SPEECH

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How do you resolve a bank in distress? *

A hot topic

The new regulations for banks around the world, what are known as Basel III, are now more or less in place after two years of intense negotiation. When the regulations have been fully implemented, which will require a few years of adjustment, we will have a banking system with more capital, better capital and better liquidity than prior to the recent crisis. The idea is that resilience to future shocks will be much better than it was when Lehman Brothers experienced problems in autumn 2008.

This winter, work began in the new European Systemic Risk Board, where central bank governors and heads of supervisory bodies will discuss the risk of future financial crises, and issue warnings when they see that risks are building up in some part of the financial system or in a particular country. Here too, the idea is to try to alleviate the effects of crises, primarily by being able to detect them in time.

But everyone is aware that, despite new regulations and increased focus on systemic risk, bank crises will nevertheless occur again in the future. And when a crisis does happen, it is important to have in place legislation that can manage it without taxpayers having to foot the bill. The experiences gained in 2007-2009 unfortunately revealed that many countries lacked adequate legislation in this field. The UK realised this when they tried to solve the problems at Northern Rock.

Internationally, both the G20 and the EU are now paying considerable attention to the question of how to resolve banks in an orderly manner. While the past two years have been used to discuss how to avoid crises and to draw up regulations that will assist this work, the focus in the coming years will be on how crises should be managed if they nevertheless occur.

Preferably, we should allow a bank in distress to go into bankruptcy just like any other company. Then the taxpayers don't need to be involved. But in practice this often proves difficult with regard to banks, especially if they are large and important to the functioning of the financial system. For example, the han-

* I would like to thank Erik Lenntorp for his assistance with this speech.

dling of Lehman Brothers, which was allowed to go bankrupt, led to catastrophic consequences around the world.

For this reason a number of banks around the world were saved and allowed to carry on operating, and taxpayers had to pay dearly for this (though not in Sweden). In a normal bankruptcy it is firstly shareholders and then creditors (usually bondholders and other banks) who suffer losses. But if a bank is saved from bankruptcy, then its creditors and also sometimes its shareholders are saved from losses, at least partly. Instead, the taxpayers suffer. This is clearly wrong.

What we need is legislation for banks that cannot be allowed to go bankrupt like ordinary companies, which ensures that shareholders and creditors will foot the bill if the bank is mismanaged and becomes insolvent. Such legislation would also have an important preventive effect. If owners and creditors know that the state will not protect them from losses, this increases their incentive to ensure the bank does not take excessive risks. In other words, the situation is more like that for normal companies.

One of the hot topics this spring, both in Sweden and abroad, is thus how to resolve banks in distress. And this is what I intend to discuss today. In this context, let me point out that the views I am expressing here are my own, and are not necessarily shared by my colleagues on the Executive Board.

Why can't a bank go bankrupt?

But why can’t we let banks go bankrupt like other companies? The reasons are as follows. Bankruptcy in a company means that operations are put on the backburner and payments are stopped while waiting for a receiver to determine the value of the assets and then distribute them between creditors and, if there is anything left over, between shareholders. If the company sells bookkeeping services or builds mopeds this works fairly well. It is more difficult with a bank. If a bank goes bankrupt and ceases payments it is not only shareholders and creditors who are affected. The bank’s customers are also affected, both companies and individuals, as they will not receive their salary or any payments made into their accounts, and they will not be able to pay their bills, take out cash from ATMs, and so on. The consequences are greater and affect so many more people than if an ordinary company defaults on its payments. And the larger the bank, that is, the more customers and important functions it has, the larger the problems will be.

In addition, banks often have many transactions with other banks in the country, which means that problems in one bank can easily spread to others. If one bank is unable to pay another bank what it has borrowed, perhaps even overnight, the other bank will not be able to pay its lenders either, and the problems will grow. If a large bank that is important to the financial system – what is usually referred to as a systemically-important bank – defaults on its payments, we could in a worst case scenario see the rapid collapse of the financial system. This was essentially what happened during the most recent banking crisis.

