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FLORENCE SCHOOL  
OF BANKING & FINANCE

# Ending “Too Big to Fail”: a Transatlantic Perspective

*Florence School of Banking & Finance – Online seminar*

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CREDIT SUISSE



# Today

- 1. A brief taxonomy of the Crisis**
- 2. Fixing what broke down**
- 3. Making solutions effective?**
- 4. US and EU – a comparison**
- 5. Where are we now?**

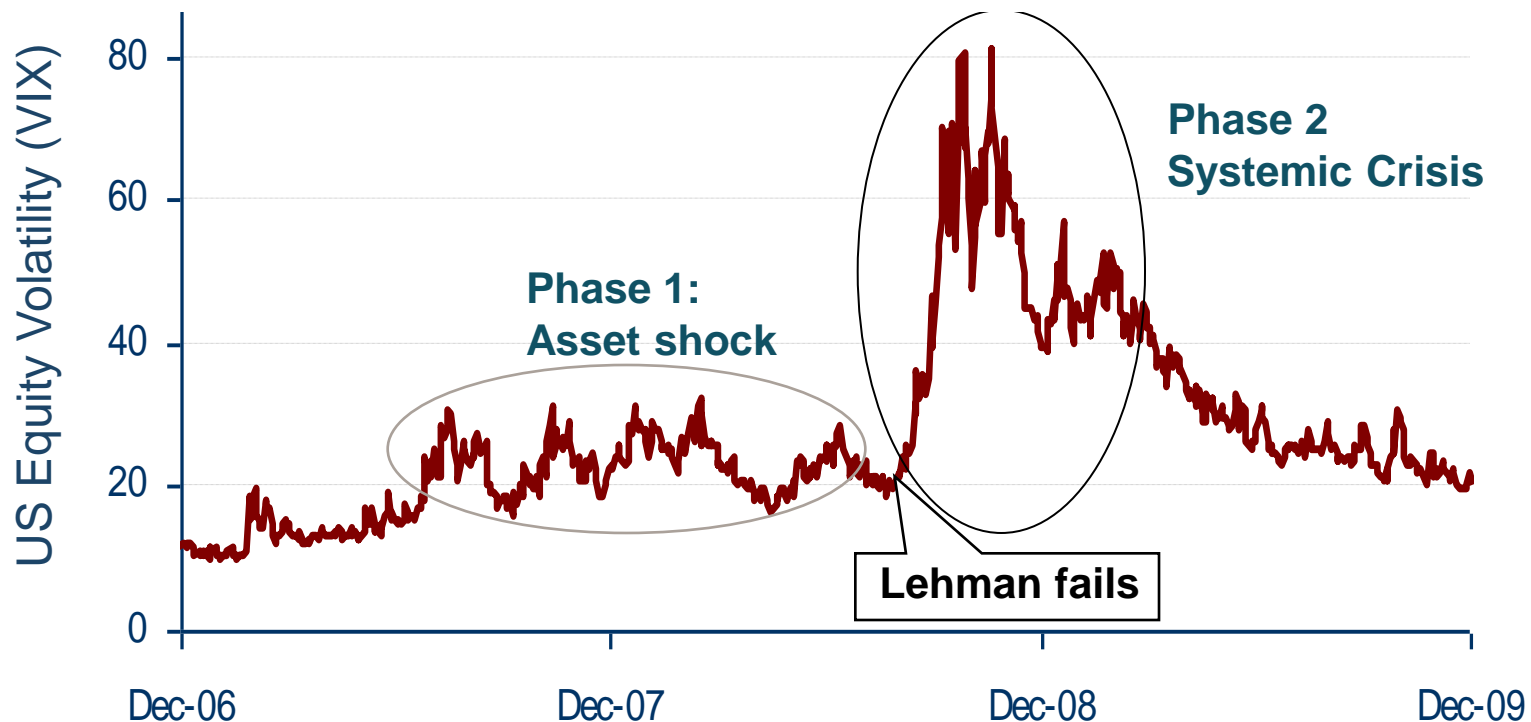
# A Taxonomy: Three Phases of the “GFC”

