisdictions will co-operate in resolution efforts. In the next section, we describe the key elements required to achieve this: (i) making co-operation feasible; and (ii) enabling the benefits from co-operation to be identified under severe time constraints. These key factors will reduce the divergence of interests among different countries in a crisis and should promote coordinated resolution efforts.

Making co-operation feasible

The first step in promoting co-operation is to establish a forum for the ongoing exchange of information and the coordination of recovery and resolution measures related to each SIFI. The FSB's Key Attributes require that crisis-management groups (CMGs) be established for SIFIs identified by the FSB and the Basel Committee on Banking Supervision as being of *global* importance (G-SIFIs) (FSB 2011b).[10]

To make co-operation possible, any legal impediments must be removed so that each participating jurisdiction has the ability to share information, recognize resolution proceedings and measures undertaken by a SIFI's home authorities, and treat all creditors equally, regardless of their location. At a minimum, as required by the Key Attributes, national resolution regimes should not contain automatic triggers leading to actions that could hamper co-operative measures aimed at stabilizing or resolving a cross-border FI. The European Commission's proposed coordination framework goes further by providing for a temporary stay (of short duration) following the entry into resolution proceedings by two or more of a SIFI's legal entities, during which time the authorities in the host country are not permitted to take unilateral actions that could prejudice the effectiveness of a group-level resolution strategy (EC 2010, 2011).

It is also essential to promote convergence in national regulatory, supervisory and resolution regimes. This is the main focus of the Basel Committee's Capital Accord (2005) and "Core Principles for Effective Banking Supervision" (2011), as well as of the FSB's Key Attributes. It would also be helpful if public sector support facilities available to FIs (lender-of-last-resort and deposit insurance facilities) were compatible across participating jurisdictions.

As a practical matter, procedures for coordination need to be in place for each SIFI. The Key Attributes call for countries with G-SIFIs to establish institution-specific co-operation agreements detailing the procedures for coordination among home and host-country authorities.

Making it easy to identify the benefits of co-operation during a crisis

Co-operation is more likely to occur if the parties are aware of the benefits it offers. This can be partly achieved by adequately preparing for crises via internationally coordinated resolution planning. The Key Attributes require a resolution plan to detail how critical services provided by a firm and its subsidiaries would be maintained during resolution and how the necessary strategies would be financed. As well, the plan would identify any impediments that might arise with respect to these resolution strategies. The plan should also clarify the extent and form of domestic and international co-operation that would be required to implement an efficient group-wide resolution. Authorities should explore when, and how likely, national authorities are to "ring-fence" (so that home authorities no longer have access to the assets located in the jurisdiction of the ring-fenced entity), and what the consequences of that might be for other jurisdictions. To be useful, the resolution plan should be subject to realistic scenario simulations, and reviewed and updated by authorities regularly. The Key Attributes require resolution plans and resolvability assessments to be undertaken and reviewed annually by CMGs for each of the identified global SIFIs.

Information sharing should be mandatory, especially during crises and resolution proceedings, even if such measures are undertaken separately by each national authority for a legal entity in its jurisdiction. To date, the effective exchange of cross-border information has been hampered by two obstacles: (i) confidentiality restrictions limit the ability of authorities to share information, and (ii) the lack of a clear and harmonized understanding across countries of the kind of information that should be shared, its level of detail, who should receive it, and when. Although confidentiality issues are difficult to address, maintaining consistency and clarity around these issues by, for example, establishing minimum standards of information sharing, would be useful.

Setting out principles for burden sharing in advance of a crisis will support the adoption of co-operative resolution actions.[11] In general, authorities are reluctant to commit to such principles during a crisis, but it would be beneficial if they could agree to them in advance, during more tranquil times. While these principles do not necessarily constitute legally binding agreements, they would help national authorities to compare the potential costs of undertaking a coordinated approach to resolution versus taking unilateral actions. These principles

10 A G-SIFI is a systemically important financial institution whose failure is likely to have the most significant impact on the global financial system. The initial list of G-SIFIs published by the FSB on 4 November 2011 will be updated annually. At present, no Canadian bank has been identified as a G-SIFI.

11 Goodhart and Schoenmaker (2009) outline several of the forms that burden-sharing agreements can take.

are not required by the Key Attributes, but the academic literature on cross-border co-operation has identified their value in co-operation models.

In sum, by providing a framework to make co-operation feasible, as well as making it easier for jurisdictions to see the benefit of co-operating in times of crisis, implementation of the Key Attributes will be critical to improving resolution outcomes. Achieving co-operation during a crisis can be challenging, however, especially if the benefits are not evenly distributed across jurisdictions. Even with a well-established framework, attempts at co-operation can fail.[12]

A practical first step to increase the likelihood of successful co-operation is the series of peer reviews that the FSB will undertake of its member jurisdictions' implementation of the Key Attributes. These peer reviews and assessments should provide regulators with more information about whether removing the technical obstacles and creating an environment that enables authorities to see the benefits of co-operating are sufficient to encourage cross-border co-operation in a crisis. In particular, it is hoped that they can help regulators to understand how to manage any divergence in interests that might remain.

12 The experience with the resolution of the Fortis Group is a case in point. The Fortis Group was a financial conglomerate with subsidiaries in Belgium, the Netherlands and Luxembourg that was partially nationalized on 28 September 2008. Although there was an initial coordinated resolution strategy on the table, Fortis was only resolved along national lines in mid-2009, in a protracted process that destroyed franchise value. The reason for this was a divergence of interests, since the Belgian authorities wanted to keep Fortis whole, but the Dutch authorities wanted to return ABN-AMRO (which Fortis had acquired prior to its failure) to Dutch control by divesting it from Fortis. A European Union Memorandum of Understanding (ECB 2008) on cross-border co-operation, signed in June 2008, failed to provide for sufficient co-operation when interests among the national authorities diverged.

Conclusion

Effective resolution is a core component of a policy framework for addressing the problem of financial institutions that are too big to fail. Internationally consistent implementation of the FSB's Key Attributes will contribute to a more effective resolution of SIFIs, primarily by ensuring that members of the FSB have effective resolution regimes in place to implement the orderly resolution of all FIs within their borders. Consistent implementation is also a necessary and important step toward achieving the cross-border co-operation required to effectively resolve SIFIs, by reducing divergence in national interests during a crisis.

The internationally consistent implementation of the Key Attributes is therefore a key priority of the FSB (2011c). To this end, in the second half of 2012, the FSB will initiate the first in a series of peer reviews of its member jurisdictions to assess their implementation of the Key Attributes. Beginning in 2013, the current group of 29 G-SIFIs will also be assessed against the FSB's requirements for CMGs, resolution plans and resolvability assessments. These peer reviews and assessments will be critical inputs into the ongoing work to improve the incentives for cross-border co-operation during a crisis.

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