Investment Management Association

2 September 2011

E-mail: fsb@bis.org

Dear Sirs

Effective resolution of systemically important financial institutions

Thank you for providing us with an opportunity to respond to your consultative document dated 19 July 2011.

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes.

They are responsible for the management of around £3.9 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. As an example, our members manage client positions which in aggregate exceed 40% of the UK stock market.

It follows that our members, on behalf of their clients, make daily decisions to buy or sell shares in systemically important financial institutions (SIFI) and, perhaps more critically, to lend or withdraw significant components of wholesale funding available to such institutions through the purchase and sale of bonds.

The structure of your paper and the use of the annexes assist greatly in describing such a complex and wide ranging subject. Our comments relate principally to the issues considered in annexes two and seven, but we make some overarching comments as well. We have also proposed a simple model to explore the likelihood that senior creditor bail-in will not offend the no creditor worse off principle. The answers to the specific questions are in the attached Appendix.

Should you have any queries then please do not hesitate to contact me.

Yours faithfully

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Appendix
Question 1

In considering whether annex 1: “Key attributes of effective resolution regimes” appropriately covers the attributes that all jurisdictions’ resolution regimes should have, we would comment as follows:

It is important that the G20 leaders appreciate that the special resolution regime addressed by the FSB is designed to resolve a financial institution "that is no longer viable and there is no reasonable prospect of it becoming so" (see the preamble to Annex 1). This means that the counterfactual to most of the propositions would be that the financial institution would fail and might do so in a disorderly manner. This is a very different situation than if some of these powers were applied where there was no prospect of immediate failure. A specific example is in the discussion about bail-in, where the powers to be given to the authorities are described as “bail-in within resolution”. Over the past 18 months, not all proposals have so limited the potential powers and it is important that the G20 understands this context.

We think it is right that you recognise there may be contractual bail-in through the issuance of instruments containing such provisions. It is right that the authorities do not seek at this stage to do more than you have suggested which essentially seems limited to understand as a matter of usual supervision the nature and type of liabilities that any financial institution has. We address the position of contractual instruments when there is a statutory bail-in, under comments relating to annex 2.

We agree that further sector-specific guidance will be needed in relation to the institutions which you identify in the introduction to annex 1. However very importantly we think the paper to date does not sufficiently address the position of assets belonging to others that may be administered or safeguarded by the SIFI (or members of its group). The paper presumes that the assets and liabilities being addressed are respectively owned by and owed by the SIFI. Commonly, however, a SIFI may have under its control a significant number of assets which are not available for its creditors (whether individually or as a class), and a resolution regime must be able to address these appropriately. Tools such as bail-in and principles such as respecting hierarchy do not adequately address the specific situations. You will be aware that the United Kingdom has altered its legislation this year in relation to the special administration of investment banks precisely to address this issue, amongst others.

We understand the FSB is addressing losses that can arise when a SIFI fails under three headings:

- The reduction of idiosyncratic losses arising from the destruction of value of the assets of the SIFI itself.
- The application of irrecoverable losses otherwise than upon the taxpayer.
- The reduction of systemic losses occasioned by the impact of the failure of the SIFI and whether transmitted through contracts, transactions or confidence.

We support this approach. If the proximate cause for a bail-in is due to systemic instability risk this is a good for the market as a whole. However if the ultimate cause is due to certain sectors of the banking system having been condensed into the hands of too few banks, it becomes a regulatory issue that should be addressed independently of the bail-in regime.

The relevant authority has to be the ultimate decision maker as to whether and when the trigger is activated. However points that should be clarified in advance are:

a. If it is publicly known that a bank is being assessed, information regarding the results of these tests must be disseminated in a timely and public manner.
b. There may be a conflict of interest between the regulator and the investors in the bank because there is limited upside for the regulator to delay putting a bank into a bail-in scenario. There should be some independent check to ensure there is no conflict of interest that leads to a bail-in occurring earlier than a point of non-viability which commands confidence amongst investors.
c. The actual trigger point should be based on a "point of non-viability" but not on one specific ratio as these can be manipulated and may not be timely.

Having made the above points we agree with the contents of annex 1. It is a sufficiently comprehensive and welcome statement which we trust will be adopted by the G20 leaders. We have comments about netting and set off which we will deal with separately at the end of this document.

Question 2

As mentioned in question 1, the framework does not yet sufficiently address SIFIs which safeguard or administer assets belonging to others. Other than that we think the framework is specific enough, yet flexible enough.

Question 3

Annex 2

Holders of bank debt cover the complete range of investors, within the UK system for example, the majority would be IMA members. Investors would differentiate between the bonds available by using the following inputs (in no particular order):

a. Whether the bond was in a relevant bond index
b. Whether the bond was liquid and could be traded in reasonable size
c. Where the bond was in the creditor hierarchy
d. Credit analysis and the credit rating of the bond
e. Whether the bond was abnormally structured or had any abnormal clauses
f. Any regulatory or tax reasons that might inhibit the ownership of the bond. If this might alter there would have to be a change to allow ownership of an equity that was a bond at the point of purchase
g. The sector restrictions for the bond fund. Client mandates often restrict holdings in bonds that are quasi equity. No equities can be held in European bond funds under the European Fund Classification as set up by the EFCF although convertible bonds are permitted. The IMA bond sectors restrict "other holdings" to 20%
h. Out of which subsidiary the bond was issued
i. The economic and regulatory situation of the country in which the relevant bank subsidiary resides

Any new regime that would significantly change any of these external inputs could disrupt the bank bond market and inhibit the future ability of banks to borrow long-term money from the bond market.

That said, annex 2 does provide a good framework. We particularly consider that senior management and supervisory involvement with recovery and resolution plans will be a major source of the advantages that may accrue from a global approach to resolutions. The comments and concerns which we have are dealt with in relation to the specific questions raised in the consultation questions at 4 to 8 below.

Questions 4 to 8

The questions ask about the liabilities covered by bail-in. We are not convinced bail-in will be that much use in practice. We are unattracted by suggestions that some senior debt but not others might be amenable to bail-in. We think impacts on the bond derivative markets have not been researched. Below we argue that the conditions under which there might be even a theoretical advantage from such an approach may be highly circumscribed (as question 8 might have in mind).

If there are reasons why some bonds/bank borrowing cannot be included in this new regime it must be made clear in advance where the line is to be drawn. In particular, it should be clear why some bonds or bank borrowing will be included despite similarity in seniority ranking with some claims that will not. A public "living will" may clarify some of these issues but we address more fundamental problems with senior creditors further down this section.

There may be defensible reasons for secured bonds not to be included but this may lead to a large increase in the proportion of these bonds on bank balance sheets and therefore insufficient unencumbered assets. The possibility of this unintended consequence, and the fragility that arises from asset encumbrance, should be dealt with by regulatory limits rather than inclusion within the bail-in regime.

There must be much greater clarity on the structure of the financial support and liability of the various subsidiaries within the banks. If there is deemed to be a different (weaker) regulatory regime for a subsidiary this must not affect the borrowing of the group. Disclosure of all relevant intra-group financial support would be necessary.

Applying the principle that creditor hierarchy should be respected wherever possible, the proposal that equity bears the first losses and subordinated debt the next losses is, in principle, uncontroversial. If conversion rather than write-down was the chosen mechanism the hierarchy of bonds versus equity must be fully enforced, that is to say, original shareholdings must be completely written off prior to conversion of bonds into equity. Alternatively if a write down mechanism is used, it should be on a strict and pre-ordained creditor hierarchy with subordinated debt written off fully prior to any senior debt. Comments below about applying any new regime to existing debt do have application even for subordinated debt.

We note the proposition that any contractually bailed-in debt will be subject to further bail-in within a resolution. We can see that if such a contractual instrument had not been triggered ahead of the authorities' intervention then it should suffer write-down or conversion, but we are unsure how the market will treat such instruments.

In many fora, the discussion over scope of liabilities for bail-in is now principally concerned with senior creditors. In most jurisdictions the class of senior creditors contains a wide and disparate list of creditors. Bondholders, of course, but also senior management and employees not only for wages but also for deferred remuneration, non-financial trade creditors such as lessors of equipment and landlords, and a whole range of creditors arising from the financial transactions entered into by the SIFI, some of whom may be intragroup. For many of the institutions considered by your paper, there is then the depositor base which may be fully or partially insured, and which will often rank as a senior creditor but which, as the paper points out, may have preference.

Limiting the impact of bail-in to any subset of all senior creditors gives rise to a variety of issues:

a. since creditor hierarchies are an expression of how losses are borne in any failure, the creation of the statutory bail in power within resolution effectively subordinates some existing senior creditor classes to others;
b. the smaller the number of liabilities by type which could be bailed in, then the greater the impact by value on each of those who are bailed in; this gearing will increase the likelihood that creditors will seek either to buy security or restructure the liability so as to obtain protection as a senior creditor which cannot be bailed in;
c. on the other hand, if the types of liabilities that can be bailed in are also the ones whose existence and value can be identified by the market then there may be some offsetting benefit in pricing. In any usual situation it is hard to know how many other creditors exist and therefore it is hard to find on an ongoing basis any reliable estimate of the likely return in any insolvency if there were a collapse in the asset value. But if, for example, only certain instruments could be bailed in, the market might then be much more informed about where the next level of losses will be born after subordinated creditors, and their likely impact;
d. significant issues arise over the application of any compensation and the principle of no creditor worse off. This occurs essentially because it is no longer clear whether compensation should be measured on the basis of a counterfactual or a factual. The examples and discussions below expand upon this and the sub-points above.

Assume simply that two senior creditors have nominal claims of £100. If there were a collapse of the SIFI, assume as well that each would have received a 30% dividend (return of claim) in a liquidation. In a resolution however one creditor is of the type that can be bailed in whilst the other is not. A resolution occurs and let us assume the authorities bail in the senior creditor (by debt write-down) so that its claim is now at £35. The other creditor benefits from the continuity and still has a nominal claim of £100 in the resolved bank. Is that bailed-in senior creditor worse off? In the counterfactual, that is to say, had the bank failed, the senior creditor is better off (since it has £35 not £30 in a liquidation). In the factual, what actually transpired, then by comparison to other creditors with whom it ranked equally immediately before the resolution, the senior creditor is worse off.

In the above example, policymakers may argue that the counterfactual should be used since the measure that creditor would use is one of monetary value of a claim, not of equal justice. We are unconvinced that behaviourally this is how all such creditors will see it. There are attractions to SIFIs for investment purposes, but there are many other issuers of debt which will not be subject to bail-in laws.

In any event, the above discussion is misleadingly straightforward. It is entirely possible that if the group of senior liabilities which have to bear the loss are small, then even compared to the counterfactual (an insolvent failure) the creditor may always be worse off. The actual situation depends upon the interaction of two contrasting effects – on the one hand, there is the arguable benefit that might accrue to the bailed-in creditor by losses being avoided from having a more orderly resolution when compared to the value destruction that can occur in any insolvency procedure; and on the other hand, there will be detriment to the bailed-in creditor from the additional losses it would have to bear which otherwise would have been applied amongst other senior creditors.

It can be readily seen that situations would exist in which the benefit to a bailed-in creditor of value preservation will not offset the weight of loss applied to them and which otherwise would have been borne amongst all senior creditors. In such a situation the no creditor worse off (NCWO) principle would mean that the state (taxpayer) would have to compensate the bailed-in creditor.

The balancing pressures of increased asset value versus increased loss-bearing by only a sub-set of senior creditors can be represented in the following statement of the condition which if true means no state subsidy would be needed to ensure bail-in senior creditors were no worse off than in an insolvency proceeding (referred to as liquidation below for ease of reference) – it is assumed that no claimant below senior creditor would receive a dividend in a liquidation:

$$A.\Delta V \geq (D_l.L_b) + L_x$$

Where:

A = the value of assets in a liquidation available to senior creditors as a class

$\Delta \mathrm{V}$ = the value of assets secured by a resolution expressed as a percentage of A

$\mathrm{D_l}$ = the dividend which would have been received by senior creditors in a liquidation

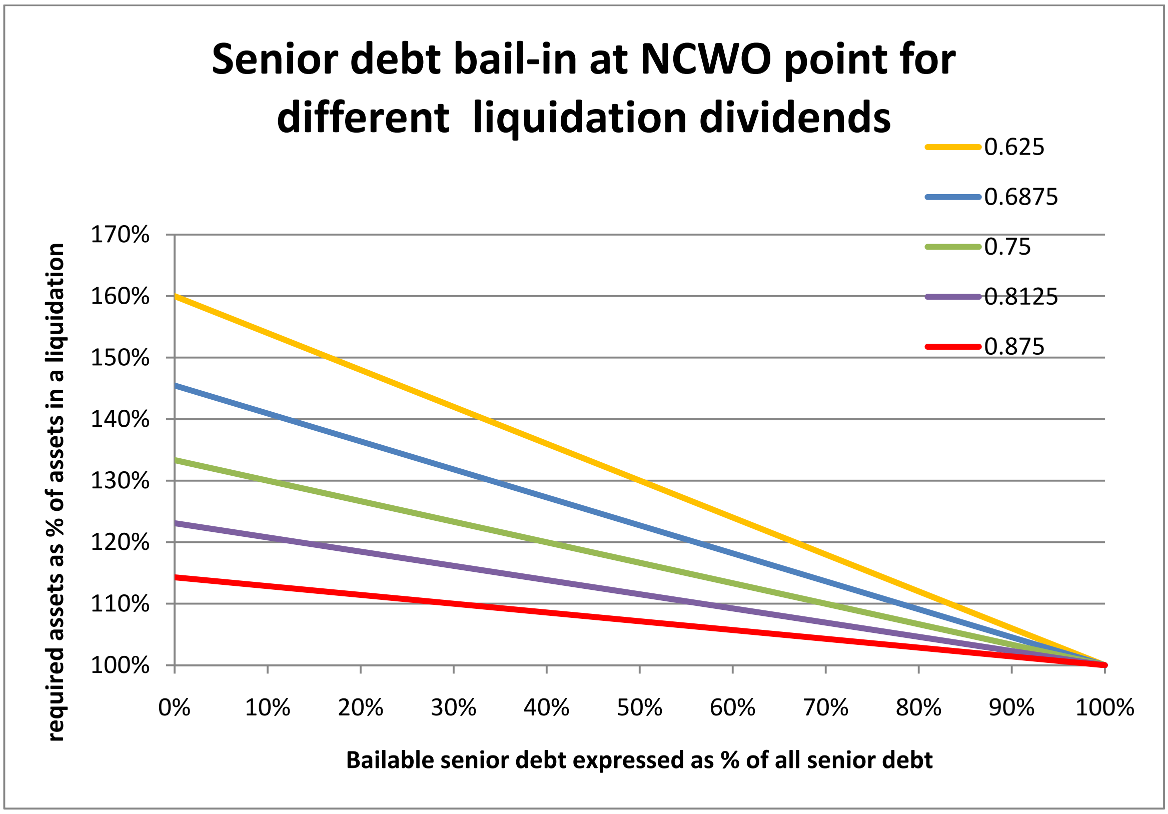
$\mathrm{L_b}$ = the value of the senior liabilities which would be subject to bail-in within a resolution

$\mathrm{L_x}$ = the value of the senior liabilities which are protected from bail-in within a resolution and $(\mathrm{L_x} + \mathrm{L_b})$ equals the total value of the senior liabilities

Example

Bank with assets of £100 for senior creditors and senior liabilities of £160 of which £90 can be bailed in and £70 cannot. $\mathrm{D_l}$ = 100/160 or 0.625; so $\Delta \mathrm{V}$ would need to be 126.25%. The likelihood of a 26.25% improvement in asset value compared with an insolvency process is then a matter for the resolution authorities to consider. The assumption being that bailing-in £90 to 0.625 of value, leaves £126.25 of liabilities (£70 unbailed + £56.25 now bailed) against £126.25 of assets.

This expression is plotted below for a series of values of $\mathrm{D_l}$ to provide some insight into the relationship of the relative proportion of bailable senior debt to the asset benefit of an orderly resolution.



We would encourage the FSB to consider the likelihood of such conditions arising in the existing market.

As for retrospectively changing the conditions of existing debt, many holders will want legacy debt to be protected since they object fundamentally to the application of retrospective legislation to investments made in good faith. There are others, however, who are holders of sovereign debt who are concerned that excluding legacy debt from bail in may, as in the Irish case, cause the inability to bail in bank debt dragging sovereign debt to default/EFSF conditionality.

Were there to be any protected legacy debt, there will need for clarity as to which bonds are legacy debts and which are under the new regime. A useful adjunct of this for regulators would be the ease of monitoring market participants' view of the credit quality of banks; there would be a major divergence in borrowing costs between old and new debt if there was any likelihood of a bail-in.

If there were retrospective changes, in the sense that the new powers could be applied to existing debt, then the issues will be more complex than the paper may suggest at 12.1 of annex 2, which seems merely to address a transitional period for what is said to be adjustment. We consider an impact assessment should be carried out in particular on the bond derivative market and how it would be affected by changes in the structure of the underlying instruments.

Our answer to question 3 also addresses question 8, the impact on funding for banks.

Questions 9 to 19

We have no specific comments concerning annexes 3, 4, 5 and 6 beyond repeating in relation to Annex 6 that the position of assets which are safeguarded or administered but which do not belong to the SIFI needs to be addressed.

Question 20

We agree with the proposed milestones; it is a matter of concern that many states do not appear to have understood sufficiently the real urgency to introduce such regimes.

Questions 21 to 25

Creditor hierarchy, depositor preference and depositor protection

We do not see the need to try to harmonise statutory creditor rankings across all jurisdictions. The role of resolution should be to ensure that there is an orderly treatment of banks according to legislation and on a transparent and predictable basis. There may be many impacts from trying to address creditor hierarchy globally. Even if this were a policy objective, which we do not think it should be, this cannot be accommodated within the milestones being considered by the FSB.

Questions 26 to 34

We do not have specific comments about early termination rights and stays. However, we continue to note that the wide-ranging policy considerations to improve financial stability do not appear yet to be willing to address the role of collateral and netting. We would not wish to appear naive; the taking of collateral and enforceable netting can bring about significant benefits to markets and the economies which they serve. But in another sense despite many proposals about statutory bail-ins, there appears to be an unqualified acceptance that market participants can always buy preference in the creditor hierarchy using private rights by entering into netting arrangements or obtaining collateral. We are not convinced that all netting arrangements and collateral positions should be seen as sacrosanct[1]; whilst it is then the likelihood must be that greater and greater asset encumbrance will occur at SIFIs as financial creditors only agree to transact business either by taking security, as for example under certain secured bond arrangements, or by obtaining collateral. There is a need to consider these issues.

[1] Separately from our own discussions about the problems arising from having fully collateralised creditors in a market, we have noted work by Professor Mark Roe of Harvard University including his paper on “The derivatives market’s payment priorities as financial crisis accelerator”