1. An asset class crisis (mortgages, esp. USA)



# A Taxonomy: Three Phases of the “GFC”

1. An asset class crisis (mortgages, esp. USA)
2. **Wall St fails** – Systemic risk dials go to “eleven”



Markets hit fear levels unseen since the 1930s

# Phase 3 of the GFC

**“Core” (DE, NE) survive crisis okay**

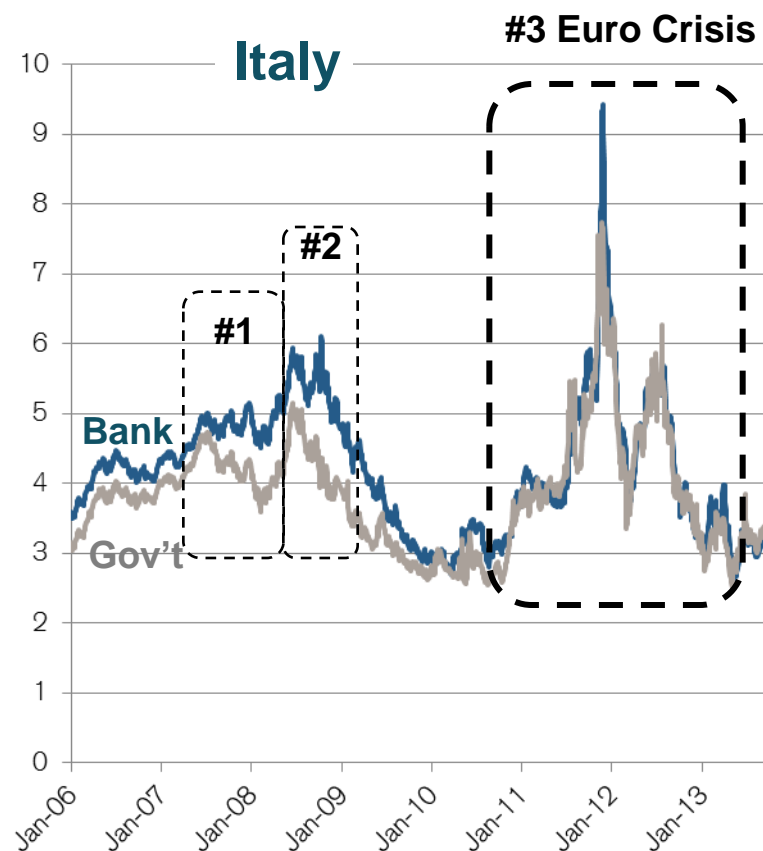
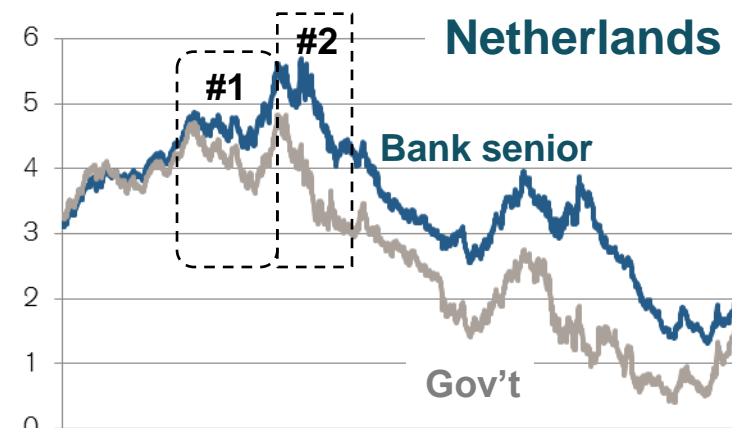
- Phase 1 & 2 less stressful than many countries
- Post-crisis markets perform okay

**“Periphery”: crisis recurs 2011-12**

- Yields spike in IT/ ES / PT/ GR
- Periphery banks rely on local gov't - and vice-versa (→ “doom loop”)

## Key Policies:

- ECB: “whatever it takes”
- BRRD & SSM –disentangle banks & sovereigns: unwind “doom loop”



# Many reforms proposed...but one is central

Vickers / Liikanen

Volcker Rule

Basel 2.5, Basel 3, Basel 4 . . .

Ring-fencing

Macro-prudential

No Basel

National firewalls

Systemic Regulation

Leverage Rules

(IHC/IPU)

Glass – Ste

Subsidiariz

Narrow Ba

Size curbs

Board Gov

Living Will

Bank Taxe

Transaction Taxes

More Mark-to-market

. . . less Mark to market

Money Market reform

Intrusive supervision

Resolution Funds

Coco's

Resolution / Bail-in

***Addressing the problem of 'too big to fail' is the next central step in the reform program***

**- Mario Draghi**

***If the crisis has a single lesson, it is that the 'too big to fail' problem must be solved***

**- Ben Bernanke**

# But...

- How can we do that?
- What would really solve TBTF?
- Can it be solved?



