

Without Credible Resolution Tools, TBTF Cannot be Ended

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Ending TBTF
Federal Reserve Bank of Minneapolis
May 16, 2016

My Focus: Resolution Policy

- ✓ Numerous policies have been launched to prevent an insolvency
 - More and higher quality capital
 - Increased risk weights
 - Capital surcharges for G-SIBs
 - Introduction of leverage ratio
 - Introduction of liquidity requirements
 - Heightened prudential supervision including stress tests
 - Derivatives push out
- ✓ But if these prudential policies are not enough, must have a credible way to resolve a G-SIB

A Consequence of Stern's Law



- ✓ To convince creditors of SIFIs that they will be subject to the risk of loss, must provide the authorities with a viable alternative to bailouts
- ✓ This is a enormous challenge oddly absent from the international regulatory agenda before 2008
 - Bailouts during crisis – a commitment equal to \$14 trillion or 25% of Global GDP¹ – demonstrated TBTF is too expensive to continue
 - Problems overwhelmed asserted goal of “No bailouts!”
 - Problems should have been learned from a string of failures from Herstatt through BCCI, Barings and LTCM

¹Haldane

LEHMAN BROTHERS



The exception that proved the rule. The authorities lacked the tools to deal with a nonviable G-SIB

Lehman profile



- ✓ Asset size: \$634 billion
 - 4th largest investment bank (more than twice as large as Bear Stearns)
 - 25,000 employees
 - Fewer than current compliance staff of Citigroup*
 - Record earnings in 2007
 - Learned that 6,000 legal entities in more than 40 countries
- ✓ Leverage (Debt/Equity) as high as 60:1 between reporting periods, but concealed through window dressing
- ✓ Main source of funding: O/N repos
- ✓ Extensive interconnections with the rest of the financial system
 - More than 1 million contracts outstanding at bankruptcy

Lehman Structure



- ✓ Managed as highly centralized single entity
 - Most employees did not know which legal entity they worked for
 - Traders booked on b/s sheets of several different entities, often without explicit knowledge of customers
 - Many operations located in London where customer funds could be mingled with the firm's own funds
- ✓ Holding Company, LBHI, acting as treasury & central bank for group
 - Issued debt
 - Managed cash
 - All cash swept in at the end of each business day
 - Distributed “as needed” the next day
- ✓ Most other support services—e.g. MIS, risk management
 - centralized and shared among affiliates
 - But 2,700 different software applications across the globe

Totally Unprepared for Bankruptcy

- ✓ When failed to find buyer, forced to seek Ch. 11 protection before Asia opened
 - By far the largest bankruptcy in history,
 - Initiated without any preparation
 - Bankruptcy process begun before cash returned to subs
 - Subs illiquid and unable to continue operations
 - Result, over 60 bankruptcy proceedings around the world
 - Many countries ill-prepared to deal with resolution of this sort of institution
 - Example: in UK, no provision for DIP financing
 - Centralized record-keeping collapsed when LBHI filed for bankruptcy.
 - Key IT systems sold to Barclays so other affiliates lost access to information vital for resolution
 - Complex intra-affiliate transactions difficult to sort out
 - Minimal record keeping by legal entity
 - Difficult to entangle who owed what to whom
 - Most insolvency proceedings lost access to critical MIS
 - 43,000 trades still live and had to be negotiated separately with each counterparty
 - Filing created an event of default and termination of > 900,00 contracts
 - Close-out netting resulted in downward pressure of asset prices

Disorderly Resolution Exacerbated Crisis

- ✓ Lehman permitted to continue operations well beyond point of economic insolvency
 - Expected to benefit from Bear Stearns like bailout
 - Losses mounted exacerbating challenge of orderly resolution
 - Authorities refused to extend bailout, but tried to persuade other banks to provide and LTCM-like rescue
- ✓ US acted unilaterally, without consulting other jurisdictions
- ✓ US provided liquidity for US broker-dealer until sale to Barclays, but did not make liquidity available for other entities
 - Liquid balances trapped in h/c
 - No liquidity assistance provided to 49 other countries attempting to resolve Lehman subs
- ✓ Because of SIPC protection for US b/d domestic spillovers limited mainly to
 - Money market mutual funds
 - Commercial paper market
- ✓ Disruptions in international markets much greater

Officials Understood That Lehman Was By No Means The Worst Possible Case

- ✓ Many G-SIBs had much
 - Larger balance sheets (trillions not billions)
 - More extensive interconnections
 - More complex intra-affiliate transactions
 - More diverse lines of business
 - More complex organizational structures
 - More extensive international involvement
- ✓ If confronted with the collapse, no plausible way to resolve without exacerbating financial instability

When world leaders met at G-20 declared
“Never Again!”



