A PLAUSIBLE REGIME FOR HANDLING LARGE CROSS-BORDER FINANCIAL FIRMS

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The Challenge of Supervising Multinational Cross-border Intermediaries

The global financial crisis (GFC) has revealed that the worries about the inability to handle problems in large financial institutions, especially where they ran across borders, were all too soundly based. The failure of one such institution, Lehman Brothers, led to the main phase of the crisis. In the main, however, the problem has been addressed by keeping such institutions open with the use of taxpayer funding. In some cases the costs of handling such systemically important financial institutions (SIFIs) has virtually bankrupted the country. Iceland and Ireland are obvious examples.

The international community has acted swiftly, particularly through the Basel Committee on Banking Supervision and the Financial Stability Board (itself set up as part of the response to the GFC) to try to address these issues, so that should further such problems occur they will have limited real effects and avoid taxpayer funding, at least on the same scale. The extra indebtedness that many countries have run up in the GFC could take a generation or so to run down, so the scope for coping with a repeat performance any time soon is small.

The suggestions put forward thus far comprise two main characteristics: making institutions less likely to fail particularly by increasing the capital and liquidity cushions that they have to hold; and changing the structures of the institutions and legal frameworks so that any failures can be handled much more readily and at no or limited cost to the taxpayer. The structural changes involve a combination of restricting the activities of institutions that cannot stop operating in the event of crisis without causing unacceptable disruption and making the institutions simple enough and the authorities and themselves prepared enough that rapid resolutions will be possible. This latter could take the form of living wills or funeral plans, so that the authorities feel that the circumstances will be manageable.

Views vary considerably over whether such plans are feasible or plausible. But naturally no one wishes to test out the idea in practice. Experience in the GFC suggests that many untried arrangements which looked excellent on paper just did not work in practice. One problem, as Rob Bliss (2012) puts it, is that in a crisis politicians panic. Commitments made in advance not to bail out or not to intervene crack under pressure.

This paper therefore considers the plausibility of one of the most vigorous attempts to put in place a resolution regime for cross-border banks that will not result in taxpayer funding and will avoid disastrous real effects on the economy. In particular it is designed to avoid the conflicts of interest and difficulties in coordination that can so easily arise between countries in a crisis. This is the case of New Zealand, where all of its SIFIs are cross-border institutions. Since all of these banks are also subject to the same home country jurisdiction, namely, Australia, this is also about the simplest case that could be put forward. If such arrangements cannot be made to work there, there is little chance of their working in much more complex environments.

Hence in the ensuing sections I set out the New Zealand regime, examine its plausibility and draw conclusions for other countries and regions, particularly Europe.

The New Zealand regime for resolving problem cross-border financial institutions

There are two main facets to the new New Zealand approach to cross-border institutions. The first has been to expand the coverage of prudential supervision and to increase capital and liquidity requirements, this last clearly in advance of the agreement and timetable suggested by the Basel Committee. The second is to insist on a structure for each institution that enables the New Zealand authorities to resolve the problem through a court appointed statutory manager (with somewhat wider powers than a receiver) in a manner which neither interrupts the flow of continuing operations nor results in any cost to the taxpayer except through mistakes or further losses while the responsibility of the Reserve Bank.

Taking these in turn:

The new supervisory regime

New Zealand has operated what is probably the lightest touch regulation in the OECD. While the Reserve Bank (RBNZ) as the prudential regulator of banks has laid down a set of rules compatible with Basel 1 and then Basel 2 prescriptions, the primary control mechanism has been through disclosure and even that was only introduced in 1996. The RBNZ does not undertake on-site inspections, although it has the power to do so. Disclosures are required every three months or immediately in the event of a breach of the rules. These public disclosures cover more than is required under Pillar 3 of the Basel framework and in particular require disclosure of maximum exposures rather than period averages or end period values. The directors of the bank are required to sign the disclosure statement and are liable in the event of a false disclosure. Not only can they be imprisoned for up to three years (it was thought to be a poor incentive to try to fine rich people or institutions) but they can be civilly liable for consequent losses.

