RESILIENCE

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This paper appraises the Financial System Inquiry's proposals for making the banking system more resilient by increasing capital buffers to reduce the chance of bank failures and by improving the resolvability of banks with minimum real impact should they fail. It concludes that the main problems lie in the area of resolvability, where Australia has taken limited steps compared with the rest of the OECD. Many questions need to be answered before satisfactory arrangements in line with the Financial Stability Board's recommendations can be introduced. On capital buffers, it is not clear why Australia should want to exceed the recommended levels or why the Basel Committee's proposed leverage ratio should be omitted. Surprisingly, the inquiry does not discuss whether the balance between Australia's big four banks and other sources of finance is best for resilience.

The Financial System Inquiry 2014, Final Report[1] sets out its fundamental belief (p. 3):

> The inquiry believes the financial system [performs its role] most effectively when it operates in an **efficient** and **resilient** manner and treats participants **fairly**. This occurs when participants fulfil their **roles and responsibilities** in a way that engenders confidence and trust in the system. [emphasis in original]

The report then elaborates on the meaning of each of the inquiry's emphasised concepts. I propose to focus on just one of these, resilience, which is the topic of Chapter 1 of the Final Report. With eight recommendations (which are set out in the Appendix), perhaps even this is too much ground to cover properly.

The inquiry defines resilience as: 'the financial system's capacity to adjust to both the normal business cycle and a severe economic shock' (p. 4). It emphasises that 'A resilient system does not preclude failure' and, more controversially, 'nor necessarily imply price stability'. Building on that statement, the report indicates:

> Rather, a resilient system can adjust to changing circumstances while continuing to provide core economic functions, even during severe but plausible shocks. In a resilient system, individual institutions in distress should be resolvable with minimal costs to depositors, policy holders, taxpayers and the real economy.

It then examines the main characteristics of the system required to achieve this, focusing largely on the capital cushion that banks are required to hold and the nature of the resolution regime for handling bank failures.

This position reflects the conventional wisdom that banks should have a much better capital buffer than previously but, if that buffer fails, the banks should all be resolvable overnight without recourse to public money. But given that in practice Australia's four large banks are 'too big to fail', implementing the inquiry's recommendations would represent a substantial step forward. My remarks therefore start with the issue of resolvability and then examine the issue of capital adequacy, before concluding.

First, however, a preamble is in order because the inquiry does not start with an analysis of the resilience of the financial system and its constituent parts but instead focuses fairly quickly on the banks, particularly the four major banks.

Preamble

One might want to start by considering whether the structure of the system is best for resilience. Should there be less reliance on banks, and more on equity markets and on commercial bond markets in particular? These markets are often referred to as a 'spare tyre' in the event of banking problems.[2] Much is said about shadow banking; for example, it may contribute to resilience by absorbing shocks. Ironically, volatility in one sector may help in ensuring the stability and resilience of the system as a whole. The more the banking system is concerned with financing higher risk activity, which is itself essential for a vibrant economy, the more it has to be able to absorb the consequent risks. Especially, since the main banks are so large, this involves building up major capital buffers associated with the whole of the banks' activities. There are major issues here about what the most appropriate structures of the financial system in Australia might be, say, in comparison with the US, where the sources of finance are more diverse and the concentration in the banking system is lower, and also with continental Europe where the focus on the banks is even greater and the financial system is consequently more vulnerable because the ratio of bank liabilities to GDP is relatively high.

The second facet to the structure of the Australian financial system which is ignored in the FSI Report is New Zealand. New Zealand may only represent 15 per cent of the Australian banks' assets but that is enough for it to be a threat to financial stability in Australia. Australia is, of course, a much greater threat to the resilience of the financial system in New Zealand, since the same four banks hold 85 per cent of the New Zealand market. The problems of resolving cross-border banks (when they fail) dominate the discussion about the world's largest banks because coordination among authorities has proved too difficult. The US and the UK propose to solve this through using what is described as the Single Point of Entry (SPOE) approach,[3] whereby the home country resolves the parent and thereby keeps all of the systemically important functions in the other host countries operating without the need to enter insolvency proceedings or elaborate joint actions with other authorities. (The EU approach is less clear and it remains to be seen how the Single Resolution Board (SRB) will seek to balance SPOE and its counterpart MPOE (multiple point of entry), as it is yet to start operating.)