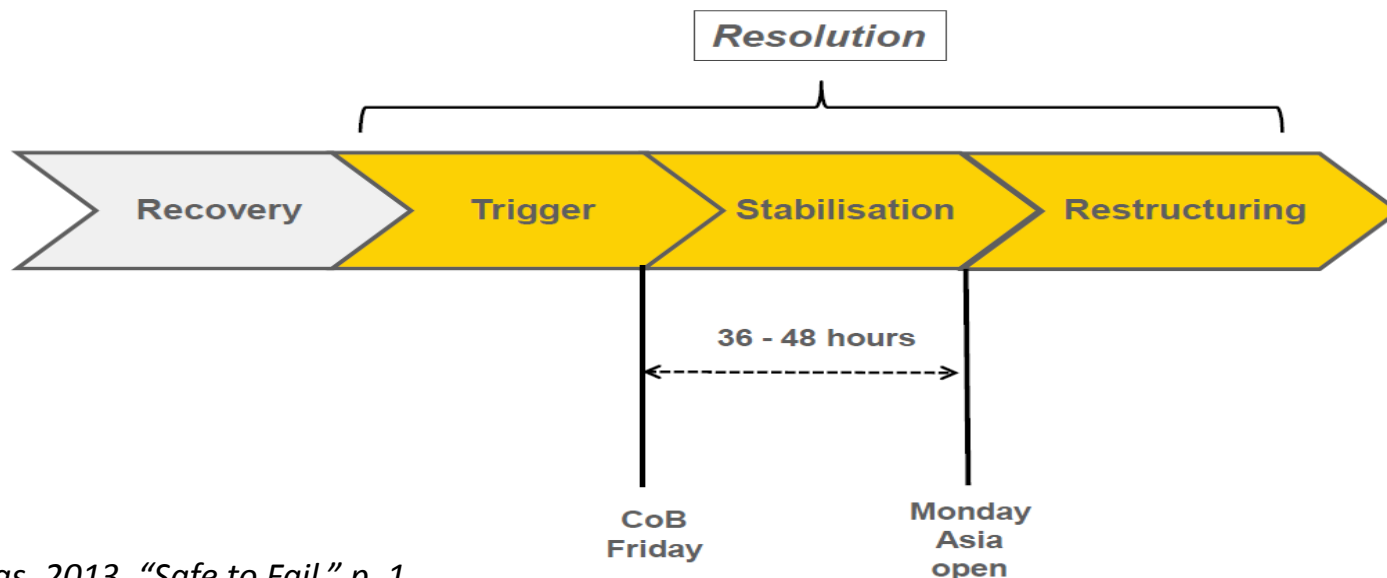
Resolution policy catapulted from no where
to the top of the reform agenda

An Enormous Challenge

How to develop a credible way to resolve any G-SIB through recapitalization, sale or wind-down without

1. Destabilizing financial system and real economy
2. Tax-payer funded bailouts

All this must be accomplished over a weekend—planning essential



G-20 Directed FSB and Basel Committee to Determine What Must Be Done



- ✓ Develop a methodology to identify G-SIBs
- ✓ Devise mechanisms to ensure international cooperation in the resolution of a G-SIB
- ✓ Establish international standards each national resolution authority should meet to
 - Assure continuation of systemically important services during resolution
 - Maintain financial stability
 - Allocate losses solely to shareholders and creditors of insolvent institution

G-SIB Indicators and Weights

Category (and weighting)	Individual Indicator	Indicator Weighting
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability (20%)	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	OTC derivatives notional value	6.67%
	Level 3 assets	6.67%
	Trading book value and Available for Sale value	6.67%

