BANKRUN=BANKRUPT?

TBTF?

TBTR?

TBTS?

Legal **Houdini** Academy

Understanding
Legal Hocus Pocus

Source:
FD January 12, 2012, adopted using Photoshop Johan Jol

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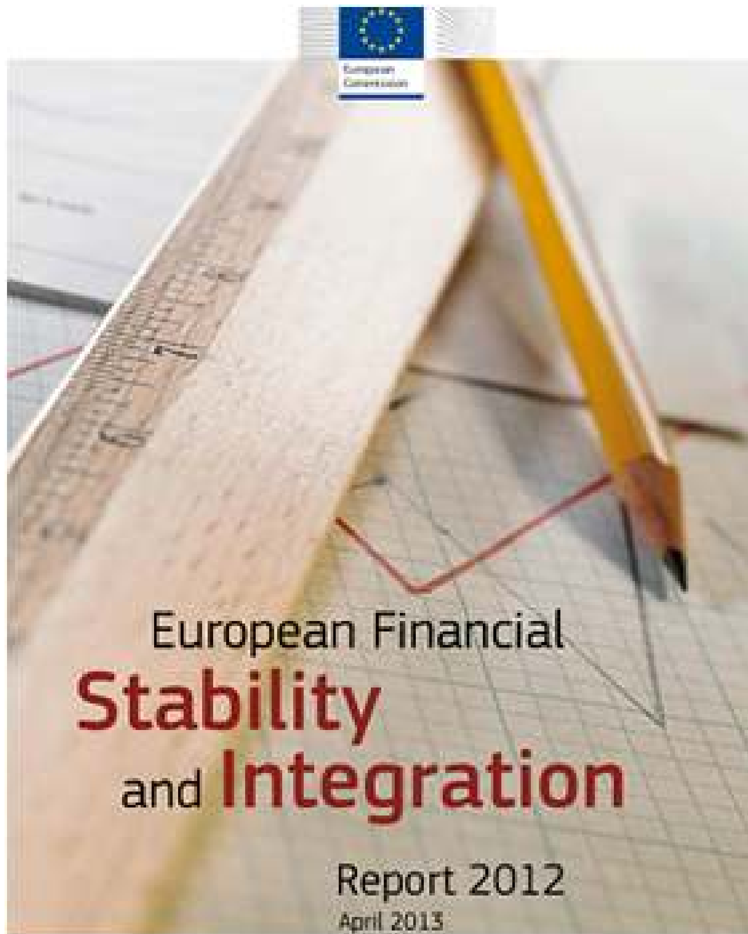
Disclaimer:
This presentation is the personal opinion of Johan T. Jol, owner of Legal Houdini Academy. Nothing in this presentation constitutes an opinion or view of ABN AMRO Bank N.V., the employer of Johan T. Jol or of the so-called Juridische Werkgroep Corporate of the Netherlands Bankers' Association in which Johan Jol participates

Reading Material:



"The immediate objective of the chapter is essentially informative and pedagogical: it seeks to make accessible to the general public the arguments advanced by proponents as well as critics of structural measures affecting large interconnected and complex banking groups. This would also allow stakeholders, including citizens, to meaningfully engage and contribute to the debate. It follows that this chapter does not take position on any matter and merely raises the issues an exposes the arguments that require the particular attention of regulators and stakeholders."

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European Financial Stability and Integration Report 2012, April 2013, Chapter 3, with great overview in Box 1
http://ec.europa.eu/internal_market/economic_analysis/reports/index_en.htm#maincontentSec1

Introduction, Setting the Scene:

- Position of Banks prior to Crisis 2007: supported by Basel rules: getting bigger with less capital
- Bankrun
- Banks are Special: TBTF, TBTR and TBTS
- Suggestions

Capital Buffers Banks

- First half of the 19th century: Banks operated as partnerships with **unlimited liability** (talking about skin in the game)
- Middle half of 19th century: **40-50 percent equity**, not too much risk: skin in the game
- In Europe, for example, average bank capital is now equivalent to less than **10 per cent of total unweighted assets**, compared with around **25 per cent towards** the beginning of the 20th century.

