# International Corporate Rescue

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EDITORIAL

# Too Big To Fail?: Is This the Right Question and is the Response to the Financial Crisis the Correct One?

**Patricia Godfrey**, Partner, Nabarro LLP, London, UK

At the Lord Mayor's Mansion House banquet on 17 June 2009, the Governor of the Bank of England, Mervyn King, cited the much repeated quote 'If some banks are thought to be too big to fail then, in the words of a distinguished American economist, they are too big'. Whilst megabanks formed by growth and consolidation are increasingly complex and may present the potential for unusually large systemic risks, small is not always beautiful as the recent failure of Southsea Mortgage & Investment Company demonstrated.

Over recent years, a number of measures have been taken, both domestically and internationally, to address the global financial crisis. These range from the introduction of the Banking Act 2009 ('the Banking Act') in the UK to the Basel Committee's tightening of capital adequacy ratios and the introduction of rescue and recovery plans ('Living Wills') for financial institutions. Most recently, we have a Government White Paper dealing with UK financial regulation which considers a proposed new approach to financial regulation as a blue print for reform. The EU has also undertaken a consultation which in due course will lead to a framework for a future EU-wide bank resolution regime.

The plethora of measures being driven forward domestically and internationally requires a delicate balancing act. Whilst seeking to instil rigid risk management they must not stymie the UK's financial services sector as a major driver of the UK economy. In cases where failure cannot be avoided, it is vital that the wider Special Resolution Regime and the new liquidation and insolvency procedures introduced by the Banking Act are both flexible and robust enough to deliver the optimum solution in the event of future crises. To assess whether the new regimes have the potential to deliver, let's briefly look at each in turn.

## Banking Act 2009

We now have a Special Resolution Regime, including new insolvency procedures for banks in the UK which has already been tested. These are contained in the Banking Act which came into force on 29 February 2009. Prior to that there was no dedicated regime. The new legislation was driven by a series of financial institution failures between 2007 and 2009, including Northern Rock, which saw the first run on a UK bank in over one hundred years. This was followed by the fall of Lehman Brothers, the major Icelandic banks such as Landsbanki, Heritable and Kaupthing, all having a significant impact in the UK. Smaller banks, including London Scottish Bank, were placed into old-style administration during this period whilst significant bail outs and mergers changed the face and ownership of our high street banks.

The overriding objective of the Banking Act was to bring about financial market stability. It was first used in the case of Dunfermline Building Society which was placed into Building Society Special Administration on 30 March 2009. At the core of the Banking Act is the Special Resolution Regime which gives our Tripartite Authorities (the Bank of England, the FSA and the Treasury) various options and powers to address failing banks. The new regimes fall into two broad categories, the first being stabilisation measures to be used pre-insolvency.

We now have three pre-insolvency stabilisation measures which in short are:

1. the transfer to a private sector purchaser ('PSP') under which the Bank of England has the power to transfer all or part of a bank to a PSP;
2. the transfer to a bridge bank under which the Bank of England can transfer all or part of a business to a bridge bank being one owned and operated by the Bank of England.
3. the transfer to temporary public ownership ('TPO') where the Treasury can transfer shares in a bank to a nominee company wholly owned by the Treasury.

In addition to the stabilisation measures to be used pre-insolvency, the Banking Act also introduced new insolvency procedures to deal with a bank which has failed. There are two new procedures; a Bank Insolvency Procedure ('BIP') – essentially a liquidation – and a new Bank Administration Procedure ('BAP').

The emphasis of the new regime is on protection and getting in early rather than at the point of insolvency.

'Normal' insolvency regimes focus on the point of insolvency and usually the trigger is a distressed bank's inability to meet the FSA's threshold conditions which are necessary to maintain authorisation.