New Zealand has effectively given up on having a coordinated discussion on this subject with Australia which does not involve the use of taxpayers' funds and has therefore implemented its own 'Open Bank Resolution' (OBR) scheme[4] that requires treating the retail operations in New Zealand as being completely separate both functionally and legally. It is by no means clear that this is the optimal solution for either country, but it is a logical one for New Zealand given the apparent lack of interest in this issue within Australia. It is a pity that the inquiry did not deal with this even in passing as strong New Zealand subsidiaries would help resilience in Australia and weak subsidiaries would harm it.

Resolvability

Recommendations 3, 5 and 6, shown in the Appendix, handle resolvability. Recommendation 3 suggests that something like what is well on the way to agreement internationally through the FSB[5] should be implemented in Australia, but Recommendation 6 on maintaining ex post funding for the Financial Claims Scheme, Australia's version of guaranteeing ordinary deposits, is not. Both the EU and the US have decided that implementing a resolution, particularly for a large institution is likely to require some funds for the resolution authority. In the US, the FDIC, their deposit insurer, already has considerable funds raised from levies on the banking industry, which it frequently uses in the resolution of smaller banks. In the case of the largest US banks, the FDIC now has access to an Orderly Liquidation Fund through the Orderly Liquidation Authority as part of Title 2 of the Dodd-Frank Act. These funds are available through the government and can be topped up as necessary. Any such funding is expected to be temporary and merely provides the means of keeping the institution operating while recapitalisation, writing down of claims or realisation of assets enables the sums to be repaid.

In the US case, it is expected that a bridge bank (and possibly more than one) run by the FDIC will be set up to manage the affairs of the failed bank in the interim and it is this which requires the financial backing. In the EU, it is hoped that a small resolution fund (up to 0.8 per cent of liabilities) will suffice, raised from the banks themselves progressively over a period of eight years. In this case, it is unclear where any back-up funding would come from if the funds ran out, as with a cross-border bank such funding might effectively be going to another country. With SPOE that particular worry should not arise.

The inquiry offers two arguments against ex ante funding. The first is that it 'would be an ongoing cost for all ADIs' (p. 83) and the second is '[b]ecause Australia's depositor preference arrangements reduce the risk of an ADI's assets being insufficient to meet insured deposits' (p 83). In this, Australia is not any different from either the US or the EU, where depositor preference will prevail (although in the EU such preference cannot be applied merely to domestic depositors as in Australia — something that would also need to change under SPOE). Hence, we have to look for some line of argument in favour of the inquiry's approach that is generally applicable and not Australia-specific.

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Taking the second argument first, it seems likely that the requirements for TLAC (total loss absorbing capacity) that is going to be placed on banks will be sufficient to cover all but the most extreme failures. (Of the large bank failures — that is large relative the country's GDP — only the case of Anglo-Irish Bank in Ireland would not meet these requirements.)[6] TLAC, however, merely puts the balance sheet straight. It first writes down the claims of shareholders and then the claims of creditors in increasing seniority under the same terms as under insolvency until either the losses are expunged (as in the New Zealand OBR) or until the bank is recapitalised up to the regulatory minimum as in the EU under the EU Bank Recovery and Resolution Directive (BRRD). There are few instances where, if the proposed rules under the BRRD had been applied in the failures in the EU during the GFC, senior (unsecured) debtholders would have been called on and then this would not have got as far as the preferred depositors, whether or not insured.[7] Even in the case of the major failures of the three main Icelandic banks it looks as if the senior bondholders will have just enough value that the depositors will not lose out after the liquidations are completed.

Thus, under a resolution of the larger banks it appears that deposit guarantee funds will normally be repaid. It is only the smaller banks that may require a permanent contribution from the deposit guarantee fund. These banks can be allowed to fail and cease operating under the new lex specialis (special insolvency regimes) such as the BRRD, which are being implemented to keep the vital functions of large banks operating. This, therefore, seems to support the inquiry's view that an ex ante fund would be unnecessary. What tips the balance is the fact that quite considerable funds may be needed in the interim before the deposit guarantor is repaid from the insolvency.

