Not Too Big to Fail!

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The global financial crisis of 2008, during which banks around the globe lost over $500 bn to sub-prime related loans and securities, resulted in bank failures, tax payer funded bail outs and significant new banking regulations. "Never again" has been the refrain from bank regulators and politicians, as they impose new rules to protect both the financial service industry and the public at large. Yet even with these new safeguards there are populist politicians, and even one regional Federal Reserve president, calling for the break-up of big banks.

It is not surprising to see politicians such as Senator Sanders, until recently an upsurge candidate for the Democratic presidential nomination, demonizing banks and calling for them to be broken up. Senator Sanders' constituents rally around such a cry, which only builds on his "democratic socialist" platform. The anger of the American electorate is palpable, and some politicians are likely to exploit that anger for political gain.

Too big to fail has led to the development of living wills and bail in capital securities. These are new tools for regulators to deal with banks which fall below minimum capital levels.

Mr. Neel Kashkari, President of the Minneapolis Federal Reserve Bank since January 1st of this year, is not convinced that the regulatory changes since the financial crisis are sufficient to ensure against future bank bail outs.

Despite the far reaching regulatory reforms since the financial crisis, including Basel III, Dodd-Frank, the bail in regime and the annual CCAR stress testing process, Mr. Kashkari feels that regulators will not actually enforce the new "bail in" rules, resulting in yet another round of bail outs by tax payers.

As a result, Mr. Kashkari has joined the call for the break-up of the big banks, under the reasoning that the resolution process for a smaller bank will be more orderly and not put the broader economy in jeopardy.

It is surprising to have a member of the Federal Reserve Board joining the call to break up the big banks, but over the past few months Mr. Kashkari has been holding a series of symposiums and giving a number of speeches on ending "too big to fail", by breaking up the big banks. While agreeing that the regulatory framework reforms since the financial crisis are headed in the right direction, he fears that come the next crisis the government will once again be put in the position to either bail out the big banks or risk broader economic collapse. To be fair, Mr. Kashkari has had a unique vantage point to the issue, serving as an Assistant Treasury Secretary for Financial Stability, from October 2008 to May 2009.

The underlying logic, is that larger banks (i.e. that are disproportionate in size to a country's GDP), pose a systemic risk if they fail, as was evidenced in Ireland and Iceland during the financial crisis. Indeed large Italian banks are currently under such pressure that there is serious talk of a publicly funded bailout. More than 50 groups (including economists, financial experts and finance industry groups) have also called for larger banks to be broken up. Still, leaders around the globe, including Mr. Kashkari's peers at the Fed and Ms. Christine Lagarde at the IMF, argue that clear and intense regulation will result in stronger banks and a more stable system.

A quick recap of the new financial regulations since the financial crisis is probably in order:

• Basel III has significantly increased the amount of common equity, the strongest and most permanent form of capital, banks must hold on their balance sheet.

• Basel III also introduced new liquidity standards for banks, basically requiring them to hold significant portfolios of low risk, very liquid securities which can be used to offset disruptions in the funding market such as were seen during the financial crisis.

• The Dodd-Frank Act has significantly curtailed the type of trading and investing activities banks can participate in, albeit through the painfully complex legislation that has become known as the Volker Rule (interestingly Mr. Volcker now laments how his initial simple idea for ring fencing more risky investment banking activities has become the poster child for excess complexity and regulatory burden).

• Dodd-Frank also instituted the "Comprehensive Capital Analysis and Review" ("CCAR") process, which requires banks to participate in a very conservative, public stress testing process, where banks run extreme stress scenarios (2016 assumptions include a severe global recession with US GDP of negative 5%, unemployment doubling to 10%, stock prices falling 40% and house prices falling 25%) – failing to have adequate capital to survive this scenario results in significant capital restrictions (e.g. dividend increases; share buy-backs).

• And new "bail in" rules that require all of a banks preferred shares, sub debt and senior unsecured debt include non-viability clauses, which basically says that in a crisis the regulator will convert such securities into common equity, as a first step in resolving a bank – the bail in rules will require a capital ratio including such securities of approximately 20% of risk weighted assets (versus a common equity requirement of about 4% prior to the financial crisis, in most jurisdictions).

While the above is a high level summary of key changes, the new regulatory burden on banks is clearly transforming the financial services industry as each bank adjusts to the new reality of higher costs, higher capital and, as a result, lower returns.

It is interesting to think through the implications of such requirements on banks that failed during the financial crisis. Washington Mutual, one of the most active and aggressive mortgage lenders prior to the sub-prime crisis, went into distress in 2009 and had to be resolved by the regulators. At the start of the crisis Washington Mutual had risk weighted assets of $240 bn, tangible common equity of $16bn and ultimately over $31bn of subprime mortgage losses. If Washington Mutual had been regulated to current standards:

- *Risk weighted assets would likely have been closer to $260bn under the new, more conservative Basel III rules.*
- *Tangible common equity would likely have been closer to $26bn.*
- *And the combination of all capital and bail in debt would have been closer to $52bn (20% of RWAs).*
- *Liquidity, which became Washington Mutuals' key pressure point when over $16bn of their deposits were withdrawn during one critical week of the crisis, would have supplied at least a 30 day liquidity buffer under the new Basel III rules.*

- *And perhaps most importantly, as Washington Mutual embarked on their aggressive growth strategy in sub-prime lending in 2004, the annual CCAR stress testing exercise would have presumably triggered warning signs as they built up over $30bn of exposure versus a tangible common equity base of about half that amount.*

High level analysis only works at the onset of a crisis if one assumes that the regulator enforces the bail in provisions; this seems to be Mr. Kashkari's main concern, that the regulator will not be willing to bail in debt holders for fear of tainting the market and causing a reputational "bank run" from such securities. From our perspective, the Global Risk Institute believes that this barn door is open and the horse is already long gone. With all newly issued bank securities now including non-viability clauses, and with the risk of conversion now being priced into certain securities (e.g. preferred shares, sub debt), on what basis could a regulator wave enforcement? The real concern here is that the time frame for a regulator to take action will be greatly reduced in the next crisis, given market forces; it is likely that long before a "nonviable" pronouncement is handed down by the regulator, the capital markets will be pricing this heightened risk into the bail in securities. And so the regulators declaration will be confirmatory of market expectations as opposed to the triggering gun.

We therefore conclude that the appropriate path forward, as advocated by Mr. Kashkari's peers at the Fed, is to fully operationalize the new regulatory framework and closely monitor the big banks' progress; we expect that the regulatory framework will continue to evolve and strengthened, based on future economic stresses.

Further, we expect the real pressure point going forward will be the speed at which the capital markets reprice securities with bail in provisions, along with the heightened anticipation of a regulatory announcement, as opposed to the regulator slowly pondering whether to enforce those clauses or not.

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Brian is an Executive in Residence at the Global Risk Institute, after retiring from CIBC in 2015. Most recently Brian was CIBC's Executive Vice President and Chief Data Officer, where he developed their data strategy and governance framework. Prior to the CDO position Brian lead the Bank's Enterprise Risk Management group, including balance sheet and capital management.

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