Although there are some differences of procedure between BIPs and BAPs the more interesting changes lie in the objectives. The objectives of a BAP are to support the PSP or bridge bank and only secondary to that, to rescue the residual bank or achieve a better realisation than would be achieved on a winding up. In the case of a BIP, the objective is a liquidation to enable the Financial Services Compensation Scheme ('FSCS') to allow eligible depositors to be transferred to a solvent institution or receive payment from the FSCS as soon as reasonably practicable (regarded to be one week). Thereafter the liquidator must wind up the affairs of the bank so as to achieve the best result for creditors as a whole.

The key players in the new regime are also noteworthy: the FSA supervises and regulates banking entities and triggers the resolution; the Bank of England has responsibility for liquidity support to banks and runs the resolution once triggered; the Treasury is responsible for funding a resolution (from public monies) and decides on any TPO and finally; the FSCS oversees the pay out to eligible depositors in a BIP and may also be called upon to contribute to the costs of both a BIP and a BAP.

Before commenting on the new regimes introduced most recently for investment banks, it is worth looking at how these new regimes have been successfully used to date.

## Dunfermline Building Society (in Building Society Special Administration) ('DBS')

On 30 March 2009, less than six weeks after the Banking Act came into force and just hours after the relevant supplementary legislation extending to Scotland and to building societies was introduced, an order was made placing DBS into special administration. DBS provides an excellent example of how the Special Resolution Regime can affect a solution without harming depositors or impacting on the banking system. This was particularly important 'hot on the heels' of what was witnessed in the case of Northern Rock. DBS involved the following:

Firstly a partial transfer of assets to a PSP (in this case, Nationwide). To enable this to happen, the Bank of England established a competitive auction process which led to four bidders coming forward and undertaking due diligence. Following that two bids were received and Nationwide was selected.

In addition, there was a smaller transfer of other assets and liabilities to a bridge bank which included the social housing loans.

The third element was the placing of the residual society into Building Society Special Administration with KPMG as administrators. The process continues to be used to manage the run off or eventual sale of the remaining assets which includes a portfolio of loans and floating rate notes.

DBS is a good example of how the new regime can effectively deliver a 'good bank/bad bank' scenario and avoid both a cash call and disruption to the payment and other banking services which customers depend upon.

## Southsea Mortgage and Investment Company Limited (in Bank Insolvency) ('Southsea')

More recently, on 16 June 2011, BDO were appointed joint bank Liquidators of Southsea following a court application by the Bank of England to place it into a BIP. This followed a decision by the FSA that the conditions for initiating the Special Resolution Regime were met. Although Southsea is a very small bank with just over two hundred and fifty depositors, it will nonetheless be interesting to see how the process evolves.

The initial provisions brought in by the Banking Act did not apply to investment banks. As Lehman Brothers demonstrated, we needed special provisions dealing with investment banks owing to the nature of the underlying business and the holding of client monies. As a result, the latest piece completing the jigsaw puzzle came in the form of the Investment Bank Special Administration Regulations 2011 and the more recently introduced rules governing how they will operate.

## Investment Bank Special Administration Regulations 2011 (the 'Regulations')

Following the introduction of the Regulations, we now have a 'Special Administration' procedure for insolvent investment banks. Of particular note are the objectives for this new procedure which are as follows: (i) to ensure the return of client assets as soon as reasonably practicable; (ii) to ensure timely engagement with market infrastructure bodies and the FSA, the Treasury and the Bank of England to resolve relevant issues; and (iii) to rescue the investment bank as a going concern or wind it up in the best interests of its creditors. The Regulations came into effect in February 2011 following consultation and rules to assist in its implementation came into effect at the end of June. The new procedure addresses some of the problems which arose on Lehman Brothers. Client assets expressly include client money as part of the wide definition incorporated. In addition, under these new provisions the administrator can also deal with unsegregated assets in whatever order he/she deems best to achieve the administration objective to return assets, and the administrator is also allowed to return assets not held in segregated accounts. The legislation provides for the introduction of a bar date for the submission of claims with an additional safeguard


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which requires a court application before distribution following the implementation of a bar date. The legislation also provides for continuity of essential services so that providers of hardware and data, for example, are added to the list of essential services which must continue to be supplied, during the administration, provided ongoing services are paid for.

