January 4, 2016

Financial Stability Board
Attn: Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB"), Consultative Document, November 3, 2015

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned consultative document (the "Consultative Document") issued by the Financial Stability Board ("FSB").

INTRODUCTION

On November 12, 2014, the FSB published its report to the G20 on the progress that has been made in reforming resolution regimes and resolution planning for global systemically important financial institutions (G-SIFIs). In that report, the FSB identified the provision of temporary funding to a G-SIFI that had failed and had been placed in resolution as an impediment to completing the FSB's reform agenda for these institutions.[2]

G-SIFIs are institutions whose size, market importance, and interconnectedness would cause significant turmoil in the financial system and inflict significant damage on the global and national economies if they fail. To minimize the damage that the failure of these institutions would inflict on financial markets, the FSB has sought to develop strategies to resolve them in an orderly manner so that these institutions can continue to maintain their

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[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular rulemaking processes aimed at reforming domestic and international financial markets.

[2] Financial Stability Board, "Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions" (Nov. 12, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/Resolution-Progress-Report-to-G20.pdf.

critical operations. Yet as the FSB has noted, there is a risk that a G-SIFI in resolution may not be able to roll over its short-term borrowing or it may lose access to sources of credit as it approaches failure or after it is placed in resolution.

To address these concerns, the FSB Plenary directed that a set of guiding principles regarding the temporary funding for G-SIFIs in resolution be developed. In response to this mandate, the FSB issued the Consultative Document, which set out six "guiding principles" for the provision of temporary funding for G-SIBs in resolution. These principles cover the following topics:

1. "Private sources of funding." The FSB's guiding principles provide that "private sources of funding should be relied upon as a first-choice source of funding."

2. "Public sector backstops." The FSB's guiding principles provide that "an effective public sector backstop funding mechanism should be available for use when necessary and appropriate."

3. "Strict conditions to minimize moral hazard." The FSB's guiding principles provide that terms for public sector backstops should include "conditions that minimize moral hazard risk."

4. "Provisions to recover any losses incurred." The FSB's guiding principles provide that governments or institutions that provide public sector funding should "make clear, *ex ante* provisions to recover any losses incurred from shareholders and unsecured creditors."

5. "Establishing the soundness and feasibility of the resolution plan." The FSB's guiding principles provide that the governmental authorities carrying out the resolution of a G-SIB should have a "well-developed and implementable resolution plan" and that that the governmental authorities should communicate that plan effectively to market participants to promote market confidence.

6. "Cross-border cooperation." The FSB's guiding principles call upon home and host countries to cooperate in implementing a resolution plan, and to "establish a clear division of responsibilities . . . for providing temporary funding in a G-SIB resolution."

<u>SUMMARY OF COMMENTS</u>

This comment letter addresses three problems raised by the Consultative Document:

- the amount and availability of private sources of funding;

- public sector backstops and moral hazard;

- cross-border cooperation in providing temporary funding for a G-SIB resolution.

Private sources of funding. As the Consultative Document notes, whether provided through private consortiums or through debtor-in-possession arrangements, private funding for the resolution of a G-SIB is likely to be insufficient to allow a G-SIB in resolution to continue its critical operations. To ensure that private sources of funding are "relied upon as a first-choice source of funding," regulators should require G-SIBs to estimate the amount of funding from private sources they would need to continue their critical operations in a resolution and to identify the possible sources of that funding. If the G-SIBs cannot identify sufficient sources of private funding to effectuate a resolution without resorting to government support, regulators should consider structural reforms that would reduce the size and complexity of the G-SIBs so that they could be resolved using only private sources of funding.

Public sector backstops and moral hazard. While the creation of a public-sector backstop could provide creditors and market participants with confidence that the G-SIB in resolution will be able to meet its obligations and thereby further financial stability, a public-sector backstop can also encourage G-SIBs, their creditors, and counterparties to take risks that they would not otherwise take. To minimize the potential for moral hazard, regulators should ensure that equity holders are extinguished and that remaining losses are fully imposed on creditors.

Cross-border cooperation. As Mervyn King famously put it, G-SIFIs "live globally but die locally." To ensure that there is sufficient temporary funding for the local subsidiary of a G-SIB to continue its critical operation, regulators should require G-SIBs to subsidiarize the local operations of a G-SIB so that they clearly fall with the jurisdiction and responsibility of the host regulator.

COMMENTS

1. Regulators should require G-SIBs to estimate the amount of funding from private sources they would need to continue their critical operations in a resolution and to identify the possible sources of that funding.

As the Consultative Document points out, the recapitalization of a G-SIB is not by itself sufficient to ensure the continuity of a G-SIB's critical functions—the G-SIB must also have access to liquidity to meet its obligations as they fall due or to refinance them. For ordinary companies, this funding is typically arranged by a financial institution and funded by a consortium of lenders. But given the daily liquidity needs of G-SIBs that are heavily-leveraged and dependent on short-term funding, it is not clear where such financing would come from.

In the United States, the largest private liquidity facility established by private lenders was $8 billion.[3] In the midst of the financial crisis, General Motors received a $33 billion liquidity facility that allowed it to be reorganized under the U.S. Bankruptcy Code—but given the magnitude of GM's financing needs and the unwillingness or inability of private lenders to provide that much lending in a financial crisis, that loan came not from private lenders but from the U.S. Treasury.

By contrast, the size and business models of G-SIBs ensure that their funding needs will dwarf those of General Motors. For example, JPMorgan Chase has estimated that it would need $200 billion in funding to be resolved under the U.S. resolution authority.[4] Bankruptcy professor Stephen Lubben has estimated that Bank of America's liquidity needs are $400 billion.[5] And former Treasury official Morgan Ricks has written that "Day-one funding needs for a failing SIFI . . . could be in the hundreds of billions of dollars."[6]

The scope of these funding needs raises serious doubt about the availability of private sources of funding to effectuate the resolution of a G-SIB. As bankruptcy professor David Skeel has pointed out, "There are serious questions whether private financing could be raised quickly enough in the midst of a systemically important financial institution's distress to satisfy its liquidity needs [in a bankruptcy filing]. Most commentators who have followed the bank resolution discussions believe that it could not be."[7]

And the FSB has itself pointed out that a privately-funded lending facility "is unlikely, by itself, to provide the amount of funding that would likely be necessary to support the funding needs" of G-SIB in resolution.[8] But at the same time, the FSB has said that "private

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[3] John J. Rapisardi and George A. Davis, "Lyondell: the largest commercial DIP in history," *Butterworths Journal of International Banking and Financial Law* (July/August 2009), *available at* http://www.cadwalader.com/uploads/books/del_unpublished_a0039779953c67a4929b0b2523f99731.pdf.

[4] Tom Braithwaite, "JP Morgan doomsday scenario revealed," *Financial Times* (June 12, 2013), *available at* http://www.ft.com/intl/cms/s/0/720e8746-b4ab-11e1-aa06-00144feabdc0.html. Note that in this scenario, JPMorgan Chase envisaged it would be resolved under Title II of the Dodd-Frank Act, rather than the Bankruptcy Code. Among other things, resolution under Title II means that the Treasury—rather than private lenders as provided for in the "living wills" process—would provide the funds necessary to reorganize the firm. For a discussion of the differences between the "living wills" process in Title I and the "Orderly Liquidation Authority" in Title II, *see* Mike Konczal, "Progress, Yet No Progress: The Two Lines of Defense Against Too-Big-To-Fail" (Aug. 7, 2014), *available at* http://rooseveltinstitute.org/progress-yet-no-progress-two-lines-defense-against-too-big-fail/.

[5] Stephen J. Lubben, "Resolution, Orderly and Otherwise: B of A in OLA" (Apr. 10, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037915.

[6] Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* (forthcoming 2016, University of Chicago press).

[7] David A. Skeel Jr., "Single Point of Entry and the Bankruptcy Alternative," (Feb. 26, 2014), *available at* http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1949&context=faculty_scholarship.