More than this, up until the crisis there was no real prudential supervision of other financial institutions, including bank-like deposit takers, provided they did not call themselves banks. One result of this was that virtually the whole deposit taking finance company sector failed between 2005 and 2010.

Much of the idea behind this regime was that market discipline would prevail. It was expected that market analysts and particularly competitors would publicise any of the weaknesses in banks and other institutions. It was also expected that customers would be alert to differences and be prepared to shift their business. Because banks would be aware of this threat to their position it was anticipated that they would act very prudently and hence a non-intrusive regulatory regime would work well.

In one sense it has, the main banks have come through the GFC virtually unscathed, they did not take on toxic assets and their lending has been prudent. No bank has come near failure. There was an initial problem with liquidity which was solved by temporary government guarantees for new securities (which had to be purchased at a commercial rate). The question is how much New Zealand was a beneficiary of the more intensive supervisory regime of the authorities responsible for the parent bank. In the non-bank sector all of the usual governance failures, related party lending, concentrated exposures, poor risk assessment and over exposure to property led to the collapse. There have been a number of successful prosecutions of directors for failing in their duties and other cases remain before the courts.

Since the crisis the RBNZ has been given prudential responsibility for both non-banks and for insurance. However, the primary responsibility for non-banks still remains with a trustee. The supervision of the rest of the financial sector has been tightened up with the creation of a new Financial Markets Authority with much stronger powers and much more inclusive coverage, so agents and advisor are now regulated more comprehensively.[1] Coupled with the new capital and liquidity requirements[2] these measures will undoubtedly lead to an improvement in the prudence of the more peripheral parts of the market and should ensure that banks are much less vulnerable to liquidity shocks. However, it should be noted that banks had already moved themselves in advance of the new liquidity rules and are largely compliant with the final liquidity requirements under Basel 3 already.

This gives two main conclusions for the ability to resolve SIFIs in the future

(i) One should not rely on supervision to detect potential problems in time for them to be acted upon

(ii) SIFIs are likely to pursue more prudent behaviour than the minimum laid down in the authorities' rule book

[1] The FMA came into being in May 2011 and the RBNZ gained its wider responsibilities in 2010, although the new rules are only being implemented progressively.

[2] Banks are required to have minimum one week and one month mismatches and a core funding ratio one year out to ensure that an adequate proportion of its funding can be drawn on over these horizons, as set out in RBNZ (2011) 'Liquidity Policy', Document BS13, issued March. The Core Funding Ratio is similar in concept to the Net Stable Funding Ratio set out as part of Basel 3, and compliance with the RBNZ's concept will ensure compliance with the Basel ratio.

The Resolution Regime for SIFIs

The new New Zealand regime, which is labeled Open Bank Resolution (OBR) is based on two principles:[3]

- The authorities should have the legal power and the technical and practical ability to resolve problem banks without interruption to their core services or significant disruption to the rest of the financial system
- As far as possible the resolution method should place the costs firmly on those who have taken on the risks in the order of priority laid down for bankruptcy and not on the taxpayer

The main legal framework was already in existence.[4] Should a bank fail the Reserve Bank will advise the Minister of Finance to petition the Governor General to appoint a statutory manager under an Order in Council to take over the running of the bank from the shareholders. How early the statutory manager can be appointed is not clear but if it reaches the point that a banking licence were to be withdrawn clearly this would trigger failure, even though equity might not have been fully exhausted beforehand.

The powers of a statutory manager are rather greater than those of receivers in other jurisdictions in that the manager has a primary concern for the stability of the financial system and maximizing the residual value for the benefit of the creditors will only follow subject to that.

There have been three steps in setting up the OBR arrangements. The first was to ensure that all systemically important banks had to be locally incorporated and separately capitalized.[5] This meant that the New Zealand authorities at least had the legal right and ability to impose a reorganization. However, the second step was in many respects more important in that it required all such institutions to organize themselves in such a way that they could operate on their own if any major 'supplier' were to fail within the 'value day' (i.e. by the opening of business on the following day they would be fully functional again).[6] The most important supplier is normally the parent, and the import of this is that a statutory manager could implement any changes in structure necessary to resolve a bank overnight or at least over a weekend, so there would be a minimum of disruption.

