VIEWPOINT

THE FALLOUT FROM TOO BIG TO FAIL

Resolution and Recovery of Financial Institutions

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Regulators around the world remain engaged in the ongoing process of regulatory reform following the 2007-8 global financial crisis. A fundamentally important pillar of the regulatory reform effort centers on achieving consistent and predictable frameworks for the recovery and resolution of failing financial institutions and, in particular, banks. The main objective of this work is to minimize the risk of systemic contagion presented by the prospect of failing financial institutions without resorting to taxpayer funded support.

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SUMMARY OF RECOMMENDATIONS

BlackRock invests on behalf of a range of clients such as public sector and multi-employer pension plans, insurance companies, mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals. We invest according to investment management agreements with individual clients and within strict guidelines for pooled funds. Bail-in – generally the power to write down or convert debt - exposes those clients invested in bank securities, and in particular those invested in senior unsecured debt such as the long term investors, to "bail-in risk." We believe it is of fundamental importance that the investment risk that our clients face is well defined, unambiguous and maintains the current creditor hierarchy with respect to senior secured, senior unsecured, subordinated and equity claims in a resolution framework. A clear understanding of how bank securities, existing or new, may be affected under a crisis management scenario will enable asset managers to better evaluate the investment risk and their suitability for clients' portfolios. Flowing from these overarching principles, we make the following recommendations:

1. **Ensure international consistency in resolution regimes.** We are encouraged by recent announcements of co-operation between some regulators on global bank resolution regimes. That said, it is still not clear if there will be a global level playing field between various regulators on the triggers for entering resolutions; the scope of institutions impacted; the path by which institutions may be resolved or the requirement for bail-in-able securities and their terms. The analysis underpinning the development of resolution regimes should take into account the possible consequences for capital market efficacy. To what extent will collateral stays in resolution impact the functioning of stock lending and repo markets? How will creditor insurance markets (credit default swaps) be impacted by new legislation? Will existing credit insurance protect investors from failing banks?
2. **Preserve creditor hierarchy.** This goes further than 'Not worse off than in liquidation' safeguards. Whilst haircuts in resolution may avoid liquidation valuations, debt investors may be unwilling to countenance significant or total loss whilst common and preferred equity remains outstanding. Maintaining a strict loss absorption waterfall during resolution increases investors' confidence in their risk/reward assumptions at all levels of the capital structure.
3. **Make distinct the roles of resolution authority and supervisors.** Remove conflicts of interest between governments, prudential regulators and resolution authorities. Requiring a 'college of sanctioning authorities' to jointly sanction entering resolution would mitigate overzealous actions by any one party.

There are a number of stakeholders in this discussion – the resolution authority, the relevant regulator(s), and those financial institutions that would be subject to recovery and resolution requirements. Investors are another important stakeholder. A central tenet of recovery and resolution planning centers on bailing-in the existing capital structure of financial institutions – an approach which may appear convenient in theory and similar to corporate bankruptcy. However, it may materially alter the investment risks investors face going forward, especially if key questions remain un-answered. The answers to these questions and the lack of predictable actions will impact investor appetite for bank securities.

Investors are highly engaged in the debate surrounding recovery and resolution of financial institutions. In this *ViewPoint* we summarize some of the proposals for recovery and resolution of financial institutions that are currently under development around the world. We set out a number of key questions about the process for investors that remain, and we suggest what the unintended consequences for the investability of banks will be if these questions are left unanswered. Finally, we make a number of recommendations, based on common principles underpinning the global regulatory focus on these issues, on how to address investor concerns with resolution authority.

Background

The failure of a number of institutions during the financial crisis demonstrated the multiple challenges of un-winding a Systemically Important Financial Institution ("SIFI"). Regulators did not have the authority or tools to resolve large systemic institutions, and were forced to inject public funds to restore market confidence and avoid a vicious circle of asset price declines. These injections increased the connection between banks and their sovereigns, creating a "government put" that incentivized size and systemic risk.

In response, policy makers around the world implemented, or are in the process of negotiating, "recovery and resolution" regimes. Although the details of these regimes will vary from region to region, they follow a common principle: mandating existing investors, equity holders and senior creditors of bank securities – not taxpayers – to bear losses in a resolution scenario ("bail-in"). The rules will require that banks "self-insure" against losses by reducing impediments to an un-wind through pre-emptive measures, holding sufficient capital to absorb losses in a worst case scenario and drafting "living wills" to reduce the probability of a systemic event.

RESOLUTION TRIGGERS AND TOOLS

Resolution triggers generate considerable uncertainty for investors given the broad regulatory discretion that could be exercised. The process of resolution would be triggered when:

- a financial institution subject to resolution requirements is in default or in danger of default;
- no viable private sector alternative exists to prevent the default; and
- the financial institution's failure and its resolution (through traditional bankruptcy or relevant insolvency process) would have a serious adverse effect on financial stability.

Resolution authorities may use one or more of the following resolution tools at the *point of non-viability* ("PoNV"):

- **Sale of Business Tool (sale of "good" assets)**: Authorities have the power to transfer to a purchaser (that is not a bridge institution) shares or other ownership instruments or any combination of some or all of the assets, rights and liabilities of an institution under resolution.
- **Bridge Institution Tool (temporary public ownership)**: Resolution authorities have the power to transfer all or specified assets, rights or liabilities of an institution under resolution to a bridge institution without the consent of the shareholders of the institution or any third party.
- **Asset Separation Tool ("Good bank / bad bank")**: Resolution authorities have the power to transfer assets, rights or liabilities to an asset management vehicle that is wholly owned by one or more public authorities with a view to maximizing their value through eventual sale or otherwise ensuring the business is wound down in an orderly manner.
- **Bail-in Tool**: Resolution authorities may opt to recapitalize critical parts of an institution to the extent necessary in order to comply with minimum regulatory requirements if there is a realistic prospect that the institution may return to sound, long-term viability. Bail-in is also available to authorities to write-down the principal amount of claims outstanding or convert to equity. All capital and liabilities may be subject to bail-in. However, ex-ante notable exclusions will exist: secured liabilities, covered deposits and liabilities with a residual maturity of less than one month.

The distinction between "recovery" and "resolution" is an important one:

- **Recovery plans** detail the actions a firm would take to avoid failure by staying well-capitalized and well-funded in the case of an adverse event (market-wide or institution specific). The goal is to identify preventative actions to ensure an institution never reaches the *point of non-viability* ("PoNV") ("going concern"). These actions could include selling subsidiaries or certain business lines. Recovery plans are triggered upon the breach of pre-specified quantitative triggers and are supplemented by stress-testing and a qualitative overlay.
- **Resolution plans**, by contrast, are designed to facilitate actions by the relevant authorities to minimize any impact to the wider financial system *after the* PoNV. In a resolution scenario, the relevant resolution authority and/or regulators – not management - make the decisions based on pre-specified plans created by the companies (so called "Living Wills"). As such it is important that the necessary information is available to allow regulators to understand the situation, make decisions, and deploy resolution tools.

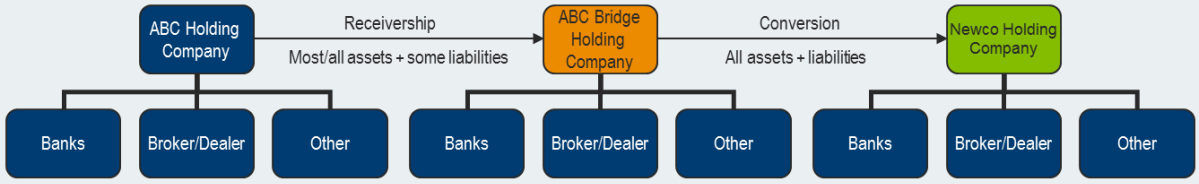
In resolution, the relevant resolution authority is granted the power to close, liquidate or otherwise resolve a failing institution so that shareholders and creditors bear all losses, with no exposure for taxpayers. In addition, management responsible for the failure would be replaced; and a stay on certain contracts would be imposed to prevent the termination or closeout of such contracts as a result of the institution's entry into resolution.

A resolution strategy may use multiple resolution tools and specify the point of entry where the resolution is applied (i.e. at the operating company ("OpCo") level, the holding company ("HoldCo") level, or at a combination of both levels). The efficacy of a resolution strategy depends on a financial institution's corporate organisation and funding capital structure.

Broadly, regulators have laid out two resolution structures:

- **Single Point of Entry ("SPE")**: Involves the application of resolution powers at the top holding or parent company level by a single resolution authority – most probably in the jurisdiction responsible for the global consolidated supervision of a group. The assets and operations of particular subsidiaries are preserved on a going concern basis, avoiding the need to apply resolution at a lower level within the group. Host authorities may need simultaneously to exercise powers to support the resolution led by a home authority, for example to bail-in intra-group debt claims.
- **Multiple point of entry ("MPE")**: Involves the application of resolution powers by two or more resolution authorities to multiple parts of the group (ideally simultaneously), including strategies in which a group is broken up into two or more separate parts. While the resolution of these parts would be under the control of two or more national authorities, the home authority should play a role in ensuring that the resolution is coordinated, given the

FIGURE 1: EXAMPLE OF SINGLE POINT OF ENTRY APPROACH



Holding Co. Balance Sheets In Millions of USD

ABC Holding Co.	
ASSETS	
Investments in Subsidiaries	182,000
Advances to Subsidiaries	141,000
Total Assets	**$323,000**
LIABILITIES	
Sr. Unsecured Debt	$ 199,000
Subordinated Debt	39,000
Total Liabilities	**238,000**
Total Equity	**85,000**
Total Liab. & SH Equity	**$ 323,000**

ABC Bridge Holding Co.	
ASSETS	
Cash	$50,000
Investments in Subsidiaries	182,000
Advances to Subsidiaries	141,000
Total Assets	**$373,000**
LIABILITIES	
OLF Liabilities	$ 50,000
Total Liabilities	**50,000**
Total Equity	**323,000**
Total Liab. & SH Equity	**$ 373,000**

- Assets are transferred from the receivership to the bridge, liabilities remain behind
- OLF borrowings from the U.S. Treasury are advanced to ABC Bridge Holding Company

ABC Bridge Holding Co.	
ASSETS	
Cash	$ -
Investments in Subsidiaries	132,000
Advances to Subsidiaries	111,000
Total Assets	**$243,000**
LIABILITIES	
OLF Liabilities	$ 50,000
Total Liabilities	**50,000**
Total Equity	**193,000**
Total Liab. & SH Equity	**$ 243,000**

- $50,000 of cash is advanced to subsidiaries to meet heightened liquidity needs
- $130,000 write down of investments in subsidiaries occurs
- $80,000 of advances to subsidiaries is converted from debt to equity

Newco Holding Co.	
ASSETS	
Investments in Subsidiaries	132,000
Advances to Subsidiaries	61,000
Total Assets	**$193,000**
LIABILITIES	
New Co. Unsecured Debt	$ 113,000
New Co. Convertible Subdebt	10,000
Total Liabilities	**123,000**
Total Equity	**70,000**
Total Liab. & SH Equity	**$ 193,000**

- $50,000 of cash is returned from subsidiaries and repaid to the U.S. Treasury prior to conversion to New Co.
- New Co. liabilities are structured to consist of $70,000 of equity, $10,000 of convertible subdebt, and $113,000 of unsecured debt; securities are distributed to ABC Holding Company unsecured claimants

Source: FDIC

complexities and potential interdependencies (e.g., to ensure that all relevant authorities and third parties are informed of proposed actions). The group could be split on a national or regional basis, along functional lines, or some combination of each. The powers applied to the separate parts need not be the same and could include different options being applied at different times across the group, such as bail-in within resolution, use of a bridge entity, transfer of business or wind-down.

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 ("Dodd Frank") reflects a preference that large financial institutions be resolved through traditional bankrupcy or relevant insolvency processes but acknowledges that such processes may not be able to handle the failure of a SIFI without posing significant harm to financial stability. Thus under Dodd-Frank, the Federal Deposit Insurance Corporation (FDIC) currently has authority to resolve a SIFI bank through Orderly Liquidation Authority ("OLA"). Banking regulators are in the process of finalizing regulations on the size, scope and structural features of bail-in in the US. In Europe, the proposal for a Recovery and Resolution Directive ("RRD") is currently under negotiation with likely agreement on the framework legislation anticipated in 2013, although implementation of many powers is not timetabled to be effective until January 2015, or January 2018 in the case of bail-in for senior creditors. In practice, banks would likely require an extended timeframe (3 - 5 years based on market constraints) to build the "bail-in-able" capital required under an SPE strategy.

Key questions for investors

We are supportive of regulatory reforms that strengthen individual financial institutions and that reduce systemic risk associated with the failure of a financial institution. By way of illustration, Figure 2 details the required level of additional loss absorbency for Global Systemically Important Banks (G-SIBs). It also reinforces the point that many of the G-SIBs operate across many jurisdictions making global coordination of resolution initiatives a necessity.

Ideally, problems that may arise in banks can be addressed with a recovery plan. In situations where recovery is not possible, resolving failed institutions at the PoNV, prior to liquidation at the insolvency point can, in our view, preserve critical functions and stabilize asset prices in times of distress. This should strengthen the global financial system.

As governments seek to minimize the losses to taxpayers of resolving failing banks and pass the risk to other stakeholders, the potential likelihood and severity of losses to investors – especially longer term investors – could increase.

As a result, the details of regulatory reform are important for investors. Features such as enhanced capital and liquidity will protect investors, whereas resolution rules, including bail-in increase the risk of loss to investors.

FIGURE 2: GLOBAL SYSTEMICALLY IMPORTANT BANK TIERING

GLOBAL SYSTEMICALLY IMPORTANT BANKS AND REQUIRED CAPITAL BUFFERS		
Bucket	Required Level of Additional Loss Absorbency	Institution
4	2.50%	Citigroup Deutsche Bank HSBC J.P. Morgan Chase
3	2.00%	Barclays BNP Paribas
2	1.50%	Bank of America Bank of New York Mellon Credit Suisse Goldman Sachs Mitsubishi UFJ FG Morgan Stanley Royal Bank of Scotland UBS
1	1.00%	Bank of China BBVA Groupe BPCE Group Crédit Agricole ING Bank Mizuho FG Nordea Santander Société Générale Standard Chartered State Street Sumitomo Mitsui FG UniCredit Group Wells Fargo

Source: Financial Stability Board

Conclusion

It is important that investors have certainty on how recovery and resolution regimes function before a systemic event occurs. A principles-based approach would allow investors to better assess risk.

