



BANK OF ENGLAND

Speech

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Ending Too Big to Fail – progress to date and remaining issues

Speech given by

Sir Jon Cunliffe, Deputy Governor Financial Stability, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of the Prudential Regulatory Authority Board

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We are now a little short of five years on from the deepest point of the recession that followed the global financial crisis. Advanced economies seem set on the path to recovery – though as every central banker will feel compelled to tell you, very real risks remain. It has been a long, hard slog to get to where we are and the damage – to jobs, to wealth, and to the productive capacity of the economy going forward – has been great.

Economic theory tells us that recessions which follow financial busts are deep and long lasting. Recent history bears that out.

There is a determination – in politics, in the regulatory community of which I am part and I think in the financial services industry itself – to learn the lessons of the recent past. There are different views – some more extreme than others – on all sides about what is necessary. On how far-reaching change should be? And how far reaching change *can* be if the financial sector is to continue to play its vital role in the economy of channelling credit efficiency between savers and borrowers?

But change there has to be – if both the regulators and regulated are to re-establish society's confidence that we can have a dynamic and global financial sector, one that serves the real economy, without generating such painful financial booms and busts.

And the process of designing, agreeing and implementing that change is long and complex. I make no apology for this. The financial crisis was not a simple and short-lived episode. Nor can the response be simple or quick. We are now, however, well into that programme of regulatory reform.

I want to talk today about some of the key elements of that programme. Elements that are now moving from the stage of discussion and design to the stages of agreement and implementation. And I want to talk particularly about the various initiatives that together bear on what is perhaps the biggest challenge; ensuring that no bank is too big to be allowed to fail.

It is pretty obvious now that we went into the crisis with a high risk, highly interconnected banking system that had dangerously thin levels of capital and liquidity. Not only were too many banks too vulnerable to serious stress; the authorities also lacked the tools and the options to deal with failure once it occurred, particularly when dealing with large international banks.

So when undercapitalised banks faced failure, when they could not raise sufficient private capital to restore viability, authorities around the world were faced with the same journey of horrors.

The first step was usually to see whether a healthy bank was able and willing – or at least able and persuadable – to buy the distressed bank's business. Examples here range from acquisitions of smaller institutions by much larger ones, such as Santander's acquisition of Alliance and Leicester; to mergers

between two large lenders, such as Lloyds TSB's with Halifax Bank of Scotland and, in the United States, Bank of America's merger with Merrill Lynch. There were some hasty shotgun weddings.

The great attractions of finding a buyer for a failing institution are of course that it both ensures continuity of service provision and avoids triggering deposit guarantees or use of public funds. Depositors find themselves banking with a different bank but access to services is maintained. And there is continuity in the provision of lines of credit, including through overdraft arrangements to households and corporates.

There are, however, two big risks. First, mergers can concentrate supply and so damage competition particularly if both the distressed bank and the rescuer are relatively large. In the UK, the largest six banks and building societies now account for 80% of the outstanding household and corporate lending, up from 65% at the start of 2008. And second, the rescue mission can go badly wrong if rather than pull the failing operation up it pulls the purchaser down. This is precisely what happened to both Lloyds Banking Group and Bank of America, which required large public capital injections after they made their acquisitions.

If no suitable purchaser could be found, the choice for the authorities was between administration – for all or some of the business – or a taxpayer bailout. In a number of small and middle sized cases it was possible, without unacceptable disruption, to protect insured depositors by drawing on deposit insurance and, in some cases, public funds, while selling some parts of the business to another firm and putting the other parts of the business, including shareholders and subordinated debt, into administration. Bradford and Bingley was the most notable example of this in the UK.

But putting all or part of large institutions – especially large international ones – into administration proved impossible with one, notorious exception. And that exception, Lehmans, proved the rule that large, complex, systemic institutions were truly too big to fail.

This should not have been a surprise. There was generally tough talk from regulators before the crisis. And there were some idiosyncratic isolated failures, like BCCI and Barings, which occurred outside a systemic crisis. But as a number of researchers have pointed out, large systemic institutions were able to raise debt on more favourable terms than smaller ones reflecting the perception – which turned out to be generally true – that investors in these institutions were protected by an implicit government guarantee. Indeed, credit rating agencies specifically identified a 'public support uplift' in their ratings.

Nor was the reluctance of authorities to put banks into administration surprising. Administration results in a poorer and potentially disruptive outcome for continuity of functions critical to the economy. Where the bank is large and complex, it can be very difficult to split up the constituent parts. And the effects of putting all or some of the bank in to administration can spill-over to hit the financial system and the wider economy.

Nowhere was failure more disruptive than for the liquidation of Lehman Brothers, where the FDIC lacked the requisite powers to resolve the firm in an orderly fashion. The process was disorderly, time consuming and expensive. And it was very contagious. It triggered the worst phase of the crisis. In the weeks following the failure, Reserve Primary Fund broke the buck, sparking a run on the US money market fund industry. More than five years on, the liquidation is still not yet fully complete. Fees paid to the administrators have, so far, totaled more than \$2bn. The sheer size and complexity of Lehman's derivative book made it very difficult to wind-down. The FDIC estimates that, had a legal framework existed to put the firm through a resolution and receivership process, a quick resolution could have recovered far more value for unsecured creditors and, importantly, limited contagion to short term commercial paper and funding markets. In the end, disorderly liquidation looks to have left unsecured creditors in the holding company with a recovery of around 20 cents on the dollar.

The last resort, if no white knight can be persuaded to come forward and if the contagion caused by administration was simply too dangerous, was to use public funds to attempt to recapitalise and resurrect a failing bank. Although it was the last resort, it was also probably the most common.

For the UK, this proved to be the only option available for what had, before the crisis, been three of largest five UK lenders. Given these banks accounted for some 40% of lending to the UK economy – and scarred by the chaos in the aftermath of Lehman – the government was left with little option but to make a huge £65bn injection of funds to shore their capital position.

The intervention was successful in stabilising the situation but UK taxpayers are still counting the cost. Today, the government's stake in RBS, equivalent to economic ownership of a little over 80% of the group, is worth around £31bn, a loss of over 25% on the funds injected.

The UK was not alone. The US injected over \$250bn of preferred stock into financial institutions, including a number of the largest firms. On the continent, the three Benelux countries injected €11bn in a part-Nationalisation of Fortis; France, Belgium and Luxembourg injected €6bn of capital into Dexia. The Swiss put CHF6 billion of funds into UBS.

None of this counts the costs to the broader economy. The UK suffered from a credit crunch, particularly for lending to SMEs: the businesses that make up LBG and RBS – the two banks in receipt of state support – accounted for over 50% of the pre-crisis stock of corporate lending. The damage to economies generally from a financial system on long lasting life-support has been deep and wide. In the UK, five years later the economy is still smaller than before the crisis. Around half of a million more people remain out of work.

With the costs of bank failures so high and the choices when they did so unpalatable, it is perhaps not surprising that post-crisis there had been pressure to reduce the probability of failure, particularly for large

international banks, as close to zero as possible. Indeed, some have argued that banks should become unlevered mutual funds – effectively the solution is to ban banking.

Others argue that regulation cannot hope to lower the probability of failure. With greater resources, the banks will always be one step ahead and find new ways to game the rules. Instead the authorities should focus efforts on ensuring that is completely safe for banks to fail. Large banks should be broken up into many smaller businesses that are easy, individually to resolve, even if that means forgoing economies of scale.

The international regulatory community has taken a different two-pronged approach. First to reduce, but not eliminate, the possibility of failure by making banks resilient not only to known, but also to unknown risks – the events in the tail of the distribution.

Second, in a world in which banks can still fail, to give the authorities real, practical options for resolving failures that neither trigger widespread economic disruption nor require huge injections of public funds. And, by making investors in banks ultimately responsible for losses, as is the case for other industries, introducing a market discipline on risk taking that will further reduce the likelihood of failure in the first place.

Reducing likelihood of failure

I believe regulation can be effective in reducing the probability of failure.

We have in Basel 3 a fundamentally reformed international risk weighted capital standard and, in the Liquidity Coverage Ratio (LCR), the first international standard on liquidity. The imposition of quantified capital add-ons for systemically important banks has been agreed. This risk weighted capital and liquidity regime has largely been legislated in the key jurisdictions. And, to complement these revised minimum standards, countries around the world are embedding a regular stress testing process as a key part of micro-prudential and macro-prudential supervision.

Banks are now making the transition to the new, higher standards. The amount of capital and liquidity in the system has already been transformed. Globally there is now some \$500bn more equity capital in the banking system than the level before the crisis. The major UK banks hold £150bn more equity and their leverage has broadly halved. Holdings of liquid assets have trebled.

However, two crucial elements of the capital and liquidity regime are still at the design and agreement stage.

The first is an international standard on leverage. Though the risk-weighted capital framework provides a system that it is more sensitive to risk, it is reliant on those risk-weights being correctly calculated and, therefore, vulnerable to so-called model risk. The risk-weighted approach will fail if the risk-weights are

wrongly calculated, either individually or, collectively. And the evidence of the crisis is that this risk can become more pronounced in boom times when asset prices are rising and the pressure to expand balance sheets with cheap funding is greatest. The result is dangerous concentrations in what appear to be low-risk assets. It is telling that if a minimum leverage standard been in place prior to the crisis, it would have bound more tightly than risk-weighted measures for a number of banks that met their risk weighted capital ratios but that subsequently failed.

The debate about the relative merits of risk weighted capital controls versus un-risk-weighted controls like the leverage ratio has in my view become too hung up on the question of backstops and frontstops – on which constraint should bite first. This is an unhelpful way to look at the issue. Risk-weighted and non-risk-weighted measures protect against different risks. The leverage measure is there to manage model risk, which can be very significant. Which of the two ratios binds first depends on the kind of risks that banks are running. The leverage ratio automatically places tighter limits on expansions in the balance sheet through supposedly low-risk assets.

The international community has made progress on the leverage ratio. The definition guiding how it should be calculated was agreed at the start of this year. This will provide the basis for banks to disclose the ratio over the next 3 years in the light of which the international community will decide in 2017 on the calculation of a minimum standard.

A number of authorities, including the US, the Netherlands, and the Swiss, have already introduced or are considering a leverage ratio in advance of the international standard. In the UK, the Prudential Regulation Authority has already asked the eight major UK banks and building societies to take steps to achieve a leverage ratio above 3%. The Financial Policy Committee has been asked by the Chancellor to review whether a leverage ratio framework should be introduced in advance of the international framework. This could include a power for the FPC to vary the ratio to counter macro-prudential risks. The FPC will consult on the review and expects to publish its conclusions towards the end of the year.

There is also important work underway to ensure the risk-weighted framework is robust. Reviews are underway to build a credible standardised approach to calculating risk-weights for banks' trading activities and their loan books; this too should help reduce the system's exposure to model risk.

The other key element of the capital and liquidity regime to be agreed is the Net Stable Funding Ratio. This standard addresses banks longer-term liquidity risks. Proposals are currently out for consultation and the Basel Committee aims to agree the standard in September this year.

Concerns have been raised by some in the industry that taken together, the main elements of the new capital and liquidity regime can interact to have potentially serious and unwelcome unintended consequences

particularly on market liquidity. The official sector takes such concerns seriously and is already looking closely at them.

We should not however set the objective of ensuring a return to pre-crisis liquidity conditions. Liquidity premia were likely too low with liquidity risk very probably under-priced before the crisis. Prior to the crisis, market-makers were permitted to fund their inventory with dangerously high levels of leverage, funded at very short-maturities. Though lax standards allowed dealers to carry high levels of inventory and to easily accommodate shifts in the demand for market making, dealers were vulnerable to falls in asset prices and tightening in wholesale markets conditions. When faced with severe stress, they were forced to withdraw from market making altogether.

With regulation tighter, it may be harder for dealers to absorb inventory when end investors wish to offload assets; market liquidity may start to fall away at an earlier point. Market participants will need to recognise this change in market structure and adjust their balance sheets accordingly. But the catastrophic risk, of dealers withdrawing from market making altogether because balance sheets have become dangerously overstretched, should be much reduced.

Managing the impact of failure

With a zero-failure regime neither feasible nor desirable, reform is also underway to reduce the impact of failure as well as its probability. And specifically to allow even the largest banking groups to fail and be resolved in a safe way without recourse to taxpayer funds.

The key is to be able to recapitalise a failed group safely, quickly and credibly by bailing in the group's uninsured, unsecured creditors, such as debt-holders. To be clear, the aim is not to resurrect every failed business, though that may be the outcome in some cases. The aim is to enable the critical parts of the group – the parts vital to the real economy and the parts that financial stability depends upon – to keep operating so the group can be safely resolved over time. The ultimate solution could involve a mixture of sales, administrations and run-off. The bail-in provides the time and the loss absorbing capacity to allow that to happen.

The required legal framework is well progressed. In both the UK and US, it will in future be possible to bail-in debt holders. An EU framework has been agreed with the Banking Recovery and Resolution Directive, which will come into effect in January next year. This not only provides the powers for bail in. It actually mandates that 8% of a bank's liabilities must be bailed in before there can be any recourse to public money or industry financed resolution funds.