Anticipated Benefits



1. Make clear to G-SIBs, the market in general, and creditors and counterparties in particular, that no G-SIB need be bailed out
2. Force G-SIBs & their boards to anticipate and internalize spillover costs that might occur
3. Make authorities aware of what must be done
4. Establish international crisis resolution groups for each G-SIB to clarify shared responsibilities and coordinate planning

A Rapid Recovery Plan (RRP)

Starts with Assumption of Insolvency

- ✓ **Requirements intended to eliminate obstacles to orderly resolution evident in Lehman case**
 1. Map and align lines of business with legal structure
 2. Identify systemically important services and how to protect them in resolution
 3. Identify crucial shared services and how to protect them in resolution
 4. Maintain a virtual data room containing all information resolution authority would need to make an expeditious resolution

US Implementation

- ✓ Title I of Dodd-Frank Act mandates **living wills** for all banks with \geq \$50 billion in assets
- ✓ Must submit plans for rapid and orderly resolution under the bankruptcy code
- ✓ If FRB & FDIC determine plan is not credible, can impose ***sanctions***
 - More stringent capital and liquidity requirements
 - Activity restrictions
 - Constraints on growth
 - Restructuring or divestment

Ist Substantive Review Did Not Go Well

- ✓ August 2014, FED & FDIC rejected living wills submitted by all 11* in October 2013
 - FDIC voted to deem submissions “not credible”
 - Would start clock for deployment of sanctions
 - FED found “shortcomings,” but warned that if no immediate action to improve by 2015 submission would join FDIC in finding of “not credible”
- ✓ FDIC stated living wills “would not facilitate an orderly resolution based on the bankruptcy code and are not sufficient to realistically exclude the need of direct or indirect public support in case of a crisis”

*In March 2015, rejected living wills submitted by HSBC, RBS and BNP Paribas

Authorities demanded improvements in 5 areas



1. Rationalize and simplify legal structure to better align legal entities with lines of business
2. Develop “clean” h/c structures to facilitate single point of entry resolution plan
3. Amend qualified financial contracts to permit brief stay to avert immediate close-out netting
4. Show how shared services –e.g. IT, risk management, treasury –would support critical operations and core business during resolution
5. Demonstrate ability to provide information on a timely basis to facilitate resolution

This April Announced 5 US G-SIBs had Failed to Make Sufficient Improvement



- ✓ “Not Credible” finding set sanction clock ticking
- ✓ Regulators made public lightly-redacted letters to each of the G-SIBs setting out
 - Areas in which progress made
 - Areas of concern
 - “Deficiencies” must be remedied by October 2016
 - “Shortcomings” that must be corrected by July 1, 2017
- ✓ Welcome advance in transparency
 - Clarified expectations of the authorities and may help focus market expectations
 - Increase accountability of G-SIBS and authorities

Concerns re: Title I Approach

- ✓ Can U.S. bankruptcy law provide the framework for an orderly resolution of a global financial institution?
 1. How can it meet the need for speed?
 - Markets move virtually instantaneously while courts move with “deliberate” speed
 2. How can the public interest in financial stability be recognized in a process designed to protect creditors?
 3. How can sufficient liquidity be provided to fund systemically important functions during process?
 - Have never before mobilized DIP financing in the quantity and with the speed needed
 4. How can international cooperation be achieved?
 - An essential component of the problem
 - No way for unidentified judge to participate in international cooperative agreements
 - Foreign authorities view the US court system as a crapshoot, would much prefer an administrative resolution

Title II Provides a Back-Up Administrative Alternative



- ✓ But can only be used after demonstrating bankruptcy would be destabilizing and overcoming a number of procedural hurdles—FDIC & Fed Boards, Secretary of Treasury and the President must agree
 - Can this decision be made over a resolution weekend?
- ✓ Would provide access to liquidity under the Orderly Liquidation Authority
- ✓ More likely to facilitate a cooperative international solution
- ✓ FDIC has undertaken extensive planning to undertake a resolution

FIDIC has Developed D-F Title II Resolution Strategy

✓ Single Point of Entry

- FDIC would implement Title II receivership at parent holding company
 - Transfer receivership assets (primarily investments in subsidiaries and loans to subsidiaries) to bridge H/C
 - Subordinated debt & equity remain in receivership
- Equity solvent subs remain open
 - Receiver provides funds/guarantees, as necessary to bridge holding company through the Orderly Liquidation Authority Fund
 - Bridge H/C serves as “source of strength” recapitalizing subsidiaries, as necessary
 - Bridge H/C will downstream liquidity, as necessary, thru intra-company advances