Now it is no longer merely the case that banks are more important than many other companies in ensuring that society functions smoothly; they are also more sensitive. Their main task in society is to lend money to companies and households, and this lending is often long-term and the money cannot be regained at short notice. However, their funding consists to a large extent of short-term market funding and deposits from the general public, which they can withdraw immediately if they wish. It only needs a rumour that a bank is suffering problems for a crisis to break out. If confidence in the bank disappears, it will be unable to fund its operations and may be forced to default on payments even before it is formally declared insolvent. Market agents and depositors who are uncertain about whether the bank is stable may choose to withdraw their money – or at least try to do so. And as the bank is unable to get back what it has lent as quickly, the consequences will be severe. You may remember the TV images of customers queuing outside Northern Rock's branches to withdraw their money at the beginning of the crisis? The point here is that the process of defaulting on payments goes much more quickly for a bank than an ordinary company.

It is thus the combination of the banks' central importance to a functioning society and their particular sensitivity towards shocks that means they need special treatment. A normal bankruptcy in a systemically-important bank will affect too many people and the management of this process moves far too slowly. It is therefore necessary in practice to allow a systemically-important bank to carry on in one form or another, at least for a period of time. We need legislation that can deal with this – otherwise the taxpayers will be the ones who must ultimately foot the bill. Small banks that are less important to the system as a whole may be allowed to go bankrupt sometimes, but this is not always a simple matter, either. I shall return to this shortly.

What should suitable legislation entail?

If the traditional bankruptcy legislation is not appropriate for banks, what kind of legislation would be suitable? Some form of consensus is now being reached in the international discussions. Without going into too much detail – although details are important given all of the legal issues involved – I believe that such legislation should include the following components.

Speed is essential

As I said, confidence in a bank can disappear even before it is declared insolvent. It is therefore important to intervene at an early stage if you want the bank to survive. One could intervene as soon as a bank does not fulfil the conditions for its licence. But one should also have the possibility to take measures where necessary to counteract the risk of a serious disruption to the financial system.

A rapid intervention then needs to be followed by a rapid procedure. This means that it ought to be handled by an authority and not by a court of law. The regulations for how such an authority should function are an important factor in determining how banks should be resolved.

When the state intervenes in private business, there is always a risk that this will lead to a conflict with the private ownership. And when the intervention is at an early stage, the conflict could be particularly difficult. There are many examples throughout history of governments wrongfully taking control over private property. We therefore need to have a reasonable legislative protection for shareholders and creditors. But this protection should not mean that the owners profit from the state measures or that they can delay the crisis management process. The owners therefore should not have the right to stop the authority's measures. However, they should have the right to financial compensation afterwards – if there is just cause for this.

Special tools are needed

One solution that is often effective is to find a buyer or to arrange a merger with another stronger company. In this way, business can carry on without any serious disruption. The authority responsible for resolution (as representative of the state) may need to issue guarantees for impaired assets or to hive off certain operations to get the sale off the ground. This would often entail a cost to the state, but given that this cost is lower than the cost to society of letting a bank fail, it should be acceptable. If there is a special fund for this purpose, to which the banks have contributed capital, the cost need not affect taxpayers.

The authority needs to have power of authority over transfer of the bank's assets, liabilities, shares and contracts. This is without breaking any contracts. Experiences from the United States in particular have shown that one may need to have the possibility to give certain creditors preferential treatment. However, the idea is not to protect any creditor from the consequences of a bankruptcy. The reason for possible preferential treatment is that it may increase the opportunity to carry on running the parts of a bank worth protecting, while the rest is allowed to go bankrupt. The possibility of preferential treatment for some creditors should be used restrictively, however, and only on condition that no creditor is worse-off than if the bank went bankrupt.

