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Resolution Plans For Global Banks May Eliminate Government Support For Some, But Progress Is Varied

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Resolution Plans For Global Banks May Eliminate Government Support For Some, But Progress Is Varied

Facing a global financial crisis that demanded "urgent and exceptional action," on Oct. 10, 2008, the finance ministers and central bank governors of the Group of Seven (G-7) countries agreed in Washington, D.C., to "take decisive action and use all available tools to support systemically important financial institutions and prevent their failure." This tough and decisive multigovernment response underscored what was considered to be a relative lack of regulatory preparedness to the crisis that was unfolding and the absence of a coherent framework to resolve globally systemically important banks (G-SIBs) in an orderly manner. And so began what has become policymakers' most significant action on restoring financial stability during the worst global financial crisis since the 1930s.

More than five years after those emergency responses to the crisis' threat to the global economy, eliminating government support for G-SIBs and ensuring that no banks remain "too big to fail" have emerged as perhaps the most important lessons learned from the 2008-2009 financial meltdown. These issues remain not fully resolved, however, and still rank high in the global regulatory reform agenda. This is why regulators, particularly in Western Europe and the U.S., continue to focus on making sure government bailouts don't happen again--and that both shareholders and unsecured creditors share the cost of a failure.

As part of their postcrisis reform, regulators have enhanced their own monitoring and supervision methodologies, revamped on-site examination processes, and, in many countries, expanded their tool kit to affect orderly resolutions of G-SIBs. The Financial Stability Board (FSB), an international body that monitors the global financial system, has recently updated the list of G-SIBs to 29 from 28. However, market participants continue to debate whether extraordinary government support has really been legislated or regulated away and will no longer be provided.

Overview

- Eliminating government support and ending "too big to fail" have become a top priority in the global regulatory reform agenda, but progress is uneven.
- In our view, the orderly resolution of a G-SIB would be technically very difficult, and we are not certain it would preserve systemic stability today. Therefore, we continue to include government support uplift in the ratings of many banks--the majority of which benefit from one to two notches of support.
- We may begin to reduce or remove such uplift if we believe a resolution regime in any one jurisdiction is credible and predictable enough to prevent contagion risk and avoid significant negative unintended consequences related to the disruption of essential banking services.

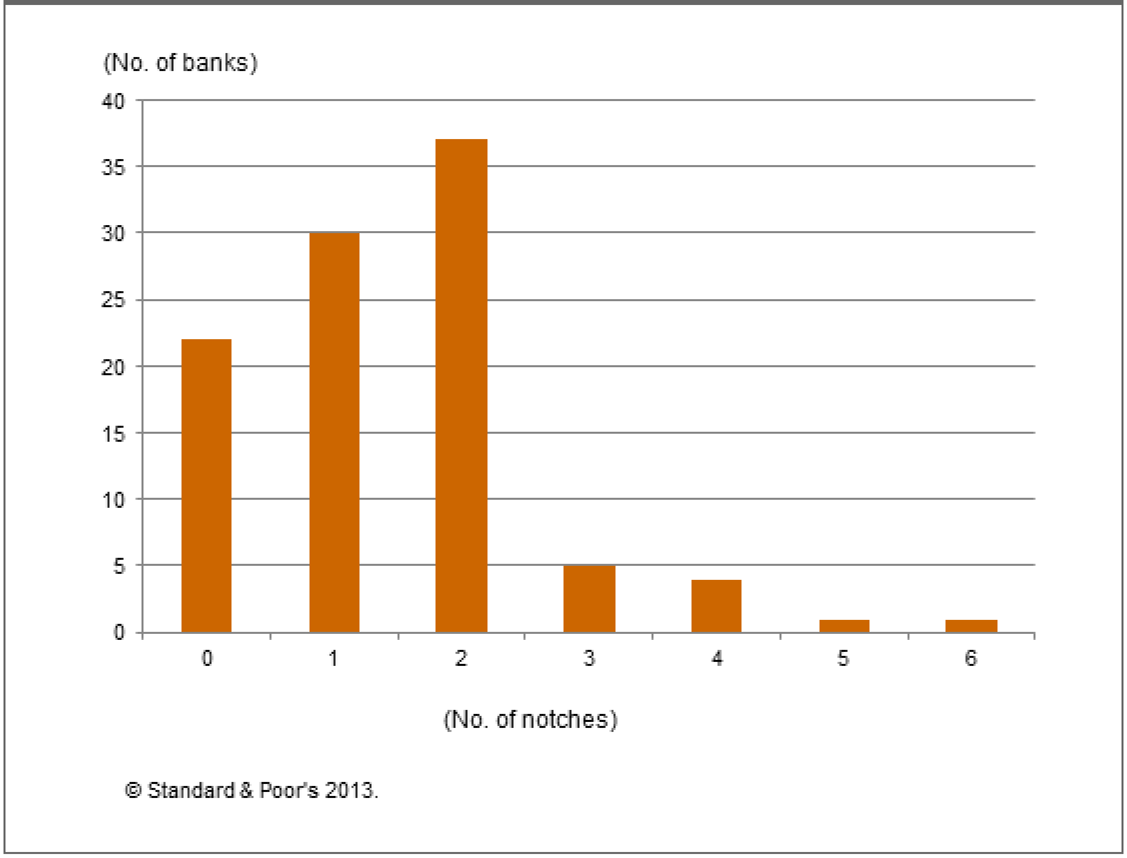
This removal of government support to banks of high or moderate systemic importance is likely to be gradual and partial (rather than immediate and in total) and selective (some countries before others) because authorities and regulators are moving at different speeds and the political attitude on the need and urgency for removing implicit taxpayer support differs across countries.