✓ Finesses two huge obstacles

1. Reduces urgency of radical simplification of legal structures
2. Reduces burden of cross-border coordination

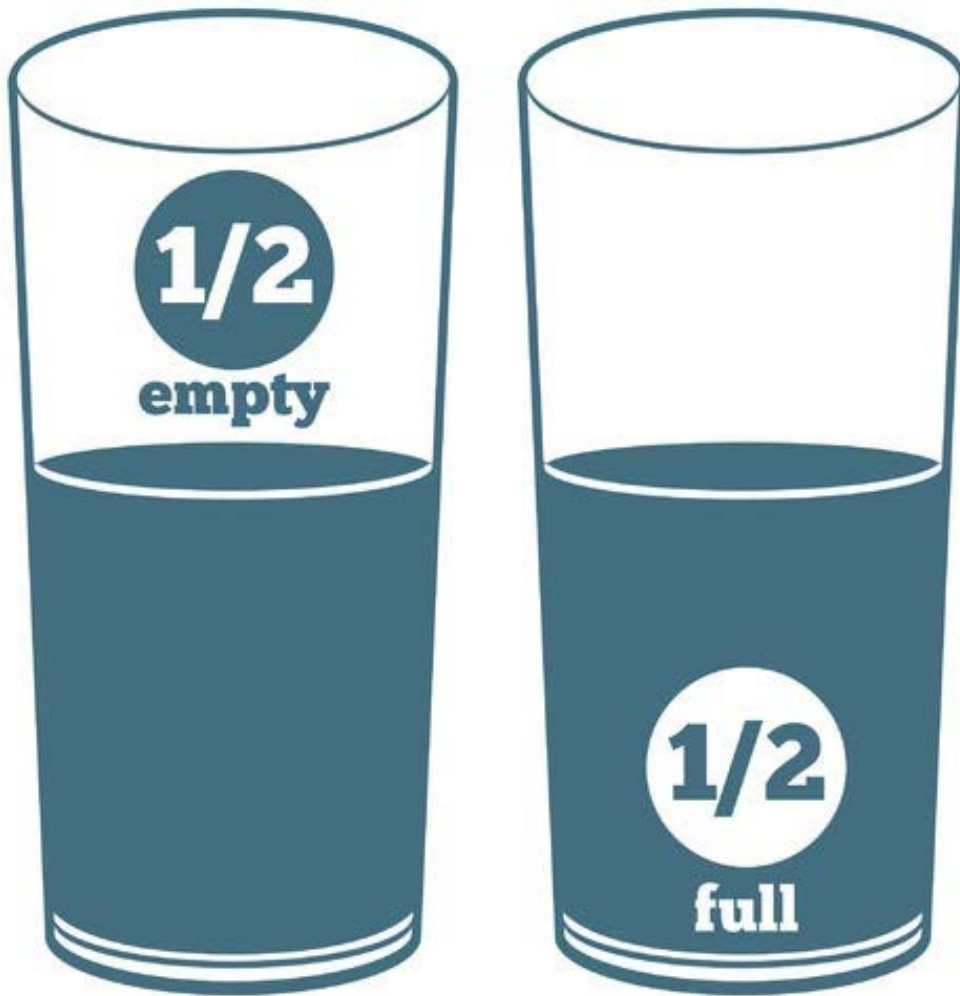
✓ Separates financial from operational restructuring

But Many Remaining Concerns

Will it work?

- ✓ Will process be initiated before necessary liquidity and bailinable capital exhausted?
 - Governance Triggers should assure Prompt Corrective Action
 - TLAC is supposed to be guarantee sufficient capital
- ✓ Will host countries abstain from ring-fencing?
 - Massive efforts to facilitate international cooperation, but no sovereign is likely to give up the option to ring fence.
 - “Prepositioning” capital and liquidity
 - US IHC requirement
- ✓ Will authorities keep up the pressure until all G-SIBs can be credibly resolved without exacerbating financial instability and without taxpayer assistance?

Where are we now?



But no longer

