Summary Financial Safety Net Conference 2015

Introduction

Hans Lindblad (Director General, Swedish National Debt Office) – A new crisis management regime

Mr Lindblad's opening centred on key themes emerging from the recent crisis such as the huge costs of banking collapses, the impossibility of allowing systemically significant institutions to fail, the inadequacy of 'normal' insolvency processes for resolving big banks and the additional challenges presented by complex cross-border groups. Moving to the policy responses, Mr Lindblad pointed to the FSB resolution framework, including bail-in, which brings clarity to market participants and a degree of harmonisation at national and global levels. However, more work is still required, in particular, to extend coverage to non-banks, to ensure cross-border cooperation works in practice, to bring consistency to TLAC / BRRD requirements and to take account of developments in capital adequacy requirements. Finally, Mr Lindblad also discussed the risks of excessively complex regulation.

Stefan Ingves (Governor, Sveriges Riksbank) – Introductory remarks

Governor Ingves began by describing the historical frequency of financial crises in Sweden dating as far back as the founding of the Riksbank in 1668. Financial crises entail significant costs in term of lost output and falling employment while a common feature in many individual crises has been the requirement for state support to restore the functioning of the financial system. Considerable work has been undertaken in the wake of the most recent crisis to improve capital and liquidity levels however financial institutions' leverage remains far in excess of levels which investors would tolerate in other sectors. This can be ascribed to moral hazard as investors anticipate that a state backed safety net exists for large banks. Turning to the resolution framework, Governor Ingves, identified a number of issues to be addressed to ensure the new tools can be deployed in practice such as identifying the activation point for resolution, deciding which creditors to bail-in without causing depositor flight and the problems of international co-ordination for cross border institutions. In addition, credible resolution frameworks still need to be developed for non-bank financial institutions. Lastly, Governor Ingves remarked that although a great of work at EU level had been undertaken, the resolution framework remained untested, particularly in a systemic crisis and the need to ensure adequate levels of capital and liquidity remains an imperative.

SESSION 1: Financial crises in perspective

Anders Borg (World Economic Forum and former Swedish Minister of Finance) – Past crises and future framework for financial stability

Mr Borg's opening remarks covered the economic effects of the crisis as well as wider consequences such as the weakening of public trust in financial institutions and the credibility of political institutions. Although significant imbalances in particular economies, such as Ireland, Iceland and Greece were evident well before 2007-08, the crisis would nonetheless have been different had Lehmann Brothers not been allowed to fail. Mr Borg outlined three key lessons from recent experience of crisis management. First, that policy-makers should not pay undue attention to moral hazard considerations of the type which led to Lehmann Brothers being allowed to fail and that liquidity support should therefore be provided as required during a crisis. Second, that valuation of bank assets in a crisis phase should be extremely conservative. Third, that fiscal policy has a central role which should go further than simply short term measures and also include longer term spending such as infrastructure investment or, as implemented in Sweden, tax incentives aimed at supporting labour supply.

Martin Hellwig (Director, Max-Planck-Institute for Research on Collective Goods and Vice Chair of Advisory Scientific Committee of the ESRB) – The next crisis will come for sure: What can we do about it?

Mr Hellwig opened with the observation that passing laws can become an end in itself for policy makers and recent reforms may not be rooted in sound analysis of the causes of the financial crisis. The crisis of 2007-08 was different from previous ones in several key respects including the contagion mechanism represented by derivative exposures, shortcomings of fair value accounting methods and common dependence on money market funds as liquidity sources. Recent policy initiatives have not addressed problems in many of these areas and whilst capital levels at financial institutions have now been raised somewhat, there are significant problems with developments regarding resolution. Regarding resolution, Mr Hellwig identified a number of specific problems such as the unfeasibility of a Multiple Point of Entry approach for systemically significant institutions, challenges with cross-border co-operation and the difficulty of enforcing losses on holders of debt instruments, as evidenced by the experience with Tier 2 instruments during the 2007-08 crises. Resolution will, therefore, arguably only work for small and medium sized banks. Mr Hellwig then turned to several other areas of concern with the financial system such as shadow banking, including off balance sheet investment vehicles run by large banks, weaknesses in new liquidity requirements and the fundamental challenge of reducing the stock of debt on a system wide basis.

Lars Frisell (Advisor to the Governor, Central Bank of Ireland) – Resolution of the Irish banking crisis: hard-earned lessons for Europe

Mr Frisell began by describing developments in the Irish economy in the run up to 2007, which on several measures was seriously overheating. The subsequent cost, solely of recapitalising the Irish banks, was €64bn compared with €12bn in the Swedish crisis of the early 1990s. Mr Frisell then turned to a key aspect of the Irish story, namely the blanket guarantee of bank liabilities provided by the Irish government shortly after Lehmann's failure, and reviewed the various policy options available at the time to the Irish government. Those options included provision of emergency liquidity assistance, complete liquidation of the banks and lastly, partial nationalisation combined with depositor preference measures and capital controls, which is comparable to the approach taken in Iceland. Each option entailed different systemic and solvency risk considerations. Decisions needed to be made within short timeframes, under high pressure and with limited information. Analysis of the Irish banks balance sheets undertaken at the time did not indicate excessive lending losses were likely and pointed to liquidity rather than capital as the key problem, which led, in part, to the decision to guarantee all liabilities. The extension of the guarantees as part of Ireland's sovereign bail-out programme in 2010 was driven by state aid considerations, which stands in contrast to the intentions of the new resolution framework.

Session 2: Recovery and resolution planning

Eva Hüpkes (Financial Stability Board) – Defining the framework

In response to the initial G20 call for actions to address the too-big-to-fail issue in 2009, the Financial Stability Board (FSB) has taken several measures towards a new resolution regime, including designing the Key Attributes standard and the concept of Total Loss Absorbing Capacity (TLAC). Hüpkes described resolution as a paradigm shift, enabling authorities to handle even G-SIBs in crisis. The new framework provides authorities with the powers and tools to maintain continuity of critical functions and preserve value without tax payers picking up the bill. The advance planning, whereby authorities identify resolution entities, coordinate cross-border solutions and assess the resolvability of institutions is key to a successful resolution process. Nevertheless, the question whether resolution will actually work in practice remains unanswered. Hüpkes stressed that problems such as market contagion, detrimental ring fencing and insufficient liquidity funding have no easy solution, but that they are being addressed in FSBs ongoing policy work.

Christian Clausen (Nordea Bank) – Recovery planning for a G-SIFI from a bank's point of view

As the CEO of the only G-SIB in the Nordic region, Clausen presented a somewhat different perspective on crisis management and planning. Identified as a G-SIB in 2011, Nordea produced its first recovery plan, based primarily on the FSB Key Attributes, the following year. With a wide range of business lines across several jurisdictions, one of the challenges was to structure the plan in an accessible manner. The recovery analysis, which aligns key contributions to the economy and key vulnerabilities with Nordea's operating model, forced the bank to address its structure and strategy from a crisis management perspective. It resulted in a simplification program, reducing number of products, simplify legal structures and investing in new core IT systems, to create one common platform. Clausen finished off by emphasising the importance of scalability and diversification for centralised banks and that continued regulatory support for these models is essential for global financial stability.

Andrew Gracie (Bank of England) – Resolution planning in practise

Similarly to his co-panellist Hüpkes, Gracie began his presentation by pointing out that recovery and resolution planning is a new paradigm. While policy frameworks of the past have suffered from not being time consistent, resolution plans provide much needed predictability, stability and continuity. Gracie sees the Single Point of Entry (SPE) as the dominant approach for G-SIBs in order to maintain operational continuity. Just as Clausen of Nordea Bank described, Gracie saw big banks changing their structure – shrinking or terminating businesses that are no longer viable – as a consequence of recovery and resolution planning. Bail-in should be used to stabilise banks going into resolution, followed by a recapitalisation enabling the subsequent reauthorisation of the bank by regulators. As several other speakers, Gracie highlighted the need to design credible liquidity back stops in order for resolutions to succeed. Throughout his presentation, Gracie returned to the importance for all parties to understand and internalise that we are indeed in the process of adopting a completely new market discipline – covering even the G-SIBs.