  - The great dying, by Niall Ferguson FT December 17, 2007, see also The Ascent of Money (2008)
  - The Bankers' New Clothes: What 's wrong with banking and what can we do about it by Anar Admata & Martin Hellwig (2013)

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Chart 1: Bank capital relative to assets
1834 to 2009

Capital relative to assets

0.7
0.6
0.5
0.4
0.3
0.2
0.1
0.0

1834 1844 1854 1864 1874 1884 1894 1904 1914 1924 1934 1944 1954 1964 1974 1984 1994 2004

The data are from Historical Statistics of the United States and the Federal Deposit Insurance Corporation (FDIC). The ratio shown is the ratio of the book value of capital to total assets. The Historical Statistics data are for all banks and the FDIC data are for insured banks. The Historical Statistics data end in 1980.

http://www.frbatlanta.org/cenfis/pubscf/nftv_1104.cfm#chart1

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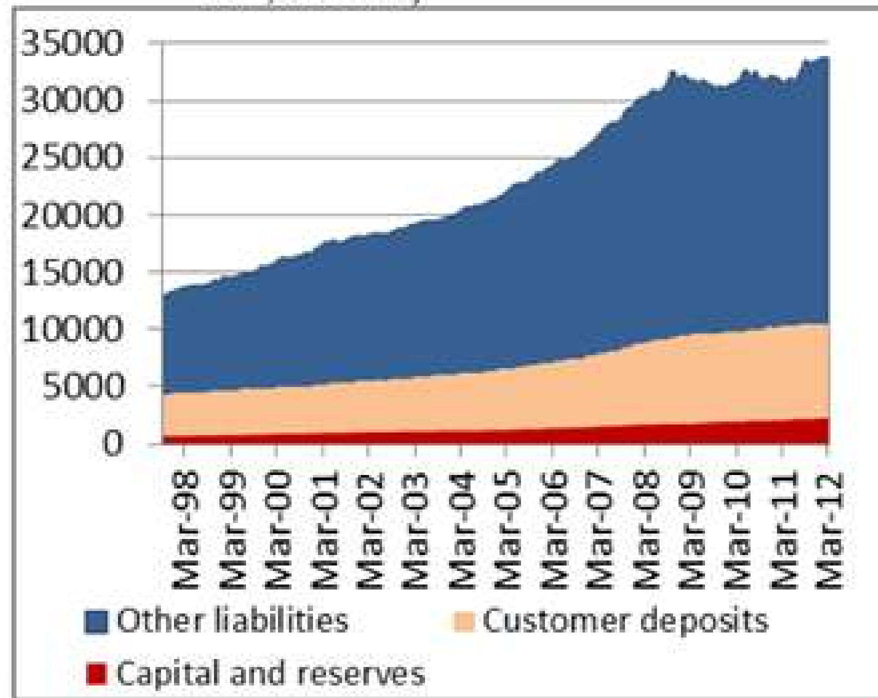
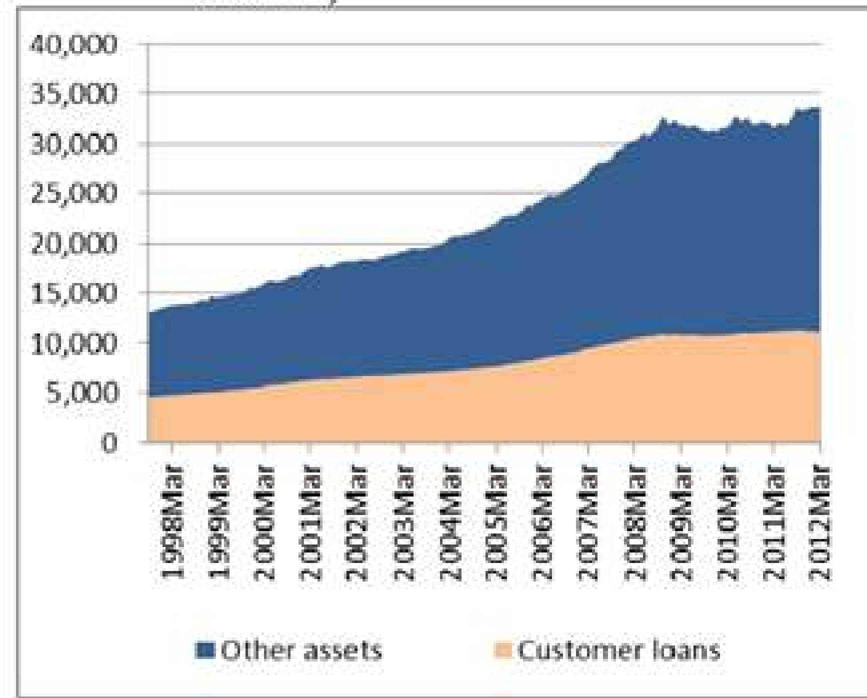
Chart 3.3.1: **Evolution of liabilities 1998-2012 (euro area, € billion)**



