

CRISIS MANAGEMENT – THE ROLE OF THE RESOLUTION REGIME¹

1. RESOLUTION REGIME WILL INFLUENCE OTHER BANK REGULATION

Bank regulation should be based on backward induction. It means that we must not confound the timing of events and the logic of incentives. Of course supervision will precede crisis management, which in turn would precede bank resolution. But the importance of resolution regime lies not least in its incentives for bank behaviour, which in turn has implications for how supervision and crisis management should be set up.

2. NORMAL BANKRUPTCY IS NOT ALWAYS AN OPTION FOR BANKS

Why are we reluctant to let a bank go bankrupt, like any other corporation?

Banks, at least of a certain size, are often systemically important. This is because the payment system is crucial to the modern economy, and because banks are tightly interconnected.

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¹ „Although the views expressed here are not very controversial, they are mine and do not necessarily represent those of my colleagues or the official policy of Sveriges Riksbank” [Lars Nyberg].

Banks are not only more important to the overall economy than other firms – they are also more vulnerable. This is mainly because banks' lending is long-term, while the financing is mostly short-term. Even rumours about problems may induce creditors to retrieve their money almost immediately.

A bankruptcy implies that payments are suspended, pending an investigation of assets and their distribution among creditors. But for the reasons mentioned above, suspending a bank's payments can have severe effects on the overall economy.

The combination of a pivotal role and a special sensitivity of banks make it necessary with a special framework for handling banks in trouble. While banks are more strictly regulated and supervised than most other firms, we cannot rule out problems. When that happens, policymakers and regulators may have to let a systemically important bank live on, at least for a while. That may apply also to small banks.

3. WE NEED A LEGAL FRAMEWORK FOR DISTRESSED BANKS

Policymakers and regulators must have the power to intervene on time. 'On time' means as soon as banks do not measure up to the legal standards, or even before that.

The need for swift intervention implies that governmental authorities, rather than courts, should handle the matters. Needless to say, shareholders and creditors must have a legal protection. However, the government's intervention must not be delayed, and owners must not benefit from it. Therefore the protection should be in form of an *ex post* compensation – should such a compensation be judged appropriate.

4. THE AUTHORITIES NEED APPROPRIATE TOOLS

The authorities dealing with bank recovery and resolutions need appropriate tools.

It is often efficient to find a buyer or a stronger player willing to merge with the distressed bank. Such a sale may require government guarantees for certain assets or divestitures of some activities. In some cases, minimizing costs to the public purse may require preferential treatment of some creditors. The authorities may need that mandate. However, it should be applied with restriction and only when it does not hurt other creditors more than a bankruptcy.

With this mandate, an authority may for example split up banks into a good and a bad bank. The good bank, or bridge bank, could then live on and be sold. Such a separation helped solve the Swedish banking crisis in the early 1990s.

The authorities also need the ability to secure the financing of the distressed institution. They should not be encumbered by a general payment restriction. Payments must be allowed, taking into consideration not only shareholders and creditors, but the whole financial system. In some situations, the government must eliminate all uncertainty by nationalizing the bank and then recapitalize it.

As is known, in recent years policymakers have been rather busy coming up with new solutions to strengthen the resilience of individual banks and the financial system. National inquiries, EU, the Basel committee and the G 20 Financial Stability Board are all considering ways of making creditors contribute to troubled banks, in an orderly fashion. One important idea is the so-called *bail-in bonds* – debt instruments that are junior to other debt and that can be written down immediately after equity. Another idea is so-called *CoCos* – bonds that can be converted into capital, for example when the equity ratio has fallen below a certain threshold – either automatically or based on supervisory judgment.

However, there are important considerations to be made before implementing such instruments. Suffice it to say that rules have to be thought through and transparent, in order to avoid unintended effects.

5. THE CRISIS HAS SPURRED REGULATORY INITIATIVES

The experience since 2008 has triggered regulatory initiatives worldwide. First, we see a development of national regulation. The Dodd-Frank Act in the United States is perhaps the most comprehensive and well-known, but similar work is going on also for instance in the EU Commission and in the United Kingdom. Another strand of regulation is the development of regulation and resolution tools for large, systemically important and complex financial institutions. This work is underway both nationally and internationally.

