FSB FINANCIAL STABILITY BOARD

1 April 2021

Evaluation of the effects of the too-big-to-fail reforms

Overview of the responses to the consultation

1. Introduction

On 28 June 2020 the FSB published a consultative document on the evaluation of the effects of the too-big-to-fail (TBTF) reforms for systemically important banks (SIBs).[1] The FSB received 28 written responses from a variety of stakeholders.[2]

Respondents generally welcomed the evaluation, noting the importance of the post-crisis reforms and their relevance in the midst of the COVID-19 pandemic. This document summarises the comments raised in the public consultation and sets out the main changes made to the evaluation report in order to address them.

2. Summary of feedback received

General comments

Comments received

Many respondents praised the report and highlighted the depth and comprehensiveness of the empirical analysis underpinning it. Many respondents also expressed agreement with the conclusions drawn from the analysis and the overall assessment of the progress made so far. In some cases, however, respondents had comments and suggestions on the report as a whole.

Several respondents commented on the tone of the conclusions. On the one hand, some respondents (mainly industry representatives) argued that the tone of the report does not adequately reflect the progress that has been made. In their view, the TBTF problem for banks has been essentially solved, in some jurisdictions, and the report should reflect this.

On the other hand, others (mainly think tanks and academics) argued that the principal finding is that implicit subsidies still exist, which implies that the TBTF problem continues to distort the pricing of risk and therefore the competitive environment in favour of SIBs. They argued that the report should be more forthright in stating that TBTF reforms have so far not achieved their objective and that new initiatives are needed.

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1 See https://www.fsb.org/2020/06/evaluation-of-the-effects-of-too-big-to-fail-reforms-consultation-report/.

2 Non-confidential responses are available on the FSB’s website.

Some respondents argued that it is not yet possible to evaluate the TBTF reforms properly, as they have not been fully implemented and few SIBs have faced trouble since their introduction.

A number of respondents (mostly banks and trade associations) suggested that the report should give more specific information on how the results and conclusions vary by jurisdiction or region in order to highlight where most progress has been made.

Several respondents argued that the FSB should investigate what can be learned from the COVID-19 pandemic, and especially from the market dislocations in March 2020. Most of the suggestions, however, went beyond the remit of the evaluation. They included the role of procyclicality of capital measures and liquidity (e.g. initial margin), the design and usability of buffers, the challenges of legal entity fragmentation, the interactions between regulations (such as leverage ratio, liquidity coverage ratio and globally systemically important bank (G-SIB) capital surcharges) and the role of accounting standards.

Changes in response to comments

With respect to the tone of the conclusions, the report highlights both the areas where progress has been made and the areas where gaps remain and further work is needed. Some drafting changes have been introduced to further clarify these areas, but the overall tone is considered appropriate and has remained broadly unchanged.

With respect to the feasibility of the evaluation, this is clearly an important point. However, the consultative document and the Technical Appendix highlight the fact that implementation of reforms is incomplete and that few SIBs have failed since their introduction. Hence no change has been made.

With respect to the heterogeneity of results, some drafting changes have been made to highlight in the main report the results by jurisdiction that are discussed in the Technical Appendix. However, the evaluation's focus is on whether heterogeneity helps to explain aggregate results rather than assessing individual jurisdictions. Furthermore, the FSB has published the data underlying the resolution reform index on its website.[3]

With respect to lessons learned from the COVID-19 pandemic, the evaluation updated its analysis to reflect the market dislocations experienced in March 2020 and the period that followed. Details of the analysis are set out later in this note and in more detail in the Addendum to the Technical Appendix.

Feasibility and credibility of resolution

Comments received

Several respondents asserted that the report should recognise more explicitly that political economy issues are central to resolving the TBTF problem. Ultimately, they argued, the decision

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[3] See https://www.fsb.org/wp-content/uploads/P280620-4.xlsx.

to resolve or bail out involves political economy considerations, and the incentives of decision-makers are affected by institutional structures. Respondents also suggested that a distinction should be made between the potential resolution of a single SIB and the resolution of several SIBs at the same time during a crisis. While most respondents agreed that progress has been made in making the resolution of a single failing SIB possible, they were sceptical that multiple SIBs would be allowed to fail at the same time. A minority of respondents also argued that even a SIB that fails idiosyncratically is not likely to be resolved, as each individual bank failure would be a candidate for exemptions from the resolution framework on grounds of national interests, which undermines the credibility of the reforms and ultimately does not prevent moral hazard. They maintain that this issue should have been further articulated in the report according to the differences in speed and intensity of the implementation of TBTF reforms across jurisdictions.

Another respondent argued that further work is needed to assess how a cross-border SIB could be resolved, because such a resolution will be complex and require the cooperation of regulators across many jurisdictions.

Some respondents argued that a credible resolution regime strengthens the resolve of central banks not to lend to insolvent banks, knowing that the economic disruptions associated with failure would be much smaller than in the absence of such a regime.