Notes: Customer deposits are deposits of non-monetary financial institutions excluding general government.
Source: ECB data.

Chart 3.3.2: **Evolution of assets 1998-2012 (euro area, € billion)**



Notes: Customer loans are loans to non-monetary financial institutions excluding general government.
Source: ECB data.

Chart 3.2.1: **Total assets of the largest EU and US banking groups (2011)**

180
160
140
120
100
80
60
40
20
0

% of domestic GDP
% of EU GDP

Deutsche Bank
HSBC
BNP Paribas
Crédit Agricole Group
Barclays
RBS
Santander
SocGen
Lloyds Banking Group
Groupe BCPE
ING
JPMorgan Chase
Bank of America
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Bank of NY Mellon
Capital One
BB&T Corp.

Source: Data from SNL Financial. Eurostat for GDP data.

Source: Liikanen (2012)

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European Financial Stability and Integration Report 2012, April 2013, Chapter 3

Leverage by Industry

% Debt Financing by Industry *D/(E+D)*

100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%

Cons. Fin. Svcs.
Investment Services
Auto & Truck Manufacturers
Real Estate Operations
Electric Utilities
Airline
Insurance (Life)
Insurance (Prop. & Casualty)
Natural Gas Utilities
Hotels & Motels
Forestry & Wood Products
Conglomerates
Paper & Paper Products
Railroads
Casinos & Gaming
Auto & Truck Parts
Average (All U.S. Firms)
Construction Services
Retail (Grocery)
Communications Services
Motion Pictures
Food Processing
Healthcare Facilities
Broadcasting & Cable TV
Advertising
Beverages (Alcoholic)
Retail (Department & Discount)
Tobacco
Beverages (Nonalcoholic)
Printing & Publishing
Restaurants
Computer Services
Oil & Gas - Integrated
Retail (Specialty)
Major Drugs
Computer Hardware
Medical Equipment & Supplies
Biotechnology & Drugs
Computer Networks
Retail (Apparel)
Semiconductors
Communications Equipment
Computer Peripherals
Computer Storage Devices
Software & Programming

http://www.gsb.stanford.edu/sites/default/files/research/documents/Chicago-fed-handout-Admati.pdf

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Build on Trust

- Banking is built on trust, not only by Bank trusting its Clients but also vice versa (and to the extent Bank is TBTF, trust in government backing the Bank)

- If Client looses trust (in Bank, or even worse, in government Backing of the Bank acting as a **lender of last resort**): **Bank Run, Liquidity Crisis**

- But: Banks are inherently prone to liquidity crisis due to the maturity mismatch of asset and liabilities, longer term duration assets compared with short term liabilities (so called: maturity transformation)