6. RECOVERY AND RESOLUTION PLANS SHOULD FACILITATE ORDERLY CRISIS MANAGEMENT

An important outcome of the regulatory work are RRP – recovery and resolution plans. They are currently under development in many countries. *Recovery plans* serve as a guide to distressed banks while they are still under control of management. They include plans to conserve capital and liquidity, divest businesses, restructure liabilities, and so on. Recovery plans are written by banks, and reviewed by the supervisor. *Resolution plans* guide authorities on how to resolve banks if recovery fails. They address systemic activities, legal and business structures, cross-border issues, vital IT systems, etcetera. Resolution plans are

written by authorities (home and host) on the basis of information provided by banks. SIFIs lacking a credible RRP could be subject to regulatory sanctions, as suggested for instance by the Vickers commission in the UK. The Basel Committee and FSB will be requiring G-SIBs – global systemically important banks – to have a framework for crisis management in place. These are all important steps. However, RRP's are unlikely to be a panacea.

7. INTERNATIONAL BANKING REQUIRES ADDRESSING CROSS-BORDER RESOLUTION

Over the last decades, banking has become a truly global business. When virtually all major banks have international operations, cross-border issues have to be an integral part of resolution planning. It is not necessary to dwell on Fortis or Icesave to make the point.

Therefore, cross-border issues must be integral to resolution planning. All countries need a national crisis management and resolution framework. They must be effective and build on a common philosophy on how to tackle problems when they occur. National frameworks have to be compatible. Effective cross-border resolution also requires cooperation and preparations for burden-sharing.

8. THE NORDIC-BALTIC INTEGRATION IS ONE EXAMPLE

In the Nordic-Baltic region the interconnectedness was discovered when – if not before – Estonia, Latvia and Lithuania were hit by the crisis in 2008. Two Swedish banking groups had relatively large business in the Baltic countries, and the banking sector in those countries became crucial to financial stability also on our side of the Baltic Sea. In addition, banks headquartered in Sweden have a considerable market share in the other Nordic countries.

Our – meaning the Nordic-Baltic – response to the current situation has been an intensified cooperation. The memorandum of understanding of 2008 between all supervisory authorities, central banks and finance ministries in EU was a good first step. Signing the MoU was not the end of a cooperation process – but rather the first step in a process to build trust and exchange information. As was agreed in the MoU for EU, all European authorities should set up cross-border stability groups when they have common financial stability concerns.

And cooperation builds on confidence, which takes some time to build. The Nordic-Baltic stability group involves the finance ministries, central banks and supervisory authorities in the five Nordic and three Baltic countries. The task

is to set up procedures on how to act in a crisis situation. Ultimately this should enhance the preparedness for managing a crisis.

9. BURDEN-SHARING NEEDS TO BE THOUGHT THROUGH

Finally, there is the issue of burden-sharing.

Higher capital standards, new macroprudential and resolution frameworks will remove or at least reduce the use of taxpayer funds, which is very welcome. Nevertheless, resolutions will still require money (either through bail-in or the use of resolution funds). Therefore, there will be a need to agree on how the cost of resolutions should be shared. Unfortunately, the division of the financial burden in cross-border resolution has hitherto often seemed to be too hot a topic.

Ex ante agreement on procedures, in order to prepare for *ex post* burden-sharing is the realistic approach. We will not foresee all possible outcomes, but when the crisis hits, short-sighted national concerns may lead to valuable time being lost. The knowledge that necessary procedures are in place will foster cooperation and improve crisis management.

10. WE NEED A COOPERATIVE SPIRIT IN THE YEARS AHEAD

There are certainly many challenges for the international financial sector in the years ahead. Closer cooperation and more information-sharing will lead to us making better decision. Therefore let us hope that we all – central bankers, supervisors, finance ministry employees and legislators alike – could keep a cooperative spirit in the years to come.