## The international dimension

The Banking Act, although a huge advance in dealing with crises within the sector, applies to UK banks (FSMA authorised deposit takers) and building societies (with certain modifications). In addition, a TPO can also be applied to a bank holding company. As noted in the case of DBS, the legislation has been extended to also apply to building societies. However, the Banking Act provisions only apply to UK undertakings and cannot be applied to foreign incorporated banks or branches of overseas banks. For example, the Banking Act provisions could not have been used with the failure of a number of the Icelandic banks which were foreign incorporated and operating through branches in the UK. In practice, this has significant relevance as a number of non-UK banks operating within the UK (including some substantial entities) operate as branches of overseas banks rather than UK incorporated entities.

In parallel with the measures being introduced in a number of European jurisdictions, the EU also undertook a consultation on a possible EU-wide banking resolution regime. In January 2011, DG Internal Markets & Services issued a working document entitled 'Technical details of a possible EU framework for bank recovery and resolution'. The first stage in the proposed process will involve establishing a common set of resolution tools and the reinforcement of cooperation between national authorities in order to improve the effectiveness of arrangements for dealing with the failure of cross border banks. The proposals come under the broad heads of 'supervision and prevention' and include measures dealing with early intervention, resolution tools and powers, group resolution and financing arrangements.

The proposed resolution tools include the familiar ones of sale of the business and transfer to a bridge bank, including provisions for continued support from the transferor, protection for counterparties in cases of partial transfer and a valuation mechanism to ensure creditors are no worse off on a resolution regime than an ordinary insolvency. Much of the measure mirrors what we now have in the UK. The document also sought views on an additional power of compulsory debt write-downs, exercisable by the resolution authorities.

A more unsatisfactory feature is the suggestion that the same regime should apply to banks and investment firms. As the UK approach of adopting different regimes demonstrates, the issues raised by failure in each instance have significant differences and need to be addressed separately.

The Commission's aim is to have an integrated resolution regime, possibly based on a single European Resolution Authority ('ERA') by 2014. The consultation closed in March and the Commission plans to adopt a legislative proposal for a harmonised EU regime for crisis prevention and resolution imminently.

## Will all these new measures make a difference?

The use of a BAP on DBS arguably delivered a far more flexible and beneficial outcome than would have been achieved had DBS been forced into a normal administration. Whether a BIP will deliver a more effective outcome on Southsea remains to be seen as we are still in the very early stages. Many have questioned whether the Dodd Frank legislation in the US or indeed the new Investment Bank Special Administration Regulations in the UK would have led to a speedier and more effective resolution to date in the case of Lehman. It is difficult if not impossible to say whether the new Regulations and overall regime would have produced a different outcome. The biggest hurdle Lehman faced was undoubtedly the speed at which insolvency processes were triggered. It is helpful that the new regime attempts to pick up on the challenges faced to date. However some of the difficulties faced by the Lehman office holders across the board, for example in unravelling ownership structures and gaining control lie not so much in a framework to deal with failure but in having a more rigid and forensic risk management regime in the first place.

Renewed turmoil this summer highlights the intense pressure the financial sector faces in Europe and beyond. This comes at a time when structural change to the industry continues to be forged in the aftermath of the previous crisis.

Whilst key market participants are focused on survival, long term structural changes continue to take place in their midst. In the UK alone banks face the challenge of gearing up for the increased capital adequacy requirements of Basel III, the unfolding provisions of the Government's White Paper on Financial Regulation, measures to implement 'Living Wills' and most recently the final recommendations of the Independent Commission on Banking published on 12 September 2011. As the first country to publicly detail what will be expected in terms of content and timelines for 'Living Wills', the UK seems determined to remain at the forefront of a worldwide effort to prevent a repeat of the disastrous financial crisis culminating in the demise of Lehman.


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## International Corporate Rescue

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