The bailout lexicon

SHUTTERSTOCK

MANY FINANCIAL EVENTS AND ERAS ATTRACT THEIR OWN TERMINOLOGY AND JARGON – AND THE AFTERMATH OF THE 2008 FINANCIAL CRISIS IS NO EXCEPTION. SARAH BOYCE AND WILL SPINNEY PROVIDE A TRANSLATION AND LOOK AT THE IMPLICATIONS

New terminology regularly appears in the financial world along with an assumption that we will all magically understand the new concept.

For example, the regulatory authorities' approach towards financial institutions and 'too big to fail' has evolved as a result of the global financial crisis. Terms such as 'bank resolution' and 'bail-in' are frequently used and it is assumed everyone understands them. This article (extensively based on articles produced by the Bank of England) is intended to explain just what these terms mean.

During the global financial crisis, banks faced significant losses that reduced the value of their balance sheets to such an extent that they lost access to liquidity. This so seriously constrained banks' activities that the authorities were forced to intervene to stop banks from collapsing and taking the real economy with them. This intervention was provided in a number of ways:

- **Liquidity injections** – emergency funding to financial markets and individual financial institutions to ensure that they could continue to meet their obligations as they fell due.
- **Asset purchases** – selected asset classes, such as corporate bonds, were purchased from financial institutions to improve the liquidity of credit markets.
- **Liability guarantees** – public authorities guaranteed some liabilities, such as deposits or new/existing debts, to shore up confidence in the financial system.
- **Capital injections** – or 'bailouts' were provided in exchange for full or partial ownership of individual firms. Thus depositors were bailed out (saved) contrasting with 'bail-in' where they take losses.

In the US, 956 firms, including some non-financial institutions, benefited from some form of government assistance, amounting to date to around $617bn.[1]

In the UK, the support was more sector-wide, with specific support for only four banks, amounting to £1,162bn at its peak.[2]

Although this stabilised the financial system successfully, the cost was borne by the public sector and shareholders rather than the banks' depositors. Shareholders did lose because share prices fell

Bail-in hierarchy

Below is the order in the UK in which capital is bailed in to resolve a failed bank. Order of priority (from January 2015):

Proceeds flow down

Fixed charge holders (ie security in the form of: mortgage, fixed charge, pledge, lien), including:
- Capital market transactions (for example, covered bonds)
- Trading book creditors (for example, collateralised positions)

Liquidators (fees and expenses)

Preferential creditors (ordinary), including:
- Financial Services Compensation Scheme (FSCS), taking the place of all protected depositors for amounts up to £85,000
- Employees with labour-related claims

Preferential creditors (secondary):
- Depositors that are individuals and micro-, small- or medium-sized businesses for amounts in excess of £85,000

Floating charge holders

Unsecured senior creditors, including:
- Bondholders
- Trading book creditors (for example, uncollateralised positions)
- Creditors with master netting agreements (net position only)
- Commercial or trade creditors arising from the provision of goods and services
- Depositors that are not individuals or micro-, small- or medium-sized businesses for amounts in excess of £85,000
- FSCS, taking the place of individuals with funds invested with the insolvent firm (including protected amounts up to £50,000)

Unsecured subordinated creditors (for example, subordinated bondholders)

Interest incurred post-insolvency

Shareholders (preference shares)

Shareholders (ordinary shares)