# How to solve TBTF? Some of the proposals

1. Better regulation; intervene early
2. Hard-nosed principles – let ‘em fail! no bail-outs!
3. Living Wills
4. Forced M&A/ P&A
5. Mutual aid strategies?
6. Good-bank / bad bank strategies
7. Break up the big banks?
8. «Narrow» or Utility Banking?
9. Something else?



# Developing a new tool: “Bail-in”

- Borrow & adapt well-known tool (“Chapter 11 for banks”)
  - A single-party, liability-based recapitalization
  - No need for a merger partner
  - Accelerated timing to address runs & market concern

<u>Old Balance Sheet</u>	<u>New Balance Sheet</u>
\$600 bn assets	→ \$575 bn (i.e. \$25 bn loss)
\$430 bn “franchise” liabilities (deposits, swaps, payables)	→ No change – <u>remains at par</u>
\$120bn senior debt	→ 15% new equity (85% unch)
\$25bn preferred & sub debt	→ new equity
\$25bn equity	→ write-off or warrants

# Implications of a Bail-in Regime

## Lowers Contagion:

- ✓ Protects retail clients - reduced pressure for “runs”
- ✓ No impact on counterparties or key market infrastructure
- ✓ Preserves value – avoids fire sales

## Less Pressure on Financial System:

- ✓ Creates new equity where needed
- ✓ Doesn't “push the problem” to other banks (forced mergers, mutual aid)
- ✓ Doesn't impair sovereign credit

**Bail-in provides a credible and consistent solution for TBTF**

**Builds on a well tested regime - Chapter 11 style “pre-pack” workout**

**Can address single failures - and replicable for broader systemic events**



# **The road(s) to Implementing “Bail-in” Europe | USA**

# Bail-in Implementation - Considerations



USA

- Single, large jurisdiction
- Toxic Politics of TARP
- Long history of FDIC resolutions
- Chapter 11 recaps highly familiar
- Well developed capital markets
- Holding company structure, with significant LTD financing

