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Response to FSB public consultation
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Dear Sirs,

The Financial Stability Board has invited feedback from interested parties on its Consultation Document entitled "Effective Resolution of Systemically Important Financial Institutions". Certain questions relating to Annex 2 "Bail-in within Resolution" and Annex 7 "Discussion note on creditor hierarchy, depositor preference and depositor protection in resolution" are of interest to fixed income investors in bank paper, and it is on these questions that we have focused our responses. Schroders Investment Management is a global asset manager with £201bn of assets under management. This includes fixed income AUM of £35bn.

**3. Are the elements defined in Annex 2 sufficiently specific to ensure that a bail-in regime is comprehensive, transparent and effective?**

As investors, we agree with the FSB's view that a statutory bail-in approach is more effective and transparent than a purely contractual one, and will provide investors with greater certainty about the operation of bail-in resolution tools. The key elements of a bail-in regime for us as investors are: trigger clarity; and maintenance of capital structure hierarchy.

In Annex 1 of the Consultation document, the trigger for resolution is defined as "when a firm is no longer viable or likely to be no longer viable and other measures have proved insufficient to prevent failure". It is also stated that "the resolution regime should provide for timely and early entry into resolution". While we appreciate that the Annex is outlining required features rather than specifying the precise trigger language, we would underline that we believe resolution should be designed as an alternative course to formal bankruptcy, in other words that there should be a single "gone concern" trigger. We would therefore question the apparent regulatory discretion allowed by the phrasing "or likely to be no longer viable", and while we agree resolution should be "timely", we question "early". In order to maximise investor ability to invest in bail-inable instruments, it is critical that the trigger for resolution be identical to that for bankruptcy.

**4. Is it desirable that the scope of liabilities covered by statutory bail-in powers is as broad as possible?**

We believe that in principle all unsecured and uninsured liabilities should be within scope of statutory bail-in powers. However, we fully accept that there is a case for excluding transactional counterparty exposures, and that there may be prudential reasons for excluding some uninsured depositors. Our main concern is that as the application of bail-in regimes alters the statutory priority of instruments currently pari passu with senior unsecured debt, it should be made clear and unambiguous where different instruments in which we may invest rank. We also consider it desirable that to the extent possible there is consistency across jurisdictions, but from our point of view this is not necessary so long as within each jurisdiction there is appropriate clarity.

**7. If authorities require a minimum level of bail-in debt, how should the minimum amount be calibrated and what form should such a requirement take eg:**

**a. A certain percentage of risk weighted assets in bail-inable liabilities, or**

**b. A limit on the degree of asset encumbrance?**

We consider bail-in debt to be a type of gone-concern or Tier 2 capital, and we would therefore see it as natural that a minimum level of bail-in debt should be set within the overall capital requirements framework. We believe that the Swiss requirement for banks to hold "low-strike cocos" for 6% of RWAs achieves an economically equivalent effect. Were such a requirement to be set, we believe it would be important for clear definition of the types of instrument that would be eligible to meet the requirement, though we do not believe it necessary to follow the Swiss approach in establishing a new type of instrument to meet the criteria. Existing senior unsecured debt, for example, should be adequate to meet the minimum requirement under a statutory bail-in regime.

We do not believe a limit on the degree of asset encumbrance is a sufficiently clear and transparent way of calibrating a minimum bail-inable amount. However, we believe that it is important that the issue of asset encumbrance be addressed, specifically on account of the increased issuance of covered bonds by deposit taking institutions. It is clear to us that the proposal to bail-in senior unsecured debt creates an incentive for banks to increase their use of secured funding formats. However, covered bonds, as instruments backed by dynamic pools of assets, have a feature whereby if the quality of the underlying collateral deteriorates, the pool is able to lay claim to additional collateral, or exchange lower quality collateral with higher quality collateral provided by the sponsor bank. The effect of this is that unsecured investors are increasingly subordinated to covered bondholder interests as collateral quality deteriorates. Furthermore, if deposits are granted preferred creditor status, it is unclear how their interests are reconciled with those of the covered bondholders, though it is clear that the subordination of unsecured creditors is amplified in periods of distress.

We believe that clear and transparent macro-prudential rules regarding asset encumbrance, specifically referencing the class of assets used in cover pools rather than the total assets of a bank, are essential where deposit taking institutions are issuing covered bonds.

**8. What consequences for banks' funding would you expect from the introduction of any such required minimum amount of bail-inable liabilities?**

We expect a limited impact on the cost of funding as a result of the introduction of a minimum level of bail-inable securities. Clearly banks that do not currently have much senior unsecured funding will be disproportionately impacted. As a general comment, in the case of European banks, we believe that the market has already discounted the introduction of bank resolution tools and bail-ins on outstanding Lower Tier II debt, and for a number of issuers, but by no means all, on senior unsecured. The process is clearly most advanced in jurisdictions with some form of Special Resolution Regime already in place, and in our view is a function of the fact that resolution powers themselves subordinate senior unsecured bondholders. We believe statutory bail-in rules would have little or no additional impact on spreads in these cases.

We also note that the introduction of statutory bail-in has an impact on the credit ratings of bank senior and Lower Tier 2 debt which may result in a reduced appetite for this paper from ratings constrained investors. While this does not impact us directly, we do need to consider the impact this may have on secondary market liquidity, particularly given that banks have already largely exited these markets. We would expect the potential for reduced liquidity to have an impact on market access for middle tier banks.

**22. Is a greater convergence of the statutory ranking of creditors across jurisdictions desirable? Should it be in the direction of depositor preference or should it be in the direction of an elimination of preferences?**

We agree that as a practical matter, explicit depositor preference is important if resolution tools are to operate effectively, or at least without being open to legal challenge. In addition, from the point of view of an unsecured investor, the existence of the resolution powers themselves creates a de facto depositor preference, so we would expect the market to price and act as if depositor preference were in place. Given this situation, explicit depositor preference, and clarity on exactly which deposits are to benefit from it, would be desirable.

**23. Is there a risk or arbitrage in giving a preference to all depositors, or should a possible preference be restricted to certain categories of depositors, e.g. retail deposits?**

In defining the respective priorities of senior obligations, where no formal definition has applied before, it is inevitable that new incentives and disincentives for specific types of obligation will be created. We have no strong opinion on whether retail deposits should be distinguished from commercial deposits for the purposes of depositor preference, but if commercial deposits are excluded, we would ask that it be made clear whether they are therefore pari passu with senior unsecured debt for the purposes of bail-in, or whether they are to occupy another position within the creditor hierarchy.

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Schroder Investment Management Ltd
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