Losses flow up

Source: www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf

Glossary

Ring fence	The separation of some aspects of commercial banking (mostly retail) into a separate entity to reduce the probability of failure.	**BRRD**	Bank Recovery and Resolution Directive (European law).
TLAC	Total loss-absorbing capital.	**Bail-in**	Where losses are absorbed by those investing in a bank.
Volcker rule	The rule in the US enacted into Dodd-Frank to prevent banks from engaging in certain risky activities.	**Bailout**	Where losses are absorbed by persons outside a bank.
Stress testing	Routine tests on banks to highlight risk of failure.	**Hierarchy**	The order in which losses are taken by those investing in a bank.
Resolution	Resolution is the process by which the authorities can intervene to manage the failure of a firm in an orderly fashion.	**G-SIB/G-SIFI**	Global systemically important bank/global systemically important financial institution.
Vickers Commission	The report that presaged ring fencing in the UK.	**TBTF**	Too big to fail.
Liikanen report	The report that presaged some separation of activities in Europe.	**Top-down/single point of entry**	Resolution starting at bank holding company level.
Commercial banking	Deposit taking and lending.	**Bottom-up/multiple point of entry**	Resolution starting at a bank operating company level.
Investment banking	Securities trading and proprietary trading.	**MREL**	Minimum requirement for own funds and eligible liabilities.
Moral hazard	An example of agency risk where managers take excessive risks knowing that their business will be saved by authorities.	**Resolution weekend**	The time in which a bank will typically be resolved, allowing it to open for trading on the Monday.

significantly, but they do retain a chance to recover their money. The key point is that depositors do not lose under a bailout, but might under a bail-in.

Following the financial crisis, central banks established a process to enable financial firms to be easily wound down if necessary, ie in an orderly manner, with continuing provision of financial services, minimal impact on other firms and no public money involved.

The process of managing the failure of a financial firm is called resolution. In order to ensure that the principal functions of a bank can be maintained, a number of stabilisation tools have been identified, which can be applied as part of the resolution process:

- **Private-sector purchaser** – the transfer of all or part of a firm's business, which can include either its shares or its property, to a willing and appropriately authorised private-sector purchaser;
- **Bridge bank** – the transfer of all or part of a firm's business to a bank, which meets the relevant conditions for authorisation, pending a future sale or share issuance; and
- **Bail-in** – the claims of shareholders and creditors are written down and/or converted into equity to restore solvency (ie they bear the cost). The write-downs are in a strict 'waterfall' of priority.

A bail-in, (previously missing in many jurisdictions) is similar in effect to a corporate restructuring under Chapter 11 of the United States Bankruptcy Code. It is intended to restore solvency and avoid the disorder that would result from the bank suddenly ceasing to trade while it is reorganised without calling upon public finances.

The powers set out in the resolution regime are designed to ensure that shareholders and unsecured creditors meet the cost of firm failure and that the authorities have sufficient flexibility to effect an orderly resolution as quickly as is necessary.

But safeguards apply, which will ensure that no creditor is left worse off than they would have been had the whole firm been placed into insolvency and secured claims are protected.

Bail-in, like the other resolution tools, can only be used when it is necessary to do so in pursuit of clearly defined public interest objectives.

Two landmark resolutions in the UK include Northern Rock plc and Bradford & Bingley plc. There have been two resolutions since 2009 in the UK, namely, the Dunfermline Building Society on 30 March 2009, and the Southsea Mortgage and Investment Company Ltd, in June 2011.

What's this got to do with the treasurer?

The main effect on the treasurer is most likely around how amounts due from the bank may be affected. Time deposits, certificates of deposit and current balances may be bailed in, as may 'in the money' derivative positions. Don't expect that, because you have loans from the bank (bilateral or syndicated), the balances will be netted. You may lose money on a deposit and still have to repay the loan. If you enjoy letters of credit or guarantees from a bank in resolution, these may be at risk as well. If a bank under resolution has issued these on your behalf, they might need replacing.

Pooling, especially notional pooling where balances are offset, may also be affected. Pooling might in any case be more difficult under Basel III.

Conclusion

Bank resolution planning seeks to ensure that financial firms – whether large or small – can fail without causing disruption to payment systems and the normal support of trade without requiring a bail-in, thus exposing taxpayers to losses. Rather, the creditors of the failing banks should bear any losses, as they would do in insolvency, but without the financial instability and disruption to critical functions that the sudden insolvency of financial institution would otherwise cause.

By itself bail-in cannot guarantee that the resolution of a failed firm will be orderly. However, it can be used to stabilise the balance sheet of a failing firm until it can be restructured and, as such, is an essential component of a wider framework that, taken together, will allow authorities to intervene to manage the failure of large, complex firms in an orderly way. Treasurers must review their counterparty risk under these regimes.

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1 projects.propublica.org/bailout/list
2 www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs