ENDING TOO BIG TO FAIL: REASONS FOR OPTIMISM

MAY 16, 2016

John F. Bovenzi

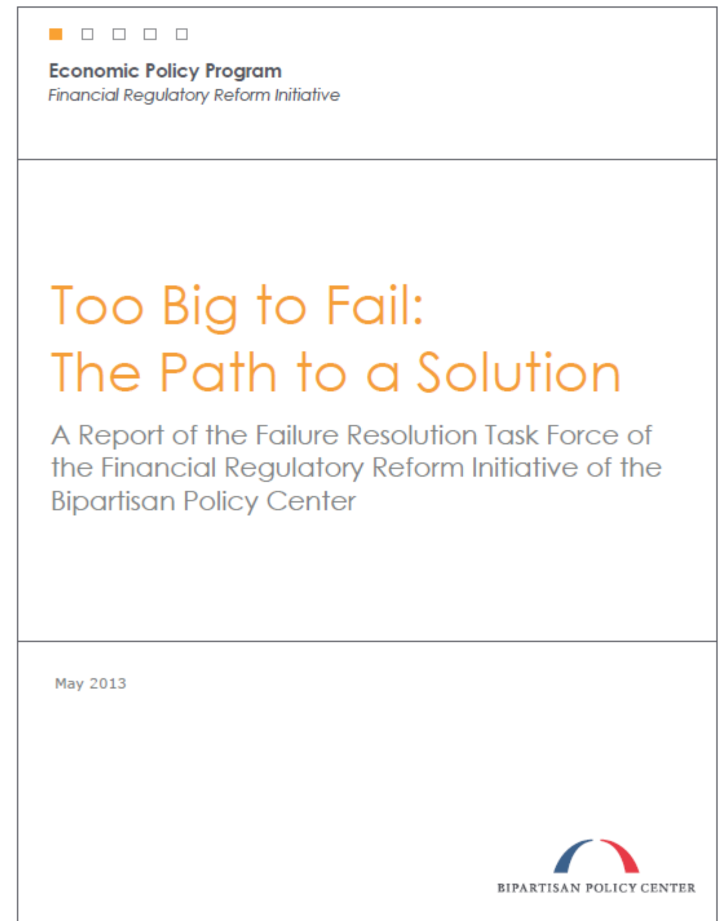
Introduction: Too-Big-to-Fail (TBTF)

How far have we come? What remains to be done? Can we get there?

- Significant progress, but most important work remains incomplete
- Require strong and sustained commitment by the FDIC, Federal Reserve, and the banking industry

What will success look like?

- Any financial institution can fail without…
  - Creating unacceptable spillover effects to our economy or our financial system; and
  - Having the government bail out creditors or create a risk of loss to taxpayers



There are six major developments that provide reasons for optimism in ending TBTF, and key stakeholders will need to be engaged as well

Reasons for optimism:

1. Change in attitude regarding the need to end TBTF
2. Legislative framework for resolving insolvent banking organizations; requiring banks to develop credible living wills
3. Significant increase in capital and liquidity at largest banking organizations
4. Development of Single Point of Entry (SPOE) resolution strategy
5. Recognition of need to hold significant long-term subordinated debt
6. Actions underway to prevent counterparties from terminating financial contracts upon insolvency

Steps by the FDIC, the Federal Reserve and the banking industry:

- Stay the course; and
- Greater clarity and transparency in the process

As the process to end TBTF unfolds:

- We will see significant restructuring in banking industry
- Market will determine appropriate structural changes
- Preferable to alternative of legislatively imposing arbitrary changes

1 Post-crisis change in attitude has resulted in significant progress

Previously

- Since Great Depression, bank bailouts have been the rule, not the exception
- Few wanted to talk about the possibility of imposing losses on large-bank creditors
  - Would always exist
  - Would scare public
- No real progress in ending TBTF in 25 years following the rescue of Continental Illinois

Now

- Intellectual firepower devoted to topic
- Built up momentum and directed in right direction
- No reason to accept TBTF as inevitable

