

Extract: Living wills – how can the concept be implemented (February 2010)

The following extract is taken from a speech by Thomas Huertas on 'Living wills – how can the concept be implemented?' (Wharton School of Management, University of Pennsylvania, 12 February 2010). The original text was read by Simon Morris, Partner in Financial Services at CMS Cameron McKenna, who highlights important details from the speech below.

“... **Recovery plans** are entirely within the scope of the bank itself ... can be implemented fairly quickly and ... will become part and parcel of good management at banks and good supervision by the authorities [and] should lessen the probability that resolution would be required.

Resolution plans are different ... The authorities will choose the method of resolution ... on the basis of information available ... the laws governing the resolution of banks ... how robust payment, clearing and settlement infrastructures would be to the failure of the bank in question .. why create a resolution plan **in advance**?

- First, resolution plans can **assure that the bank** has the capability to generate the information that the authorities would require at the point of intervention.
- Second, resolution plans can **highlight the problems** that infrastructures and other market participants would face, if resolution were required ...
- Finally, resolution plans may highlight that the bank itself has a structure that rules out certain resolution methods and/or makes such resolution methods inordinately costly. This may **require that the firm change** its structure and/or hold supplemental capital and liquidity so as to reduce the probability that resolution would be required.

Conceptually recovery plans **should make it less likely** that a bank will require intervention, and resolution plans should **lower the impact on society**, if intervention is required. This has significant potential implications for the **capital and liquidity requirements** that society should impose on banks, especially large, complex banks ...

... Under a **recovery plan** the bank is forced to think through in advance what it would do if the bank were to fall under extreme stress ... what could the bank do to assure that it continued to maintain adequate capital and adequate liquidity?

Under a **resolution plan**, the bank is asked to plan for how it would provide to the authorities in a timely manner the information the authorities would require in order to make a choice among the resolution methods available to resolve the bank, should resolution be required ...

Living wills focus on solving **bank-specific problems** and on diminishing the probability that the failure of one bank will itself cause others to topple over. Living wills **do not affect systemic problems** that affect all banks, such as sudden changes in interest or exchange rates or sovereign defaults.

Recovery plans

It should be within a bank's control and capacity **to produce a recovery plan in reasonably short order** and to keep it up-to-date. If it is not, management and/or controls at the bank may be deficient, and supervisors would be well advised to have the bank address these more fundamental problems directly and urgently.

Recovery plans build on two things that banks should be doing in any event – **capital planning and liquidity planning** ... [and] ask how the bank would maintain adequate capital and adequate liquidity if the stress turns out to be even greater than postulated ... The options proposed under a recovery plan should be **judged under four criteria**:

- They should be capable of execution within a **reasonably short time frame**, certainly no longer than six months and ideally within three ...
- The ... plan has a reasonable chance of being able to **turn the institution around** ...

- They should be diverse, so that the bank has a **range of options** to choose from ...
- They should be **credible to key stakeholders** – shareholders, debtholders, depositors, counterparties, central banks and supervisors ...

A recovery plan will necessarily require the bank to consider in advance some **tough strategic choices** ...

- **Raising additional capital** ... a recovery plan forces a bank to think through ... generat[ing] additional capital in a time of stress ... Even if the bank does succeed in getting new capital, it is likely to be **very expensive indeed**. Consequently, banks may wish to give greater consideration to raising **contingent capital** whilst they are still some distance from real trouble ... debt or preferred stock [that] converts to core Tier I capital if a certain threshold is passed ... Much needs to be done to develop further the market for contingent capital. Regulators need to establish how the new Basel framework currently under negotiation will treat contingent capital ...
- **Raising additional liquidity** ... Banks are already required to develop a contingency funding plan as part of their normal liquidity management ... [with] a recovery plan, it can be assumed that the bank is already under extreme stress ...
- **Sale or run down of business** ... If the sale of one or more business units is to be part of a credible recovery plan, the bank should be able to demonstrate that the unit in question is **readily saleable** ... [including] the need to obtain shareholder and regulatory approval and the likely time required to obtain such approvals ... Exit via **solvent run-off** from a weak subsidiary business will generally be the best course of action ... it is usually a very bad idea for a major international bank even to **contemplate walking away** from a wholly owned bank subsidiary.
- **Running down the book** ... banks will want to give particular attention to how quickly cash can be generated from various businesses, if the bank shifts from normal business more toward a run-off mode ...
- **Sale of the entire business** ... the recovery plan should give some consideration as to whether the entire business could be sold to a third party ... Two additional issues stand out – antitrust and completion risk ...