Such powers of authority would help the authority along the path to resolving the bank's crisis. For instance, one can transfer suitable assets and contracts to a new bank, often called a bridge bank, which can then be sold. The "healthy" bank can then receive a reasonable capitalisation and a more transparent asset portfolio. The unhealthy bank can then be liquidated in its own time. In principle, these divisions into a good and a bad bank were used to resolve the Swedish banking crisis in the 1990s. But it is evident that such a significant restructuring will often take time.

During the period a bank is in resolution, it may be difficult for it to obtain funding. The authority must therefore be able to secure the bank's funding. This can be arranged in slightly different ways; one is that the authority is given permission to guarantee new loans. It is also important that the authority is not limited by any general suspension of payments for the bank. The authority should be able to decide on what payments will be made and in doing so take into account not only the bank's creditors and shareholders, but also the effects on the financial system as a whole.

If nothing else works, the state must take over

In some situations it may be so that the uncertainty regarding the bank's financial position needs to be removed so quickly that there is no time for a sale or other form of orderly resolution. The state must instead have the possibility to take over the bank and inject the necessary capital.

One problem with this form of "nationalisation" has previously been that it is believed to be in contravention of the European Convention on Human Rights.

As previously pointed out, the state may not confiscate private property without paying compensation. But nor can it be reasonable for the banks' owners to earn money from government rescue operations. Nevertheless, this has happened in a number of cases when the state has rescued banks. The final result has then been that the shareholders have been able to keep a lot more of their money than they would have done if the bank had gone bankrupt.

"Bail-in" – ideas to make creditors contribute

Of course, the best thing would be if one could avoid the state taking over banks. But then one has to find other means of improving the capital situation for a bank in distress if it is to survive – and this is the whole point. One alternative is to write off some of the bond loans or convert them into shares. Neither conversion nor writing-off debts is essentially a new idea. These methods are often used in negotiations with creditors in normal bankruptcies and perhaps most of all with regard to company reorganisation. The new element here is that they could be used for banks, too, and outside of the normal procedure for bankruptcy or company reorganisation.

At present there are intensive discussions as to how one could persuade bond holders and other creditors to contribute when a bank is in distress. Internationally, the ideas along these lines are known as "bail-in", in contrast to a tax-funded "bail-out". The EU, the Basel Committee and the Financial Stability Board of the G20 are considering how to develop the "bail-in" concept.

One possibility would be to give the responsible authority the right to write off debts. Given the alternative, this does not appear unreasonable at all. If the bank had been allowed to go bankrupt, the creditors would probably not have got back the money they had lent. One can see writing-off debts as a means of simulating a bankruptcy in the cases where the bank is allowed to survive. What one wins here is that the bank improves its capital situation at the same time as the creditors must bear their share of the losses. But it is of course important not to write off debts without first writing off shareholders' equity – it is the shareholders who should primarily bear the losses.

Writing off or converting debts in a bank at the initiative of an authority would be in breach of most (if not all) bond contracts. We therefore need clearer rules regarding what circumstances should apply here. If investors feel uncertain as to what rules apply, they probably will not want to buy any bank bonds. It is the shaping of these rules that is now under discussion.

There actually exist special bonds now, where it is stated clearly in the contract that they will be automatically converted into shares in certain situations, for instance, if the bank's capital adequacy falls below a certain level. These are usually called co-co bonds, with co-co standing for "contingent convertible". Co-cos are traded on the market just like other bonds. The pricing reflects the market's assessment of the risk of a conversion. So far, only small quantities of co-cos have been issued, and by banks with very strong capital. The discussions in government circles concern whether banks should be forced, or at least given strong incentive, to issue a certain amount of this type of bond. Whether investors in the market would be willing to buy them in any great quantity remains to be seen.