Despite the progress made to date in building effective resolution regimes, Standard & Poor's Ratings Services continues to include uplift in our ratings for government support to many systemically important banks worldwide. For about 75% of the top 100 banks we rate, we include at least one or two notches of uplift in the rating from the bank's stand-alone credit profile due to government support (see chart). We believe that apart from considerations regarding the impact on financial stability and contagion risk, many obstacles, including several technical ones, remain for an effective resolution regime and the bail-in, or transferring the financial burden of a bank rescue, of senior unsecured creditors. These include cross-default provisions (which place the borrower in default if it defaults on another obligation) in many securities and derivative contracts, cross guarantees that often exist within a financial group, the lack of harmonized resolution agreements among different countries, and the uneven pace in the international recognition of bail-in mechanisms. This would be true for either single point of entry (SPE) or multiple point of entry (MPE) resolution frameworks. The SPE approach typically would apply the steps of resolution at the parent-company level. The MPE approach would apply resolution to multiple parts of the banking group, and we view this as likely more complicated. In this regard, we continue to believe that the orderly resolution of a G-SIB, particularly an internationally active one, would be technically very difficult, and we are uncertain about its success.

Banks have made progress in strengthening their balance sheets and removing many of the obstacles that exist for resolving G-SIBs in a timely and orderly basis. A resolution plan sets up how a bank will go through orderly liquidation if it becomes insolvent. Among other initiatives, regulators have strengthened the legal powers of banking authorities, set higher minimum capital standards, mandated capital stress testing, recommended new minimum liquidity requirements, created new bail-in mechanisms for senior and junior debt, introduced resolution planning for large interconnected financial institutions, and, finally, tried to bring shadow banking activities--financial services that are outside the traditional banking system--under the formal regulatory umbrella. Regulatory coordination for central clearing of over-the-counter (OTC) derivatives and reformulating the role of central counterparties have also been significant efforts.

However, many of these initiatives are still very much a work in progress and others have longer timelines for transition and implementation that last until the end of the decade. In addition, progress across countries has been uneven, and some have moved much further than others. Nonetheless, it is clear that in an increasing number of countries' junior creditors, including holders of nondeferrable Tier 2 instruments, now stand at higher risk than before the crisis, and there are significant inroads being made for the bail-in of senior unsecured creditors as well. However, the bail-in would not be necessary if a bank has enough common equity and junior debt to fund the necessary recapitalization.