[8] Financial Stability Board, "Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ('G-SIB')" (Nov. 3, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/Funding-in-Resolution-Guiding-Principles-Consultative-Document.pdf.

sources of funding" should be relied upon as a first-choice of funding, to the degree such funding is available.

Rather than conditioning the priority and preferability of private funding to public-sector support on the "degree such funding is available," the FSB should direct regulators to do everything they can to ensure that such funding is in fact available. The regulators should require G-SIBs to estimate the amount of private financing that would be necessary to effectuate a reorganization as well as identify potential sources of that funding.

If the G-SIBs cannot identify sufficient sources of private funding to effectuate a resolution without resorting to government support, regulators should consider structural reforms that would reduce the size and complexity of the G-SIBs so that they could be resolved using only private sources of funding. Reducing the size and complexity of the G-SIBs to fit the availability of private funding would be the most effective way to ensure that the failure of a G-SIB did not require a public-sector bailout to prevent outsize damage to the financial system.

2. To minimize the potential for moral hazard, regulators should ensure that equity holders are extinguished and that remaining losses are fully imposed on creditors.

As Willem Buiter tersely explained,

> When this crisis is over and when, in the fullness of time, the real economy has recovered, we want to see less lending by and to US banks than we saw in the years 2004 – 2006. How do we get those who provided US banks and other financial institutions with too much funding at too low a cost to behave with greater prudence and caution in the future? Presumably by making sure that they pay the price for their reckless financial decisions.[9]

But as the Consultative Document notes, that is precisely the risk created by the provision of public-sector backstops: as demonstrated by the "resolution" of many of the large, complex financial institutions during the financial crisis, the shareholders of these institutions suffered significant short-term losses while their creditors were paid in full. The result was that for these creditors, there was no market discipline. As Buiter put it,

> Unless the counterparties pay the full price for their hubris and recklessness, they will be back for more. It is therefore tragic that central banks and governments everywhere are going out of their way to protect and shelter the unsecured creditors of the banks (holders of junior and senior debt among them), by raiding the tax payer or the credit and reputation of the central bank. Significant mandatory debt-to-equity conversions and large write-downs of

[9] Willem Buiter, "The Fed's moral hazard maximising strategy" (March 6, 2009), *available* http://blogs.ft.com/maverecon/2009/03/the-feds-moral-hazard-maximising-strategy/.

> (haircuts on) the claims of other unsecured creditors should be an integral part of any financial assistance package.

To ensure that public-sector backstops do not engender the moral hazard that results when creditors are protected from losses, the principles that Buiter describes should be part of any public backstop facility: regulators should be clear *ex ante* that the price of any such facility will include mandatory debt-to-equity conversions and haircuts on unsecured creditors, among other things.

And public-sector backstops should provide that equity-holders will be wiped out entirely as a condition of liquidity provision to G-SIB in resolution. As Brad Delong explained,

> Bagehot's fourth rule is that central bank lending in a financial crisis should be undertaken at a "penalty rate": nobody—no organization, no manager, no trader, and no investor—should end the crisis in any sense happy that they were forced to rely on the government. This would appear to mean, particularly, that equity should be extinguished before the central bank begins providing support at interest rates that are at all concessionary. To the extent that equity rights are preserved and less than a proper penalty rate is charged, the criticism that the central bank has unnecessarily provided incentives for moral hazard is unanswerable.[10]

Finally, the Consultative Document provides that regulators should "make clear, *ex ante*, provisions to recover any losses incurred either from shareholders and unsecured creditors." For the reasons that DeLong gave, the equity stake of shareholders should be extinguished in a resolution—they should bear the losses to the full extent of their equity stake in the failed G-SIB. More than that, however, the regulators should never be put in the position of having to recover losses from creditors. The only way regulators could find themselves in such a position, however, is if regulators have overpaid creditors because creditors were paid more than the regulators realized from the resolution of the G-SIB. Rather than run the risk of overpayment and the attendant difficulties of trying to recoup those overpayments from creditors, the regulators should instead adopt—*ex ante*—a schedule of partial payments to creditors that depends on the amounts that the regulators have realized from the resolution of the G-SIB. Creditors may have to wait for their claims to be fully settled, but it is better that creditors have to wait than it is that taxpayers have to pursue claims for overpayments made through the public-sector backstop.

