Paul Tucker: Solving too big to fail – where do things stand on resolution?

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of the Prudential Regulation Authority Board, at the Institute of International Finance 2013 Annual Membership meeting, Washington DC, 12 October 2013.

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By way of setting the scene for this morning's discussion, I shall make five broad and big points about where the international community has got to on addressing the Too Big To Fail problem through planning for orderly resolution. Before continuing, I should stress that these are my views and do not necessarily represent the views of any of the UK and international bodies of which I have been a member.

(1) The US authorities could resolve most US SIFIs right now

First, I repeat what I said in London recently. I cannot see how the US Administration could persuade Congress to provide taxpayer solvency support to – ie bailout – some of the biggest US banks and dealers. In short, the US authorities have the technology – via Title II of Dodd Frank; and, just as important, most US bank and dealer groups are, through an accident of history,[1] organised in way that lends them to top-down resolution on a group-wide basis. I don't mean it would be completely smooth right now; it would be smoother in a year or so as more progress is made. But in extremis, it could be done now. That surely is a massive signal to bankers and markets.

Europe has not yet reached the same point, but contrary to some commentary is not far behind. The necessary legislative regime is close to completion. In contrast to the US, however, many of the largest European – including UK – banking groups will need to reorganise in order to make themselves susceptible to either Single Point of Entry or Multiple Point of Entry resolution.

That brings me to my second point.

(2) The Single Point of Entry versus Multiple Point of Entry resolution strategy distinction may be the most important innovation in banking policy in decades

We will learn to speak of banks and dealers as either "SPE groups" or "MPE groups". Some technical developments don't matter hugely. This one does. A lot will follow from it, as I will sketch in a moment. But first I should recap the difference between SPE and MPE resolution strategies.

A single-point-of-entry or SPE resolution works downwards from the group's top company – most simply, a pure holding company (Holdco). Losses in subsidiaries are first transferred up to Holdco. If Holdco is bankrupt as a result, the group needs resolving. The "bailin" tool is applied to Holdco, with the equity being written off and bonds converted as necessary into equity to recapitalise the group. Those bondholders become the new owners. The group stays together.

Under multiple-point-of-entry or MPE resolutions, by contrast, a group would be split up into some of its parts. Healthy parts might be sold or be maintained as a residual group shorn of

[1] The accident of history arose from the McFadden Act ban on interstate banking. Banks set up holding companies so that they could own banks in different states. A variant of that story applies to broker dealer groups.

their distressed sister companies. The resolution of the distressed parts might be effected via bailin of bonds that had been issued to the market by a regional intermediate holding company.

This is, of course, no more than a brief sketch, but I hope it will suffice for me to draw out some of the implications for the industry and regulators.[2]

For many financial groups, it is fairly obvious which broad resolution strategy (SPE or MPE) they are currently most suited to. But few major groups will escape having to make significant changes to their legal, organisational and financial structure to remove obstacles to effective resolution under that preferred strategy.

For example, outside of the US, many "SPE groups" will need to establish holding companies from which to issue bonds that can absorb losses and be converted into equity through a resolution. And even in the US, nearly all "SPE groups" will need to ensure that there exists intra-group debt, issued by key subsidiaries around the world to the holding company, that can be written down when a distressed subsidiary would otherwise need to be resolved.

For "MPE groups", many will need to do more to organise themselves into well-defined regional and functional subgroups, perhaps with regional or functional intermediate holding companies, which could be subjected to SPE resolutions. And these groups will need to ensure that common services, such as IT, are provided by stand-alone entities under contracts that are robust enough to survive the break up of the group.

There will be implications for the regulatory regime too. As I see it, the amount of equity that a host regulator requires to be held in a subsidiary over and above the Basel minimum may vary according to whether it is part of an "SPE group" in which the parent/holding company is a source of strength through resolution.

Where that is the case, it may be possible to shade the subsidiary's capital structure from equity to subordinated debt issued to the HoldCo. Where the group as a whole is not a source of strength in resolution, a subsidiary may need more equity than otherwise. What I am describing would entail some recasting of the key pillars of international supervisory co-operation: the Basel Concordat, Core Principles of Supervision, and Capital Accord.[3]

(3) There is no such thing as a "bailin bond". Bailin is a resolution tool. All creditors can face having to absorb losses. What matters is the creditor hierarchy

Notwithstanding the clarity in the Financial Stability Board's international standard on resolution,[4] and in the US and draft EU legislative regimes, it is still common for commentators and industry participants to refer to "bailin bonds".[5]

As I have said before, "bailin" is a verb not a noun. It is a power, not a special kind of bond. Like other resolution tools, it can be applied to any kind of debt obligation.

What is true is that if bonds are issued from a holding company and the resolution is top-down (SPE), then those bonds will absorb losses before any creditors of the operating

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[2] See Financial Stability Board (2013), "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies" and Tucker (2013), "Resolution and the future of finance".

[3] See Tucker (2013), "The reform of international banking: some remaining challenges".

[4] See Financial Stability Board (2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions".

