Speech

Resolution in context: the policy drivers of the new paradigm

Speech given by

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Three years ago the Financial Stability Board published the "Key Attributes of Effective Resolution Regimes".

The objective of the Key Attributes was to ensure that we can let banks fail without causing excessive collateral damage to the financial system and the real economy and that we can let banks fail without the taxpayer footing the bill.

Bail-in not bail-out

We have come a long way from where we were in 2011. However, at the risk of stating the obvious, let me remind you of why we want to ensure that we never again have to bail out banks.

First, bail-outs are unfair. The implicit government guarantee enjoyed by 'too-big-to-fail' banks has meant that while taxpayers bore the risks of failure and the costs of the financial crisis, profits in the good times were enjoyed by private investors.

The ability for private investors to take the rewards but not the risks of their investments is at odds with a free market economy. Some have argued, however, that ultimately this is less of a problem since taxpayers and investors tend to be the same people.

But this claim is not supported by the data. In the UK, the top 10% of households own almost 45% of overall wealth. For pension funds, one of the largest investors in bank debt, the distribution is even more skewed: the same households own almost 50% of private pension wealth.[1]

By protecting investors, a small self-selecting group of people stands to reap most of the benefits of risk-taking by banks, while the losses arising from bail-outs are spread out across taxpayers. This may take the form of higher taxes or may deprive governments of funds to build schools and hospitals. In the dislocation of the crisis, it has also resulted in cuts in welfare, hitting those least likely to benefit from banks' profits.

This comparison does not even consider the international dimension of the problem: investors, especially those investing in global banks, are not necessarily based in the UK, while taxpayers are. Again, this implies that the people who benefit from the upside may not be the same that bear the downside risk.

Second, bail-outs create moral hazard. Without a credible resolution regime, a government cannot walk away from its 'implicit guarantee' of banks. And it cannot charge a price that reflects the risks it is facing and the increase in its own cost of debt. Hence, a government cannot exert 'market discipline'. In contrast,

[1] Source: Wealth and Assets Survey for years 2010/2012, Office for National Statistics. Note that in contrast to private pensions, public pensions are only backed by the government's promise of future payments. Hence, state pensioners are not bank creditors. If anything, they are creditors of the government and bear the cost of any bail-outs.

creditors can decide not to roll over a bank's debt if they do not like the risks they are exposed to. Or they can demand a return that compensates them for higher risks.

Unlike shareholders, uninsured creditors do not benefit from the upside of the borrower's risk-taking and are hence inherently risk-averse. They focus on downside risk and may be effective monitors of risk-taking by banks once they no longer benefit from government guarantees.[2]

If banks' funding costs become more reactive to the risks they are taking this reduces banks' incentives for 'excessive' risk-taking.[3] It should also act as an additional check on leverage by reducing banks' incentives to over-lend during a boom (and to enter a crisis more than 30 times leveraged). Both of these factors should make the financial system more resilient. If some risky lending becomes more expensive due to credible resolution regimes, then this is a sign that the medicine is working.

Third, it is not obvious that governments are best placed to absorb losses in a crisis. The losses of a failed bank will always be borne by individuals, just like losses of any other firm. They cannot evaporate behind some corporate veil. But institutions with a strong balance sheet can absorb the initial impact and spread the pain over time.

We might think that governments are best placed to absorb shocks in a systemic crisis. However, this is hard to reconcile with experience. In Spain and Cyprus, governments were unable to absorb losses stemming from multiple bank failures. They ended up having to impose losses on bank creditors.

In countries like the UK, the government bailed out banks. But because of the strain that these bail-outs put on public finances, governments felt that they had to impose strict austerity measures to cope with the contingent risks to their balance sheets. Moreover, many sovereigns' credit worthiness deteriorated, which put pressure on the prices of government bonds and on the banks that held them. This is what became known as the sovereign-banking feedback loop

All of this suggests that even when ignoring fairness and moral hazard, it is unclear if bail-outs are the best way to cope with a banking crisis. In a systemic crisis it may be particularly challenging for governments to absorb the (entire) cost of multiple bank failures.

