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NATIONAL VERSUS GLOBAL APPROACHES TO FINANCIAL CRISIS MANAGEMENT

– THOUGHT LEADERSHIP

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In the immediate aftermath of the 2008 financial crisis, it was decided that the response needed to be global and that the concept of "too big to fail" no longer applied. However, in reality, policy makers have often taken national and protectionist approaches to crisis management, focusing on financial stability and the impact on taxpayers, rather than the broader global economy. Clifford Chance experts explore the reasons why.

The G20 mandated the FSB to take the lead on a raft of post-crisis measures. The most important of these were the Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011, updated 2014) and the Total Loss Absorbing Capacity Principles and Termsheet (November 2015). These documents aimed at creating a mechanism whereby a global institution could be resolved in an orderly manner at the level of its ultimate holding company (the "Single Point of Entry" model).

Effective resolution regimes

The FSB called on G20 jurisdictions to put in place effective resolution regimes giving resolution authorities a broad range of powers to resolve failing banks in an orderly manner, where losses are imposed on shareholders and investors – and not taxpayers. The Key Attributes document sets out twelve features that it identified as essential for an effective resolution regime.

TLAC

The TLAC requirements are designed to ensure that if a global systemically important bank (G-SIB) fails, it has sufficient loss-absorbing capacity available in resolution to implement an orderly resolution that minimises impacts on financial stability, ensures the continuity of critical functions and avoids exposing public funds to loss.

Single Point of Entry and loss-absorbing capacity

The Single Point of Entry model aims to enable the resolution of global banking groups at the ultimate holding company level. However, local subsidiarisation and intermediate holding company requirements and restrictions on the deployment of loss-absorbing capacity across global groups point to a national or regional approach and could hamper the effectiveness of the Single Point of Entry model.

Although governments approved of the Single Point of Entry model for the resolution of global banking groups in principle, they soon became uncomfortable with it in practice. In particular, US regulators became concerned that foreign banks operating in the United States were accessing the US domestic dollar markets in order to fund their non-US business, resulting in significant "due from" balances on the books of foreign banks' US operations. As a result, they imposed an Intermediate Holding Company (**IHC**) rule, requiring foreign banks to maintain a single US holding company in respect of their US non-branch operations. The EU retaliated with the Intermediate Parent Undertaking

(**IPU**) rule, which will require non-EU banks and investment firms to maintain a single EU holding company in respect of their EU subsidiaries.

The effect of these requirements is to trap capital and liquidity in the newly-created subsidiaries, since such resources could only be used to meet losses elsewhere in the group with the consent of the local authorities. This undercuts the basis of the Single Point of Entry approach, which was designed to create the maximum degree of flexibility to deploy capital wherever needed.

The fragmentation effect of these geographic ring-fencing requirements was compounded by two other developments. One was ring-fencing of deposit-taking activities (most notably in the UK in the wake of the Vickers Commission report). Since the purpose of ring-fencing retail deposit-taking is to ensure that retail depositors receive a higher level of protection than other creditors, it is extremely unlikely that the capital held in a ring-fenced bank will ever be released, and is therefore lost to the rest of the group.

The other was the demand by local regulators for high levels of TLAC to be issued by local subsidiaries. The original FSB term sheet had provided for wholly-owned subsidiaries to require only 75% of the amount of TLAC which they would have required had they been independent. However national authorities have the power to increase this, and many have done so. Again, the effect of this is to trap loss-absorbing capacity in local subsidiaries, preventing them being used elsewhere in the group.

The consequence of this fragmentation of loss-absorbing capacity is that bank groups become "brittle". It is increasingly easy to imagine a loss in a relatively small subsidiary of a G-SIB group causing the collapse of that group, since although the group as a whole may have more than enough capacity to absorb the loss, the capacity may be incapable of being transferred to the part of the group where the loss has occurred.

The policy drivers behind this fragmentation of loss-absorbing capacity are broadly twofold. One is a lack of confidence by national governments and resolution authorities in each other – ring-fenced capital and liquidity pools may be regarded as insurance policies against the authorities in the home country seeking to renege on host country creditors and depositors. The other is a desire of host countries to grow their financial markets by domesticating activities. This latter driver can also be seen in measures such as local trading mandates, which prohibit firms from executing certain trades (derivatives and, in the EU, equities) outside the jurisdiction.

The practical impact of this "ring-fencing" of international financial firms' capital and liquidity for the benefit of local creditors looks set to continue and grow, as new internal TLAC rules and IPU requirements start to take effect over the next few years.

"some national policymakers… fear that banks are still "national in death" and that they might have to carry the burden when a bank gets into trouble. In the absence of clear safeguards to protect domestic interests in bad times, policymakers thus feel the need to require the local entities of banks to maintain relatively high amounts of capital and liquidity, also in good times."

Speech by Andrea Enria, Chair of the Supervisory Board of the ECB on "Supervising banks – Principles and priorities" (7 March 2019)

"The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation."

Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011)

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