COMMENT

Shipshape banks

Shipping has a lesson for bank resolution, says **Barnabas Reynolds**

Regulators are still grappling with the paradox that their most important banks are "too big to fail" and yet too costly and risky to bail out. Significant banks have very hefty balance sheets relative to their nation's economy and, although larger institutions can spread risk better than smaller ones, their balance sheets remain hazardous. Counterparty default, unpredictable markets and contagion stalk the business and threats such as the possibility of US class actions over Libor are just as real.

Indeed, the newly discovered potential for a sudden feast of litigation makes banks less stable than ever. With no international forum able to carry out consistent and definitive dispute resolution, there is the possibility of politicised and punitive judgments. Local regulators will follow their local courts, potentially leading to crippling, duplicative payouts. In the regulated sector, it should generally be for the (normally home state) regulators to punish and the courts to provide redress. But this is an unrealistic aspiration. In a globalised world, one nation's attempt to maintain a stable banking system will tangle with the imperatives of another.

A better way of preserving the value that banks represent must be found

Existing approaches to the too-big-to-fail issue aim at risk reduction but it is arguable that safety belts are hampering economic activity when it is needed most. There is, however, a straightforward model for preventing the complete failure of key institutions and preserving value, which takes a more balanced approach to reducing bank risk.

This is the regime that allows shipowners to continue trading after calamitous events. They are permitted to limit their liability for any one incident – and against all claimants – to an amount based on the tonnage of the ship or, in the US, its value. After an incident, the shipowner establishes a fund covering the liability amount and all claims are paid only from this. Claimants who prove their cases satisfactorily in local courts apply for a pro rata payout. The concept is applied in most states by international convention.

Attempts to solve the "too-big-to-fail" problem have so far involved damping financial activity by requiring regulated financial institutions to hold more capital, take more collateral, and exit or ringfence activities perceived as higher risk. Further stringency is likely. However, banks underpin economic activity and certain banks should be capable of being preserved, come what may. Global banking franchises take decades to develop and have been critical in fostering globalisation and a worldwide expansion of cross-border trade and investment. Mismanagement of banks does, of course, occur but a better way of preserving the value they represent must be found.

It should be possible to build on the resolution regimes being introduced or refined. These permit the hiving off of impaired assets into a "bad" bank while the "good" bank continues in business. Here, the approach would be bank-driven and would involve a cap on liabilities based on the assets of the bad bank and the interests of shareholders. All possible claims would be offloaded to enable the "clean" remains of the institution to carry on business unfettered. Current bank resolution processes are triggered by state entities, which can be slow-moving. Under the shipping approach, there is no need to wait for state intervention. This brings speed, effectiveness and finality. It means that the failed institution could itself form a bad bank and carry on under new management without the uncertainties of litigation. The bad bank could be managed through to better economic times and wound down when valuations were less affected by panic.

Such a scheme would clearly have to be approved by the court. Claims left unsatisfied from the assets of the bad bank would be entitled to a statutory charge on the equity of the good bank, enforceable after a prescribed waiting period that allowed the good bank to recover. If the equity value of the good bank permitted, residual claimants would be made whole. While creditors would still enjoy priority over shareholders, creditors' rights to recovery would be capped at the value of the good bank's equity and should not interfere with its business.

The current drive of regulatory reform – to ensure that bank creditors come first – threatens to kill off many of the benefits of sophisticated finance. We need to think beyond restraint. Banks that fail should be permitted to carry on, free from the uncertainties of multi-year litigation and global regulatory action. The setting up of a fund (comprising bad bank assets and equity of the good bank), as sufficient as possible to pay out creditors, would bring finality without destroying banks.

This would surely be in most people's interests. The alternative is full insolvency, where sums recovered by claimants would most likely involve lower returns and an inexorable wait.

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