2 Enactment of Title I and Title II in the Dodd-Frank Act

Prior to 2008 financial crisis

- Little to no advanced planning; no viable framework to handle resolutions
- Required improvisation

Title I of Dodd-Frank Act

- Requires Systematically Important Financial Institutions (SIFIs) to develop credible living wills
- Initially, plans judged on informational completeness; now, on credibility
  - 5 of 8 large-bank plans deemed non-credible
- Living wills can have impact
  - Structure of large financial firms changing
  - Some are shrinking and reducing operational complexity

Title II of Dodd-Frank Act

- Framework for resolving large complex financial institutions
- FDIC granted similar authorities as it had for resolving individual field banks
  - Bridge financial company creation
  - Automatic stays
  - Orderly liquidation funds

❸ Significant increase in bank capital and liquidity

- Improvements have helped in two important ways:

  1. Probability of failure for individual institutions reduced
  2. Likelihood of chain reaction of SIFI failures at the same time is reduced

- Let's expand on the second point:

  – If one large bank fails → likely multiple large banks fail → more likely to resort to taxpayer bailouts

  – Fed's annual stress tests show all large banks have more than enough capital to survive an economic disaster on par with financial crisis

    - Suggests some combination of severe economic downturn plus idiosyncratic event(s) needed for individual large bank to fail

  – If largest banks have more than enough capital, odds are much less of multiple large banks experiencing adverse idiosyncratic events at the same time

❹ The Single Point of Entry resolution strategy

- SPOE provides vehicle through which SIFI's most important legal entities remain open and operational in the event of solvency
- Reduces the challenges posed by cross-border activities
  – Ring-fencing of assets less likely
  – Countries may still ring fence when there is not enough capital and long-term convertible debt (the US is protecting against this)
- May result in Multiple Point of Entry (MPOE) resolution strategy
  – Closes parent holding company; leaving critical subsidiaries open and operational
  – Practical implications same as for SPOE

5 Greater reliance on long-term subordinated debt

Growing recognition

- SIFIs need to hold enough long-term subordinated debt
- Requirement to hold more long-term debt is counter to historical practice
- Long-term debt is more expensive than short-term debt, but it cannot run
  - Taxpayers off the hook
  - Can recapitalize bank (if convertible)
  - Short-term creditors less exposed

Proposed rulemaking

- Federal Reserve rulemaking will require Global SIFIs in US to maintain substantial amounts of long-term debt or total loss absorbing capital (TLAC) at holding company level
- Rulemaking not yet complete, but living will process requires firms to hold sufficient levels of long-term debt
- Foreign banking organizations: TLAC requirements likely to be extended to domestic intermediate holdco and material operating entities

6 Ability to prevent counterparty termination of financial contracts upon resolution

- Insolvency of one firm can have adverse spillover effects on other firms
  - e.g., Lehman Brothers: counterparty termination of contracts; fire sale of collateral

Three noteworthy developments since financial crisis

1 2010: Title II of Dodd-Frank Act created an automatic stay for US SIFIs and domestic counterparties in event of resolution

2 2014: 18 of world's largest financial companies agreed to abide by similar automatic stay for financial contracts

3 2016: Federal Reserve issued proposal for rulemaking for G-SIFIs: prohibits entering financial contracts with any firm not agreeing to an automatic stay

There are two remaining general requirements for the FDIC, the Federal Reserve and the banking industry

1

The FDIC, the Federal Reserve and the banking industry need to stay the course

- Finalize both TLAC and automatic stays, and follow through on living will process
- SIFIs will need to make difficult decisions on changing operations and structure
- Restructuring of financial system will be necessary
- Government regulators to set parameters

2

The FDIC and the Federal Reserve need to provide greater clarity and transparency

- Market and public need to understand
- Market will help regulate itself and protect taxpayers from bailouts
  - Long-term subordinated debt holders need to understand and price risk
  - Forces banks to make changes
- Short-term creditors need to understand they are not at risk
- Federal Reserve to clarify its role as a lender of last resort