This may sound simple, but there are problems involved. If investors suspect that a conversion or write-off is approaching, the rational action would be to try to sell their bonds. If a lot of them do so, the price could fall rapidly, which could in itself be enough to cause the bank to fail. A "bail-in" could thus entail an inherent negative dynamic that could have serious consequences in vulnerable situations. There are still problems in this area that need to be resolved.

And what happens in reality?

There are thus many ideas and here and there the beginnings of a consensus on new legislation for how banks should be resolved. But what happens in reality? As a direct consequence of the crisis, new laws have been passed or are being planned in a number of countries. It is particularly interesting to see what has been done in the United States and the United Kingdom, and how this work stands up against the principles for resolving banks that I have outlined here. It is also interesting to make a comparison with the Swedish Support to Credit Institutions Act, which was drawn up at very short notice at the beginning of the crisis in 2008, and with the ideas the European Commission recently put forward regarding future European legislation on banks in distress.

The US legislation - Dodd Frank

The United States has long had a regulatory framework that gives their deposit guarantee authority, the Federal Deposit Insurance Corporation (FDIC), the possibility to manage a bank in distress in a way that means the losses are borne by owners and creditors. The legislation gives the FDIC far-reaching powers of authority to sell, liquidate and restructure a bank. The FDIC also has the opportunity to give certain creditors preferential treatment, on condition that no creditor has a poorer outcome than if the bank went bankrupt.

The FDIC has applied the regulations in many cases, but primarily with regard to small banks. But with the new Dodd Frank Wall Street Reform and Consumer Protection Act, the regulatory framework has developed further to enable the management of situations where the financial system is under threat. Moreover, the FDIC has received powers of authority to manage other types of financial company than banks.

The United States has long been regarded as a leading country with regard to sensible regulations for managing banks in distress. It is therefore no surprise that the US regulations stand up well in a comparison of the components that should be included in appropriate legislation that I just listed. But the FDIC is not allowed to buy shares in a bank. The reason is that the new regulatory framework is considered sufficient and that there is thus no need for the state to go in as owner. As we all know, state ownership is a sensitive issue in the United States.[1]

[1] Nevertheless, during the crisis the authorities in the United States were forced to intervene and take fairly substantial ownership stakes in several large institutions, at least temporarily.

The British legislation

The United Kingdom has introduced a special act for resolving banks, the "Special Resolution Regime" (SRR), as part of the "Banking Act 2009". The act also contains a special bankruptcy procedure for banks in general, the "Bank Insolvency Procedure" (BIP).

According to the British laws, a bank can be put under the special legislation (SRR) if it does not meet the requirements for its bank licence – or can be assumed not to do so. The word "assume" is important, as it gives the authorities the possibility to intervene proactively, which actually means before it is too late. The law gives the authorities the right to transfer assets, liabilities and contracts from the bank, as well as shares from the owners, to either a private or public-owned company. It also gives the authorities the possibility to give preferential treatment to certain creditors, given that no one is worse off than they would be in a bankruptcy.

The British act also specifies several public interests[2] that must be under threat to allow the tools in the act to be used. What is special about this act is that it specifies different conditions for different tools. The special bankruptcy procedure (BIP) can always be used. But to be allowed to use the tools in SRR to sell a bank, for instance, or to transfer parts of it to a bridge bank, one must show that this is necessary to protect at least one of the stated public interests. The state can also temporarily take over a bank, but in this case there must be a serious threat to financial stability.

In total, thus, the toolbox provided by the new British legislation appears to agree well with the toolbox I outlined earlier. It is also interesting that the act stipulates that loans and collateral may not be separated, for instance, by putting collateral in the good bank and loans in the bad bank. Some assets and liabilities can also be sold off as a priority to prevent the spread of problems to other banks – the result of dearly bought experience from the Lehman Brothers crash.