Who should pay for such funds? Should they be at the discretion of the government? One of the advantages of an ex ante fund is that they are levied on the whole banking industry including the bank which fails rather than simply on the survivors. Also, the resolution authority will have access to the funds within the terms of the legislation. This then makes their use a technical decision based on what will be the lowest cost and the lowest impact to the real economy (and hence the taxpayer). With ex post funding it remains a political decision. In any case, a cost-benefit assessment might be a sensible way forward and in the case of the EU the finding in favour of the fund was clearly positive.

One of the major gains from implementing the new resolution legislation around the world is that it would make resolution of any bank plausible ex ante without the use of taxpayer funds. This, it is hoped, will reduce the moral hazard, both encouraging banks and their shareholders to ensure that they manage their risks well because the shareholders and the senior management will be the first to be hit in a resolution, and encouraging the shareholders to find a market solution — i.e. a 'recovery' rather than a resolution, which at least enables them to retain some value and control.

Australia has not yet put into effect a version of the lex specialis, such as the BRRD[8] or the OBR in New Zealand, and the inquiry rightly advocates getting on with this job, which was proposed in 2012 but put on hold until the inquiry reported. However, it advocates omitting one facet, which forms part of the Dodd-Frank Act and 2013 Banking Act in the UK, namely, some requirements for separating the riskier 'non-banking' activities from the banking activities that need to be saved. In the Dodd-Frank Act it is a version of what is known as the Volcker Rule and in the UK it is a version of the ring-fencing advocated by the Vickers Report. (The EU legislation, proposed in January 2014,[9] following the Liikanen Report[10] seems to have stalled, but Belgium, France and Germany at least have implemented their own legislation.)

The inquiry's reasons for not following the general pattern are: 'These measures can have high costs, and require changes in all institutions regardless of the institution-specific risks. Neither APRA nor the RBA nor the banking industry saw a strong case for these reforms.' (No surprise in the last case of course.) It is possible to have some sympathy for the inquiry's conclusion for a different reason. There has been little agreement internationally about how to impose these restrictions.

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Capital buffers

As a G20 member, Australia is a party to the discussions about capital buffers through the Basel bodies and hence one would expect that the inquiry would conclude that it should at least follow the standards being set. In Recommendation 7 (see Appendix), the inquiry focuses on one area where Australia has decided not to implement the Basel III recommendations, namely in the use of a leverage ratio as a backstop, and it argues that such a backstop should be added. The inquiry does not rehearse the rather weak arguments that have been advanced in Australia (and New Zealand) for not having the backstop but it also does not really draw out the main argument in favour of this.

The history of detecting banking problems from declines in risk-weighted capital is at best poor. The measure is most misleading for large banks when they are getting into trouble.[11] A leverage ratio is more difficult to finesse and it is much more obvious to outside observers. Over-optimistic assessments of risk are a normal feature of banking problems and widely held over-optimism is usually a characteristic of crises. Hence, risk-weighting is inherently likely to be a weak measure just at the time it is most needed. A leverage ratio offsets this. Given the inquiry's enthusiasm for higher than average standards in Australia, the question is: why have they simply advocated the use of the minimum agreed ratio as a backstop rather than adding a more ambitious ratio as a normal part of the capital buffer?

The inquiry's explanation of the nature of the international agreement on buffers is very clear and its Figure 3 on p. 39 will no doubt be used widely in teaching on the subject. However, their justification of why the main Australian banks should seek to have capital buffers in the top quartile of international banks is difficult to understand. For a start, if international banks generally are under- or over-capitalised, why should Australia follow the trend? The appropriate height of buffers should reflect the risk of the individual banks, the Australian financial system and the country as a whole to shocks. The extent of exposure to volatile commodity prices is one reason why Australia might wish to have above-average requirements, as is the high concentration in the banking system, but the AAA rating for the country suggests that the absorptive capacity of the country in the face of shocks is thought to be high. An argument not raised by the inquiry is that since it is not advocating any division of financial institutions into riskier and core banking elements, the overall risk of Australian ADIs may be greater than that of their counterparts.

