Too-big-to fail, RIP?

The latest set of prudential rules is the strongest sign yet that too-big-to-fail has seen its last days

Despite the comprehensive reforms put in place in the wake of the financial crisis by the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the concept of too-big-to fail (TBTF) remains a highly politicised issue. The origin of TBTF is often traced to the bailout of Continental Illinois National Bank in 1984 and subsequent testimony by then Comptroller of the Currency CT Conover that regulators would not be able to liquidate the 11 largest US banks. Notwithstanding the source, TBTF has struck a chord in American politics that has been long invoked by presidential candidates including Andrew Jackson in 1832 (describing the Second Bank of the United States as a "hydra of corruption"), William Jennings Bryan in 1896 and Bernie Sanders in 2016 (telling Wall Street that "greed is not good").

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Distrust, or lack of understanding, of the operations of the financial system coupled with a sense of fair play makes the phrase TBTF an appealing, albeit misleading, rallying cry. In the bailout of Continental, the bank's shareholders were essentially wiped out and its senior management was replaced. As such, Continental was not bailed out in any real sense; rather, the markets were protected from direct credit losses and the potential loss of market confidence that could have followed from its liquidation. The Federal Deposit Insurance Corporation (FDIC), which provided funds to re-capitalise Continental, has identified the domino effect that would likely have resulted from a complete failure of the lender – including the failure of a significant number of correspondent banks with investments in Continental and the triggering of problems at other large banks in a vulnerable financial condition.

The concept that the failure of one or more significant businesses can directly and adversely impact the economy more broadly is neither new nor limited to banking organisations. Walter Bagehot wrote about the importance of maintaining market confidence in the face of potential panic in his book *Lombard Street: A Description of the Money Market* in 1873. More recent history includes government programmes that were intended to assist or take over private companies, including companies in the automobile, airline and railroad industries. In certain circumstances, the need to prevent broader financial disruptions, including widespread economic panic and paralysis, and the enormous human toll that can flow from a severe recession or depression, may warrant government intervention. However, such an option encourages moral hazard – the likelihood that businesses and their counterparties will take increased risks with the belief that the government will save them from adverse consequences.

Notwithstanding the persistence of political rhetoric, the requirements of the Dodd-Frank Act, coupled with international standards established by the Basel Committee on Bank Supervision and the Financial Stability Board (as implemented by the Federal Banking Agencies), have significantly reduced the likelihood of a failure of large banking organisations in the US. They also ensure that, should a failure occur, their investors and management do not benefit from the high-risk strategies that contributed to an institution's demise.

Diminishing TBTF

Section 165 of the Dodd-Frank Act provides the statutory basis for many of the new reforms aimed at ending TBTF. Specifically, section 165 requires enhanced prudential standards for large US bank holding companies (BHCs), with total consolidated assets of at least $50 billion, certain foreign banking organisations (FBOs) and non-bank financial companies that the Financial Stability Oversight Council (FSOC) designates as systematically important financial institutions (Sifis) concerning capital and liquidity, risk management and concentration limits. The enhanced prudential standards also authorise the implementation of additional standards (such as stress tests). As noted by the Fed chair Janet Yellen in February 2014, these provisions, as implemented by the FRB, serve as a prophylactic to prevent the "destabilising effects on the financial system" that can result from the "sudden failure or near failure of large financial institutions". In effect, the standards function as a first line of defence against TBTF, ensuring that the largest BHCs, FBOs and nonbank Sifis take additional precautions to limit threats to the stability of the US markets that were overlooked during the financial crisis.

As compared to before the crisis, BHCs and FBOs must now maintain significantly stronger capital positions due to rules implementing Basel III in the US, the supplementary leverage ratio and the surcharge for global systemically important banks (G-Sibs, which today includes Bank of America, BNY Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corporation and Wells Fargo). Capital in banking organisations serves as a shock absorber for losses; accordingly, higher capital means a greater ability to withstand financial stress. The Dodd-Frank Act has forced banking organisations to improve both the quality and quantity of their capital. The requirements for tier 1 capital instruments have become significantly tighter and some risk weights have been increased. Banks subject to US Basel III must maintain a minimum ratio of common equity tier 1 capital to risk-weighted assets (RWAs) of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of RWAs. Banks subject to the 'advanced approaches' risk-based capital rule are also required to maintain a supplementary leverage ratio of 3% of tier 1 capital to on- and off-balance sheet exposures.

G-Sibs are also subject to a so-called G-Sib surcharge. The G-Sib surcharge establishes criteria for identifying a G-Sib and the specific methods that must be used to calculate the surcharge based on the bank's overall systemic risk. The estimated surcharges for G-Sibs range from 1.0% to 4.5% of their total RWAs. The purpose of the surcharge is two-fold. First, it aims to reduce the risk of a G-Sib's failure and the impact the failure would have on US market stability when compared to that of a non-G-Sib. Second, it aims to increase the costs of operations for G-Sibs in an attempt to remove any funding cost advantages that it may enjoy in the market.

In addition, new liquidity requirements seek to ensure that banks' liquidity profile will be able to withstand the rapid onset of liquidity pressure that is typically associated with financial stress. The need to sell assets to meet funding requirements can quickly erode capital. To address this risk, the liquidity coverage ratio (LCR) rule requires larger banking organisations to maintain a minimum amount of unencumbered high quality liquid assets (HQLAs) sufficient to cover their projected net cash outflows over a 30-day standardised stress scenario. The LCR rule defines the types of instruments that constitute eligible HQLA and establishes methodologies for calculating the net cash outflows.

Moreover, larger banking organisations are also required to conduct company-run stress tests, and be subject to supervisory stress tests conducted by the FRB. These assess the potential impact that three macroeconomic scenarios – baseline, adverse and severely adverse – will have on the companies' total consolidated losses, revenues, balance sheets and capital (DFAST). DFAST ensures that large BHCs, FBOs and nonbank Sifis have the necessary internal processes to evaluate whether they have sufficient capital to withstand stress scenarios. In addition to DFAST, which provides a forward-looking quantitative evaluation of the ways in which stress scenarios impact an institution's capital, the FRB is able to evaluate a BHC's 'capital adequacy, capital adequacy processes and planned capital distributions' through the establishment of the Comprehensive Capital Analysis and Review. By publicising whether or not banking organisations have passed their stress tests, the Federal Banking Agencies have been able to invoke market discipline through the risk of negative public perception.

The Dodd-Frank Act also establishes new risk management and risk committee requirements in order to remedy the lack of internal oversight that was pervasive throughout the financial crisis. BHCs must now develop and implement an enterprise-wide risk management policy:

> *'commensurate with the company's structure, risk profile, complexity, activities, and size, and . . . include policies and procedures establishing risk management governance, risk management practices, and risk control infrastructure for the company's global operations and processes . . . .'*

BHCs must maintain risk committees that are specifically tasked with understanding the bank's enterprise-wide risk management policies and framework, and have an understanding of the bank's general risk profile. The risk committee must also have a risk management expert who has experience managing risk at large, complex financial firms.

The Dodd-Frank Act also requires other reforms, beyond the enhanced supervisory standards contemplated by section 165, which reduce the likelihood of failure of large banking organisations, as well as the impact that such failure would have on the market. These include the Volcker Rule, which limits the ability of banking organisations to engage in proprietary trading activities and to invest in certain types of investment funds, and new requirements for the trading and clearing of over-the-counter derivative transactions to reduce the likelihood of these transactions impeding the orderly resolution of a large banking organisation. Dodd-Frank also introduces enhanced oversight of payment, clearing and settlement systems to diminish the likelihood that a failure will disrupt the clearing and settlement of financial instruments and payments. Lastly, new consumer protection requirements for transactions including residential mortgage transactions, should lessen the likelihood of an accumulation of assets at banking organisations that exposes the banks to significant losses.

Foreign banking organisations

In addition to addressing the risk of TBTF at the largest US financial institutions, national reforms also address the potential of the US government having to bailout the local operations of an FBO. FBOs with a significant US presence (namely, consolidated US non-branch assets of at least $50 billion) must establish a US intermediate holding company (IHC) over its US subsidiaries to ensure oversight of its local operations. The IHC is subject to the enhanced prudential standards that apply to large US banks, and the IHC's subsidiaries are subject to examination and inspection by the FRB. For example, the IHC must adhere to the risk-based and leverage ratio requirements applicable to the largest US BHCs. This means an FBO must certify to the FRB that its capital adequacy standards, as required by its home country's supervisors, are consistent with the Basel Capital Framework. Further, FBOs, like large US BHCs, must also: perform capital stress tests; adhere to enhanced risk management and risk committee requirements; not exceed single counterparty credit limits and debt-to-equity limits (to the extent the FBO is designated as a Sifi by FSOC); and submit an annual resolution plan.

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Anticipating a failure

If these measures prove insufficient and large banking organisations fail, the US has begun implementing a second line of defence against TBTF that includes additional measures to preserve market stability and market confidence. Conceptually, the approach is designed to ensure that losses in a banking organisation are passed upstream to the top-tier BHC, leaving the public at large (and their wallets) unscathed.

First, pursuant to Title I of the Dodd-Frank Act, BHCs with assets of at least $50 billion must submit annual resolution plans, or living wills, to the FRB and

FDIC. These must document the BHC's plan for a rapid and orderly resolution under the Bankruptcy Code, or applicable insolvency regime, in the event of material financial distress or failure. In the event that a BHC fails, its resolution plan will provide regulators with a road map for the likely consequences of the failure and the ways in which the BHC will prevent the failure from eroding market stability (without the need for taxpayer assistance). The constant development of these resolution plans and their review by the FRB and FDIC ensures that there is an orderly path to a credible resolution.

Second, Title II of the Dodd-Frank Act establishes the Orderly Liquidation Authority (OLA), which provides the FDIC with the ability to resolve a failed G-Sib's BHC if its bankruptcy will have serious adverse effects on US financial stability. Under Title II, a BHC may be placed into an FDIC receivership where no feasible alternative is available, including a private sector sale or declaration of bankruptcy. Specifically, Title II requires that the BHC's:

- shareholders do not receive payment until all other claims are paid;
- unsecured creditors bear losses in accordance with an established priority scheme; and
- management and members of its board of directors responsible for the failed condition are removed.

The FDIC has proposed the use of the Single Point of Entry (SPOE) strategy in order to implement its authority under Title II, under which a failed G-Sib's BHC would be placed in receivership while its subsidiaries remain intact. Should a G-Sib fail, the SPOE strategy achieves the dual goals of stabilising the financial markets, while simultaneously 'hold[ing] shareholders, debt holders and culpable management accountable for the failure of the [G-Sib].' The SPOE strategy is designed to expressly establish that the BHC's shareholders and management will no longer be saved through a bailout. On the contrary, the intervention by the FDIC is designed to protect the markets and financial stability rather than the errant institution.

The FRB's recently proposed rule (Proposed Rule), which would require G-Sibs to maintain a minimum amount of loss-absorbing instruments (total loss-absorbing capacity, or TLAC) and a minimum amount of unsecured long-term debt (LTD), is designed to provide funding for the SPOE strategy. A covered BHC would be required to maintain outstanding eligible external LTD at least equal to the greater of: 6% of RWAs, plus the applicable G-Sib buffer and 4.5% of total leverage exposure. Eligible external LTD consists of unsecured, plain vanilla debt issued by the covered BHC and governed by US law. Eligible external LTD with a remaining maturity of between one and two years is subject to a 50% haircut for purposes of the requirement. Debt with a remaining maturity of less than one year would not count toward satisfying this requirement.

A covered BHC would also be required to maintain outstanding minimum levels of eligible external TLAC, or instruments issued by the BHC to third-party investors, equal to the greater of:

- 18% of total RWAs (on a fully phased-in basis), and
- 9.5% of the covered BHC's total leverage exposure.

Total eligible external TLAC would be the sum of the bank's tier 1 capital issued directly by the covered BHC and the covered BHC's eligible external LTD. Tier 2 capital that meets the definition of eligible external LTD would count towards the external TLAC requirement. An external TLAC buffer is added on top of the 18% risk-based capital component of the TLAC requirement, which can only be satisfied with common equity tier 1 capital, any applicable countercyclical capital buffer and the G-Sib surcharge (as calculated under Method 1 of the G-Sib surcharge calculations).

In order to further simplify the process of resolving a G-Sib, the Proposed Rule also introduces a new concept of a 'clean holding company'. As a clean holding company, a covered BHC would be prohibited from:

- issuing short-term debt (or debt with maturities of less than one year), including deposits, to third parties;
- entering into qualified financial contracts, such as securities contracts, commodities contracts, forward contracts, repos, swaps and security-based swaps;
- maintaining liabilities that are either subject to upstream guarantees from the covered BHC's subsidiaries or contractual offset rights for subsidiaries' creditors; and
- issuing guarantees of its subsidiaries' liabilities if the issuance of the guarantee would result in the covered BHC's insolvency or resolution.

Taken in their totality, the proposed TLAC, LTD and clean holding company requirements not only provide for additional loss-absorbing capacity at the BHC level, but also provide a source of funds that can be used to recapitalise a bridge holding company for the purposes of holding, and carrying on the business of, the BHC's subsidiaries. As such, they minimise market disruption in the event of a failure.

RIP, but forever in memoriam?

The likelihood that a large US banking organisation, FBO or nonbank Sifi will be TBTF, necessitating a government bailout, has been dramatically reduced, if not entirely eliminated, by the enhanced prudential standards and other reforms outlined above. Likewise, the potential for market disruption due to a failure akin to that of Lehman Brothers is substantially minimised by the submission of annual resolution plans, the establishment of OLA and the advent of the SPOE strategy (as funded by TLAC and LTD). This amalgam of reforms should allow the markets to continue to deal with large banking organisations with confidence, while concomitantly limiting the spectre of public bailouts that only exacerbate the moral hazards associated with rewarding reckless behaviour.

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