The Swedish Support to Credit Institutions Act

In Sweden we gained an act in 2008 that gives the government and the Swedish National Debt Office a broad mandate for dealing with situations where the financial system is under threat. This act was primarily created to manage a systemic crisis, although it does to some extent refer to managing banks in distress. This means that the act is less detailed than the more specific bankruptcy regulations in the United States and United Kingdom with regard to what can be done, and not least, how it should be done. This of course gives some flexibility, but the flip side of the coin is that there is uncertainty regarding what actually applies.

The act states that support can be provided in various forms. The institution or its assets and liabilities can be taken over by another institution, the institution

[2] The public interests specified in the legislation in brief concern maintaining financial stability, maintaining confidence in the banking sector, protecting depositors and taxpayers and avoiding conflicts with the European Convention for Human Rights.

can be recapitalised with state funds or liquidated in an orderly manner. There is also a possibility for an institution to receive liquidity assistance from the state or for the support authority to issue guarantees.

Support will primarily be given by means of the support authority and the company, or its owners, reaching agreement in a voluntary contract. But if this is not possible, the act also offers some opportunity for the state to enforce an agreement or certain conditions on a bank. This is on condition that the Credit Institutions Support Approval Commission, a special court, finds the agreement or conditions legitimate.

European Commission's consultative paper

I will now say a few words about what is happening in the EU. At present there is no harmonised legislation on crisis management in Europe. In some countries there is special legislation for banks, while others rely on the normal bankruptcy procedure.

The Commission is currently working on producing guidelines for managing banking crises. The starting point for these is that the resolution of banks should ensure that both shareholders and creditors bear any losses. The Commission's consultative paper proposes that the EU member states should have legislation that enables a bank's assets, liabilities, shares and contracts to be transferred. The Commission also appears to be leaning towards creditors being able to receive preferential treatment, provided that no one then suffers a poorer outcome than in the event of a bankruptcy. One can essentially say that the proposed EU framework appears, at least so far, to be in line with the principles for suitable legislation that I discussed earlier.

Although much of this is good, there are some elements in the Commission's proposals that I have doubts about. One example is the proposal that the financial supervisory authority should be able to appoint what is known as a special manager. This special manager would take control over the bank before it meets the conditions for resolution. This may sound good, but the problem is that it should be the shareholders' job to steer the boat in the right direction, not the state's. It is only when the shareholders do not succeed that the state should intervene and the resolution process can begin. In this way, there is a clear delimitation between the shareholders' responsibility and the state's responsibility. Having a special manager would make the boundaries less clear. As I see it, it should be crystal clear that the day the state intervenes is the day the shareholders' money, and control, is forfeit.

The Commission's proposal for an EU framework does not contain any tools for a state takeover. However, there are other EU regulations governing how states should give support to private operations. During the crisis, special exemptions were introduced in the regulations regarding state support with regard to banks. But clear regulations regarding state takeovers of banks are a question that has been avoided so far in Brussels.

Similarities and differences in regulatory frameworks

It would appear that if all of the four regulatory structures can manage the most important problem, namely resolving a bank so that the shareholders are the ones affected most, and not the taxpayers. But there are differences, and I would like to take up three of them, namely the way creditors are treated, how views differ regarding state takeovers, and how small banks are treated.

I shall begin with creditors. In the United States and the United Kingdom it is possible to allow creditors to bear losses to a greater extent than in Sweden. This is because these countries have clear regulations making it possible to divide up a bank and leave some creditors in the old bank (or the bad bank). The Swedish act, on the other hand, does not contain any provisions for this, which can make it more difficult to resolve a crisis and to allow creditors to bear the losses.

Then we have the role of the state as potential owner of a bank. State takeovers are a sensitive issue in the United States and in the EU, where they don't even want to discuss this possibility. I think this is unfortunate and it also lacks credibility. All experience, not least from the crisis we have recently lived through, and not least from the United States and Europe, points to the fact that it is sometimes necessary for the state to take over banks. It is then better to have regulations on how to do this, rather than to deny the possibility of it happening.

