A missing tool against ‘too big to fail’

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There is no simple, easy way to cure the problem revealed by the crisis: The financial giants at the heart of the global financial system were so large that they were too big to fail. However, in a functioning market economy every financial institution, regardless of its size and complexity, must be able to exit the market without putting the financial system and broader economy at risk.

Meeting this challenge requires a framework of interlocking policy reforms, on which the international community must agree. Each element of such a framework brings a benefit in making the financial system more robust. But all the reforms have to be in place before we can have the confidence to resolve a failing global giant safely without taxpayer support.

Key aspects of the framework are already being put in place. More stringent international capital and liquidity standards mean that it is less likely that banks will fail in the first place. Important work remains to finish the prudential framework for banks: We need to consider whether to reassess the preferential treatment of sovereign exposures on banks' balance sheets, to complete the design of the net stable funding ratio, and to agree a minimum standard on required leverage ratios.

Under a G-20 agreement, over-the-counter derivative contracts have been mandated for central clearing, and prudential standards for financial-market infrastructure have been reformed across Europe, North America and Asia. But the key missing piece in the framework is effective resolution regimes in all the major jurisdictions. The good news is that we now have the international mechanisms to enable a bank's regulators in different jurisdictions to have an agreed resolution plan—a living will—for each of these banks. And jurisdictions worldwide are implementing international agreements on the resolution regimes and the powers necessary to deal with failure.

However, these resolution regimes still have to gain credibility. Bail-in of a bank's creditors is the name of the game. But the rules of the game are still not entirely clear. In particular, we see the need to ensure that, in the event of the failure of a global systemically important bank, adequate bail-inable resources are available. These resources, the so-called "gone-concern loss absorbing capacity," or GLAC, must be available in the right form, at the right time and in the right place to allow the bank to be safely resolved. We think that, similar to the Basel III minimum standard for going-concern capital, there is a need for a global minimum standard for GLAC.

Work is progressing at the global level on developing a proposal for GLAC. One open issue is whether GLAC should be based on risk-weighted assets or on a non-risk-weighted measure. We see merit in both approaches. Using a risk-weighted approach would be coherent with Basel III capital requirements; but from an EU perspective, a non-risk weighted concept would be preferable, as this would be compatible with the resolution regime envisaged by the EU's directive on bank recovery and resolution.

We see scope for combining both approaches. Concretely this would mean for GLAC that a minimum ratio could be defined as a percentage of a bank's risk-weighted assets and also as a percentage of an equivalent quantum of a non-risk weighted measure. The higher of the two should apply. In either case, the GLAC standard should be of a minimum quantity and quality to allow the bank's critical economic functions to continue while the firm is resolved and its non-critical functions are reorganized or wound down over a period of time.

The G-20 have agreed that a draft standard for GLAC should be presented at the Brisbane summit in November. This will allow a thorough public consultation and quantitative impact study, which will be the basis for calibrating the final rules. Because GLAC is likely to change banks' business models, the phasing-in of the new rules will take some time.

Another crucial part of the too-big-to-fail framework is the cross-border recognition of national resolution measures, including bail-ins of debt issued under foreign laws. So far the vast majority of resolution authorities around the world are not yet empowered to recognize and give effect to resolution measures that were taken by authorities in other jurisdictions. This hampers the resolution of cross-border banks.

Firms' contracts should be structured in a way that recognizes resolution measures taken in different jurisdictions. In particular, there is a need for new global derivative contracts that provide for a short stay on close-out rights when a systemically important bank enters resolution. We fully support the Financial Stability Board and the International Swaps and Derivatives Association in their joint effort to encourage the world's major dealers in such instruments to move towards a new set of contracts.

Discussions about ending too-big-to-fail and improving banks' resolvability are not confined to GLAC. The Volcker, Vickers and Liikanen proposals are further pieces in the too-big-to-fail program. Due to their preventive nature, these proposals are useful to make too-big-to-fail less likely. However, even with effective bank-separation laws in some jurisdictions, we cannot rule out the failure of systemically important cross-border banks. This is why we need a minimum GLAC standard.

Finally, to complete the framework, we should not forget other important financial entities, such as clearing houses or non-banks, which can cause unacceptable systemic disruptions. Without putting all these reforms together and driving them to completion, we will not have succeeded in ending the problem of too-big-to-fail.

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