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[2] Effectively, shareholders own a call option on a firm's asset value. In the absence of perfect market discipline this can give shareholders incentives to urge the management to take more risks. See e.g. M. Jensen and Meckling W., "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure.", 1976, Journal of Financial Economics, 3: 305-60. For creditors the opposite is the case: they suffer from uncertainty and should favour more prudent investment choices.

[3] The academic literature provides evidence that market discipline is undermined by implicit government guarantees. See e.g. Acharya, V., Anginer, D. and Wharburton, A., "The End of Market Discipline? Investor Expectations of Implicit Government Guarantees", 2014, mimeo or Afonso, G., Santos, J. and Traina, J., "Do Too-Big-To-Fail Banks Take on More Risk?", 2014, NY Fed Economic Policy Review, 20(2).

Bail-in is not just about avoiding bail-outs. Some have advocated achieving this by setting much higher capital requirements instead. But it is essential for the health of the system to make resolution work and banks 'safe to fail'.

We of course do not want banks to fail as soon as they encounter difficulties. We need a strong macro and micro prudential framework, which includes provisions for capital buffers that are usable without entry to resolution. But there is not an appetite for imposing capital requirements that cover any imaginable loss a bank could face. Banks will not be 'fail-safe'. So we have to make resolution work and make them 'safe to fail'.

Even if we could impose arbitrarily high capital requirements, it is not clear that we would want to do so. By keeping firms from failing we undermine the 'creative destruction' that characterises any competitive industry. We have to remove 'barriers to exit' that keep firms with bad business models in the market and prevent others from entering.

This is achieved by resolution. The entry into resolution means that the bank has failed. And resolution entails many of the consequences that we would expect to see in insolvency, while also maintaining financial stability. Following the 'resolution weekend', the bank would be restructured, its critical economic functions may be sold and other business lines may be wound down over time and in an orderly way. Throughout this process, insured deposits would be protected and depositors would have access to their accounts.

The credible prospect of failure is also a valuable disciplining device for a firms' management. If managers know that they will either need to pay their creditors tomorrow or fail, they will be more careful with the risks they take today.[4]

Bail-in is one specific resolution tool – a legal mechanism for imposing losses on creditors. In a bail-in some of a bank's liabilities are written down or converted into equity to ensure that a bank can once more meet its capital requirements and command market confidence during the restructuring period. This is often confused with the write-down of a contingent convertible bond, a so-called 'CoCo' that banks may, in at least some cases, use to meet certain of the existing Basel III capital requirements. However, almost any unsecured liability can be exposed to loss in resolution, not just CoCos.

[4] This is what the academic literature calls the 'free cash-flow effect'. According to this theory, debt funding features an implicit commitment by investors to let a firm fail if the firm does not return funds to its investors (e.g. via coupon payments). However, this relies on failure being a credible option. Exclusively equity-funded firms do not have to return funds to investors and managers may hence be more likely to use funds for the purpose of 'vanity projects' or 'empire-building'. See e.g. Jensen, M., "Agency costs of free cash flow, corporate finance, and takeovers", 1986, American Economic Review, 76(2): 323-329.

This distinction is important for a number of reasons:

First, I don't think we will ever have enough CoCos to cover all realistic loss-absorption and recapitalization needs in resolution.

Second, the write-down of a CoCo does not in itself address the cause of a failure. It would usually need to be accompanied by other resolution actions.

Third, resolution may become necessary before the trigger for converting the CoCo is reached.

Finally, and most importantly, most CoCos are highly complex products. It is doubtful they are fully understood by investors in all cases. For example, from a creditor perspective CoCos that write down to zero effectively rank junior to equity. And it is not clear that investors appreciate the incentive effects that some CoCos create. At their trigger point, many CoCos transfer wealth to existing shareholders. This means that shareholders' profits increase if the firm performs worse and triggers the conversion of its CoCos.[5]

The risk that standard liabilities will be written down or converted to equity in resolution is considerably easier to understand. When exposing liabilities to losses and carrying out a recapitalisation by conversions to equity, resolution authorities are committed to following the creditor hierarchy closely. The treatment of bond holders as a result should not differ from the treatment of corporate bondholders in insolvency. And it would not have the perverse incentive effects of some CoCos.