Resolution plans

... resolution plans ... ask banks to make preparations ... to **furnish at short notice information** ... [to] enable the **authorities to choose** among the resolution options ... [so] the authorities can reduce or possibly even eliminate the possibility that the intervention/resolution of a troubled bank would require **the injection of taxpayer funds and/or the extension of government guarantees** ...

If the ... bank's preliminary **information reveals that taxpayer support** is likely to be the only method of resolving the bank, were the bank to require intervention, there are broadly [approaches]

- Changes in the way the **bank is structured**, so that resolution could be achieved without taxpayer support.
- Changes in **law and/or regulation** so that resolution does not require taxpayer support.
- Increases in **capital and liquidity** requirements so as to reduce the probability that intervention would be required.

Resolution methods

Broadly speaking there are four resolution methods open to the authorities in dealing with a troubled bank:

- **Early equity injection** ... This is effectively the method that the authorities used many times during the crisis but wish to avoid using again. Under this method the troubled bank issues new equity to the government ... [and] may receive liquidity assistance from the central bank ... government support assures that the troubled bank will not fail and therefore assures that the troubled bank will not harm counterparties or cause wider social damage. But such assistance has both **immediate and long-run costs** ... The longer run costs are potentially even larger. By aiding troubled banks in this fashion, governments run the risk of confirming the market's expectation that certain banks are 'too big' or 'too interconnected' to fail. This reduces the incentives of market participants to demand a higher spread from banks that run a higher risk of failure ...
- **Share transfer order (including temporary public ownership)** ... the authorities may intervene (usually upon a finding by the bank's supervisor that the bank no longer meets threshold conditions or fulfils minimum regulatory requirements) to order that the shares of the bank be transferred, either to a third party or to the government at a price determined in the transfer order. Usually this transfer price will be negligible ... [this] effectively amounts to placing the troubled bank into temporary public ownership ... [this] has **some immediate advantages** but also **poses immediate problems**. The advantage is lower initial cost. In contrast to the injection of new equity, there is no immediate outlay of taxpayer funds. However, for the institution to continue in operation, it will in all likelihood **require a government guarantee** of some or all of its liabilities for some period of time ... The direct costs are the losses that the government might have to bear, if the assets of the bank are insufficient to pay off the liabilities that the government has guaranteed. The indirect costs are twofold ... the market is likely to assume that liabilities that are guaranteed in the case of one bank resolution are likely to be guaranteed again ... reduc[ing] the market

discipline that the investors in such liabilities would otherwise provide to banks. The second indirect cost is the potential deterioration in the sovereign's own credit rating and potential increase in the government's own borrowing costs ...

- **Deposit transfer/bridge bank** ... the authorities sell the bank's deposit book to a third party. The deposit liabilities are matched either with good assets from the bank's portfolio or with cash ... Under a bridge bank, certain assets and liabilities of the troubled bank are placed into a new institution that will continue ... whilst other assets and liabilities are left behind in a rump to be liquidated over time ... Such solutions **limit the cost to government and increase market discipline**. Although the government ... may need to extend a credit to the estate of the failed bank to provide the cash necessary to match the deposit liabilities, [it] need not make any investment in the failed bank nor ... provide any guarantee to the deposits transferred or the liabilities transferred into the bridge bank. Creditors of the bank, especially capital providers ... will be certainly be exposed to loss ... [this] will make investors wary that the authorities could impose such losses in the case of other banks ... and will 'encourage the others' to become more careful in the future. [This] may have **significant short-run costs** ... stemming from the assets and/or liabilities 'left behind' in the rump [that] effectively go into liquidation. Assets suffer an immediate loss of value; and liabilities are frozen ... If liabilities to other counterparties become frozen, that can adversely affect the liquidity and/or capital of those counterparties. That could cause a **chain reaction** ... Obligations of the failed bank to payment, clearing and settlement infrastructures are particularly important ... If the failed bank had a significant share of the market for credit to small to medium sized enterprises and/or unsecured consumer credit, suddenly shutting off such credit facilities could have seriously adverse macroeconomic consequences ...
- **Liquidation/deposit pay-off** ... Under this approach the failed bank is put into liquidation. Not only does the failed bank's credit machinery stop, but its deposit accounts cease. Under this solution, the **deposit-guarantee fund moves promptly** to pay off the insured depositors, who in turn redeposit their funds at other banks. Such a solution is only viable, if the deposit guarantee fund is in a position to pay out the insured deposits promptly. Making large numbers of customers wait any more than a few days to regain access to their funds is likely to undermine the confidence of the public in the deposit guarantee scheme itself. If such confidence were lost, widespread panic could result. [Avoiding this requires] **prompt access to information** from the failed bank about the amount of insured deposits and the identity of the depositors ... Capacity of other banks to open new accounts and accept new deposits within a very short period of time is also an issue ... [this] may require the government or central bank to **extend a very large credit to the deposit guarantee scheme** ... potentially a very large immediate addition to the public sector borrowing requirement ... [and levies may] themselves weaken the remaining banks to the point where one or more of them also require intervention/resolution ...