The third and crucial step is that the changes required need to be feasible in the time available and that sufficient planning and 'pre-positioning' is done in advance. Failure of a large institution is unlikely to be a complete surprise so many of the necessary steps will have been completed before the statutory manager steps in. However, to make this plausible the RBNZ has outlined what it would expect to be the normal procedure in these cases. It does not expect that a buyer will have been found or that

[3] The regime was originally labelled Bank Creditor Recapitalisation (BCR), when it was being drawn up (Harrison et al., 2007). The more recent proposals are described in Hoskin and Woolford (2011).
[4] Under the terms of the Reserve Bank Act 1989.
[5] This is explained in W. Chetwin, 'The Reserve Bank's local incorporation policy', *Reserve Bank of New Zealand Bulletin*, vol.69(4), pp.12-21, 2006. It is only the systemically important activities that have to be in the subsidiary. A branch can be used for wholesale business for example, and most of the large banks also have branches for that purpose.
[6] This has been labeled the 'Outsourcing Policy' and is detailed RBNZ (2006).

activities can be transferred to a different provider, except in so far as these are non-core activities, which do not form part of the sequence that has to be carried on without interruption. They assume that the existing institution will continue to provide the services but under the control of the statutory manager and not the shareholders. What will change will be the nature of claims on the bank.

The statutory manager will make an approximate and conservative valuation of the extent of the losses of the bank and then write down the creditors in order of priority in order to return the bank to viability. It is not at present quite clear whether this write down will include creating enough new capital that the bank is properly capitalized again or whether the intention is to operate with the RBNZ standing behind the reorganized bank in lieu of equity until a new issue or purchase can be organized. (It is the latter which is described by Hoskin and Woolford (2012).) In other versions of this style of arrangement the creditors would face a debt for equity swap. In so far as their claims on the bank have been written down too far they would effectively have an equity claim on the bank according to the extent of the written down parts of their claim. Clearly such claims could be converted into common stock if this seemed the right way forward. Thus this debt for equity swap is very much the traditional approach advocated by Aghion et al. (1992) or indeed myself in Mayes et al. (2001). However, in the present case a portion of the claim would merely remain frozen. If the value of the bank were to be found to be larger than estimated then more of the claim would be unfrozen. However, the process is not symmetric. If the writing down process turned out to be insufficient, further losses would be borne by the taxpayer (as this would represent an error on the part of the statutory manager).

Once this freeing process is completed the bank can reopen – backed by a government guarantee against further losses so it is to be able to undertake new contracts. The point where this is clearly different from other proposals is in the treatment of depositors. Depositors are junior creditors as they have no preference in New Zealand. They will hence be among those written down. They are also not insured (New Zealand is the only OECD country without deposit insurance). Hence their accounts will have to be changed and not simply that a deposit insurer succeeds to the depositors' insured claims, while making good the insured depositors' share of the write down. This is quite a substantial requirement for pre-positioning. In a debt for equity swap all the debt-holders need to be identified but in the case of depositors their accounts need to be divided into a frozen (written down portion) and a new account which can be accessed as normal. This will be a significant but not implausibly difficult computer exercise. Debit cards, credit cards, cheques, ATMs etc all need to be operating in the morning. In effect it would just be as if a withdrawal had been made from everybody's account and placed in a new frozen account.

Clearly the bank must be able to identify the balances in all accounts at the end of the day. Since all accounts would be affected no aggregation or worries about netting would be needed. However, it is proposed to complicate this by imposing a de minimis rule. On the one side this is sensible as it gets rid of the myriad of small or dormant accounts from consideration. But on the other it does require aggregation of each customer's accounts. This also presents a problem in terms of the fair treatment of all creditors. If there is no write down on some creditors under a de minimis rule the funding has to come from the others. The RBNZ has not said where the de minimis line would be drawn. If it were at $2,000 the cost would be fairly limited and

the trivial claims would be eliminated from the process of division. If the line were drawn at $10,000, which has been mentioned, then most ordinary deposits would be exempt and the political cost of the resolution would be much smaller. However the cost on the other creditors would then become non-trivial.

