# T-LAC Resolution – And Then What?

By C.A.E. Goodhart
Fianncial Markets Group
London School of Economics

## Introduction

In the Consultative Paper on T-LAC (FSB, November 10, 2014) there is a clear description of the process leading up to the resolution of a failing bank under these new procedures. But there is no account of what might happen thereafter. In a game with many rounds, such as chess, the expert players are those that are trained to think many steps ahead. Within the bail-in process, the (main) operating subsidiary (op-co) is meant to continue, so this is supposed to be a multi-stage exercise. Yet nothing is said in this paper about such subsequent stages, nor about the problems that might arise therein. In this brief note, I raise some queries about what might happen after the initial resolution is triggered.

## Liquidity?

The main focus of the paper is on the provision of sufficient capital, by a bail-in of creditors, to support the continuing workings of op-co. But there is not a word about ensuring that it will have sufficient liquidity as well. Such sufficiency of liquidity is by no means assured.

The resolution process is bound to be newsworthy. The overall strength of the banking group will have become undoubtedly impaired, with hold-co liquidated or drastically written down. The name, and reputation, of the bank will have been brought into question. The likelihood is that the initial reaction, of both informed and uninformed investors, (as with Northern Rock), will be to flee. At least, in advance, no one can guarantee that this will *not* happen. Unless there is protection against that eventuality, in the guise of an associated commitment by the relevant Central Bank to provide sufficient LOLR support, the whole exercise stands at risk of failing, disastrously, at the first hurdle.

Since op-co is, by design, solvent, there should be no ideological barrier to such LOLR support. Yet there are suggestions that Dodd-Frank, or other constraints, may restrict such LOLR in the USA. If true, and I hope not, this could be the whole approach at risk. If this is not the case, then what is

needed is the addition of a sentence such as, "With op-co being thus clearly solvent, its Central Bank will, of course, stand ready to meet any resultant temporary liquidity requirement". In any case you cannot burke the issue; liquidity provision must be openly discussed.

## Recovery

As noted earlier, with hold-co liquidated or sharply written down, the overall valuation and strength of the banking group will have been much impaired. Op-co will have sufficient capital of its own, but it will no longer have hold-co as a buffer above it. Thus op-co will be significantly weaker than all the competitive banks around it. Op-co by itself will no longer have the T-LAC support deemed necessary for everyone else. So what happens then?

Presumably op-co cannot then pay out dividends, or do buy-backs, until it can fully reconstitute a hold-co that meets standard requirements? Is this the intention? If so, why not say so? What other additional constraints, if any, on the subsequent working of op-co are envisaged? It will hardly be possible for op-co, (and/or a residual or new hold-co) to issue new equity or debt unless the constraints and terms under which the resolved entity will subsequently operate are fully and transparently spelt out. Yet the present draft consultative paper takes us, in considerable detail, up to the initial resolution, but is totally silent on life thereafter. What will this after-life look like?

## Valuation

Once a failing bank is put into resolution, a forensic auditor will, no doubt, be sent in to estimate the necessary size of the creditor haircuts required to recapitalise op-co sufficiently. There can hardly be two bites at this, if only because transactions in such assets will begin again once the initial write-downs have been established. For this, and other reasons, such as uncertainty about the effect of the resolution process on market values, my own expectation is that the forensic auditor will aim to err on the side of austere caution in such valuations, i.e. to propose larger haircuts than subsequently turn out to have been necessary.

It is, of course, possible that this is not the case, and that the auditor underestimates the necessary haircuts. This would be particularly likely if the initial resolution should turn out to be the start of a systemic and major financial crisis. What then, if op-co should fail to repair profitability, and need

further recapitalisation? In the Eurozone this possibility is met within the Banking Union by the SRM and ESM. Should there be a similar back-stop world-wide?

However, let me revert to the more probable outcome, that the proposed haircuts go well beyond what eventually turns out to be necessary. Will this not open up the authorities to legal suit under the 'no creditor worse off' principle? This possibility can be mitigated by giving the bailed-in creditors warrants against such up-side recovery. But the more that the upside recovery option would go to reimburse prior creditors, the less the attraction of the equity in op-co (or the reconstituted hold-co) to new buyers. How is, or should, this balance be set? What will be the form and detail of such warrants?

<u>Pro-cyclicality and Contagion?</u>

As argued earlier, the valuations of the forensic auditor will tend to err on the austere side, and the haircuts will be larger than previously expected on the basis of the last, pre-resolution accounts. The market will be shocked. The bail-inable debt will, almost by definition, have previously been bought by optimists (and the ill-informed), and their optimism will suddenly appear misguided. There must be a good chance that, after the first newsworthy resolution, the market for such bail-inable debt will completely dry up, for some period of time (how long?) before re-opening at a much higher, and to bank CEOs unattractive, yield. What then happens as bail-inable debt rolls over? Will there not be an incentive on all other banks to delever sharply to avoid the penalties imposed on banks falling short of T-LAC? All regulation tends to be pro-cyclical. Is this not another example where the T-LAC approach would reinforce the cycle and makes the financial sector even more prone to systemic crisis.

There is some, but not much, mitigation of this danger from the one-year criterion for (eligible external) T-LAC (Box 11, p. 16). This latter does mean that, if another bank is forced into resolution during the period – assumed to be less than one year – during which refinancing roll-overs is impossible – it will still have enough T-LAC to recapitalise op-co. But just as much bail-inable debt will pass through the one-year gateway as will need roll-over refinancing, so measured T-LAC will still be falling.

How can one protect against the contagion and procyclicality that this regulatory procedure – alongside most other regulation – is likely to enhance? Why not give Central Banks the power to

vary the maturity time limit for eligible external T-LAC, so that in a systemic crisis, (preferably with such a crisis being called on the basis of a pre-determined metric, rather than just discretion), all banks can treat all bail-inable debt right up to final maturity against the T-LAC requirement? Could, or should, the percentage amount of T-LAC be made state-contingent? Has any thought been given to the question of how to counteract the pro-cyclical potentiality of T-LAC, and to the possibility that the exercise might worsen, rather than improve, the systemic stability of the financial system?

I hope that such thought has been applied, but there is no sign of this in the consultative document. It takes us up to the occasion of the initial resolution, and is completely silent on what happens afterwards. While getting the first step right is important, if one cannot foresee the likely course of the subsequent stages of the game, one is likely to lose the match and the financial system and the economy too.