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The inquiry does not recommend either a specific level for capital ratios or a specific increase over current levels. It merely suggests that the benefits from greater resilience are considerable and the costs of raising such extra capital are small by comparison. The interesting question which the inquiry does not address is where the extra capital should lie in the spectrum of loss absorbing capacity. The implication is that it should be equity but it is not clear whether the extra cushion should occur at the next level up through hybrids and debt that can be converted into equity on the basis of objective triggers that lie above the regulatory limits. The advantage of using such instruments is that they threaten to dilute the equity of the existing shareholders, thus giving them an extra incentive to act early and assess risk carefully. Furthermore, it adds a second group of stakeholders who have something at risk even if a bank only has to go through a recovery program and not a resolution. Such an incentive for greater monitoring is clearly a help.

There are of course downsides, as having the threat of this bail-in will tend to bring forward the point at which the banking problem becomes reflected more widely in asset prices rather than just the stock of the affected institution.[12] However, an incentive to earlier action may be exactly what is needed to keep the costs of the crisis down.

Concluding remarks

Views will differ on whether the inquiry has made the right recommendations on resilience but it has clearly produced a helpful basis for debate and raised most of the issues which need to be considered. If the authorities simply follow their advice, the debate is likely to be a move in the right direction. Legislative action to ensure resolvability is a high priority as here Australia is clearly behind the major countries. Here, in particular, I think there is room for modification, both in including New Zealand and in ensuring that there are adequate funds available to handle the four major banks and make their likely resolution without a bailout appear credible. It would be a major step forward to put the whole process of recovery through enhanced capital buffers and resolution through loss absorbing capacity that does not have significant adverse effects on the real economy into a single coherent framework would be a major step forward. This would put Australia towards the forefront of preparedness for resilience rather than being somewhat behind in some areas as it is at present. At least, as the inquiry notes, Australia is starting from a point of relative strength.

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Appendix — The recommendations for resilience

1. Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
2. Raise the average internal ratings-based (IRB) risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
3. Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.
4. Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.
5. Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the inquiry.
6. Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.
7. Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.
8. Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

Notes

1. Commonwealth of Australia 2014, *Financial System Inquiry Final Report*, November.
2. For a recent example see Levine, R, Lin, C and Xie, W 2015, 'Spare tire? Stock markets, banking Crises, and economic recoveries', *NBER Working Papers*, no. 20863.
3. Federal Deposit Insurance Corporation and the Bank of England joint paper 2012, *Resolving Globally Active, Systemically Important, Financial Institutions*.
4. Hoskin, K and Javier, N 2013, 'Open bank resolution — the New Zealand response to a global challenge', *Reserve Bank of New Zealand: Bulletin*, vol. 76, no. 1, pp. 12–18.
5. Financial Stability Board 2014, *Key Attributes of Effective Resolution Regimes for Financial Institutions*.
6. According to the Vickers Commission, *The Independent Commission on Banking 2013: The Vickers Report and the Parliamentary Commission on Banking*.
7. Conlon, T and Cotter, J 2015, 'Eurozone bank resolution and bail in — intervention, triggers and write-downs', in *European Banking Union: Prospects and Challenges*, J Castaneda, D Mayes and G Wood eds, forthcoming, Routledge, Abingdon.
8. Directive 2014/59/EU of the European Parliament and of the Council firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulation (EU) no. 1093/2010 and (EU) no. 648/2012, of the European Parliament and of the Council, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0190.01.ENG

9. European Commission 2014, *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*.

10. High-level expert group on reforming the structure of the EU banking sector in 2012.

11. Haldane, A and Madouros, V 2012, 'The dog and the frisbee', paper given at the Federal Reserve Bank of Kansas City's 36th economic policy symposium, The Changing Policy Landscape, Jackson Hole, Wyoming.

12. Goodhart, C and Avgouleas, E 2014, 'A critical evaluation of bail-ins as bank recapitalisation mechanisms', *Centre for Economic Policy Research Discussion Paper*, no. 10065.