Bank-run (i)

- Bankrun 1930

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Bank-run (ii)

- Recent Bankruns, samples:
  - UK: **Northern Rock** (September 14 to 17, 2007)
  - USA: **IndyMac** (July 2008) and **Washington Mutual** (September 2008)
  - NL: **DSB** (October 2009) and **SNS** (February 2013)
  - Different league: **Iceland** (2008) and **Cyprus** (2013)

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Banks are special

- **Argument 1**: Bank are **Supervised**

- **Argument 2**: Banks are **Too Big to Fail**
    - **“We have a new kind of bank. It is called ‘too big to fail’—TBTF—and it is a wonderful bank”**
        - Congressman McKinney in Congressional hearings Continental Illinois, Too big to fail, the hazards of bank bailouts, Gary H. Stern and Ron J. Feldman, paperback edition (2009), p. 13

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The Government steps in to avoid Bank Run: SIFI = TBTF

- **Systemically Important Financial Institutions** :

- Financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. To avoid this outcome, authorities have all too frequently had no choice but to forestall the failure of such institutions through public solvency support. As underscored by this crisis, this has deleterious consequences for private incentives and for public finances.

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NL SIFIS

- ING Bank

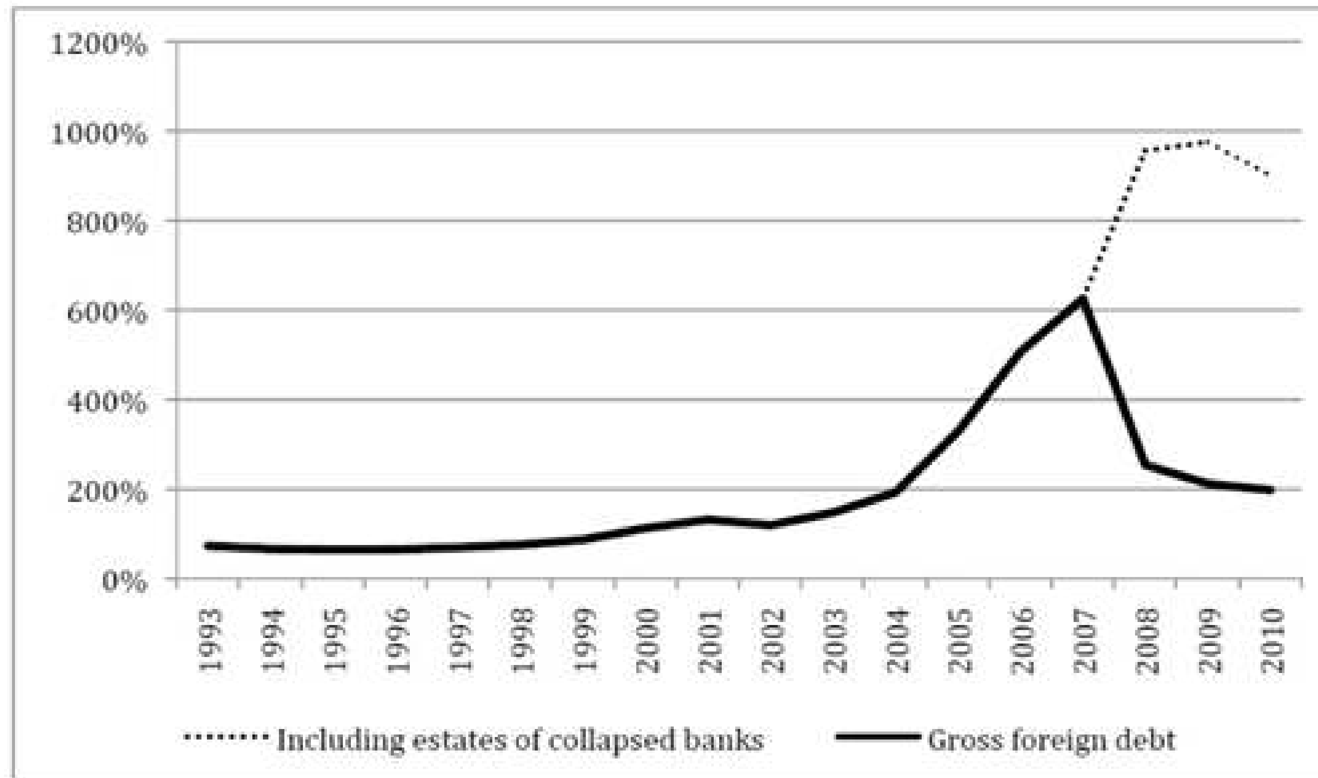
- Rabobank

- ABN AMRO

- SNS Bank (thus saved)

SIFI, Iceland Sample

Figure 27 Iceland's gross foreign debt as a percentage of GDP



Source: Central bank of Iceland (2010)

TBTS: Too Big to Save
TBTR: Too Big to Rescue

And of Course:
Cyprus 2013

"The Icelandic Central Bank was unable to act as a lender of last resort because it lacked the resources to guarantee foreign currency liabilities of such magnitude. The liabilities of the three banks were simply too large given the size of Iceland's economy"

Michael Waibel in Chapter 13, Cross-Border Bank Insolvency (2011)

Global SIFIS, list per end 2012

- Bank of America
- Bank of China
- Bank of New York Mellon
- Banque Populaire CdE
- Barclays
- BNP Paribas
- Citigroup
- Commerzbank
- Credit Suisse
- Deutsche Bank
- Dexia
- Goldman Sachs
- Group Crédit Agricole
- HSBC
- **ING Bank**
- JP Morgan Chase
- Lloyds Banking Group
- Mitsubishi UFJ FG
- Mizuho FG
- Morgan Stanley
- Nordea
- Royal Bank of Scotland
- Santander
- Société Générale
- State Street
- Sumitomo Mitsui FG
- UBS
- Unicredit Group
- Wells Fargo

Website Financial Stability Board
http://www.financialstabilityboard.org/publications/r_111104bb.pdf

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Dealing with (Global) SIFIS, Questions:

- Who is backing TBTS National SIFI
- Who is backing the Global SIFI

Suggestions

- Structural Separation:
  - Small(er) is Beautiful, Stop making bigger and Split up
  - Ringfencing specific activities
- Increase Capital
- Manage Leverage and Duration Mismatch
- Derisking Suggestions:
  - Central Clearing Houses
  - Get rid of wrong Incentives
  - Enhance Corporate Governance
  - Enhance Risk Management

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Small(er) is Beautiful

Split up the Bank?

Yes

We return the favor

Source:
FD December 16, 2011,
adopted using Photoshop
Johan Jol

Sanford Weill former CEO Citigroup: Split up saving banks and investments banks

Stop making Bigger

- **Limit growth**:
  - "Section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act" or "Dodd-Frank Act") establishes a financial sector concentration limit that generally prohibits a financial company from merging or consolidating with, or acquiring, another company if the resulting company's consolidated liabilities would exceed **10 percent of the aggregate consolidated liabilities of all financial companies**"
  - http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf

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Ringfencing – ICB proposals

- Key points ICB report published in September 2011 and the UK Governments' response to it in December 2011 :
  - Vital banking services – in particular the taking of retail deposits – should only be provided by ring-fenced banks
  - Ring-fenced banks should carry out SME and overdraft lending and accounting services to support core functions
  - a set of wholesale and investment banking services should be prohibited from the ring fenced bank
  - the ring fenced bank should be legally and operationally independent from the rest of the corporate group
  - economically the ring-fenced bank should not be dependant for its liquidity and solvency on the financial health of the rest of its group
  - UK Government intends to introduce higher equity requirements for large ring-fenced banks

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Reaction EU

Arguments against structural separation:

- Costs are high
- Claimed Benefits do not materialise
- Competition harmed
- Consistency other structural reform
- Lack of clarity

  – "Stakeholders have voiced strong concerns that inadequate structural reform:
    (i) may undermine some of the benefits typically associated with the universal banking business model,
    (ii) might make bank borrowing and hence lending more difficult and more expensive, and
    (iii) may put EU banking groups at a competitive disadvantage.

  – These concerns are taken seriously and need to be analysed and scrutinised carefully. "

European Financial Stability and Integration Report 2012, April 2013, Chapter 3

Increase Capital Buffers (i)

Component Proposed calibration Switzerland

1. Minimum requirement 4.5% common equity
2. Buffer 8.5%, comprising of
- at least 5.5% common equity,
- up to 3% CoCos
  (trigger at 7% common equity)
3. Progressive component 6% CoCos subject to big bank status quo
   (trigger at 5% common equity)

Total 1, 2 and 3: **19%** of total capital, comprising
- at least **10%** common equity
- up to **9%** CoCos

Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, p. 31
See also surcharge between 2,5% and 3,5% for GSIFIS as suggested by BIS
http://www.bis.org/publ/bcbs207.pdf

19 %
13 %
10 %
7 %
4.5 %

~ 19 %
Resolution CoCos
(trigger @ 5% CET1)
~ 6 %
Progressive component

13 %
Recovery CoCos
(trigger @ 7% CET1)
3 %

10.5 %
Tier 2
2 %
8.5 %
Additionnal tier 1 - 1.5 %
7 %
Capital conservation
buffer 2.5 % CET1

10 %
Capital conservation
buffer
5.5 % CET1
Buffer

Minimum
4.5 % CET 1

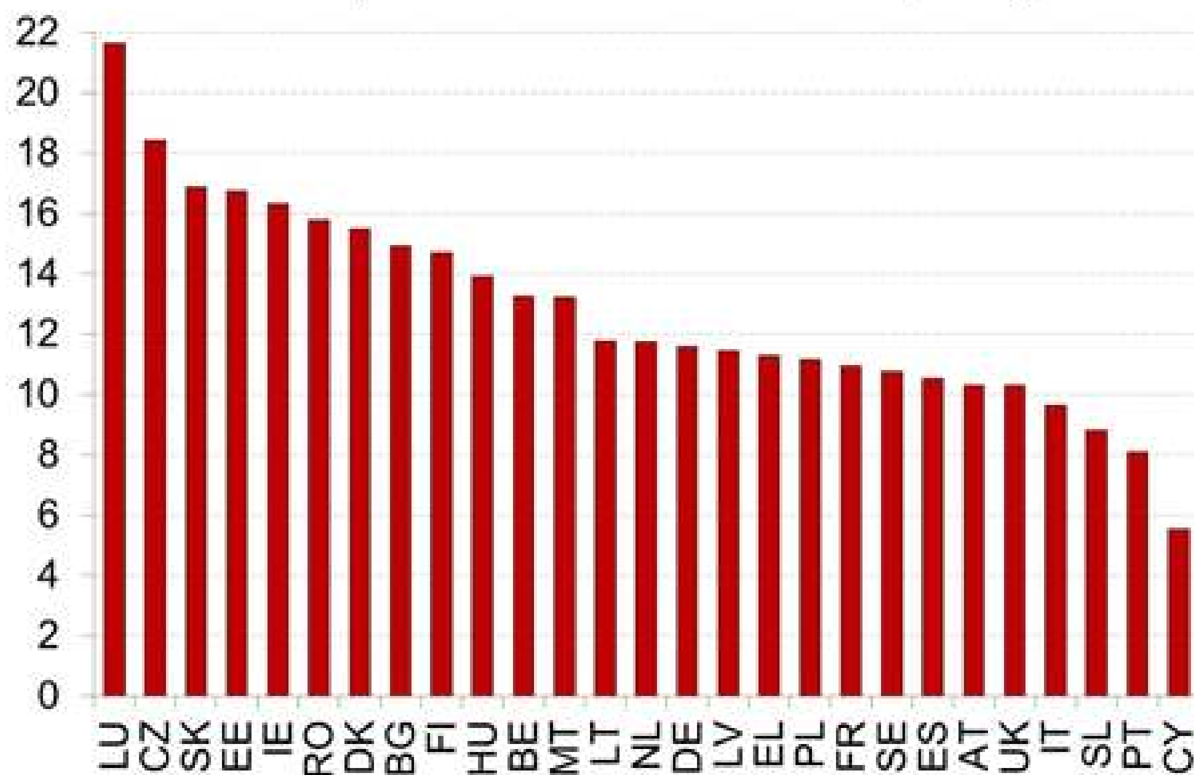
Minimum
4.5 % CET 1
Minimum

Basel III minimum for all banks

CH-TBTF proposal

REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES FINANCIAL STABILITY OVERSIGHT COUNCIL Completed pursuant to Section 115(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, July 2012, http://www.treasury.gov/initiatives/fsoc/Documents/Co%20co%20study%5B2%5D.pdf

Increase Capital Buffers (iii)



European Financial Stability and Integration Report 2012, April 2013, Chapter 3

Increase Capital Buffers (iv)

- But is additional capital really too expensive? : Not according to some scholars: Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer:
  - Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: **Why Bank Equity is Not Expensive**, August 2010, http://www.gsb.stanford.edu/news/research/admati.etal.html#.UAaBWO-C7iE.twitter,
  - The Bankers' New Clothes: What 's wrong with banking and what can we do about it bij Anar Admata & Martin Hellwig (2013)

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Increase Capital Buffers (v)

- **Banks' View**
- Higher funding costs and lower return on equity
- Tax shield of debt: interest debt deductable, dividend on shares not

- **Scholars' View**
- Leverage reduction means less risk, and thus less requirement for return
- Perverse Incentive: downside risk of too much debt for government due to implicit government guarantee