The freezing and reopening is not however the end of the story as that leaves the bank in the temporary hands of the statutory manager. Exit will take one of the standard forms of resolution, purchase by a suitable financial institution, restructure for continued operation in its current form or simply liquidation. Clearly, parts of the entity could be sold or liquidated separately. The important step is that this buys time. In some respects it is rather like creating a bridge bank in the US framework (Mayes, 2007) as emulated by the UK in the 2009 Banking Act. Clearly there are problems for purchase as the New Zealand banking system is already highly concentrated and a new entrant might be needed.

An omission

The New Zealand authorities have not offered any clear view on the value of new ideas for shock absorbers, short of failure. Contingent capital is an obvious example. If a portion of debt were held as contingent capital, triggered before the minimum regulatory equity (Tier 1) ratios were breached, this would clearly assist the process of resolving problem banks while keeping them open. Indeed macroprudential tools might well do the same. However, it is not clear that the New Zealand environment has anything special to offer in the assessment of these tools. Clearly any such refinancing would need to apply directly to the subsidiary otherwise the capital could simply leak out into the parent and leave the New Zealand operation with its previous problems.

Will it work?

What distinguishes the forgoing discussion from that in Europe is that there has been no mention of any other country, despite the fact that all New Zealand's SIFIs are cross-border banks. Indeed the subject is not mentioned anywhere in the RBNZ's discussion of the system (Hoskin and Woolford, 2011). While the RBNZ does co-operate with the Australian Prudential Regulatory Authority (APRA) and there is a commitment to closer co-operation through the Trans-Tasman Banking Council, it is clear that the New Zealand authorities feel that their arrangements can be operated without regard to what the Australian or any other foreign authorities decide to do. This is not to say that actions taken in response to distress might cause harm, as both countries require the authorities to have regard to, and seek to avoid adverse impact on, the stability of financial systems in both countries in responding to bank distress. Clearly sharing of information will make anticipation of problems easier but this position represents the opposite end of the spectrum – how to look after your own systemic concerns despite having foreign-owned banks.

It is somewhat difficult to find a clear statement of the view in Australia. Mortlock (2012), for example, argues quite strongly against the New Zealand approach, labelling the approach as 'autarchic' and likely to impose costs on the operation of banks. However, it is not at all clear that the separation between the Australian parents and their New Zealand subsidiaries required by the RBNZ does impose much of a

cost.[7] Chetwin (2006) points out that three out of the four banks had voluntarily opted for subsidiarisation rather than using branches so clearly the costs of this choice could not be large. The banks themselves have not cited any particular evidence in this regard. Even the new aspects of pre-positioning discussed above are not thought of sufficient cost to warrant a mention by the RBNZ.

New Zealand circumstances are unusual with the four main bank all being subsidiaries of the four main banks in Australia. Thus the Australian authorities are highly likely to be faced by the identical problems as those in New Zealand unless there is some completely specific New Zealand shock, which of course is possible in the case of a natural disaster. However, New Zealand is strongly linked to Australia in both trade and investment, so the economies tend to move together despite the lack of Australia's important mineral exports. New Zealand will therefore be affected by what the Australian authorities decide to do and even if they are purely concerned with their own domestic interests this is likely to have a positive impact on New Zealand unless the strategy is to withdraw assets from the New Zealand operations in the event of difficulty at home. Similarly, the health of the New Zealand subsidiaries will be affected (positively) by the quality of the Australian supervisory regime.