Making resolution credible

Prior to the crisis, policy-makers around the world advocated a policy of "constructive ambiguity" when it came to the possibility of bank bail-outs. It was thought to be "ambiguous" as policymakers tried to keep banks in the dark on what they would do if a large bank were to fail. And it was considered to be "constructive" since it was supposed to encourage banks not to rely on bail-outs, without tying the government's hands in a crisis.

This turned out to be neither ambiguous nor constructive. It was not ambiguous since bankers and investors surmised – correctly it transpired – that governments would bail banks out. And they chose their investments and priced risk accordingly. And it did not turn out to be constructive since creditors came to expect that they would not suffer losses. When Lehman was allowed to fail, bank creditors rapidly changed their expectations and funding costs across the financial system skyrocketed. Effectively, governments had tied their hands. They were unable to let another bank fail without causing wide-spread panic.

[5] See Berg, T and Kaserer, C., "Does Contingent Capital Induce Excessive Risk-Taking?", 2014, mimeo.

Resolution is changing this. It replaces what was thought to be "constructive ambiguity" with ex-ante clarity. We are clear that we will let banks fail. And that in resolution, losses will be absorbed in a way that is predictable and consistent with the creditor hierarchy. Resolution will always involve an element of discretion. But we do not want to surprise markets. The discretion is merely a result of the fact that we cannot describe our reaction function for every firm and in every state of the world ex-ante. This is similar to what has become known as 'constrained discretion' in monetary policy.[6] While we firmly commit to an outcome, we have to retain some discretion on how exactly to achieve it.

There are encouraging signs that market participants have been listening.

Estimates of the implicit subsidies that banks receive due to perceived government guarantees have been declining over the past years. While part of this may reflect cyclical trends, it is still welcome news.[7] Separately, rating agencies are also changing their assumptions regarding government support and argue that it is becoming less likely that banks will be bailed out.

Convincing market participants that we are serious is essential to ensure that the resolution of a systemically important bank would not trigger market panic. If investors are fully aware of the risk of bail-in, bail-in will not come as a surprise. And creditors of other banks will not withdraw funding simply because the creditors of one bank are not bailed-out.

However, investors will not change their expectations (just) because of convincing speeches.

We are also designing a regime that makes resolution time-consistent and the threat of failure credible. The work we have done and the work we still have to do should ensure that when it comes down to the choice between bail-outs and resolution, governments will prefer resolution.

Let me highlight some of the areas where we have made progress.

- In Europe, the legal tools to resolve a bank in an orderly fashion are now enshrined in legislation via the "Bank Recovery and Resolution Directive" (BRRD) and will come into force in January. The BRRD also includes a requirement to expose at least 8% of a bank's creditors to loss before accessing resolution funds.

- The FSB has provided guidance on the interplay between resolution and group structures. The proposed approach greatly simplifies the bail-in process. And it limits the amount of resources needed to resolve

[6] See e.g. Bernanke, B., "Constrained Discretion and Monetary Policy", 2003, (Speech at the New York University). Haldane, A., "Constraining discretion in bank regulation", 2013, (Speech at the Federal Reserve Bank of Atlanta) introduced the term of constrained discretion in the context of prudential regulation, albeit in a different context.
[7] The value of implicit government guarantees to banks depends not only on the probability that failing banks receive bail-outs, but also on the probability that banks will threaten to become non-viable in the first place. Hence, we would expect implicit subsidies to decline in times of lower uncertainty.

multiple banks within a limited time frame. In the case of "Single-Point-of-Entry" banks, we would aim to only apply resolution tools to one entity in the group. But even in "Multiple-Point-of-Entry" banks, only a small number of entities would be put into resolution. We would not resolve a cross-border group on an entity-by-entity basis.

- A protocol to ISDA netting agreements has been agreed to ensure that OTC derivative contracts are not closed out in a disorderly way as a bank enters resolution. This agreement is a crucial supplement to statutory stays and ensures that stays are effective in a cross-border context. While this protocol is voluntary, it has already been adopted by the 18 largest dealer banks and we intend to encourage more market participants to sign up to it.

- We have finished in the FSB the first round of Resolvability Assessment Processes (RAP) reviewing resolution strategies prepared in Crisis Management Groups for G-SIBs. These RAPs have given us valuable insight on the remaining barriers to resolution – significantly, there is consistency across G-SIBs as to the key barriers to resolvability. This is clear from the FSB's report on G-SIB resolvability to the G20 leaders in Brisbane. Resolvability is not binary and work to address the barriers will help us to make G-SIBs progressively more resolvable. Moreover, as barriers are removed, authorities will be able to communicate more clearly how resolution will look in practice.

Total Loss Absorbing Capacity

Finally, this November the FSB's proposed a standard on "total loss absorbing capacity". This is a watershed moment in ending TBTF. The standard will ensure that G-SIBs have sufficient loss-absorbing capacity that can be credibly bailed-in in resolution to recapitalise the G-SIB and to ensure that the G-SIB can subsequently be restructured or wound down in an orderly fashion.

But why do we need such designated loss-absorbing capacity?

In principle, every liability is loss-absorbing. If a firm does not have the assets to repay a certain liability, the liability will not be repaid. It absorbs losses. This is mirrored in the design of bail-in regimes: most statutory bail-in regimes allow authorities to impose losses on a wide set of liabilities.

However, liabilities differ with respect to how 'readily' they absorb losses. For some liabilities bail-in is operationally difficult whether for legal enforceability, valuation or other reasons. For others, their bail-in may undermine the objectives of financial stability and continuity of critical functions that the bail-in is designed to achieve.

This has been recognized by the FSB. The TLAC requirement forces G-SIBs to hold a sufficient amount of liabilities that are most readily loss-absorbing. Faced with the risk of bail-in G-SIBs might want to replace

liabilities that are easy to bail-in by cheaper liabilities that are harder to bail-in. A minimum TLAC standard prevents this.[8]

Should we be concerned about contagion when bailing in TLAC that is held by other banks?

Yes, we should. This is the reason why the Basel Committee is currently developing policies that will significantly reduce banks' incentives to invest in TLAC-eligible instruments. And banks that do invest in TLAC may need to increase their own loss-absorbing capacity.

For banks, the risk of contagion may be particularly high since they may already be under stress at the point where a G-SIB fails. Also, few financial institutions are as leveraged as banks. However, this does not mean that other investors shouldn't prepare for potential losses arising from bail-in. There is no reason why a pension or investment fund should expect to be exposed to losses following the default of a corporate, but not following the default of a G-SIB.

Isn't bail-in of TLAC likely to be disruptive and subject to legal challenge?

As resolution will result in creditors bearing losses, it is quite possible, if not probable, that some may seek to challenge aspects of the resolution in the courts. But we have included in resolution regimes a set of creditor safeguards which minimise the likelihood that litigation will be successful, by making it unlikely that discretionary actions by a resolution authority will penalise creditors relative to the 'insolvency counterfactual'.

We aim to follow the creditor hierarchy closely and to preserve franchise value in resolution. This minimises the risk that creditors are worse off than insolvency, which would entitle them to ex-post compensation. And it is the reason why we require TLAC to be subordinated. If legal recourse is successful, creditors should be compensated ex-post. But recourse cannot be used as a bargaining technique or to undermine successful execution over the resolution weekend.

I want to stress that even a successful resolution of a G-SIB will inevitably result in some disruption and uncertainty, particularly when the tools are used for the first time. But this disruption can be tolerated when set against the benefits of ending "too-big-to-fail" and the long-term costs of bail-out.
How about liquidity? Bail-in does not create new liquid assets.

Liquidity and solvency are related: every pound of liabilities that is converted into equity does not have to be repaid or serviced through coupon payments. This reduces liquidity outflows. More importantly, a strongly

[8] The FSB proposal only covers the Pillar 1 minimum requirement for TLAC. Authorities may choose to apply additional Pillar 2 add-ons to ensure that sufficient loss-absorbing capacity is available in resolution.

capitalised institution should be able to retain liabilities or to attract new funds. This is why we have pushed for a robust calibration of TLAC.

