Friday 30th August, 2013
Concurrent Session 1A
1.50pm – 3.05pm

Introduction by
Paul Rogerson
NRMA – Motoring & Services

What happens when the music stops?
Dealing with bank collapses. Bail out? Bail in? Other options for bank resolution.

WHAT HAPPENS WHEN THE MUSIC STOPS: DEALING WITH BANK COLLAPSES? BAIL OUT? BAIL IN? OTHER OPTIONS FOR BANK RESOLUTION

R P Rogerson, Solicitor

INTRODUCTORY REMARKS

The global financial crisis (**GFC**) highlighted many regulatory inadequacies in the supervision of banks and other financial institutions. Whilst Australia was largely immune from the worst ravages of the GFC, the Australian government nevertheless is embarking upon a significant regulatory overhaul of its prudential supervisory regulation. In particular, the Australian Prudential Regulation Authority (**APRA**) and prudential regulators in many parts of the world have consulted widely with industry in implementing revised capital adequacy and liquidity rules to give effect to what is widely known as 'Basel lll'[1]. APRA released updated prudential standards that came into effect from 1 January 2013[2].

There are two broad aspects to Basel lll namely to reduce:

1. the probability of failure through mechanisms designed to improve the ability of a bank to absorb losses as a going concern; and
2. the impact of failure by improving recovery and resolution frameworks.

This short note provides an introduction to the session where the speakers will examine some of the principles that underlie bank resolution regimes and their potential implementation.

WHAT IS A BANK RESOLUTION REGIME?

In this area of regulation the term 'resolution' is used deliberately rather than 'liquidation' or 'winding-up' because its purpose is to rescue a bank that may be temporarily insolvent and restructure it so that it can continue to trade or otherwise be dealt with an orderly fashion. Rarely would a bank be hopelessly insolvent. It is more likely that one area has become distressed leading to a temporary lack of solvency. Frequently, this occurs in an institution's wholesale or investment banking area but not exclusively[3].

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[1] Basel Committee on Banking Supervision "*Basel lll: A global regulatory framework for more resilient banks and banking systems"* BIS, December 2010 (revised June 2011) and *"Basel lll: International framework for liquidity risk measurement, standards and monitoring"* BIS, December 2010

[2] See: media releases from APRA at http://www.apra.gov.au/MediaReleases/Pages/12_23.aspx dated 28 September 2012 and http://www.apra.gov.au/MediaReleases/Pages/12_29.aspx dated 13 November 2012 .
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[3] For example, British bank Northern Rock needed to be bailed out by the British government in late 2007 due to its funding model for its mortgage business. See: Brummer, A *The Crunch: the scandal of Northern Rock and the escalating credit crisis* Random House 2008

THE NEED FOR BANK RESOLUTION REGIMES

In considering the need for a special regime for dealing with banks in distress, the starting point must be to recognise that "banks are different"[4] and that they play a special place in our society in facilitating credit intermediation between depositors and borrowers as well as providing many of the services that consumers, business and government need each day in order to conduct business and international trade. Collapse of any one financial institution of significance could cause widespread economic disruption far beyond the collapse of most other enterprises.

The severity of the GFC throughout Western Europe and the United States during 2008 caught many governments by surprise and many did not have adequate regulation to deal with the collapse of financial institutions[5]. For example, when Icelandic banks began to fail in 2008 some had operations in the United Kingdom, offering attractive terms to consumers for deposits. One bank, Landsbanki, became financially distressed and in order that the British government could prevent funds being removed from the United Kingdom to the prejudice of depositors it issued a freezing order under the *Anti – Terrorism, Crime and Security Act 2001* freezing the assets of the London branch of Landsbanki[6]. It seems extraordinary that the British government in seeking to protect depositors and other creditors needed to resort to anti – money laundering legislation to achieve that purpose.

During 2007 and 2008 the availability of credit and liquidity for banks began to tighten around the world. This in turn fuelled a loss of confidence in the solvency or liquidity of many banking institutions during 2008. Weakness in the banking sector then led to a sharp contraction in liquidity and credit availability that affected the rest of the global economy.

With institutions, especially in Western Europe and the United States, collapsing or nearing collapse, governments stepped in with massive injections of capital, liquidity and other support. In 2008, the British government injected £45.5 billion in equity capital to stave off the collapse the Royal Bank of Scotland and by December 2011 the value of that injection had shrunk to £20 billion[7]. Clearly, such action by governments was unsustainable with the burden of such massive losses being borne by the taxpayer. However, the 'bail out' seemed to be the only effective policy response by governments at the height of the GFC.

As summed up by one regulator, whilst the absence of robust bank resolution regimes was not a cause of the GFC, "the inability of regulators in many jurisdictions to

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[4] See Lord Adair Turner's foreword in the Financial Services Authority Board Report, *The failure of the Royal Bank of Scotland*, FSA December 2011 p3. This point was echoed in Australia in the Senate Committee report on banking which noted "banks are accorded special status and given special privileges": Senate Economic Reference Committee *Competition within the Australian Banking Sector* AGPS May 2011, [11.99]

[5] A Darling, *Back from the Brink*, Atlantic Books, London, 2011, pp 9 – 10

[6] See: *Jefferies International Limited v Landsbanki Islands HF* [2009] EWHC 894 (Comm) for a discussion of the events surrounding the issuance of the order.

[7] Turner, n 4 at p1

remove a bank from the system in an orderly fashion exacerbated the crisis when it was near its peak"[8] and also forced governments to bail out institutions.

To address the situation, the Group of 20 nations (**G20**) declared at their meeting in London in April 2009 to establish the Financial Stability Board (**FSB**). Part of the object of the FSB was to promote financial stability and develop frameworks for bank resolution regimes[9]. After conducting consultation in relation to a discussion document the FSB published its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (**Key Attributes document**) in November 2011. Meanwhile the Basel Committee on Banking Supervision (**BCBS**) issued a report[10] recommending that national authorities have appropriate tools to deal with financial institutions in difficulty so that an orderly resolution can be achieved to maintain financial stability[11].

Where government and prudential regulation in this area goes next is the subject of the session.

[8] Wayne Byres, *Redesigning financial regulation: Do we have all the necessary ingredients?* Speech delivered to CEDA, 22 February 2011, p3

[9] G20, *Declaration on strengthening the financial system* – London, 2 April 2009 found at http://www.g20.org/documents/ viewed 31 December 2012

[10] Basel Committee on Banking Supervision, "*Report and Recommendations of the Cross-border Bank Resolution Group"* Bank of International Settlements, March 2010

[11] BCBS, n 10, p 22