Several commenters highlighted operational obstacles to resolution, including access to funding and to central counterparties (CCPs) in resolution. One respondent argued that resolution is not credible as long as the problem of ensuring adequate funding in resolution is unresolved. Solving the funding problem is key to preventing decisions from being made too quickly and leading to greater losses. Another respondent asserted that a fiscal backstop is needed to ensure continued funding and that the backstop has been excluded as a matter of principle in some jurisdictions. Several commenters called for more clarity on post-bail-in recapitalisation needs and on authorities' procedures for determining both going- and gone-concern requirements.

Respondents also argued that the lack of information on who holds total loss-absorbing capacity (TLAC) is a significant shortcoming, as it makes it impossible to know which parts of the financial system are exposed to bank failures, and also because it may be politically difficult to impose losses on retail investors.

Several respondents commented on the analysis on internal TLAC and on its alleged fragmentary effects. They argued that the report's conclusions on complexity and fragmentation are insufficiently supported by analysis and that more attention should be paid to this issue. Moreover, they maintained that the report does not sufficiently address the issue of potentially excessive internal TLAC requirements and ex-ante ring-fencing of both capital and liquidity. Several respondents would welcome guidelines which define internal TLAC recapitalisation levels and timelines to help prevent cross-border fragmentation and provide clarity for host jurisdictions. One respondent also argued that external TLAC may propagate instability rather than reduce it, as debt holders are forced to take losses.

Several respondents agreed with the report's conclusion that further work is needed to enhance supervisory coordination, with a focus on cross-border cooperation agreements and memoranda of understanding, including on internal TLAC allocation and procedures for the recapitalisation of subsidiaries after a single-point-of-entry bail-in.

Changes in response to comments

Several respondents suggested actions that although very important are outside the remit of the evaluation. For example, many respondents mentioned issues that go beyond the mandate of this evaluation or that relate to resolution frameworks in specific jurisdictions. Hence no additional work has been conducted in these areas and no changes introduced to the report.

Others suggested actions would require data (e.g. on internal TLAC requirements and issuance) that is not yet available. The report includes new drafting that adds clarity on the relevant information gaps. Despite these gaps, the FSB continues technical work on unallocated internal TLAC. Crisis management groups (CMGs) will use technical guidelines to assist home and host authorities to have a common basis for assessing and understanding firms' unallocated TLAC based on common definitions and calculation formulae. On this basis, the FSB will subsequently review whether further guidance is needed.[4]

The report discusses more prominently the importance of political economy considerations in resolution decisions in Section 3.4.

The analysis on the pricing of TLAC debt contained in Section 2.2 of the Technical Appendix has been updated to include data from the COVID-19 pandemic, and these are now reflected in the report and in the Addendum to the Technical Appendix. The report also includes drafting to explain the nature of the FSB's continuing work on fragmentation, which was described in the FSB's updated report to the G20 published on 14 October 2020.[5]

The final report also contains more discussion of the effects of enhanced supervision of SIBs. Official-sector literature assessing the implementation of supervisory reforms has been summarised as an annex in the final report.

Implicit funding subsidies

Comments received

As mentioned above, stakeholders were split on the extent to which the TBTF problem has been solved, and they interpreted the results on implicit funding subsidies in different ways. On the one hand, some respondents (from the industry) pointed to the fact that, since the 2008 financial crisis, estimated funding cost advantages have been substantially reduced, and argued that the problem has been substantially solved. On the other hand, other respondents (non-governmental organisations and some academics) noted that funding cost advantages are not lower than they were in the period before the 2008 financial crisis, and therefore that not much progress has been made.

Respondents also asked the FSB to clarify the role of macroeconomic conditions in the determination of funding cost advantages, the role of moral hazard and the drivers of implicit

4 See https://www.fsb.org/2020/11/2020-resolution-report-be-prepared/.

5 See https://www.fsb.org/2020/10/fsb-updates-on-work-to-address-market-fragmentation/.

funding subsidies. Respondents also asked for more information on differences in funding cost advantages across regions and jurisdictions.

Changes in response to comments

The report has been revised to clarify the interpretation of the results and the role played by macroeconomic conditions. It also includes new analysis to incorporate the COVID-19 period in the estimates of funding cost advantages.

Banks' responses to the reforms

Comments received

Some respondents argued that causal inference was difficult and that the report relied mainly on correlations rather than causal effects identified statistically.

There were also a few comments on the scoring methodology used to identify G-SIBs. One respondent argued that that the phase-out of LIBOR could temporarily increase G-SIB scores, as it could induce some G-SIBs to temporarily increase their notional derivatives exposure, and suggested that unwarranted increases in capital requirements should be avoided.

The consultation report found that, measured crudely by the number of subsidiaries, G-SIBs are still complex. A number of respondents argued that the number of legal entities was an insufficient measure of organisational complexity, and that the structure of resolution entities and resolution planning should also be taken into account.

There were also some issues raised by individual respondents. One respondent argued that the report did not consider the possibility that SIBs' current loss absorbing capacity could still be insufficient and needed to be strengthened further, and that the use of internal ratings-based models allowed G-SIBs to operate with lower risk weights, which in turn increased their risk-weighted capital ratios compared with other banks. Another argued that higher equity levels could have positive effects on lending in the medium term, as better-capitalised institutions would be better able to absorb shocks while maintaining the provision of lending to the real economy. Another respondent argued that it would be useful to include a section on the challenges of managing financial institutions that have become 'too-big-to-manage' as a result of TBTF reforms, and also encouraged sharing of best practices to address this issue. Many comments also focused on issues outside the remit of the evaluation.

Changes in response to comments

Drafting changes have been introduced throughout the report to respond to these comments.

- **Causal interpretation of the results**: the consultation report noted upfront that identification is challenging, given the many confounding factors. The report already includes relevant confounding factors and acknowledges identification challenges. Additional text to clarify the interpretation of the results has been introduced.

- **G-SIB scoring methodology**: the impact of the phase-out of LIBOR on G-SIB scores is a short-term policy issue related to the G-SIB framework which is clearly important, but is not within the mandate of the evaluation. No changes have therefore been made to the report.

- **Complexity**: the report mentions extensively that other important dimensions could not be analysed with a systematic and consistent approach, owing to the lack of data. Drafting that further clarifies the nature of such data gaps has been added.

- **Beneficial long-run effects**: the report includes references to relevant ex-ante cost-benefit studies that highlight this effect.

- **'Too-big-to-manage'**: The evaluation has seen no evidence to support a claim that financial institutions have become 'too big to manage' because of the TBTF reforms; such reforms might, in fact, help to mitigate any such problem. The report already discusses challenges relating to size and complexity.

Broader effects of the reforms

Comments received

Comments on the broader effects of the reforms focused on three areas.

The first is the analysis of the social costs and benefits of the reforms. Respondents argued that while the analysis focuses explicitly on credit provision, banks provide several other services such as capital formation and market making, which are not taken into consideration. In addition, benefits from increases on capital requirements are non-linear, so they depend on the starting point. In addition, some respondents noted that the analysis fails to incorporate changes in financial structure (e.g. increased participation of non-banks), fragmentation costs, effects on wealth inequality and changes in the computation of risk-weighted assets.

The second area is the role of non-bank financial institutions (NBFIs). Respondents would welcome further research to assess the financial stability and welfare implications of the increasing involvement of NBFIs in banking-related activities.

The third area is measures of systemic risk. Respondents questioned the usefulness of systemic risk measures that are based on market data (such as SRISK) as they are likely to be procyclical. In addition, these measures focus on equity and ignore the availability of resources such as TLAC to absorb losses in resolution.

Changes in response to comments

The FSB updated the analysis on the measures of systemic risk to incorporate the COVID-19 period. Drafting changes have also been introduced to address other comments received on cost-benefit analysis. However, the BCBS macroeconomic assessment framework, while simple, is well-established in the literature and it was not clear how respondents' requests for more complex modelling could be met by the evaluation itself. The drafting added information about the advantages and limitations of using the framework for assessing costs and benefits.

The FSB has also published a spreadsheet[6] on its FSB website that allows users to investigate results under different assumptions.

The FSB published a holistic review of the March 2020 market turmoil and is carrying out a comprehensive work programme to enhance the resilience of non-bank financial intermediation.[7] The final report refers to that work which represent a substantial part of the FSB's work programme but no additional analysis has been carried out as part of the evaluation.

The report also includes a brief analysis of the effects of taking into account LAC resources when measuring systemic risk.

3. Analytical updates to take into account COVID-19

The FSB also carried out updates to its analyses based on market prices. The choice of analytical updates was guided by the expected insights they could produce, feedback received from stakeholders and the feasibility of the updates themselves.

In particular, the FSB carried out updates in the following areas:

- First, an update of the various studies on SIBs' funding cost advantages based on secondary market data. Chapter 4 of the consultative report and Chapter 3 of the Technical Appendix present the results of various studies that estimate the funding cost advantages of SIBs. The studies use diverse datasets and approaches to estimate funding cost advantages. The FSB updated all the studies that rely on secondary market data. The high frequency at which the data are available makes it possible to assess what happened to the estimates during the acute phase of the COVID-19 pandemic in of the first and second quarters of 2020.

- Second, an update of the analysis of measures of systemic risk**.** Chapter 5 of the consultation report includes an analysis of market-based measures of systemic risk (SRISK and ΔCoVAR) up to the end of 2019. These measures have changed considerably during the pandemic and updated figures are now in the final report.

- Third, an update on the work on TLAC debt pricing. Given the large number of comments received that suggest that the behaviour of TLAC debt is crucial for the credibility of the reforms, the FSB extended the sample to cover the stress period associated with the pandemic.

The choices acknowledge the fact that policy responses to the pandemic will affect any conclusions about structural changes that may have been triggered by the pandemic.

6 See https://www.fsb.org/wp-content/uploads/P280620-3.xlsx.

7 See https://www.fsb.org/2020/11/holistic-review-of-the-march-market-turmoil/.