Finally, we come to the views on small banks in distress. Here, Sweden and our Support to Credit Institutions stand out. Our act is only applicable when there is a threat to the system. In the United States, on the other hand, the regulations are applicable to all banks, while in the United Kingdom they have chosen to specify which public interests must be threatened for most of the tools in the SRR to be applicable. However, this structure means that measures within the SRR may also apply to a bank that is not systemically-important. Moreover, the specially-adapted bankruptcy procedure applies to banks in general and in all situations. As it is we in Sweden who differ with regard to the possibility of managing small banks, I will discuss this in greater detail.

How should we handle small banks?

Most people now appear to agree that large, systemically-important banks cannot be liquidated according to traditional bankruptcy procedure. But what about small banks that are distressed? Can't they be liquidated in the good old-fashioned way, just like ordinary companies? The answer is that they probably can, in many cases. They are not important to the functioning of the financial system and therefore should not need to be liquidated with the aid of any special legislation. As we all know, it is always wise to be cautious in making exceptions.

Nevertheless, countries such as the United States and United Kingdom have introduced legislation that is to apply to all banks, both large and small. And I believe there are fairly good reasons for doing so.

One important reason is that in real situations it may be very difficult to determine whether or not a bank is systemically important. This is because one must make an assessment of the risks that a failure might have contagion effects. In Sweden, both Kaupthing and Carnegie were assessed as systemically-important in autumn 2008, quite simply because the situation in the Baltic countries had spread uncertainty concerning the entire Swedish financial system. If depositors had begun to queue outside Kaupthing and Carnegie, the doubts could have spread to Latvia and Lithuania – and not least to London and New York, where the major Swedish banks obtain a lot of their funding. One could say that the mood was rather strained. When HQ Bank suffered problems in 2010 the mood was quite different, and the contagion risks were assessed as slight. HQ Bank was therefore not assessed as systemically important, although there was some concern as to how deposits in other small banks might be affected.

The point is that systemic importance is not always so easy to determine, and that it is certainly not merely related to the size of the bank. An assessment needs to be made in each individual case, and each assessment contains some measure of discretion. But when a bank is liquidated there can be considerable differences in the consequences for customers, creditors and other associates depending on whether one uses a bank-specific or a traditional bankruptcy procedure. And it may feel uncomfortable if the consequences have to be so dependent on a particular situation and on assessments that are far from self-evident. This points in favour of a general legislation that can be applied to all banks.

The fact that the consequences differ to much depending on which means of liquidation is chosen is of course due to the banks' operations being so special in many respects. A traditional bankruptcy procedure involves a suspension of payments. But even in the case of a small bank, a suspension of payments can have major consequences, often much greater than in a normal company. A suspension of payments is quite simply not such a good idea in companies where payments are the mainstay of their business. It often reduces the value of a bank much more than a suspension of payments in an ordinary company. If one can avoid a long interruption to the bank's operations, the costs will be much lower. And here I am not talking about the shareholders' money, but about the costs that affect the banks' customers and business partners and, not least, the deposit guarantee. It is quite simply economically-efficient, even in the case of small banks, to use a bankruptcy procedure specially-adapted to banks. It is primarily this insight that has persuaded the Americans and the Brits to introduce such a procedure.

Further exciting discussions remain

At present there is a lot going on with regard to the resolution of banks in distress. All over the world, views on these issues have changed since the crisis. In Sweden, too, we now have a committee that has been given the task of considering how the Swedish act can be adjusted. And in Europe the discussions will gradually intensify over the coming year.

If resolving banks is a complicated and controversial process in itself, it is not made simpler when the banks have cross-border operations. This also means that it is important that the legislation in different countries is reasonably compatible, which has not previously been the case, not world-wide and not even within Europe. The Commission's work may be an important step on the right road, but it is only one step. The really big problems begin when we try to reach agreement on how to divide up the costs of resolution between different countries. But this is so exciting, that I thought I would save it for another speech.