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TOO BIG TO FAIL BANKS: CAN THEY BE RESOLVED?

Prepared for the Brookings Conference on dealing with too important to fail banks

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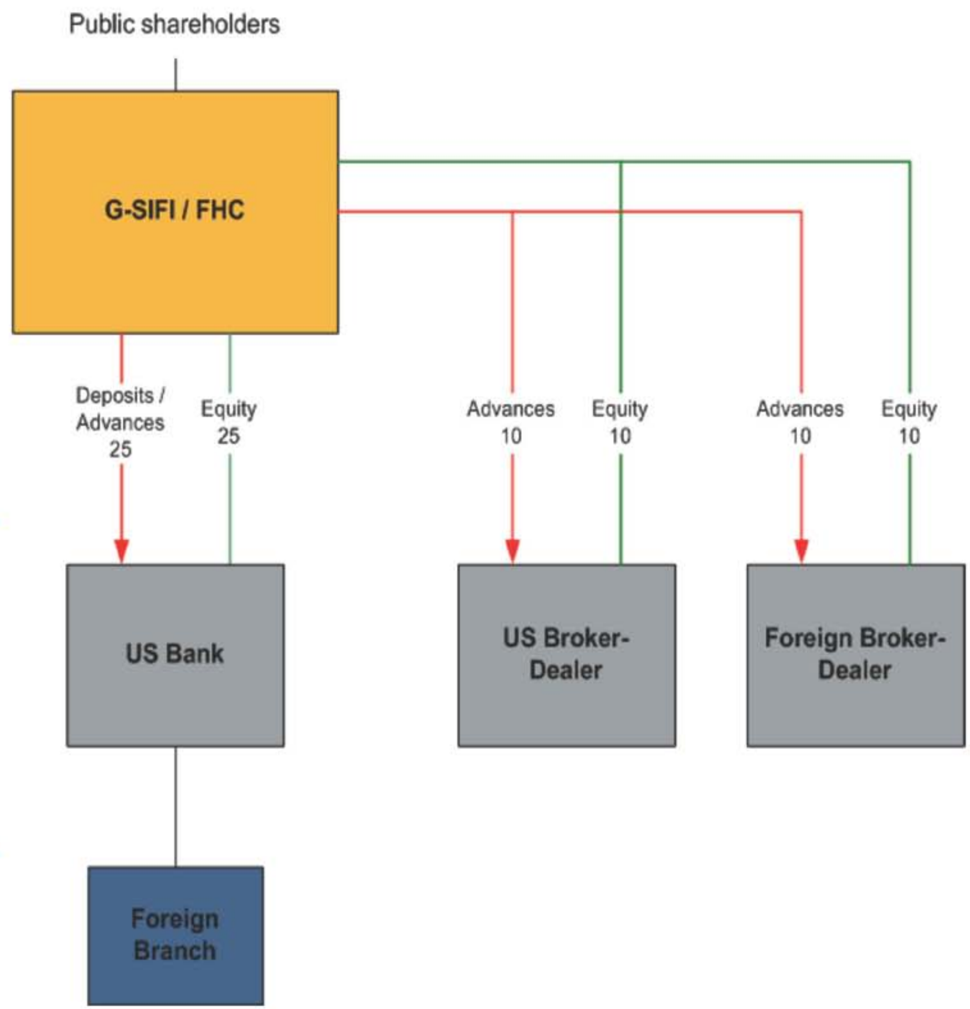
The Brookings Institution

Resolving Large Institutions and Eliminating the Government Subsidy

- The Single Point of Entry (SPOE) approach, developed by the FDIC and the Federal Reserve, provides a breakthrough allowing large complex institutions to fail safely without bailouts from taxpayers.
- Cross-border concerns make it difficult to resolve such institutions. Hard issues remain, but the SPOE approach makes things a lot easier because the foreign subs would remain operational.
- Liquidity financing must be made available by the Fed or the FDIC.
- If markets are convinced that equity and subordinated debt at the holding company level will bear the costs of failure, then the subsidy to large bank funding costs is eliminated.
- Drawn from *Too Big to Fail: The Path to a Solution,* Bipartisan Policy Center, Financial Regulatory Reform Initiative, by Randall Guynn, John Bovenzi and Thomas Jackson. Initiative is co-chaired by Martin Neil Baily and Phillip Swagel. Olivia Rosenthal provided valuable assistance. Baily is responsible for errors and opinions here.

