The New Normal of Riskier Mega Banks

Why Size May Not Mean Safety under OLA[1]

Abstract

Global banking authorities' moves to resolve systemically important financial institutions (SIFIs) may result in first losses being borne by bank creditors in the event of a failure. Under the new resolution authority, size no longer may be an indication of safety for bank credit. Instead, one should look to a bank's fundamental business condition and financial management, which may warrant a permanent change of behavior in cash investment strategies.

We urge corporate practitioners to take note of the following:

- Creditors to systemically important banks (SIBs) may incur credit losses before governments step in
- Beware of subordinated bank holding company debt
- Commercial paper investors may have an advantage over bond investors
- Depositors in a solvent operating bank subsidiary may not be subject to losses
- Treasury managers may need to consider longer duration or moderately lower credit quality names

Introduction

Exactly a year ago, we wrote about the negative credit ratings trend in large global banks and how the megatrend might impact corporate cash investors. Since that piece was published, the ratings downgrade trend continued as agencies knocked down bank ratings in the U.S., Canada, Australia and Europe.

At the end of 2012, we saw the expiration of a major U.S. government initiative in bank crisis management – the transaction account guarantee (TAG) program. Treasury organizations' deposits above $250,000 are now fully exposed to the credit risk of the respective bank in addition to any exposures the organization may have through debt instruments, commercial credit, trade finance and derivatives contracts, among others.

Yet, the deterioration of ratings and concentration of bank credit exposure did not seem to fundamentally change how treasury professionals conduct business with the "too big to fail" (TBTF) banks. Except for ratings-based guidelines that prohibit certain banks as counterparties, many firms continue to place deposits, invest in debt instruments and maintain counter-party relationships indiscriminately with them.

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[1] Orderly Liquidation Authority (OLA)

In this paper, we will discuss how global banking authorities have moved toward resolving SIFIs in a bankruptcy scenario, with potential losses borne by bank creditors as a part of the plan. We hope to raise awareness that, when it comes to bank credit, size may not be an indication of safety for corporate practitioners and may warrant a permanent change of behavior in cash investment strategies.

Government Support for Mega Banks

Throughout history, government support for bank credit was present in most parts of the world, either explicitly or implicitly. The essential services provided by the banks and their confidence-sensitive deposit base often called for government intervention when financial system stability was threatened. Understandably, larger banks tended to get more support than smaller banks.

Big Banks in Trouble Get Bigger: The 2008 financial crisis offered a good case study on how governments provide support to banks during extraordinary periods. Central banks around the world cut interest rates, purchased government bonds and lent directly to banks to provide liquidity. Bank debt and deposits were guaranteed by national governments. When all else failed, banks were nationalized or forced to merge with other banks with government backing. Ironically, governments' support of big banks that were in trouble led to even larger banks as they grew through mergers, exposing governments to greater future liabilities.

Support Varies by Region: A bank may receive different degrees of support in different parts of the world, depending on its size relative to its economy, the role it has in credit creation, and the local fiscal and monetary policy framework. For example, the U.S. and the U.K. traditionally are viewed as low support countries, while continental Europe and the Asia-Pacific region are viewed as highly supportive. Credit rating agencies often have built-in rating notches based on a bank's home market and its size relative to the banking industry.

Flaws Exposed: The 2008 financial crisis brought the perils of government support for banks to a head. As national authorities rushed to save their economies from disasters by providing extraordinary support to their large banks, many governments eventually faced fiscal and debt burdens that resulted in sovereign ratings downgrades, and, in some cases, national solvency concerns. Borne out of this predicament were the vows of national regulators to reduce their liabilities to the mega banks.

From Too-Big-To-Fail to G-SIFI

The road to addressing the issue of TBTF banks has been winding. Almost by definition, these banks are very large, globally interconnected institutions engaged in complex

financial transactions. Efforts to develop policy initiatives were complicated by uneven economic recoveries and government indebtedness in different parts of the world.

Much of the discussions on the Basel III Accord on bank capitalization and the Dodd-Frank Wall Street Reform Act are beyond the scope of this paper. Suffice it to say, global regulators were able to clear a path to minimize the systemic impact from banks dubbed global systemically important financial institutions (G-SIFIs).

Identifying G-SIFIs: The limited authorities of global policy organizations over national financial overseers make it difficult to establish a standard set of rules in identifying the G-SIFIs. However, the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system, annually updates a list of global systemically important banks (G-SIBs) based on four main criteria: ***size, interconnectedness, complexity*** and ***substitutability***.

In 2012, the FSB's updated list of G-SIBs included 28 bank holding companies (see Appendix 1).

In the U.S., the Federal Reserve Board and the Office of the Comptroller of Currency are the primary bank regulators and they follow the same four areas of selection criteria when subjecting large banks to annual capital adequacy tests. The 19 domestic banks selected to undergo stress tests since 2009 are widely viewed as SIFIs in the U.S. (see Appendix 1).

Capital Surcharges, Living Wills and Resolution Authorities: To minimize the systemic impact, the Basel III Accord imposes capital surcharges on SIBs, requiring institutions to carry capital levels from 7% to as high as 13%, if surcharges are applied. SIBs also must file resolution plans known as "living wills" which describe the firms' plans for a rapid and orderly wind down in the event of financial distress or failure of the company. In the U.S., the threshold for filing resolution plans is bank holding companies with $250 billion in total U.S. nonbank assets. The Dodd-Frank Act also designates the FDIC as the liquidator for bank and nonbank financial institutions. Similar resolution plans also are being developed and finalized in other countries.

It is apparent to us that the ultimate goal of these initiatives is to allow large banks to fail without causing catastrophic damage to the financial system. Alternatively, the parts of a troubled bank that offer essential services to the economy may be allowed to function normally when its holding company fails. The existing creditors of the holding company, however, may be forced to bear the consequences of the failure. We use the FDIC's single entry receivership as an example to illustrate this point.

The FDIC and Single Entry Receivership

For much of 2012, the FDIC kept bond investors informed of initiatives toward its orderly liquidation authority (OLA) under the Dodd-Frank Act's Title II provisions. In essence, the OLA grants the FDIC the ability to receive and shut down any failing SIFI. Previously, the FDIC's powers were limited only to banks. The FDIC plans to release detailed descriptions of its methods in 2013.

Traditional Receivership: The FDIC always has receivership authority over banks according to the Federal Deposit Insurance Act. Usually, when a bank holding company fails, its assets and deposits are transferred to a bridge bank and sold to a bank buyer. Losses related to the failed bank are borne first by the shareholders and creditors, with the FDIC covering the residual losses.

Single Entry Receivership: Post-2008, regulators recognized the FDIC's limited powers over nonbank financial companies and also the challenges of the size and complexity of SIFIs. In 2010, the Dodd-Frank Act gave the FDIC the power to receive all SIFIs and granted the agency additional flexibility in administering a receivership.

Under OLA, the FDIC will place the failed holding company into receivership. The holding company's assets and certain liabilities will be transferred to a bridge holding company and ultimately to a new holding company (New Co.). Solvent operating subsidiaries will operate as going concerns with liquidity from the bridge holding company provided through intra-company advances from the U.S. Treasury.

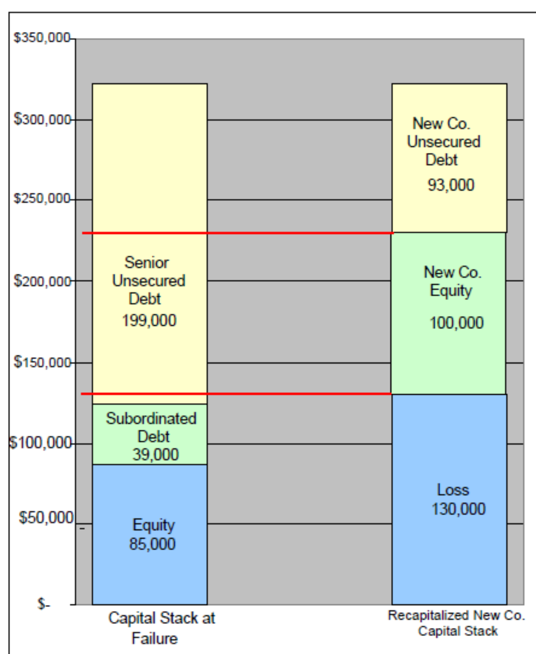

Figure 1: Unsecured Claims Waterfall

Source: FDIC Advisory Committee on Systemic Resolution

Loss Waterfall: Depending on the magnitude of the loss resulting from the failure, holding company equity, preferred stock, subordinated and senior holding company debt may be used to offset losses. This means that the risk of impairment is present for all stakeholders. Unsecured creditors may receive New Co. securities in exchange for their claims. The value of such securities may range from one hundred cents on the dollar to potentially zero, depending on the facts and circumstances of a given receivership. (See *Figure 1*)

The Changing Mega Bank Credit Profiles

We think that credit profiles of global banks will change permanently in the new world of resolution authority. After earnest efforts by financial regulators in curtailing government involvement in bank bailouts, the imposition of "bail-ins" should sound alarms in the minds of treasury professionals. At the very least, they should re-examine and reconsider the too-big-to-fail assumptions in the banks with which they have credit, deposit, investment, derivative and other relationships.

