From Bail-out to Bail-in

Remarks before the Federal Reserve Board-IMF Conference
“Seeing the Forest and the Trees – Supervising Systemic Risk”

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Resolution

• Too big to fail is too costly to continue

• Reduce probability that resolution will be required

• Improve resolution so that banks are safe to fail
  – Banks should be resolvable in the same way that airlines, retail stores, etc, are resolvable – customer operations continue whilst capital is restructured
  – This should be at no cost to the taxpayer and at minimal social cost
Bankruptcy doesn’t work for banks

- Bankruptcy for banks is tantamount to liquidation
- Liquidation imposes incremental costs and reduces the value of the estate of the failed bank

Value of assets if bank remains in operation

Value of assets under if liquidation

- Derivative close out
- Sale of repo collateral
- Incremental loan losses

So banks need a special resolution regime
Time is short

Close Friday

50 hours

Open Monday
Resolution via bridge bank

**Bank A**
In receivership

- Asset is claim on equity in Bank B + Assets not transferred to Bank B
- Liabilities are equity, preferred stock, subordinated debt and other liabilities 'left behind'

**Bank B**
Going concern

- Assets are good assets from Bank A at 'transfer' (conservative) values
- Liabilities are deposits, and such other liabilities transferred to bank B at haircut value
- Excess of assets over liabilities equals equity in Bank B
Resolution via bail-in

- **COB Friday**
- **Monday Asia open**
- **Subsequent “month”**

**Execute Bail-in**

**Resolution authority evaluates options**

- **Recovery**
- **Sale**
- **Deposit transfer/Bridge bank**
Bail-in via conversion

Liability structure prior to intervention

- Deposits
- Other debt
- Senior debt
  - Subject to bail-in
- Tier 2
- Non-core Tier 1
- Common equity

Liability structure after conversion

- Deposits
- Other debt
- New Common equity
- Distribution of new common equity among old providers of investor capital
- Common Equity After Write down

Formerly senior obligations acquire predominant share in new equity

Old common equity suffers ‘death by dilution’
Bail-in: what would determine success?

• Bail-in produces clean and strong balance sheet.
  – This requires that bank must have sufficient amount of back-up capital available for bail-in.
• Strict seniority should be respected
• Bail-in should occur rapidly
• Bail-in should preserve bank as a going concern
• Bail-in may need to be reinforced through liquidity provision from official sources
If bail-in doesn’t work, what will?

× Return to bail out

? Make banks smaller
? Make banks simpler