A Large Balance Sheet Before a Crisis. The FHC has 45 in Equity and 45 in Advances to Subs. Long Term Debt and Equity Cushion at FHC is 95



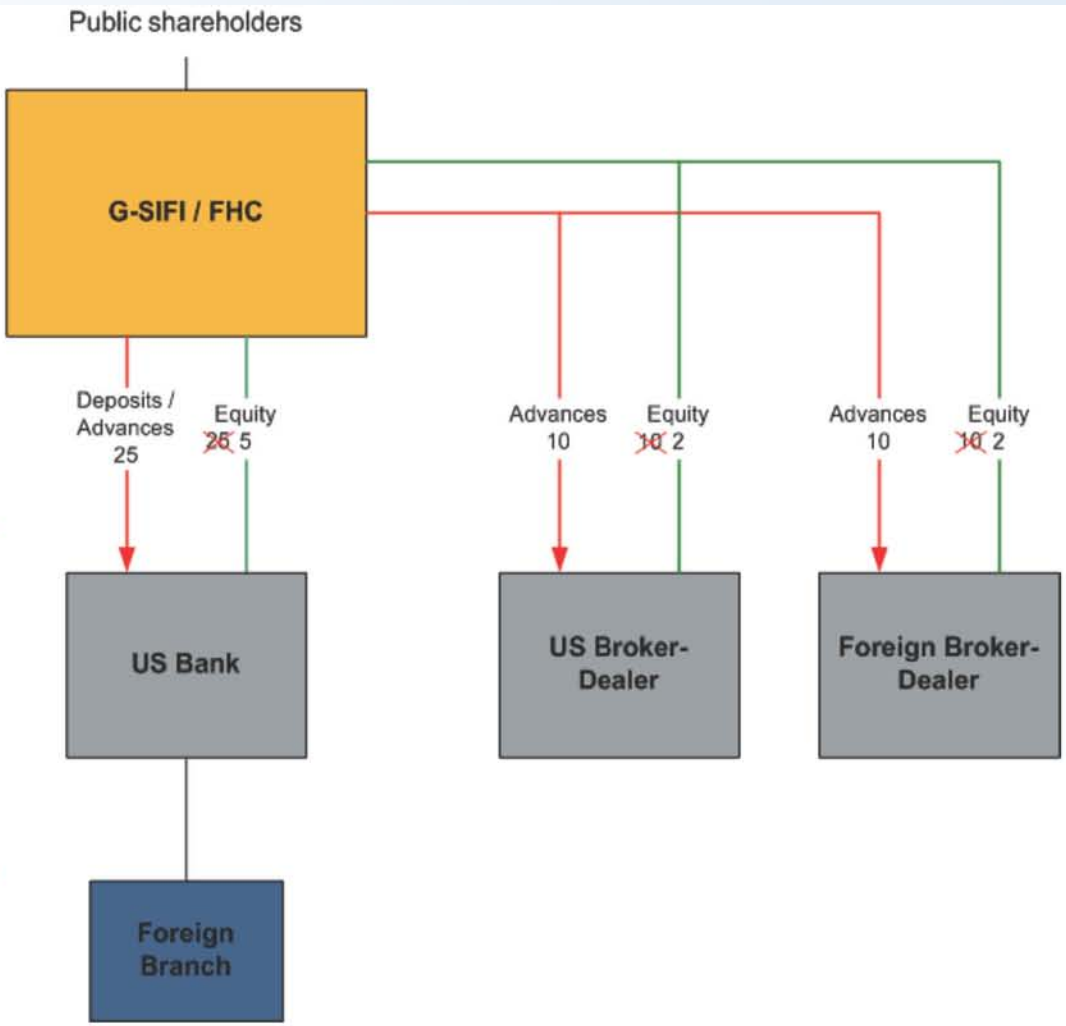
Parent Only Balance Sheet

Deposits / advances to subs	45	Unsecured long-term debt	50
Equity in subs	45	Unsecured short-term debt	5
Other assets	10	Secured liabilities	0
Total	**100**	Other liabilities	0
		Equity	45
		Total	**100**