Bail-ins Instead of Bail-outs: In the past, the FDIC preferred to play "matchmaker" and quietly found buyers for large, interconnected banks. As a result, holding company bondholders were bailed out, along with the depositors and creditors of the solvent operating bank subsidiaries. Under new resolution plans, holding company creditors will be treated separately from depositors and bank-level creditors. As a result, subordinated or even senior holding company debt holders may incur significant losses given the limited assets in many bank holding companies.

Permanent Ratings Downgrades: As we discussed in our whitepaper a year ago, rating agencies took negative actions last year not only based on credit deterioration in the respective banks, but also on reduced expectations of government support. For example, the Moody's notching differential, or the gap between standalone and supported bank ratings, was reduced from a maximum of six notches to only two notches in the cases of Bank of America and Citigroup.

Eroding Size Advantage: When creditors of large banks recognize that size may not necessarily protect them from credit losses, the perception of size advantage may start to dissipate. This, in turn, may level the playing field for banks, further reducing the regulators' need to take extraordinary measures to wind down a large bank. Capital surcharges borne by G-SIFIs also may force banks to re-rationalize their business models to right-size business units that further reduce the concentration of interconnected transactions.

Conclusions - What Corporate Practitioners Need to Know

At present, the ultimate solution in dealing with G-SIFIs remains unclear and the road to coordinated global regulation is winding. However, we hope to have established a reasonable argument that, as investors, we no longer should hold comfort merely in the size of a particular bank nor should we expect the government to come to the aid of bondholders in a bank failure. Instead, we should look to the fundamental business conditions and financial management of the respective banks for creditworthiness.

As national financial authorities contemplate forcing private investors to bear losses before they step in and stabilize a failing bank, we urge corporate practitioners to take note of the following parting thoughts:

- Creditors to SIBs may incur credit losses before government support kicks in. Banks may be allowed to operate while existing senior credit claims are wiped out.
- Invest in holding company debt, particularly subordinated debt, only after a thoughtful assessment of the standalone credit strength of the entity. The decision to invest should not be based on support assumptions.
- The FDIC, as receiver, has the incentive to treat short-term creditors better than long-term creditors to preserve funding stability. This may mean that commercial paper investors may have an advantage over bond investors.
- The OLA assumes that the holding company fails from nonbank related activities, so bond holders and depositors in a solvent operating bank subsidiary may not be subject to losses.
- As investors look beyond financial institution debt as investment vehicles, the limited universe of non-financial issuers may compel treasury managers to consider longer duration or moderately lower credit quality, including low single-A-rated and/or Tier Two commercial paper, names.

Appendix 1: List of G-SIFI and CCAR Bank Holding Companies

NAME	REGION	COUNTRY	FSB G-SIFI	U.S. CCAR
Ally Financial	Americas	USA		2013
American Express	Americas	USA		2013
Bank of America	Americas	USA	2011	2013
Bank of New York Mellon	Americas	USA	2011	2013
BB&T	Americas	USA		2013
Capital One Financial	Americas	USA		2013
Citigroup	Americas	USA	2011	2013
Fifth Third Bank	Americas	USA		2013
Goldman Sachs	Americas	USA	2011	2013
JP Morgan Chase	Americas	USA	2011	2013
Key Corp	Americas	USA		2013
MetLife	Americas	USA		2013
Morgan Stanley	Americas	USA	2011	2013
PNC Financial Services	Americas	USA		2013
Regions Financial	Americas	USA		2013
State Street	Americas	USA	2011	2013
SunTrust Banks	Americas	USA		2013
U.S. Bancorp	Americas	USA		2013
Wells Fargo	Americas	USA	2011	2013
Bank of China	Asia	China	2011	
Mitsubishi UFJ FG	Asia	Japan	2011	
Mizuho FG	Asia	Japan	2011	
Sumitomo Mitsui	Asia	Japan	2011	
Banque Populaire CE	EMEA	France	2011	
BNP Paribas	EMEA	France	2011	
Crédit Agricole	EMEA	France	2011	
Société Générale	EMEA	France	2011	
Deutsche Bank	EMEA	Germany	2011	
Unicredit Group	EMEA	Italy	2011	
ING Bank	EMEA	Netherlands	2011	
Royal Bank of Scotland	EMEA	Scotland	2011	
Banco Bilbao Vizcaya Argen	EMEA	Spain	2012	
Santander	EMEA	Spain	2011	
Nordea	EMEA	Sweden	2011	
Credit Suisse	EMEA	Switzerland	2011	
UBS	EMEA	Switzerland	2011	
Barclays	EMEA	U.K.	2011	
HSBC	EMEA	U.K.	2011	
Standard Chartered	EMEA	U.K.	2012	

* FSB G-SIFI - Firms identified by the FSB as systemically important financial institions in 2011 and 2012.

* U.S. CCAR - Bank holding companies participating in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) in 2013.

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