Investor demand will be dependent on the details of individual securities, including the PoNV and the scope of application. Asset managers invest according to pre-determined investment management agreements with individual clients and within strict guidelines for pooled funds. The riskiness of new types of bank securities or changes to the risk profile of current securities may not suit all of our clients. If the loss under resolution in the future regulatory world differs from the existing loss given default, or investors are no longer able to judge with any tangible certainty the likelihood of encountering losses, then the suitability of such investments for clients will need to be reviewed.

In addition, since there will be end-investors who do not wish to bear "bail-in risk", the supply of capital or funds to banks could be restricted. In this event, banks would need to shrink their balance sheets and specialize on particular products, clients and/or geographies to a much higher degree.

In practice, removing the government "put" also increases market discipline, generating greater differentiation of banks by investors and incentivizing lower systemic footprints / a reduction in complexity. A critical benefit of living wills is that they reduce impediments to resolution (lower probability of default) and improve recovery if correctly executed.

In concept, reduced systemic risk would benefit domestic economies as they reduce the volatility of asset price swings and smooth the provision of credit in a tail scenario. However, it has been commented that in reality, one practical implication of requirements to hold bail-in-able instruments in as yet undefined quantities could be that the cost of credit rises and credit assessment standards could tighten. If this were to be the case, these processes in combination could lead to less lending if the scope of application is not sufficiently tailored, which at worst would compound economic stagnation or at best, dampen economic growth.

We are supportive of regulatory reforms that strengthen individual financial institutions and that reduce systemic risk associated with the failure of a financial institution. Ideally, problems can be addressed with a recovery plan. In situations where recovery is not possible, resolving failed institutions at the PoNV, prior to liquidation at the insolvency point can, in our view, preserve critical functions and stabilize asset prices in times of distress. This should strengthen the global financial system.

OUTSTANDING ISSUES

What will be the size and form of the bail-in-able requirements?

The details around bail-in are extremely important to investors, and additional information is required to assess bank securities.

In the US, regulators may require the parent company of a SIFI to hold sufficient amounts of unsecured debt plus equity, to facilitate the recapitalization of a newly created operating company after stake-holders have been written down. Subordinated debt should be held to absorb expected losses, while a senior unsecured debt provides "tail protection". Some industry experts estimate that this could require substantial amounts of incremental issuance for U.S. banks but the size and composition of requirements are unclear.

In Europe, the market is still digesting Capital Requirements Directive (CRD) IV and new forms of capital to meet this Risk and Resolution legislation are nascent. How this demand is taken up and how risk weighted assets migrate under Basel III will have an impact on the level of other bail-in-able securities which are required.

Will investors have a clear understanding of the "presumptive path" of resolution?

The presumptive path is a critical concept for investors – it defines both the scope of the institutions to be resolved, the steps regulators would take to prevent a resolution and the actions undertaken once a resolution is initiated. Regulators globally, have not explicitly defined the presumptive path, which creates challenges calculating the probability of "default" and the recovery (entity focused versus HoldCo). The scope of bail-in application also has important implications for assessing risk. While intuitively, application of a resolution regime should be a function of a bank's systemic footprint (e.g., interconnectedness, complexity, size, etc.) it is unclear which banks would be impacted.

Given the lack of resolution precedents, the challenges for cross-border coordination in resolving a global SIFI and the differences in resolution authorities, the path remains quite uncertain. As investors, we prefer pre-defined parameters that balance regulatory flexibility with investor certainty. Prudent use of resolution regimes is also important as regulators could trigger the systemic "event" they seek to avoid.

How effective is international coordination and cooperation likely to be?

Banking activity and the capital markets into which they issue securities are global. It is unclear if, for example, a US court would recognize the applicability of an EU statutory regime to a bond instrument governed by US law (US$ market for Euro bank securities). Differing regulatory regimes could also create regulatory arbitrage given a higher cost of capital under proposed structures. A cross-border resolution of a SIFI remains the key challenge towards creating a workable resolution framework given the international focus of most institutions (e.g., local regulators will be pre-disposed to protect local interests). This could lead regulators to impose "ring-fenced" capital/liquidity requirements in many jurisdictions.

RELATED CONTENT

- Regulatory Reform of European Debt Markets - Balancing the Costs and Benefits (September 2012)
- A Regulatory Roadmap is Not Banking Territory: Evolving Trends in Capital Requirements and Responses to Regulation (May 2011)

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