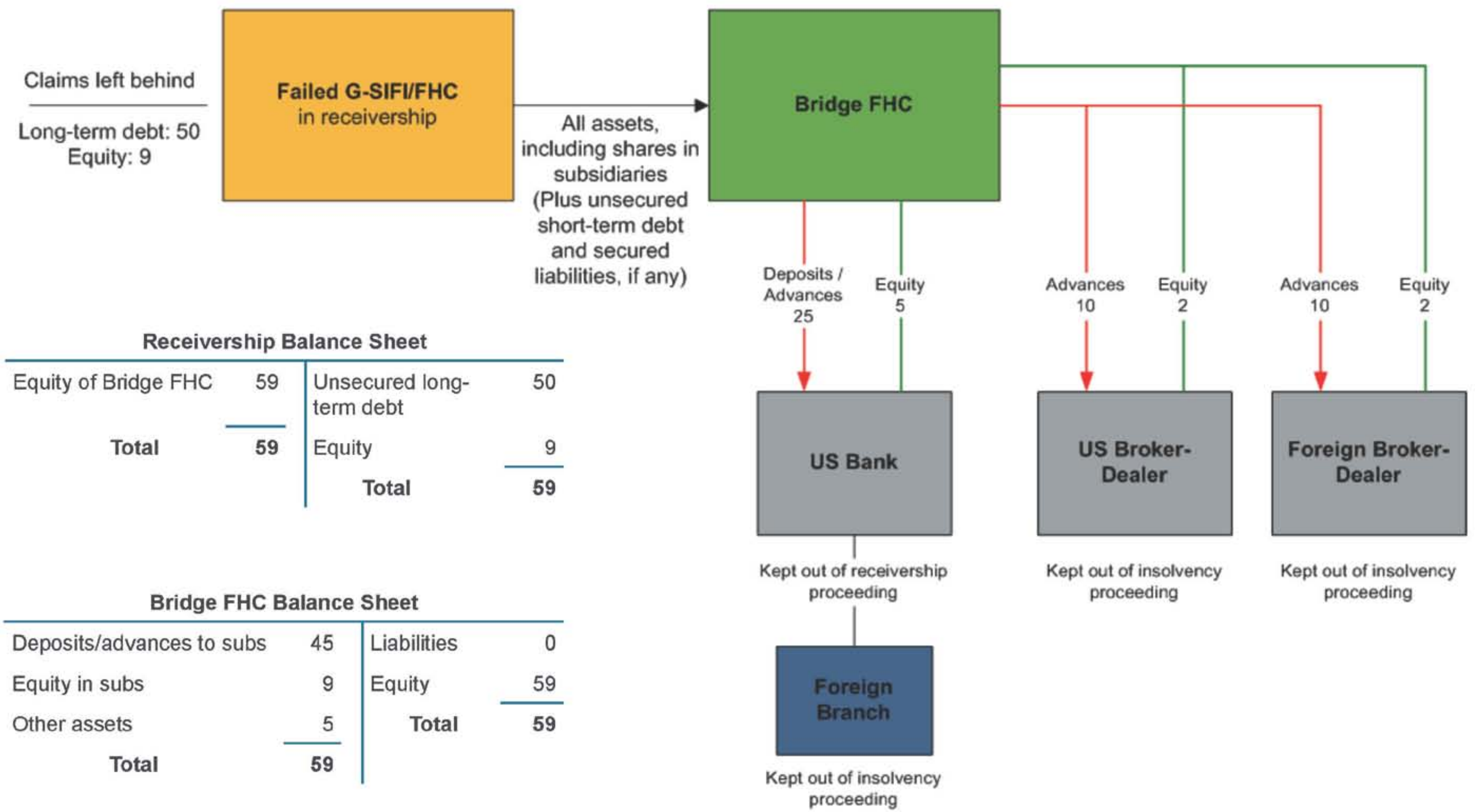
The Same FHC after Losses of 36 in the Subs, which now Lack Adequate Capital