The Australian government has made it clear that it thinks the survival of these four banks is essential. While its plans are still in progress (Mortlock, 2012) it is clear that the approach will be different. First of all Australia has both deposit insurance and domestic depositor preference. Second it seems likely that some form of bail out would be used by the government, presumably in the form of loans that would convert into equity if conditions were not met.[8]

There is thus going to be a considerable discrepancy between the approaches in the two countries. A failure of the New Zealand subsidiary, while the Australian parent remains healthy, seems rather unlikely. First of all, reputation risk would probably preclude it as a strategy but the sheer size of the New Zealand subsidiaries is sufficient that this would in itself pose problems for the parent from consequential losses. It is therefore likely that the Australian authorities would be stepping in at the same time that the New Zealand authorities would be contemplating OBR. Since problems in New Zealand would have contributed to the losses in Australia it seems unlikely that the Australian government would be particularly willing to shoulder the entire burden of recapitalization and might look to New Zealand to supplement it. The normal epithet in these circumstances is that the system 'internationalises the profits but nationalizes the losses'. Here the impact might be different with pressure to internationalise the losses as well. A failure in New Zealand would already imply that

[7] Whereas Mortlock suggests: 'Taken to the extreme, an autarkic approach would impose severe efficiency costs on the global, regional and national banking systems, reducing markedly the scope for risk diversification and management, increasing operating costs, increasing funding costs in host jurisdictions, and reducing the scope for lending, particularly in the host jurisdictions.'

[8] Mortlock's personal view is clear. 'In some situations, I believe that a taxpayer-funded resolution may be the only viable or potentially the most cost-effective means of resolving a systemically important bank distress. Taxpayer-funded resolutions do not necessarily need to involve losses for the taxpayer; in some situations they may actually result in a positive economic return for the taxpayer, as has been demonstrated in some taxpayer-funded bail-outs.' He does not feel that the moral hazard involved need be great. Clearly his assertion is correct, a nicely judged taxpayer assisted bail out when bank equity is undervalued could work out very well for the bank, financial stability and the taxpayer. The problem is making the correct judgement in the face of an uncertain future and the costs of getting it wrong.

the parent and possibly the Australian government had not been willing to act as a source of strength and recapitalize the subsidiary.

Thus the two approaches, while they may not be incompatible could certainly generate tensions. Thus even as self-contained a regime as that being implemented in New Zealand would be impacted by the decisions of the home country authorities. It remains to be seen in practice whether New Zealand could benefit from Australia's actions in its own interest while insulating their taxpayers.

A second source of implausibility lies with the treatment of depositors. The GFC has been characterized by a rush to increase deposit insurance and in some cases to offer guarantees. (Although the experience in Ireland is likely to make future use of guarantees much more circumspect.) Even New Zealand implemented a temporary Crown Retail Deposit Guarantee Scheme.[9] There will therefore be an expectation, that whatever is said in advance, in the event of a major failure, depositors will be protected. Possibly an idiosyncratic failure in one of the big four banks could be dealt with in a way that involved the depositors losing significant sums of money, especially with a de minimis rule, but with system wide problems in another crisis this would be a courageous strategy for a government that would like to be re-elected.

One area which needs to be cleared up for OBR to be plausible is the way in which the resolution will be treated by ISDA and in other contracts. It will clearly be a 'credit event'.[10] Contracts will have to be crafted carefully to prevent it causing the unraveling of transactions that an OBR is specifically designed to avoid. Clearly this will result in a narrowing of the group of creditors who will be caught up in the resolution process. New Zealand has covered bonds. If the losses are incurred in the collateral this will have to be topped up again presumably at the expense of the assets covering the losses facing the other more junior creditors. Such issues have to be addressed. However, these are known problems facing any resolution process and legal routes for handling them exist in the US and elsewhere.

Of most interest in the New Zealand plans is that the write down process avoids all of the concerns about whether a funeral plan or living will can be executed sufficiently rapidly to avoid the need for taxpayer loans to keep the institution open. Most of the real changes can occur after the resolution (although this rather dilutes the meaning of the word 'resolution'). Sales of assets and businesses, injections of new capital, the finding of potential buyers for the bank etc. can all take place after the write down and while the bank still continues to trade. With smaller institutions, experience in the US suggests that it is normally possible to keep the institution going for long enough that

[9] The scheme is described and evaluated in Office of the Auditor General (2011) *The Treasury: Implementing and Managing the Crown Retail Deposit Guarantee Scheme*, available at http://www.oag.govt.nz/2011/treasury.