Making a decision

... the **longest period of time** that the authorities are likely to have to make a decision is the roughly 36 to 48 hours between the close of business on a Friday in Europe and North America and the opening of markets in Asia when it is still Sunday evening in North America. To make such decisions in that time frame the authorities **must have information** on which to base the decision and a framework for making the decision ... This includes the legal vehicle structure of the banking group, a mapping of its principal businesses against that legal vehicle structure and identification of financial and operational dependencies among various elements of the group. It also includes information concerning the bank's membership in payments, clearing and settlement infrastructures, information concerning the segregation of client assets and the procedures by which such segregated client assets could be transferred to third parties. Finally, the authorities will need information concerning the bank's deposit base: what is insured and what is not, as well as what is the maturity structure, terms and conditions of the deposits. This is exactly the information that the **resolution plan requires** the bank to be able to generate at short notice for the authorities ...

... the authorities will also need to assure that they have to hand information from the **infrastructures and deposit guarantee schemes** of which the bank is a member ...

... Are businesses **easily separable**, in that they are exclusively or predominantly booked in separate legal vehicles, where the sale of stock in the legal vehicle effectively constitutes a sale of the business? Or are the bank's businesses **booked across a variety of legal vehicles**, so that each legal vehicle contains many businesses, and each business is booked in many legal vehicles? The former allows for **easier and more rapid sale** of separate businesses to third parties; the latter does not, and may imply that groups with such structures would **need higher capital and/or liquidity requirements** to assure that they remain further away from the point of intervention/resolution.

The authorities are also likely to pay particular attention to the arrangements that the firm has in place for the **segregation of client assets** and the measures that could be taken to transfer such assets to third parties at short notice. If clients lose access to their funds whilst the troubled bank is being resolved, this poses liquidity issues for the client and exposes the client to the risk of market losses whilst the client is unable to trade the instruments frozen at the firm in resolution ...

... **communication** is an important aspect of resolution plans, before, during and after a decision is made, with respect to the resolution of a large, systemically important banking group.

... Moody's has already alerted investors to the fact that resolution plans 'would remove the necessity to support banks as banks would no longer be too interconnected or complex to fail. This could potentially result in **ratings downgrades** where ratings currently incorporate a high degree of government support'.

Ideally, the authorities would be able to devise a resolution method that would allow for maximum continuity in customer-related activities whilst assuring that capital providers remained exposed to loss and avoiding the need to give widespread

or long lasting guarantees of the bank's liabilities. This would avoid the problems that arise from abruptly unplugging a bank from payments, clearing and settlement infrastructures. It would also allow for deposit accounts to be maintained, and revolving credit arrangements to continue functioning. In effect, such a solution would amount to an accelerated, but solvent wind down of the bank through rapid sales of certain aspects of the bank's activities to third parties and through a rapid reduction in certain activities. That would leave customers largely unaffected, but impose losses on investors/capital providers. This is much more likely to be the case if critical portions of the institution can be kept as going concerns for even a few days.

[ideal are] **methods that would allow** the authorities to keep an institution as a going concern whilst they took measures to limit the exposure of infrastructures to the troubled institution, measures to transfer client money to third parties, and measures to carve out and sell portions of the enterprise to third parties."



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