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# THE G20'S PROGRAMME TO END TOO BIG TO FAIL: A DIGEST OF VIEWS

## *Context and summary*

In the aftermath of the financial crisis that began a decade ago, the G20 initiated a process to "end too big to fail". The objective was to reduce reliance on fiscal bailouts and solvency support, thereby lowering moral hazard, distortions in competition and widespread discontent arising from the political elite riding to the rescue of the financial elite. The programme had two components. One was to reduce the probability of failure of systemically significant financial institutions. The second was to lower the costs, in particular the systemic costs, of failure in the event that it occurs.

The first component entailed raising capital standards, introducing more stringent liquidity requirements and moulding the incentives of managers and owners to be compatible with stability. The second involved putting in place effective resolution regimes so that in the event of failure essential financial services could be preserved without the use of taxpayers' money. As a result, the requisite powers were created and assigned to different authorities in all major and many minor jurisdictions. Minimum total loss absorbing capacity (TLAC) standards together with bail in mechanisms were established to contribute to such absorbency. In addition two different approaches were established to deal with complex groups in multiple jurisdictions (single point of entry and multiple point of entry).

The sense of the February 2018 meeting of the Forum was that the measures taken are a worthy attempt to mitigate the danger of systemic financial crises. Higher capital standards, stronger liquidity standards and TLAC all help. So too do stress tests and living wills. The improved clarity of mandates of respective Authorities also helps, and architectural frameworks for decision making and deployment of effective instruments to mitigate risk build-ups have advanced significantly. However, the new arrangements have not been tested by a financial crisis. Indeed it is not entirely clear what in practice "solving" TBTF might mean. Will there be the political will to use the new tools and will the technically based mechanisms put in place work in practice? If "solving" means that financial distress can now be addressed without the use of public funds, experience to date with even minor episodes such as those in Italy, suggest that it has not actually been "solved". In addition there has been, and is now, no yardstick for determining ex ante whether TBTF has in fact been "solved".

## *How safe should the system be?*

'How safe the system should be' is a prior question that needs to be addressed before considering whether we have solved the TBTF problem. If solving TBTF means creating systems with no failures and no fiscal recourse ever being required in the event of failures, we run the risk of stifling change in an industry that is now being disrupted by innovation and of hampering efficiency in financial intermediation, with adverse consequences for economic growth.

To complicate the debate, there is also a range of views regarding what the use of public resources actually entails. Does it mean that public money (including central bank liquidity support) will never be <u>used</u> to cope with financial distress? Or does it mean that the public sector will not suffer financial <u>loss</u> in the event public money is used? In some jurisdictions taxpayers' money has been used to deal with distress in the financial system. However, those

authorities have not suffered losses and have fully (sometimes more than fully) recovered all the funds that have been put at risk.

### *Will the measures work in practice?*

One way to approach the question whether the measures will work in practice is to consider whether the powers and resources are adequate and, if they are, whether it is likely that the political will be found to use them. If it can be found, is there the capacity to use them swiftly and effectively?

1. *Are the resources (capital and TLAC) adequate?*

The desirability of limiting the cost to the taxpayer and of providing private sector resources to enable a bank, insurer or infrastructure provider to fail without jeopardizing the on-going provision of essential financial services has led to the concept of TLAC/MREL requirements for banks, together with the possibility that some of this TLAC may be made available through “bail-in” of subordinated debt, as opposed to complete reliance on equity. Naturally this is aimed at providing more absorptive capacity than would be the case in traditional approaches based on capital adequacy for individual institutions.

To underline their determination further, governments in different jurisdictions have acted to curtail the ability of the financial authorities to provide funding. In the US for example the provision of guarantees by the FDIC for bond debt requires government approval. Moreover, the Fed’s ability to lend has also been altered: it can only lend in the context of programmes for classes of institutions. And the current Congress would not approve another TARP. Elsewhere for example in Indonesia no provision of public resources may be considered without the involvement of the Parliament.

Whatever the willingness of governments to see the use of public resources, there is also the question of whether the amounts would be sufficient in a general systemic crisis, as opposed to the failure of a single institution. In this respect, even large amounts of TLAC, may not be enough, especially if the resources needed for resolution of a gone-concern are consumed in attempts to secure recovery.

In addition whilst here has been much focus on the liabilities side of the balance sheet (“bail-in”), it is important also to think about the asset side and in particular the role of asset sales in resolution. Knowing what values they may have in times of stress is problematic. Asset markets are very large relative to GDP. Real estate debt stands at around 300% of GDP, with stock and bond markets around 100% of GDP. This makes it difficult to know how much absorbing capacity will be needed. Significant amounts of TLAC may suffice to contain “normal” events but would fail in the face of abnormal “black swan” shocks.

2. *Beyond this, political factors intervene*

Experience to date indicates that governments can be loath to bail in subordinated debt holders. Those to be bailed in may be vulnerable themselves and/or have political clout. The political will to impose losses on subordinated debt holders is difficult to marshal. In the recent case of a small bank failure in Italy, this proved to be the case. On another level those who would be bailed in might resort to litigation. Even if the courts eventually found in favour of the authorities, delay could scuttle the resolution efforts. There needs therefore to be greater awareness, and ex ante acceptance amongst holders of instruments available as TLAC, that they may in fact be bailed in.

### 3. *Will the capabilities be in place?*

While financial resources are important, human resources and skill sets as well as tested preparations of all aspects are arguably more important. Contingency preparations that will facilitate early and swift intervention are always difficult for unlikely or rare events. As time passes, those with experience in crisis handling leave the public sector. Emphasis needs to shift from the technical features embedded in the preparations themselves towards ensuring that they can be implemented effectively.

### 4. *Issues relating to SIFIs*

Much emphasis is placed on determining which banking or insurance entities are worthy of additional scrutiny because of their supposed greater potential to lead to the need for recourse. With living wills and stress tests, regulators should now have a consolidated picture of the exposures of SIFIs, so that they are able to assess (a) the ability of board and management to cope with distress, (b) the locus of vulnerabilities/fragilities and (c) the nature of linkages and the risk of contagion.

However since the systemic implications of entities are time and state dependent, can we really identify who should be designated SIFIs, whether global or domestic, and correctly calibrate the additional capital needed ex ante? Dealing with large and complex institutions is not enough. Small institutions can also trigger a crisis by provoking runs, whether singly [as in the case of Northern Rock in the UK] or in groups. Attention should therefore not be confined to SIFIs.

### 5. *Is the overall design still appropriate, and does it contain the right incentives?*

Changes in the environment since the crisis ten years ago have been considerable. This means that there is a risk that the **overall design** and tools that have been put in place are suitable for 'fighting the last war' The design of the safety net is bank centric – with capital and TLAC to address the leverage issues that their business models produce. Market-based forms of finance [shadow banking and market intermediated finance] are of growing importance. Funds are often leveraged, sometimes using derivatives, and both ETFs and mutual funds could face significant liquidity risk in the face of large sales or redemptions. The mitigants of systemic crises in the face of such scenarios are much less well developed. TLAC and bail in are of little direct relevance here.

CCPs and other market infrastructures have also become more critical. The ability to manage their failure has thus become more important at the same time that distributed ledger technology raises questions about their overall business model. More generally, greater attention needs to be given to newly emerging risks from e.g. blockchain related technologies such as cryptocurrencies and digital assets, whatever their advantages may be.

**As to incentives,** whilst the right mix is essential to make TLAC work in a crisis, incentives may, in practice, be significantly compromised. There is, for example, the tension between going concern and gone concern supervisors, with the former facing the temptation of forbearance. This has a bearing on who is given the authority to pull the trigger.

Where central banks do not act as Resolution Authorities, another tension arises between the duty of the central bank to look after the integrity of its balance sheet, and the desire of the resolution authority to ensure that liquidity is made available as needed in resolution.

Structural solutions, such as Volcker, Vickers, or Liikanen, may give some comfort. But here the incentives will be strong for market participants to game the system through regulatory

arbitrage. This in turn highlights the challenge of devising suitable measures to foster financial stability in the non-banking area. Of course, some of the types of institutions that failed (investment banks) are now part of bank holding companies for which new tools have been developed, though not yet tested (Dodd-Frank Title II, TLAC, resolution plans, etc).

### *6. How are International Issues best to be handled?*

The international dimension remains intractable. This is less because different countries have different frameworks for decision-making. It is more that there is have been no fundamental change in banks being global in life but local in death. Local interests continue to mean that there is political unwillingness to accept what amounts to preordained burden sharing that could make resolution arrangements more dependable.

For example, with a single point of entry approach to resolution, it is necessary to rely on the effectiveness of decisions made in the home jurisdiction even when resources are pre-positioned. The question that host authorities face is whether reliance on home authorities is justified.

In Asia, agreements on ‘financial integration’ that permit institutions to operate in other markets have helped promote financial stability. There is an integrated but largely informal crisis management framework, and simulations have shown that it is possible to get all the central bank governors together within a very short span of time (45 minutes).

In Europe and the Eurozone, a set of formal processes are in place designed to create some sort of proxy for a single decision-making authority in relation to resolution matters in the region.

## ***Conclusion.***

Much has been achieved. The wisdom of a loss absorption approach for all jurisdictions is clear. One day it will be tested. Some issues are already visible. The environment is continually changing over time. So the quest for “solving too big to fail” needs to continue.