SESSION 3: Bank resolution – case studies

David Ereira (Partner, Linklaters London) – The Lehman Brothers experience: what are the lessons that can be learned?

In his opening remarks Mr Ereira clarified that Lehmans was an insolvency event not a resolution but that there were several valuable lessons for future resolution planning. Firstly, the unplanned nature of the insolvency and absence of any international framework for handling failure of a global institution presented huge challenges. Secondly, there is significant risk in managing the tension between moving quickly to avoid value erosion, as seen in the divestment of Lehman's US prime brokerage business, and the need to establish accurate asset values. Thirdly, Mr Ereira described the ineffectiveness of certain consumer protection regulations covering, for example, pension and client monies held in pooling arrangements. Fourthly, valuing derivative positions is extremely difficult making accurate balance sheet calculations complicated. Fifthly, it is not clear that bail-in would have prevented Lehman's failure since the key issue was one of liquidity. Lastly, Mr Ereira turned to problems of control during a resolution and stressed, in particular, that uncertainty in legal outcomes significantly limits regulators ability to act decisively.

Pedro Duarte Neves (Vice-Governor, Banco de Portugal) – The Resolution of Banco Espírito Santo

Mr Duarte Neves initially outlined the size of Banco Espírito Santo (BES), which had assets equivalent to c50% of Portugal's GDP, its global reach and its systemic significance for the Portuguese economy. BES started to experience problems as a result of uncertainty over exposures to its Angolan subsidiary and due to losses at a related party, Grupo Espírito Santo. The run-up to BES's resolution was therefore characterised by a spiral of liquidity problems, deposit outflows and ratings downgrades. In July 2014, it became apparent that losses would be materially in excess of expected levels causing a breach of BES's solvency requirements which exacerbated the liquidity problems and made resolution unavoidable. The Portuguese resolution framework at the time allowed for bridge bank or sale of business solutions, however the short time frame meant a sale of the business was impossible to achieve and on 3rd August 2014 a bridge vehicle, "Novo Bank", was established to which the viable assets and certain liabilities of BES were transferred. Novo Bank was capitalised by the Portuguese Resolution Fund with a target CET1 ratio of 8.5% and is now being managed on a going concern basis with an intention to transfer the bank to private sector control over time. Mr Duarte Neves then covered some general lessons for resolution planning from the BES experience including the importance of adequate operational capacity and skills at supervisory/resolution authorities, the key role of new management teams post-resolution and ensuring effective communications with all stakeholders impacted by a resolution event.

Ceyla Pazarbasioglu (Deputy Director in the Monetary and Capital Markets Department, IMF) – How do the policy choices in the current crisis compare to those made in past crises?

Ms Pazarbasioglu began by surveying historical financial crises and suggested the underlying causes could generally be attributed to either real-estate lending (either commercial or residential) or weak corporate governance involving, for example, excessive lending to related corporates. Each type of crisis requires a different solution but, broadly, crisis management has 3 phases. Phase one entails containment through measures such as providing liquidity to solvent institutions. Phase two involves balance sheet restructuring via recapitalisation. Phase three requires dealing with legacy assets by, for instance, transfer to asset management vehicles for workout. Ms Pazarbasioglu then discussed the importance of regulators taking over or closing non-viable institutions and the criticality of recognising lending losses quickly. Looking at the recent crisis Ms Pazarbasioglu contrasted the impact of the US TARP programme which effectively put loss limits on securitised assets with the experience of Ireland and Spain where losses emerged with a longer time lag due to the downturns in each economy making accurate calculation of loan losses difficult. Stress tests have been an important policy innovation, the US SCAP leading to a $200bn recapitalisation and the European equivalent providing an unprecedented level of market disclosure. Lastly, Ms Pazarbasioglu turned to the policy responses to the crisis noting developments in resolution powers and improvements in capital and liquidity regimes.

Session 4: Introducing bail-in

Wilson Ervin (Credit Suisse) – Bail-in: Origins, principles and market implications

One of the key lessons of the financial crisis of 2008-2009 is that the too-big-to-fail problem must be solved. The resolution and bail-in reform is central in addressing this issue. Using Lehman Brothers, where bankruptcy losses amounted to some USD 100bn, as the obvious example, Ervin argued that a going-concern strategy, involving bail-in followed by a fast "Chapter 11" recapitalisation, could avoid the value destruction, market contagion and loss of function of a bankruptcy procedure. Commenting on some of the most common critiques of bail-in, Ervin highlighted that bail-in is built on Chapter 11 concepts, which have indeed been subject to substantial real-world testing, as well as the importance of announcing a credible liquidity program for a recapitalised bank by "Sunday night". The presentation concluded with some evidence that markets view bail-in as a technically credible and politically essential tool for handling systemic crisis, but also that there is a need for further investor education.

George G. Pennacchi (University of Illinois) – Re-establishing market discipline and reducing taxpayer burden: will bail-in do the job?

While policy makers see bail-in as a tool to simplify large bank failures, reduce taxpayer exposure and potentially improve market discipline, Pennacchi emphasised three main challenges in implementing the instrument. Firstly, correctly determining the point of non-viability, when resolution should be initiated, might prove difficult, especially as regulatory capital ratios are slow to reflect problems. In order to lower the risk of intervention delays, which could cause losses to exceed TLAC, Pennacchi proposed a solution whereby resolution authorities would be required to intervene when a market financial ratio breaches a certain threshold. The second concern involved the division of new equity among the eligible senior unsecured, subordinated and equity investors in resolution. To enhance market discipline and remove regulatory uncertainty, it is imperative that the allocation respects investor seniority and the no-creditor-worse-off principle. Finally, Pennacchi argued that, while bail-in should make yields on eligible debt more sensitive to default risk, the required longer maturity of this type of debt means that the higher interest penalty arising from greater risk can be small in the short term. One possible solution to equity investors' moral hazard would be to require banks to issue highly dilutive going-concern CoCos that would not absorb losses – as opposed to the ones issued thus far, whose terms benefit shareholders at the expense of CoCo investors. In conclusion, whereas Pennacchi believes that the bail-in resolution regime improves upon the pre-crisis policy framework, much more can be done to avoid situations that would require bail-in.

Charles Gray (Federal Reserve Bank of New York) – Making bail-in operational

According to Gray, one of the key prerequisites for a feasible and credible Single Point of Entry (SPE) bail-in resolution strategy for a G-SIB is adequate loss-absorbing capital at the top-tier entity of the institution along with satisfactory capacity to downstream capital to operating subsidiaries. The FSB has proposed external Total Loss Absorbing Capital (TLAC) minimums for all resolution entities (e.g. the parent of an SPE firm) as well as internal TLAC requirements for designated material subsidiaries operating in foreign jurisdictions. By maintaining unallocated internal TLAC (in addition to the pre-positioned capital on the balance sheet of the subsidiary) that can be downstreamed to subsidiaries should losses exceed the pre-positioned internal TLAC, the risk of disruptive ring-fencing is somewhat mitigated. Gray presented a schematic overview of how a resolution authority could convert an insolvent holding company's unsecured debt into equity in a bridge company to which the original company's assets would be transferred, while the bailed-in debt would be left behind in the failed holding company. Gray concluded with pointing out some of the challenges to operationalising bail-in, such as the need to effectively balance certainty for host authorities associated with the pre-positioned internal TLAC in material entities, while retaining appropriate flexibility at the parent company to be able to allocate where it is needed in a crisis situation.

Session 5: Cross-border recovery and resolution

Dr. Elke König (Single Resolution Board) – Resolution in the Eurozone

With the Single Resolution Board (SRB) in place since January of this year, the Single Resolution Mechanism (SRM), as the second pillar of the Banking Union, is now operational. In order to restore the market economy in banking, König explained that the SRB's key focus for this year and beyond is on forward-looking, proactive resolution planning, including the assessment of resolvability, and removing obstacles, in cooperation with both European and international colleagues. The first and still incomplete round of Resolvability Assessment Process (RAP) letters for G-SIBs was prepared in 2014 and there are still numerous obstacles to resolution. The most common impediments stem from inadequate IT and reporting systems or the organisation of critical functions. From authorities' point of view, one of the biggest challenges is cross-border recognition of resolution measures. TLAC and MREL are critical in creating a level playing field for European banks and in ensuring that they will never again be too big to fail. While these bail-in tools are not the solution to all problems, a successful implementation of a resolution plan is impossible with adequate loss-absorbing capital. In extraordinary circumstances – and only after the bail-in of equity and eligible liabilities of at least 8% of total liability – the Single Resolution Fund, financed by the banking sector itself, can be accessed. The total target size of the fund, whose terms are still to be decided, is 1% of the covered deposits of all banks in Banking Union member states, equalling approximately EUR 55bn, by 2024. König concluded with stressing that the SRB will be a game changer in banking resolution. The SRB is committed to follow a clear, transparent and "no-surprises" policy, in helping to avoid future bail-outs and firmly placing the burden of bank resolution on the banks, their owners and their creditors.

Arnoud Boot (University of Amsterdam) – Crisis management: cross-border perspective and beyond

Boot started off by illustrating the degree of complexity of the financial sector – and how it accelerated in the years leading up to the crisis. As banks retreated to home markets the trend reversed, but the level of connections and interdependencies remain high. By enabling institutions and markets to become more and more intertwined, information technology has contributed to an increase in risks via opportunistic and herding behaviour. Hence, one of the key issues of effective crisis management, and one which, in Boot's opinion, is largely ignored, must be how to deal with not merely the complexity of institutions but the complexity of the system as a whole. Boot emphasised that policymakers and regulators must not draw any comfort from the current arrangements, but should put more efforts into building in redundancy and creating diversity in the financial system and should – not least – focus on making society less vulnerable.

Martin Noréus (The Swedish FSA) – Bank resolution and the need for cross-border cooperation

Noréus welcomed the new framework, which, in his view, will clarify whether an institution is a going or gone concern. The new regulation also provides much-needed ex-ante clarity by way of a more robust framework for loss hierarchy with credible write-down and conversion procedures. When it comes to the challenge of cross-border recovery and resolution planning, Noréus had two main messages. Firstly, authorities need to maintain a degree of flexibility and avoid overly complex or mechanistic procedures. Each crisis tends to be different in nature and in executing resolution strategies authorities must avoid processes and requirements that could trigger or accelerate a crisis. Secondly, speaking from experience of participating in a number of supervisory colleges, Noréus believed that cross-border cooperation can provide an even greater challenge in recovery and resolution planning than in supervision. As the objective is so clearly to limit the cost for the national economy and its tax payers, it will be very difficult to agree on key issues, such as management and allocation of capital and liquidity across the group – especially in a crisis situation. Noréus stressed that overcoming conflicting national interests is indeed critical to cross-border resolution and if we succeed in doing so, it will benefit us all.

Session 6: Resolution of non-systemic banks

Gail Verley (International Association of Deposit Insurers) – Global overview of resolution tools: a focus on purchase and assumption

The International Association of Deposit Insurers (IADI) was founded in 2002 and has currently around 100 members, associates and partners. In addition to the protection of financial consumers, Verley argued that the benefits of an explicit Deposit Insurance System (DIS) include fair competition, confidence, stability and greater certainty. While liquidation and depositor reimbursement is the most widely used tool for handling non-viable banks at the present, the use of the "purchase and assumption" (P&A) method, promoted by FSB's Key Attributes, is increasing. The P&A instrument, whereby a healthy institution purchases some or all of the assets of a failing institution and assumes some of the liabilities, has the potential to minimise the disruption of services and functions without any additional funds from the resolution authority. An obvious challenge for authorities involves finding a suitable acquirer without having to cover losses associated with the assets of the failed bank. The Whole Bank P&A with optional asset pools is the most common tool in jurisdictions that use P&A for the resolution of failed institutions. Verley concluded with an overview of the varying mandates of deposit insurers internationally, illustrating that DIAs in North and Latin America play a more active role in dealing with systemic crisis than do DIAs in other regions.

Jesper Rangvid (Copenhagen Business School) – The Danish experience: why did more than a third of banks disappear and how was it handled?

Even though they were all small, a vast number of Danish banks failed during the crisis. The total number of banks in Denmark fell from 150 in 2008 to just below 90 in 2013. Rangvid described the period leading up to the crisis as characterised by liberalised lending rules and standards and an increase in lending, fuelled by the strong economy, soaring house prices and household optimism. As a result, many inexperienced banks started relying on market funding. When the crisis hit in 2008, Danish authorities responded by launching The Stability Package, issuing a two-year blanket guarantee covering all banks. In 2010, the first package was replaced by The Exit Package that introduced haircuts on unsecured senior loans and deposits above EUR 100,000. The first bank to run into trouble following the expiration of the government guarantee was Amagerbanken. The decision to impose a 41% haircut on its senior debt was described by international media as a precedent for the treatment of failing institutions. When rating agencies reacted by downgrading five Danish lenders, including Danske Bank, the Danish authorities were forced to take initiatives to soften the impact on the banking sector. In launching The Consolidation Package, they enabled the Danish Deposit Guarantee Fund to provide funding or guarantees against losses to an acquirer. Since then, solutions other than bail-in have been found. In Rangvid's view, the key lesson from the Danish experience is that it is indeed possible to wind down a small bank over a weekend, including imposing losses on senior debt holders, and continue operations on Monday morning with no effect on ordinary customers. However, being the first one to do so poses a great challenge in limiting market contagion.

Session 7: Non-bank recovery and resolution

Patrick Montagner (Autorité de Contrôle Prudentiel et de Résolution) – Insurance resolution

The Insurance Cross Border Crisis Management Group (iCBCM) has been set up by the FSB in response to the lack of a comprehensive scheme for the resolution of systemic insurers in various national frameworks. In order to create an effective resolution framework, Montagner argued that policymakers need to strengthen the on-going supervision and remove any barriers to good cooperation between jurisdictions. In resolution planning, critical functions must be identified in order to minimise the risk for major disruptions, which could impact financial markets or the wider economy. The iCBCM is currently working on guidance on resolution strategies for insurers, reflecting activities, business organisation and legal structure of the individual systemic insurers as well as the powers available under national frameworks and arrangements for cross-border cooperation. While the big question of funding in resolution of insurers is still being evaluated, Montagner believes that the new framework will provide clarity for policy holders and market investors as well as consistency across jurisdictions.

Klaus Löber (Bank for International Settlements) – Recovery and resolution of financial market infrastructures

Financial Market Infrastructures (FMIs) naturally differ from banks in many ways and provide other challenges to creating feasible recovery and resolution plans. FMIs are critical services, meaning there is generally no feasible alternative. Their balance sheets are typically very different from banks', as they are not designed to bear risks themselves. Moreover, they already have arrangements in place to share losses with their participants. The criticality of FMIs and the lack of substitutes place even more emphasis on recovery planning. The fact that recovery tools must be comprehensive, effective and transparent, while creating appropriate incentives and minimising negative impact, limits the range of adequate instruments available in practice. In order to deal with uncovered losses or liquidity shortfalls, Löber suggests that instruments such as cash calls, whereby participants provide additional resources, or variation margin "hair cutting", reducing liabilities to participants, could be implemented. The same set of tools will be available in resolution, with the addition of the bridge institution instrument. Löber concluded by highlighting various outstanding issues, including the assessment of the need for additional capital and liquidity resources in FMI resolution.