However, the powers, and indeed the requirement to bail-in, are not enough in of themselves. Bail-in powers need something to work with once a resolution is triggered. For resolution to be effective, we need banks to

hold sufficient debt structured in a form that can be safely and quickly bailed in – or, to give it its inelegant full name “Gone Concern Loss Absorbing Capacity” – G.L.A.C for short.

There is now agreement on the broad objective for an international GLAC standard: it must allow for an orderly wind down of large, complex cross-border groups, whilst protecting its critical economic functions.

Discussions have moved on to the key design features. What sort of standard? How much GLAC? What type of debt should count and where should it be located?

On the quantity, I repeat, we are not seeking an amount of GLAC capable of resurrecting any failing bank including the global giants. Rather, we are looking for sufficient GLAC to recapitalise the entities carrying out critical economic functions to a level sufficient to regain and maintain market access. For the remaining entities, sufficient capacity to provide for an orderly run-off is what is required.

On what kind of instruments should count as GLAC, the debt needs to be of a sufficient maturity to give confidence that the funding will not have been withdrawn before the bail-in can be executed. It needs to be structured in a way that is subordinate to general creditors, allowing for debt to be bailed in without the disruption of also having to bail in general depositors, or the operational difficulty of having to unpick a large derivatives book.

And, for the large, complex international groups, the GLAC needs to be held in the right place so that the resolution plans drawn up in advance can be implemented. Where it is intended that the bank should be resolved at group level, the GLAC needs to be held in the holding company with a mechanism for transferring the loss absorbing capacity it provides to subsidiaries in other jurisdictions. Where the bank is to be resolved at a local level, the necessary GLAC needs to be held in each jurisdiction, either in subsidiaries or intermediate holding companies.

The effectiveness of the legal framework for resolution relies not only on bail-in powers and having something that can be quickly and easily bailed in. It also requires contracts that recognise resolution powers across different jurisdictions. Though domestic and European law will create powers for the resolution authority to adjust the terms of local contracts, the law does not automatically provide for recognition of powers for contracts issued in different jurisdictions.

Derivative contracts, in their current form, are a potential show-stopper here. As structured, most contracts would allow the counterparties in another jurisdiction of a firm that had been put into a resolution to close out their contracts and to seize collateral covering their replacement value. For example were a resolution authority in Europe to put a cross-border bank into resolution, close-out by US counterparties could trigger a disorderly unwinding of the derivatives book undermining the effectiveness of the operation. The international regulatory community is working with the International Swaps and Derivatives Association to

develop a revised protocol for derivatives which put in place a stay on close-out rights to permit the orderly use of resolution powers.

Drawing up a revised standard for derivative contracts is just the first step; the next and harder step is effecting a move of the hundreds of trillions of dollars of derivatives onto a revised set of contracts. The way forward will likely entail the major dealers, the 'sell side', who together account for around 80% of contracts in the market, moving first.

Structural reform

There is one other, extremely important element of the agenda to end too big to fail – structural reform.

Legislators and authorities worldwide have concluded that simply breaking banks up is not the answer. However, some jurisdictions – particularly the those with very large, international financial sectors – have concluded that, given the risks, structural reform measures are also necessary to ensure that the parts of banks crucial to the domestic economy are insulated and kept apart from riskier activities and can be resolved if necessary. The UK, through the Independent Commission on Banking proposals, and the US, through Dodd Frank, are key examples of this. The EU have also proposed a structural reform measure of this nature.

I do not want to go into the detail of the reforms, which can take very different approaches. The reforms are, in the general, complementary to the resolution agenda. By seeking to ensure that critical economic functions are insulated from riskier parts of the group, they make it easier for the resolution authority to protect continuity in those services through a resolution scenario. All entities within the group, of course, still need to be resolvable.

When working out the details of implementation, we need to make sure they too line up with the grain of the resolution strategy adopted for the firm. For cross-border banks, that will require work to ensure that the application of different structural reform measures in different jurisdictions add up to form a coherent package for the group as a whole.

Conclusion

As I have noted, the crisis was not only hugely costly, but also complex and long lasting. It revealed wide spread weaknesses, and weaknesses of very different types, in the financial sector and in regulation and supervision. So the reform programme is complex and wide ranging. There are many elements I have not mentioned today.

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The overall message, however, is that the landscape must and will change very materially. The change is happening. Many of the key pieces of reform have been agreed and are already being implemented. As a result, there is already more resilience and lower risk in the system. Some key pieces remain to be agreed. Particularly important here are the remaining reforms on resolution that, when taken together with what has already been achieved, will mean that we will finally be able to say with confidence that no bank is too big to fail.