[5] Most recently in Chapter 3, "Changes in bank funding patterns and financial stability risks", of the IMF's October GFSR, which misleadingly refers throughout to "bail-in debt".

subsidiaries; holdco creditors are structurally subordinated to opco creditors. But if the losses are vast enough, then the haircuts imposed by the resolution authority can in principle permeate to any level of the creditor stack.

In the case of insured deposits, that means Deposit Guarantee Schemes (DGS) suffering losses, as they would in Purchase & Assumption-style resolutions of an operating bank. But, due to less destruction of value, those losses under bailin would be smaller (and never greater) than the losses the DGS would have suffered in a liquidation. Insured deposits themselves do not get haircut under any resolution techniques; the losses of the DGS get picked up by the rest of the industry standing behind it. Bailin is no different from other resolution tools in that respect.

The point I have been labouring about all creditors being exposed to loss needs to be distinguished from the quite separate issue of whether the authorities should mandate a specified amount of bonded debt to act as required layer of gone-concern loss-absorbing capacity (GCLAC). That may be issued from a holding company, or it might be subordinated debt issued by an operating company. through such requirements, the authorities would in effect be determining part of the creditor hierarchy – the order in which creditor classes take losses – in order to reduce spillovers into the wider financial system when a distressed financial group is resolved. The G20 Leaders' Summit have asked the FSB to develop such a regime over the coming year.

(4) Some impediments to smooth cross-border resolution need to be removed

I said earlier that the resolution process will become smoother over time. A range of impediments have been identified.[6]

Some of them require steps by policymakers. For example, I have said on behalf of the Bank of England[7] that in principle the Bank, as the UK's resolution authority, would be prepared to step aside and allow UK subsidiaries of the big US financial groups to be resolved as part of a group-wide resolution led by the US authorities.

To take this further, the Bank of England needs to set out the conditions that would need to be met in practice for it to deliver on its "in principle policy". Second, the UK needs the US authorities to make a reciprocal "in principle statement" about their being prepared to step back to facilitate a UK-led top-down whole-group resolution of UK groups with a presence in the US. That cannot, in my view, wait very long after the EU's Resolution Directive is passed. And, third, similar commitments need to be made between other pairs of countries – particularly the major jurisdictions in which the headquarters of global systemically important financial institutions are domiciled. On that, I can tell you that progress in this field is not limited to the US and UK.

Separately, some technical impediments need to be removed. Perhaps most obviously for this audience, the standard market agreements for derivatives and repos need to be amended so that putting a firm into resolution or the exercise of a resolution power is not an event of default. If necessary, there will have to be regulatory changes to induce or require this. That too is on the FSB's agenda for the next year.

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[6] See Financial Stability Board (2013), "Progress and Next Steps Towards Ending "Too-Big-To-Fail"".

[7] For example, at the FDIC Systemic Resolution Advisory Committee Meeting on 10th December 2012. The webcast for the meeting is available online at: http://www.fdic.gov/about/srac/2012/2012_12_10_agenda.html

(5) The resolution agenda is not just about banks and dealers. It is about central counterparties too, for example

Banks became TBTF by accident. The G20 Leaders having mandated that standardised OTC derivatives must be centrally cleared, there is a risk that central counterparties (CCPs) will come to be seen as too important to fail as a matter of policy.

That makes it incredibly important that CCPs are robust, effectively managed, effectively supervised, and have first rate recovery plans. And, beyond that, they absolutely must be subject to a credible resolution regime.

I worry that CCPs are "for profit", or are typically part of "for profit" groups. If a CCP fails and it turns out that its risk management was slack, this point is bound to come up in the public response. Policymakers should think about that now in the context of the governance structure they want for CCPs embedded in vertically integrated groups.

Meanwhile, work is underway in CPSS/ IOSCO[8] on loss-allocation rules. Unlike banks, CCPs are essentially rule-based machines for netting and allocating risks. Those rules need to be enriched so that it is clear what happens when, due to a member's default , both the initial margin and default fund are exhausted. The guidance which CPSS/ IOSCO produce following the current consultation will need to be unambiguous.

That work can build a solid defence against failure. But one of the central lessons of the crisis is that we must be able to cater for the worst, when all defences are breached. The FSB has therefore been consulting on how resolution regimes can be applied to CCPs (and other financial-infrastructure providers). I hope that G20 Ministers will keep the FSB's feet to the fire on this.

If CCPs are probably the most important example of where resolution regimes need to be extended, they are not the only one. Insurance is another. And you won't be surprised to hear me say that, given the ubiquity of regulatory arbitrage, shadow banking and the world of funds and special purpose vehicles could be another. That makes it important that resolution is not the special preserve of the G20 jurisdictions. With many asset management vehicles domiciled in offshore centres, we are going to need them to get on the resolution bandwagon

Conclusion

To conclude, let me say just this.

It is absolutely essential that the TBTF problem is cracked. Nothing is more important to the success of the international reform agenda. Without it, global finance would remain fragile; and to protect against that, the international financial system would balkanise as individual countries sought to protect themselves. The stakes are high.

My final point, therefore, is that the authorities will have no excuse if they don't solve the TBTF problem through resolution regimes and reforms. The necessary technology is clear. The necessary restructuring of firms is clear. The necessary degrees and forms of cross-border co-operation are clear. It is a matter of: just do it.

[8] Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO).