Six structures in search of stability

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Overview of structuring proposals

Proposal	Structuring principle		
	Activity	Geography	Creditor hierarchy
Liikanen	✓		✓
Volcker	✓		
US FBO/IHC		✓	
Depositor preference			✓
Bail-in/TLAC			✓
Vickers	✓	✓	✓

Is assigning activities the avenue to safety and stability?

- Liikanen, Volcker and Vickers all mandate separation in some form or other of investment banking/trading activities from commercial banking/non-trading activities
- Premise is that such separation will reduce risk, enhance safety and promote resolvability (at least at the commercial bank).
- But commercial banking is not inherently safer than investment banking.
- And as bonds become less liquid, and loans become tradable,
  - the difference between investment banking and commercial banking diminishes; and
  - separation becomes both more difficult to police and less effective.

Commercial banking is not inherently safer than investment banking (1)

Commercial bank

- Assets are long-term, non-recourse mortgages on commercial real estate to single-building companies ("Office XYZ, Ltd.") leased at short-term to tenants of doubtful credit quality.
- Loans are concentrated in a limited number of geographic areas.
- Loans are not assignable or tradable

Investment bank

- Assets are benchmark, liquid, short and medium-term investment-grade corporate bonds
- Portfolio is diversified across industry and geography

Funding for the two banks is identical and consists of deposits, subordinated debt and common equity

Commercial banking is not inherently safer than investment banking (2)

Commercial bank

- Assets are loans that are not assignable or tradable.

Investment bank

- Assets are tradable bonds.

- Assets are otherwise identical in every aspect (obligor, tenor, covenants, rate, amortisation etc.).
- For each obligor, the loan held by the commercial bank is pari passu with the bond held by the investment bank.
- The diversified portfolios held by the commercial bank and the investment bank are identical (each has a claim of X on obligor Y).
- Funding for the two banks is identical.

Is separation sustainable, if loans are tradable?

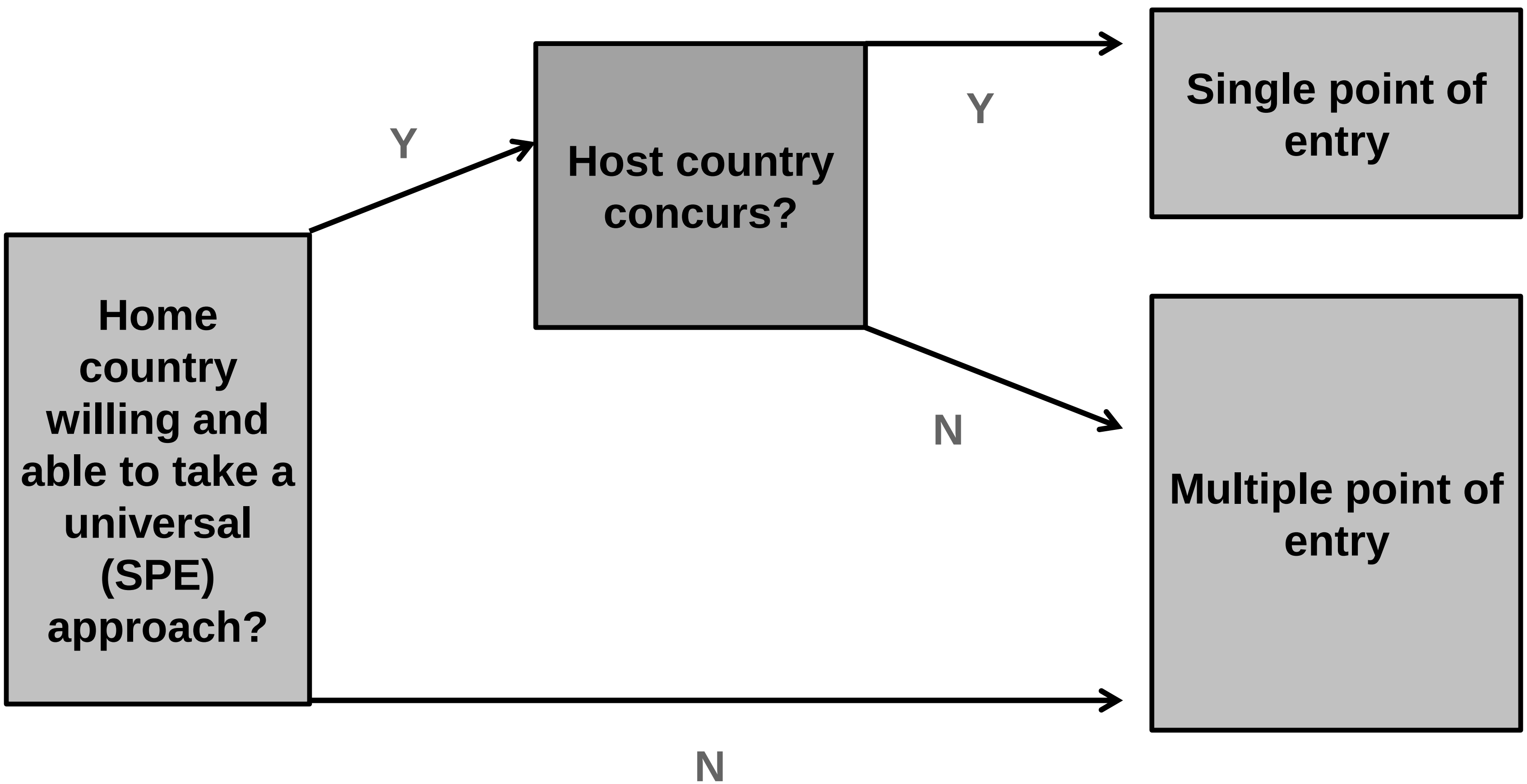
If loans are tradable, does a ban on prop trading become

- Ineffective, the ban applies only to securities; or
- Counterproductive, if the ban applies to any instrument that trades?

Does Balkanisation bolster the bank?

- Restructuring proposals have a distinct home country bias:
  - Under Vickers, the ring-fenced bank may not have foreign branches and may not have foreign subsidiaries.
  - Under US IHC regulation foreign banking organisations must create intermediate holding company in US. This must meet all requirements applicable to US bank holding companies, including Enhanced Prudential Standards and have governance independent from that of the main board.
- Foreign activities are not necessarily riskier than domestic activities.

Is resolution the rationale for geographic segregation?



SPE approach requires concurrence of home and host

Reordering the credit hierarchy (1)
depositor preference: a step in the right direction

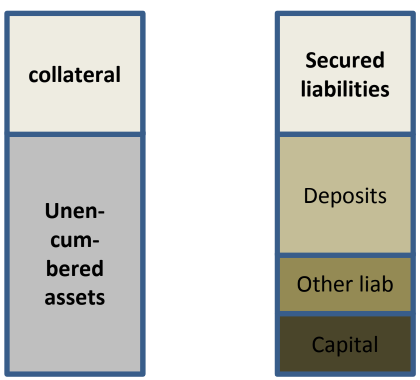
Depositor preference:

– lowers the risk of deposits.

– lowers risk to the deposit guarantee fund and should therefore reduce risk-based premiums

– can facilitate resolution. Resolution authority can cherry pick best assets to match deposits and transfer bundle to bridge bank.

  - But bridge bank solution leaves rest of assets and liabilities in rump to be liquidated over time. This process will increase losses to creditors and can disrupt financial markets and damage the real economy.
  - To avoid such losses, non-preferred creditors will demand that the bank collateralise its borrowings. This counteracts benefits of depositor preference.



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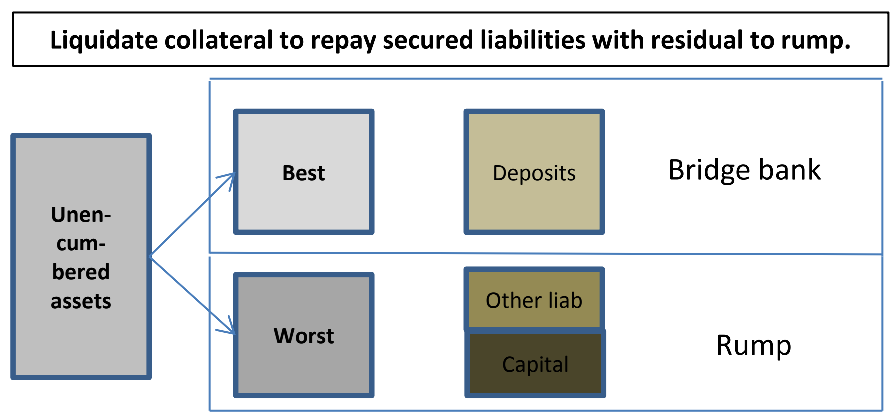
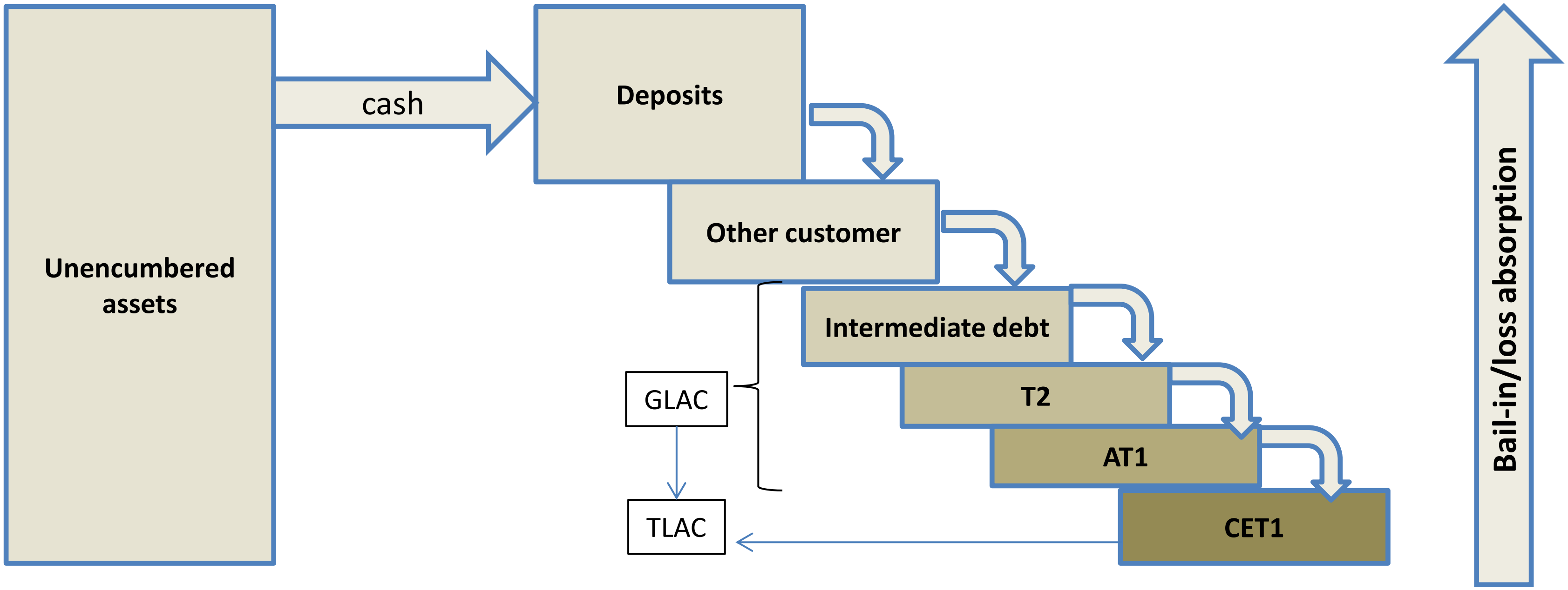


Resolution

Reordering the credit hierarchy (2): Bail-in/TLAC



Bail-in should occur according to the creditor hierarchy, and TLAC assures that there should be enough investor capital outstanding to restore CET1 to required levels, if a bank reaches the point of non-viability and enters resolution. This creates the basis for stabilising the bank in resolution so that it can continue critical economic functions without recourse to taxpayer solvency support.

Recapitalisation is necessary but insufficient for stabilisation

		Status	Comment
Recapitalisation	Bail-in	◑	Established in law in major jurisdictions (e.g. BRRD) and required under Basel III for AT1 and T2 capital
	TLAC/GLAC	◑	FSB proposal under review
Treatment of QFCs		◔	ISDA stay protocol delays close out
Access to FMUs		◔	Under review
International cooperation	Retention of licenses	◔	Under discussion in crisis management groups
	No unilateral action		
Access to liquidity	Unencumbered assets as collateral	◔	Banks will need to track and be able to pledge on short notice
	Role of central bank and other authorities	◑	FSB proposal under review BoE has confirmed that recapitalised bank in resolution would have access to central bank facilities, but potential limits in US

Bail-in/TLAC is the most effective of the proposals in reducing risk and enhancing resolvability

	Risk reduction	Resolvability	Comment
Liikanen	◔	◔	Segregation of trading activity does not necessarily reduce risk in bank or in group overall. Greater complexity in structure may enhance resolvability of individual units, but not necessarily of the group as a whole.
Volcker	◔	◔	Prohibition on prop trading does not necessarily reduce risk or enhance resolvability.
US FBO/IHC	◔	◔	Reduction in risk, if any, restricted to US entities. Although resolvability of US entity may be enhanced, separate US approach could compromise global resolvability.
Depositor preference	◔	◑	Reduces the risk of deposits, but not necessarily of the bank as a whole. Facilitates resolution for deposits via bridge bank (but this solution is not as yet practical for systemic banks) , but leaves rump to be liquidated.
Bail-in/GLAC/TLAC	◕	◕	Reduces risk and enhances resolvability of the whole bank.
Vickers	◔	◑	Reduction in risk and improvement in resolvability restricted to the ring-fenced bank.

If bail-in/TLAC can assure resolvability of the whole bank, does separation still make sense?

	Vickers		Bail-in/TLAC
	Ring-fenced bank	Non-ring fenced bank	Whole bank
Depositor preference	✓		✓
Extra capital	✓		✓
Enhanced governance	✓		✓

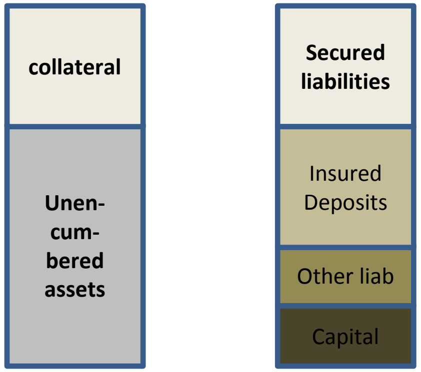
Appendix

Some further details on depositor preference

Insured depositor preference: a step too far?

Preference for insured deposits only:

- *further lowers the risk of insured deposits and consequently risk to the deposit guarantee scheme;*
- *further facilitates creation of bridge bank, but*
  - *subordinates uninsured deposits, creating requirement for disclosure to such creditors and heightening danger that such depositors will run; and*
  - *aggravates problems stemming from liquidation of rump.*



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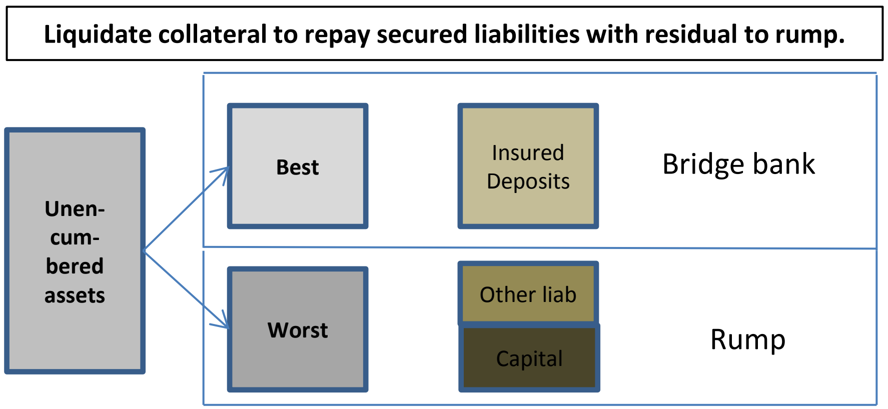
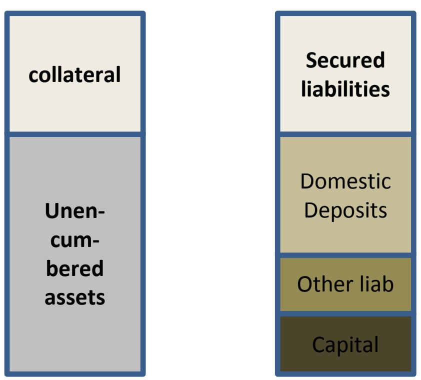


Resolution

Domestic depositor preference: a step in the wrong direction?

- Preference for domestic deposits effectively subordinates deposits in foreign branches (places them in rump).
- To avoid this host country may insist on:
  - subsidiarisation; and/or
  - opt to impose asset coverage requirement on branch (especially in jurisdictions taking a territorial approach to bank resolution).



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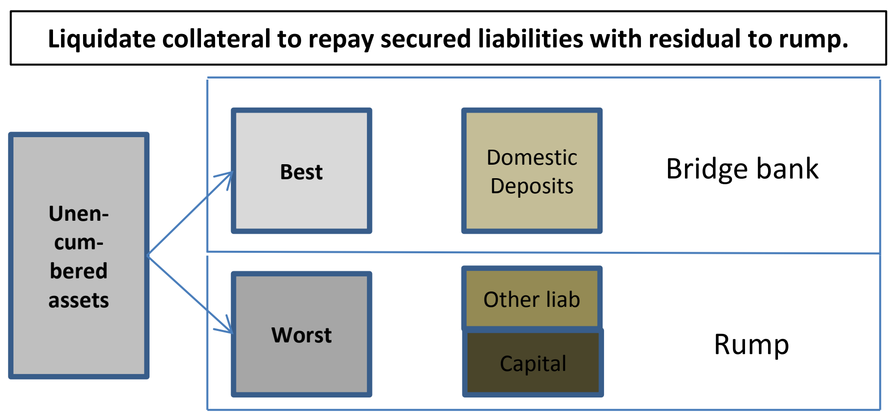

Resolution

Huertas, "Six structures" does not necessarily represent the views of EY