[10] One problem here is that once a bank has been placed into statutory management the commercial activities of the bank are restricted. Upon commencement of statutory management a very wide 'moratorium' applies under s 122. This freezes, for an indefinite period, the exercise or enforcement of a range of rights and claims against the bank such as proceedings, executions, liquidation applications, enforcement by secured creditors, repossessions of property and set-offs without leave of the High Court or the statutory manager: Reserve Bank of New Zealand Act 1989 s 122(2). However, these powers in themselves offer the solution as the statutory manager can halt any of the pressure towards insolvency.

it can be resolved smoothly on closure, maintaining continuity for depositors at least. This proposal gets round the need to have the whole process in place and hence makes it more plausible especially in the event of a surprise. This is particularly useful where a degree of co-operation with foreign authorities would be helpful. Such co-operation is difficult to execute well in a hurry and will tend to lead to delay even where the parties are keen to work together.

What remains contentious is the ability to value the problem adequately to estimate the write down in a hurry. The experience in the GFC is not promising. Some catastrophic errors were made, particularly in Ireland where the ensuing losses from what was expected to be a manageable guarantee nearly bankrupted the country and lead to the need for IMF and EU assistance. Similarly in the UK, Northern Rock was judged solvent by its supervisor, the FSA and Lloyds' assessment of the problems it was taking on in the merger with HBOS turned out to be a major underestimate. This same sort of problem has occurred in New Zealand with the collapse of South Canterbury Finance. Here it was expected initially that the losses that the Crown would face would be less than $1/2bn. The latest estimates[11] suggest more than double that.

There is therefore going to be a very strong incentive for conservatism, which will increase the extent of the write down and the frozen deposits. However, it is a mistake to treat this problem as a negative signal as the proper comparator is the potential cost to the taxpayer of alternative approaches. The status quo would be a loan covering the full deficiency without any write down being borne by the creditors.

One problem with this arrangement is that anything new needs to be trialled and kept in a reasonable state of readiness. This can certainly be achieved for the technical issues of being able effect the division and freezing of accounts overnight. It is much more difficult to trial the writing down process, although even that could be attempted. As is always the case what is really needed is a real trial through the failure of a smaller institution, although of course no one wants this to happen. The UK achieved this with the Dunfermline Building Society in 2009. However, with a larger institution it would be really difficult to work through the political feedback. We cannot find out realistically in artificial circumstances whether the government would suddenly implement deposit insurance or a guarantee or even offer a bailout.

Could others adopt it?

All of the technical aspects of the New Zealand system could be applied elsewhere. However, one essential precursor is that all SIFIs can be subject not just to domestic law but be restructured so that they are independently capitalized and capable of running themselves (or rather running under the control of the equivalent of a statutory manager overnight or over a weekend. Outside the EU this could be a condition of getting a banking licence. In the EU the position is very different. It is not possible to compel banks to operate as subsidiaries under host country law rather than branches under home country law. However, in many cases such banks may well choose to be domestically incorporated.

[11] The figure quoted in evidence to the Finance and Expenditure Committee by the Deputy Auditor-General on 28 March 2012 was $1.1bn.

Other countries are highly unlikely to follow the route of writing down depositors but they might well chose to impose such losses on the deposit insurance fund. Depending on the form of the fund this in turn could mean that the costs fall on the survivors, existing pre-paid funds or on the taxpayer. In the event of systemic problems it is unlikely that the prefunding route will be sufficient and either the taxpayer will cover the cost, or the taxpayer will have to cover the borrowing required by the fund, either through guarantees or by direct lending. This would not invalidate the procedures. However, the higher the coverage of the insurance the greater the cost to the fund of the write down. While returning to lower coverage is plausible for idiosyncratic shocks it less likely for crises.

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