→ **Dodd-Frank «Title 2» (2010)**

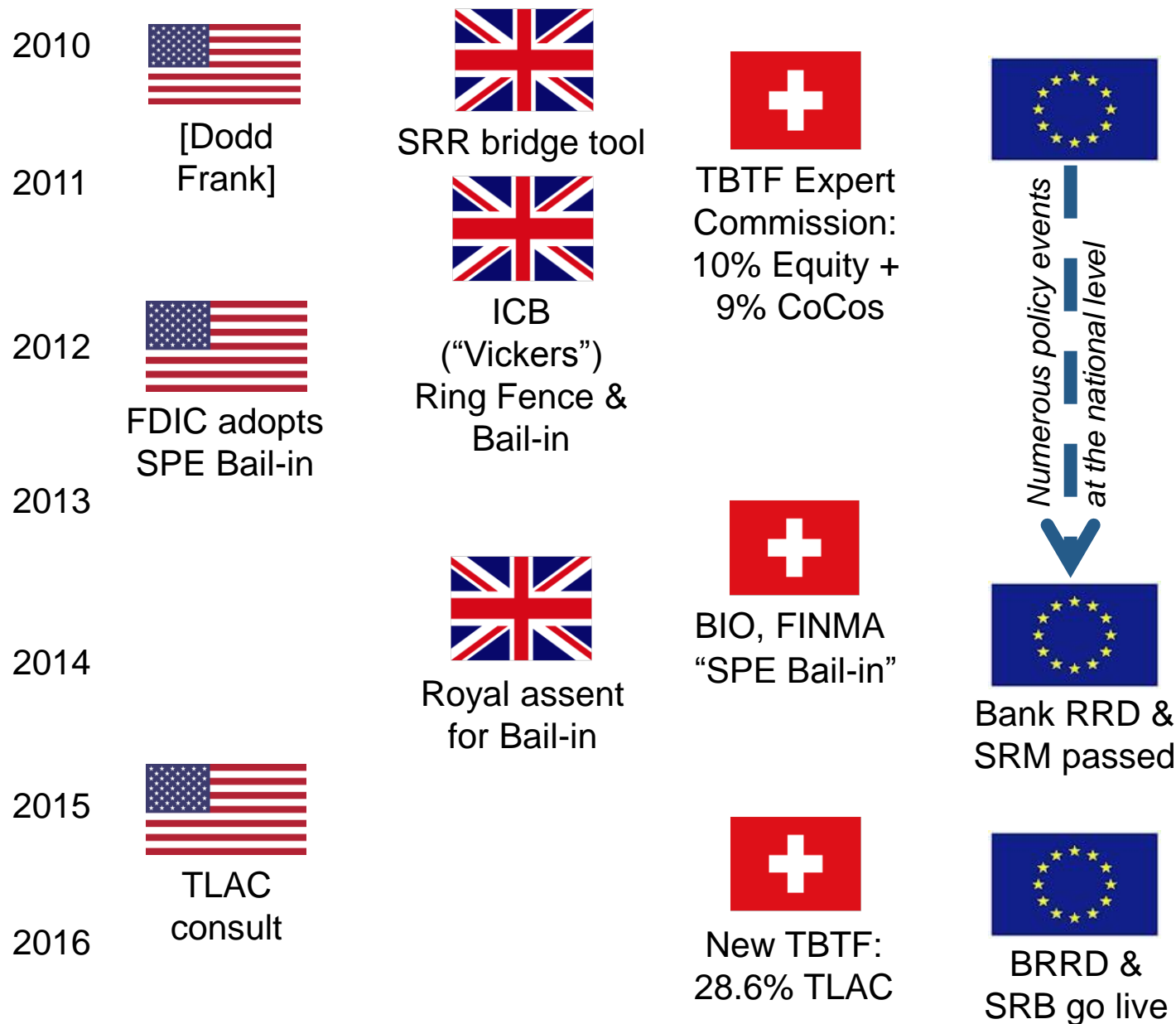


EU

- Complex, multi-state jurisdiction
- Politics complex; national variation
- Historic expectation of state aid
- SRB & SSM newly established
- No common deposit insurance (yet)
- Bank finance >> capital markets
- Heterogenous bank structures; emphasis on universal banking.

→ **BRRD (2014; in force 2016)**

# Bail-in: Implementation Milestones



Numerous policy events  
at the national level



**Key Attributes**



**Swap Protocol**

# Implementing Bail-in (2013)

*“In short, the US authorities have the technology – via Title II of Dodd Frank; . . . most US banks are . . . 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 two as more progress is made. But, in extremis, it could be done now.*

*Europe has not reached the same point, but contrary to some commentary is not far behind.”*

- Paul Tucker – Head of FSB Resolution Group  
October 12, 2013

# EU resolution - A major shift to private capital post crisis

## Post 2010 Loss-sharing / Bail-in events



*“A bail-in itself is not a problem: it is the lack of ex ante rules known to all parties and the lack of capital buffers ... that may make a bail-in a disorderly event...[and] gives the impression of an ad hoc approach...”*

**- Mario Draghi, post Cyprus News Conference**



# Solving TBTF - The Good Part

## 1. Ex Ante Rules: BRRD and Dodd Frank and now fully in force

- Resolution Plans well advanced (depends on country)
- ISDA protocol in place to stop derivatives unwind / runs

## 2. Capital Buffers (TLAC) resourcing building out rapidly

a) USA: a «Trillion Dollar Wall» in place today; markets fully adapted

b) UK: Avg. GSIB at 24% TLAC today

c) Germany: statutory change. G-SIB at 34% TLAC

d) Switzerland: TLAC ~30% of RWA today

~\$400bn

European

GLAC

Roughly 70% of the Western G-SIBs have crossed the TBTF Rubicon

Scale of capital resources on call already larger than 2008 needs



# Solving TBTF - The Challenges

## 1. USA: Politics - potential repeal of Title 2

- RRP adaptation to Title 1 has many positive elements, but also:
  - Banks could fail much earlier (RLEN/RCEN triggers)
  - Liquidation strategies more likely. Implications?
- Federal Reserve liquidity constraints

## 2. EU: Uncertainty & Complexity. Rules (mostly) require Bail-in, but . . .

- MREL not fully in place /usable in many countries
- Local politics in some countries
- BRRD loopholes?
- SRB execution capacity build-out ?
- Liquidity? Eurozone challenges?

## 3. Global Ring-fencing pressures

# Bail-in and future crises



## Eliminating asset shock crises is hard!

- And can lead to risk build up– (per Minsky)

**Systemic crises** – when financial system begins to unravel – are far more destructive

## Bail-in: a key new tool to fight Crises

- FSB Key Attributes aligned US/EU rules
- “Single point of control” simplifies execution
- Adds resilience and avoids fire sale loop
- Removes government burden (& helps address bank-sovereign doom loop)
- Replicable and consistent

**Rapid global progress:** Have crossed the “TBTF Rubicon” in many countries;

- EU moving quickly, but many countries not yet over
- Politics, Internal TLAC & Liquidity remain serious concerns

# Commentary

## Q&A Session



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