Parent Only Balance Sheet

Deposits / advances to subs	45	Unsecured long-term debt	50
Equity in subs	9	Unsecured short-term debt	0
Other assets	5	Secured liabilities	0
Total	**59**	Other liabilities	0
		Equity	9
		Total	**59**



In the Resolution Process the Subs are Transferred to a Bridge FHC, along with unsecured short-term debt and secured liabilities



Receivership Balance Sheet

Equity of Bridge FHC	59	Unsecured long-term debt	50
Total	**59**	Equity	9
		Total	**59**

Bridge FHC Balance Sheet

Deposits/advances to subs	45	Liabilities	0
Equity in subs	9	Equity	59
Other assets	5	**Total**	**59**
Total	**59**		

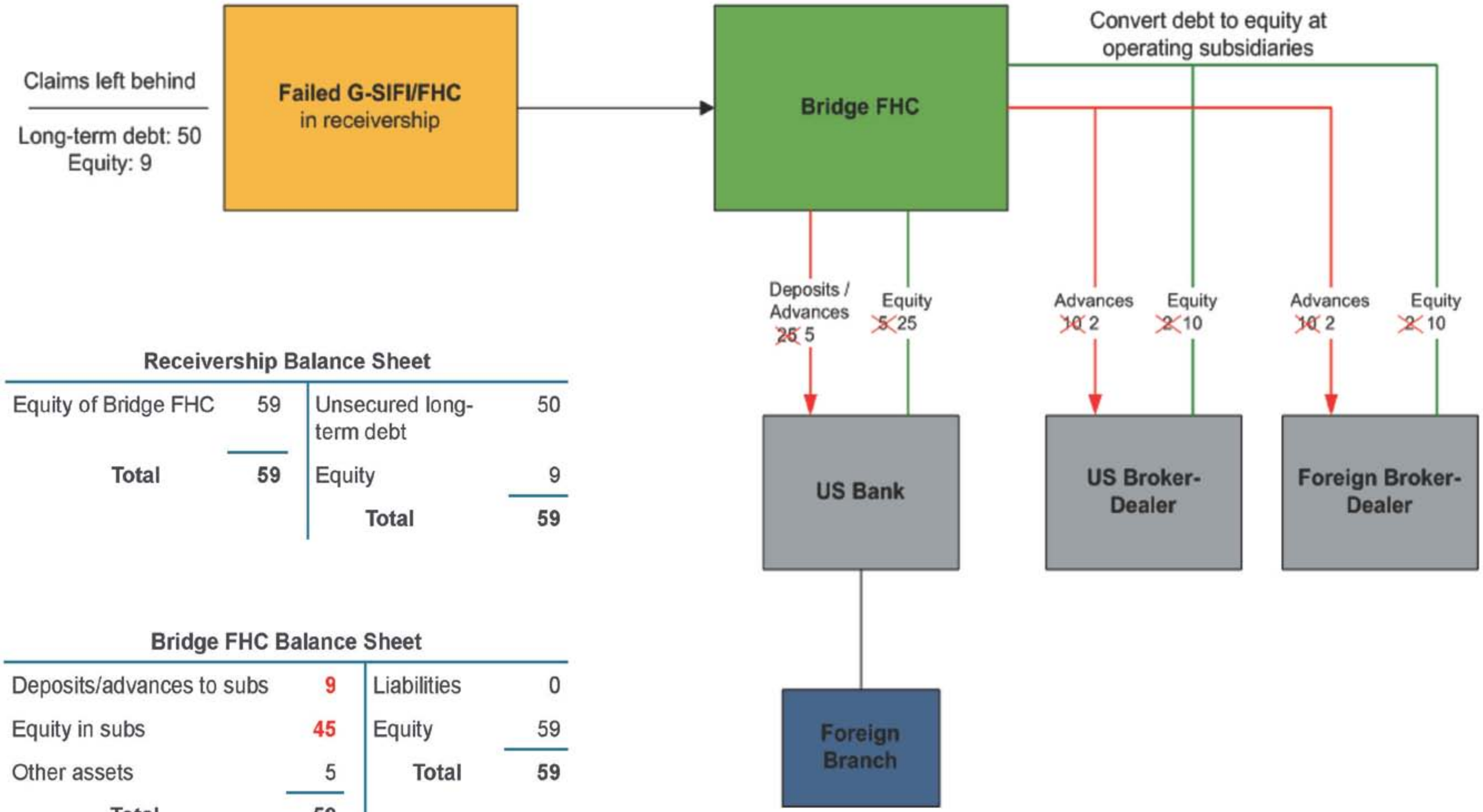
Recapitalizing the Bridge FHC

- The business transferred to the bridge would be *recapitalized as a result of leaving behind the long-term unsecured debt and equity in the receivership*.
- Operating subsidiaries continue providing critical services and stay out of local resolution proceedings. The FDIC would require the bridge to contribute its own unconsolidated assets to any operating subsidiaries that need to be recapitalized.
- One of the most common holding company assets is intercompany loans from the holding company to its operating subsidiaries. If there are enough such assets, the FDIC could cause the bridge to recapitalize the operating subsidiaries by forgiving such intercompany loans.

Recapitalizing the Bridge FHC: Continued

- If a subsidiary did not have enough intercompany debt for the bridge to forgive, the bridge could, subject to any regulatory requirements or limitations, contribute receivables from other subsidiaries to the troubled subsidiary since receivables would be assets on the bridge company's unconsolidated balance sheet.
- Even though the bridge bank is solvent, it would likely experience difficulty borrowing to cover immediate liquidity needs. Either the Fed or a government facility (the OLF) would be needed to provide such funding at penalty rates secured by Newco's assets.

In this Example, the Subs are Recapitalized by Forgiving the Inter-Company Loans to the FHC