http://www.gsb.stanford.edu/news/research/admati_equity.html

Alternative forms of risk bearing capital funding

- Contingent Convertibles (Cocos):
  - Loss absorption: thus (temporary) write off instruments
  - Debt for equity: convert debt into equity
- Back up Capital
  - F.e.: Crisis Cause, Containment and Cure, Thomas F. Huertas (2011), Conclusion Chapter

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Manage Leverage and Duration Mismatch

- **More Equity mean less debt, thus lowering the so Lower Leverage Ratio**; and
- **Link duration Asset** side **to duration Liability** side
  - "In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, **their leverage ratios were as high as 40 to 1**, meaning for every $ 40 in assets, there was only $ 1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm. To make matters worse, **much of their borrowing was short-term, in the overnight market—meaning the borrowing had to be renewed each and every day."**
  - Financial Crisis Inquiry report, p. XIX
  - Basel III: **Liquidity Coverage Ratio** (required liquid assets buffer) and **Net Stable Funding Ratio** (match maturity assets with liability)

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Other suggestions (i):

- **Create Central Clearinghouses**

  - These platforms should be viewed and regulated as public utilities, William Buiter in FT Jun 24, 2009
  - But, then they are **TBTF**: What If a Clearing House Failed?, WSJ December 2, 2011

- **Get rid of Wrong Incentives**

  - Regulating remuneration: Claw back bonus and long term commitment
    - "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited."
    - Financial Crisis Inquiry report, p. XIX

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Other suggestions (ii):

- **Enhance (Corporate) Governance:**
  - Get rid of Moral Hazard of a bail out
  - Valuation, Concentrations, More Keeping Skin in the Game (sample: USA securitisation)
  - Disclosure, Due Diligence and Rating Agencies transparancy
  - Stress Tests
  - Living Wills

- **Risk Management Focus:**
  - Is there a separate risk committee of the board of directors?
  - What is the relationship of risk management to the business line?
  - What is the overall risk appetite of the bank?
  - Does the bank's business model accurately capture and price the key risks that the bank takes?
  - Does the bank regard the treasury unit as a profit center in its own right?