3. Regulators should require G-SIBs to subsidiarize the local operations of a G-SIB so that they clearly fall with the jurisdiction and responsibility of the host regulator.

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[10] J. Bradford DeLong, "This Time, It Is *Not* Different: The Persistent Concerns of Financial Macroeconomics" (April 2012), *available at* http://delong.typepad.com/20120411-russell-sage-delong-paper.pdf.

The Consultative Document calls upon host and local authorities to cooperate in supporting group-wide and local resolution plans. The difficulty is that in times of stress, those pledges of cooperation—no matter how sincerely made—are not enforceable and cannot be relied upon. As the International Monetary Fund observed,

> When the regulatory authorities are faced with the distress or failure of a financial institution within their territory, they tend to give primary consideration to the potential impact on their own stakeholders: namely, creditors to branches or subsidiaries located within their jurisdiction, depositors, and in the final analysis, taxpayers.[11]

The conflicts of interest between home and host countries poses an intractable difficulty for cooperation: the regulatory authorities in the home country have no interest in providing financing that will benefit the host-country creditors of a subsidiary, and the regulatory authorities in the host-country have every incentive to seize assets that may be used to satisfy claims in the home country.

Rather than rely on cooperation between home and host-country regulators, the regulators should require G-SIBs to form distinct legal subsidiaries, separately capitalized with segregated liquidity holdings, that can be resolved relatively easily if one of the subsidiaries fails. In fact, the Board of Governors of the U.S. Federal Reserve System has required non-U.S. banking operations with a significant U.S. presence to create an intermediate holding company over their U.S. subsidiaries for this reason.[12]

CONCLUSION

The funding required to resolve a failed G-SIB demonstrates that although some progress has been made in ending the "too big to fail" problem, much remains to be done. While relying primarily on private sources of funding to effectuate the resolution of a G-SIB remains an aspiration of regulators, the difficulty in obtaining sufficient funding from the private sector remains a significant impediment to resolving such institutions without a public backstop. If the reliance on private funding is to be at all credible, then regulators must require G-SIBs to estimate how much private funding they would need to be resolved and to identify possible sources of such funding. If it proves that there are not sufficient amounts of private funding to allow a failed G-SIB to continue its critical operations while it is being resolved, perhaps the regulators should adopt structural reforms that would allow these institutions to be resolved with only private sources of funding.

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11 International Monetary Fund, "Resolution of cross-border banks-a proposed framework for enhanced coordination" (June 11, 2010), *available at* https://www.imf.org/external/np/pp/eng/2010/061110.pdf.

12 "Emhamced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 79 *Federal Register* 17,240 (March 27, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf; *see generally* Jeff Lacker, "Ending 'Too Big to Fail' Is Going to Be Hard Work" (April 9, 2013), *available at* https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2013/lacker_speech_20130409.

If regulators provide public backstops to provide liquidity to G-SIBs in resolution, they must be sure that the terms on which these facilities are provided minimize the moral hazard associated with such facilities. At a minimum, these terms must direct that the claims or equity-holders are extinguished in a resolution and that creditors will bear residual losses. And these public backstops must be structured to avoid the possibility that creditors will be overpaid—it is easier for regulators to "top off" creditor claims after a resolution has been completed than it is for them to pursue clams for overpayments that were made during the course of a resolution.

Finally, the issues raised by the cross-border resolution of a global financial institution demand a stronger response than hortatory statements about cooperation between home and host country regulators. To ensure that the funding needs of a G-SIB in resolution can be met, the responsibility for providing that funding must be clearly delineated. The only way to clearly delineate that responsibility is to subsidiarize the operations of a G-SIB so that it is clear which regulators are responsible for and which laws apply to the supervision, resolution, and the provision of funding to effectuate the resolution of a G-SIB.

We hope these comments are helpful.

Sincerely,

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