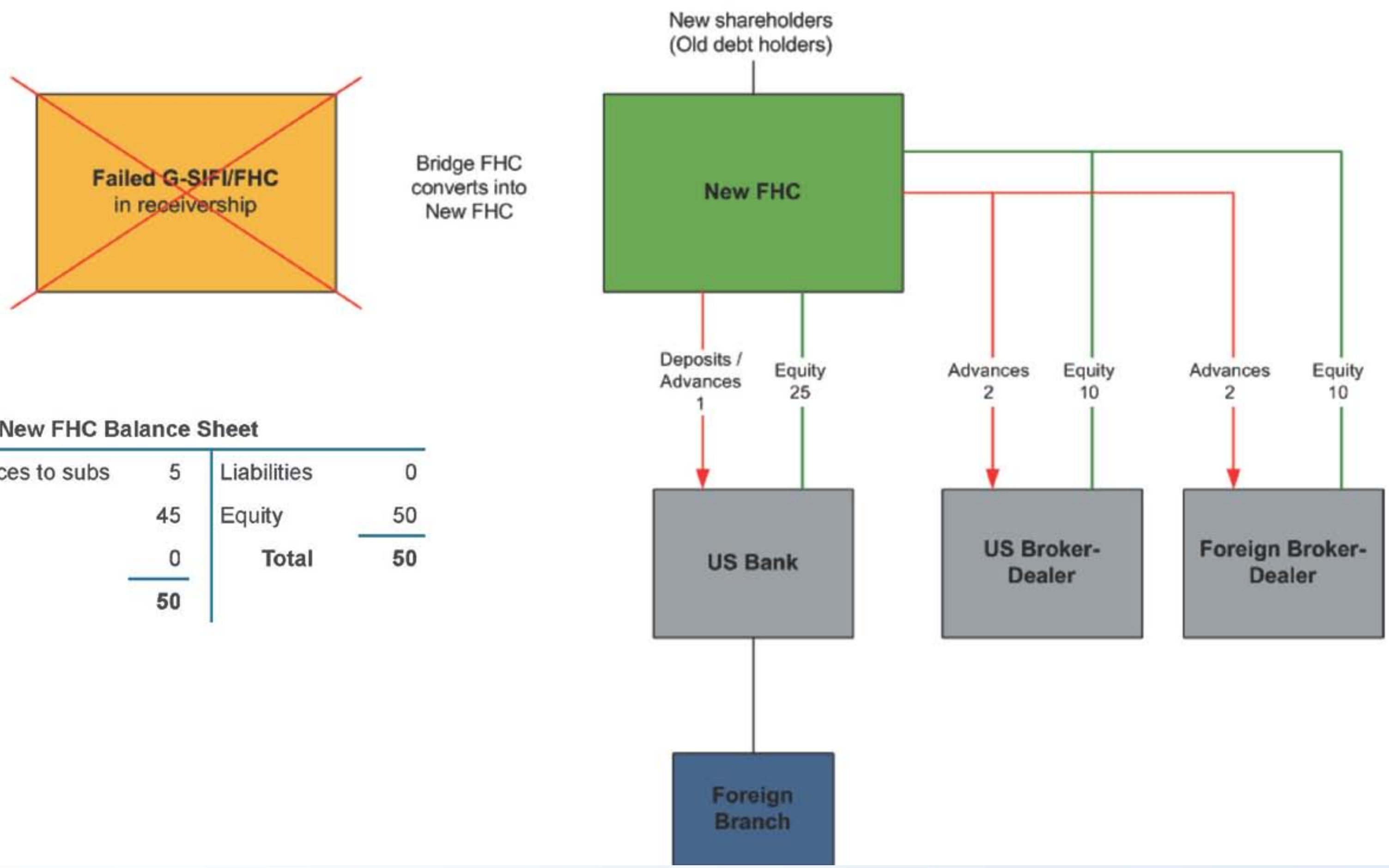
Receivership Balance Sheet

Equity of Bridge FHC	59	Unsecured long-term debt	50
Total	**59**	Equity	9
		Total	**59**

Bridge FHC Balance Sheet

Deposits/advances to subs	9	Liabilities	0
Equity in subs	45	Equity	59
Other assets	5	**Total**	**59**
Total	**59**		

The holders of the failed holding company's equity, long-term unsecured debt and other similar liabilities would receive all of the residual value of the recapitalized bridge holding company – its equity.



New FHC Balance Sheet

Deposits/advances to subs	5	Liabilities	0
Equity in subs	45	Equity	50
Other assets	0	**Total**	**50**
Total	**50**		

Eliminating the Subsidy to Large Complex Banks

- Some past studies have found that SIFIs have a funding cost advantage, notably a 2012 IMF report cited by Bloomberg which showed an increased subsidy post the crisis.* However, this study looked at many countries, not just the US, and included non-banks such as insurance companies.
- In response to a query, IMF co-author Kenichi Ueda sent a note, which suggests that this study may not have sought or found US-specific econometric support for a cost of funds subsidy:
- "Some of our tables show US specific numbers. These are fitted values from our econometric analysis based on samples from many countries. Country differentials are primarily controlled by the sovereign credit ratings. However, US de facto has a most superior credit rating, even within the AAA category (at least then in 2007 and 2009). This would create downward bias for the estimated value of US government's backing compared to other AAA government's backing." Source: Email June 12, 2013.

* http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf
http://www.bloomberg.com/news/2013-05-22/goldman-sachs-research-disputes-too-big-to-fail-bank-subsidy.html

Eliminating the Subsidy to Large Complex Banks

- **A 2013 Goldman Sachs study by Steve Strongin et al.** concluded that SIFIs have no funding advantage since the crisis. The authors find that small banks are less safe than large banks and consequently should be expected to have higher borrowing costs. They say that large firms in nonfinancial industries typically have lower borrowing costs than small firms**
- **Rating agencies say that they upgrade the credit ratings of systemically important banks worldwide because they believe their governments will bail them out. This is a *prima facie* case for a funding advantage.**
- **Jury is still out concerning the current situation. To eliminate the government funding subsidy going forward, markets and rating agencies will have to be convinced that equity and subordinated debt will bear the cost of a failure and that taxpayers will not bail out large or complex banks.**

- ** Goldman Sachs *Measuring the TBTF effect on bond pricing, May 2013.*