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Crisis Cause, Containment and Cure,
Thomas F. Huertas (2011), Chapter 10

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Passing the Buck

Micro Supervision
Versus
Macro Supervision

Source:
FD December 23, 2011, adopted using Photoshop
Johan Jol

BUT: Manage Expectations

ΕΝ ΟΙΔΑ ΟΤΙ ΟΥΔΕΝ ΟΙΔΑ

ΣΩΚΡΑΤΗΣ

"The only thing that I know is that I don't know anything" Socrates

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Banana Skins: The Top Ten since 1996

1996
1 Poor management
2 EMU turbulence
3 Rogue trader
4 Excessive competition
5 Bad lending
6 Emerging markets
7 Fraud
8 Derivatives
9 New products
10 Technology foul-up

1998
1 Poor risk management
2 Y2K
3 Poor strategy
4 EMU turbulence
5 Regulation
6 Emerging markets
7 New entrants
8 Cross-border competition
9 Product mis-pricing
10 Grasp of technology

2000
1 Equity market crash
2 E-commerce
3 Asset quality
4 Grasp of new technology
5 High dependence on tech.
6 Banking market o'-capacity
7 Merger mania
8 Economy overheating
9 Comp. from new entrants
10 Complex fin. instruments

2002
1 Credit risk
2 Macro-economy
3 Equity markets
4 Complex financial instruments
5 Business continuation
6 Domestic regulation
7 Insurance
8 Emerging markets
9 Banking market o'-capacity
10 International regulation

2003
1 Complex financial instruments
2 Credit risk
3 Macro economy
4 Insurance
5 Business continuation
6 International regulation
7 Equity markets
8 Corporate governance
9 Interest rates
10 Political shocks

2005
1 Too much regulation
2 Credit risk
3 Corporate governance
4 Derivatives
5 Hedge funds
6 Fraud
7 Currencies
8 High dependence on tech.
9 Risk management
10 Macro-economic trends

2006
1 Too much regulation
2 Credit risk
3 Derivatives
4 Commodities
5 Interest rates
6 High dependence on tech.
7 Hedge funds
8 Corporate governance
9 Emerging markets
10 Risk management

2008
1 Liquidity
2 Credit risk
3 Credit spreads
4 Derivatives
5 Macro-economic trends
6 Risk management
7 Equities
8 Too much regulation
9 Interest rates
10 Hedge funds

2010
1 Political interference
2 Credit risk
3 Too much regulation
4 Macro-economic trends
5 Liquidity
6 Capital availability
7 Derivatives
8 Risk management quality
9 Credit spreads
10 Equities

Banking Banana Skins 2012

(2010 ranking in brackets)

1 Macro-economic risk (4)
2 Credit risk (2)
3 Liquidity (5)
4 Capital availability (6)
5 Political interference (1)
6 Regulation (3)
7 Profitability (-)
8 Derivatives (7)
9 Corporate governance (12)
10 Quality of risk management (8)
11 Pricing of risk (9)
12 Business continuation (21)
13 Back office (24)
14 Management incentives (16)
15 Change management (28)
16 Hedge funds (19)
17 Interest rates (14)
18 High dependence on technology (18)
19 Currencies (11)
20 Business practices (22)
21 Equity markets (10)
22 Emerging markets (17)
23 Rogue trader (20)
24 Criminality (27)
25 Sustainability (25)
26 Commodities (13)
27 Fraud (15)
28 Human resources (-)
29 Reliance on third parties (-)
30 Payment systems (26)

Banking Banana Skins 2012, The system in peril
Centre for the Study of Financial Innovation

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