However, this may not be enough. Some public liquidity backstop may be needed to make resolution work. In some regimes, a resolution fund is established for this purpose. In others, the central bank might perform this back stop role. But this still requires a robust calibration of TLAC to ensure that any public lending is not subject to meaningful solvency risk.

What about a systemic crisis? Surely bail-in of TLAC cannot solve a systemic crisis.

As I have argued before, in a systemic crisis the government may be the last 'person' that is able to absorb any additional losses. This would leave bail-in (or other forms of resolution) as the only option.

But even if the government decides to offer support, a robust resolution framework can still ensure that creditors bear some of the costs of failure. This is beneficial for a number of reasons. Let me highlight two aspects that I believe to be particularly important.

First, there is a path-dependency to government support. In the early stages of the crisis by bailing out small banks, government reinforced perceptions that other institutions of similar or higher systemic importance would be saved, too. This tied the government's hands once other banks did fail. If a credible resolution regime allows us to impose losses on creditors at the beginning of a crisis, then we retain the option of bailing in other creditors later on without surprising investors and without triggering a sudden re-pricing of risk.

Second, a government's ability to support the financial system will always be limited. So by imposing losses on some creditors, it can ensure that it will be able to offer support in situations where doing so is most important to protect financial stability.

Where next?

Over the past three years we have made considerable progress on making resolution a credible option. However, we know that more remains to be done to make it fully effective. Let me highlight just a few of the items on our agenda.

First, we need to implement the standards that have been agreed:

- The FSB is currently consulting on its proposal on TLAC and is conducting a comprehensive impact assessment to inform the final calibration. The goal is to finalize the standard in time for the G20 leaders summit in 2015. Subsequently, it may have to be transposed into national laws. And banks will have at

least until 2019 to comply. In the EU, the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) that will apply to all EU banks from 2016 onwards offers a good framework to implement the TLAC standard for G-SIBs.

- The ISDA protocol on derivative stays has been a major achievement and in 2015 we will need to ensure that other banks and the buy-side buy into it. The FSB expects the rest of the G-SIB population to adhere to the protocol by the end of 2015 and regulators have committed to measures that will require a broad range of firms to have such provisions in their trading agreements. This will ensure a level playing-field across market counterparties.

Second, we need to work on post-resolution restructuring, which is critical to preventing the resolved bank from succumbing to a second failure. This will require ensuring operational continuity beyond the 'resolution weekend'. But it also involves a clear vision of how we expect a failed bank or its successors to look a year after entering into resolution and thereafter. A large scale restructuring of a G-SIB may take as much as four or five years and will involve significant costs, potentially 10-20% of annual revenues. The time and costs demonstrate the importance of ex-ante preparation in our ability to effectively restructure a bank following resolution.

In the UK the ring-fencing of retail banks is one example for this ex-ante preparation. Ex-ante planning can also provide a deeper understanding of which business lines can be effectively sold or wound-down in a manner that may further limit restructuring costs and protect the value of the continuing business. But it is also very important that a bank has sufficient loss-absorbing capacity to cover the anticipated costs of restructuring.

Finally, we will have to turn our attention to access to financial market infrastructure and the resolvability of FMIs themselves.

If a bank loses access to FMIs simply because it enters resolution, then this is almost guaranteed to threaten the continuity of critical economic functions and financial stability more broadly. Hence, we need to ensure that this does not happen.

But many FMIs are themselves systemically important. So they should be subject to appropriate resolution arrangements. Due to the financial risks they are exposed to, central counterparties (CCPs) are probably top of the list. We expect EU legislation on CCP resolution in 2015, and given the global reach of CCPs, it is critical to ensure that it is consistent with the internationally agreed principles set out in the *Key Attributes* and the supporting annex.

This covers not only the tools and safeguards available in resolution, but also powers to assess and enhance the resolvability of CCPs ex-ante, including the amount of loss absorbing capacity in their liability structure.