Top 100 Banks Distribution Of Government Support Notches



We believe many of the obstacles to orderly resolution will eventually be removed, though the international coordination of regulators during a financial crisis and contagion risk will likely remain difficult hurdles. For example, we anticipate material changes to many banks' legal structures, funding approaches, and operating models as they take steps to increase their resolvability. In practical terms, we may remove government support partially or totally from ratings depending on the particular circumstances in a country or of a bank, and this removal may not be simultaneous across countries. However, the build-up of effective capital buffers that may be large enough to effectively protect senior unsecured creditors against a very severe stress scenario could offset the ultimate rating impact of removing uplift for operating companies. We might also decide that our consideration of government support in our rating should be reduced gradually and in some countries before others.

Banks May Need Extraordinary Government Support After All

Bank regulators worldwide are working toward meeting the FSB's key attributes for resolution planning deadlines, and some countries like the U.K., the U.S., and Switzerland are ahead of others. But being ahead does not necessarily mean being ready, in our view. We see several reasons regulators will likely face obstacles for some time in executing an orderly resolution of failing banks and ensuring that confidence in financial markets does not erode during periods of stress.

Franchise stability and market confidence are critical

For resolution to be effective, it has to be quick, clear, and confidence-building. In our view, even if well executed with effective resolution powers, a G-SIB resolution could increase uncertainty for senior creditors of other banks (counterparties of the bank facing stress) and trigger contagion risk in the market at a time when confidence needs boosting. We believe regulators can indeed create prudential standards and market structures to encourage market stability. But it is difficult to create a resolution framework (i.e., legal powers, macro- and micro-prudential standards, market structures, and resolution strategies) that ensures market confidence at all times without a regulator to promote it.

Large financial firms are structurally complex

The structural complexity of financial institutions can make resolution planning and execution more difficult. Many large institutions are functionally organized around lines of business to improve efficiency, manage risk effectively, support product capabilities, provide access for customers, and minimize tax liabilities, among other reasons. The functional structure, however, will not necessarily match the legal structure. As a result, a given function or business may operate in many separately incorporated lines of business in a multitude of jurisdictions but be completely intertwined operationally and financially. G-SIBs, with the agreement of regulators, would have to identify critical functions within their subsidiaries in advance of a resolution and would need to adapt their legal structure to minimize the unintended consequences that would result from failure.

Cross-border operations will be subject to different jurisdictional regimes and timelines

National authorities have a strong tendency to focus solely on the optimal solution for creditors of entities in their jurisdictions when a cross-border insolvency occurs, but an effective resolution framework will require national authorities to work collaboratively in their mutual best interests. The Federal Reserve Board (Fed), for example, has found that U.S.-based bank holding companies with $50 billion or more in consolidated assets own, in aggregate, more than 6,000 foreign entities. These U.S.-operated foreign entities include more than 550 foreign branches and engage in a variety of activities, including investment advice and investment banking and securities dealing, commercial banking, insurance, trust, fiduciary, and custody activities, and acting as financial vehicles. Particularly under an SPE approach, some national authorities would need to stand back and allow the home country regulator to manage the groupwide recapitalization process. This would require immense levels of trust and cooperation during stressful times.

The failure of Lehman Brothers, which filed for bankruptcy in September 2008, illustrates the difficulties for an effective international resolution. The firm had 2,985 entities operating in about 50 countries. The Fed provided liquidity to its U.S. broker-dealer to wind it down, and Barclays ultimately acquired some Lehman assets and liabilities. Some entities were not acquired, so insolvency officials in several jurisdictions are still winding them down, illustrating the challenges of proceedings with different policies and priorities. Perhaps the most effective resolution plans (and living wills) will be those that assume and plan for minimal coordination across jurisdictions.

For example, an attraction of the SPE approach, which banks would likely use if they operate as an integrated group, is that, in principle, operating entities can continue to operate while holding company creditors are bailed-in as necessary. But even if a holding company structure does not exist, SPE implies that an appointed trustee would work toward restructuring the firm and transferring equity and perhaps debt to the original creditors of the bank. In any case, resolution authorities would rule on what approach to resolution, SPE or MPE, would make the most sense in view of the firm's specific operating model. Banks would use the MPE method if they operate as a network of locally capitalized and locally funded subsidiaries. Under both methods, there needs to be enough capital to support ongoing operations and enough debt for bail-in mechanisms to be effective. Moreover, these capital and debt resources must be held in the appropriate legal entities to support the SPE or MPE strategies. However, the MPE method would be more problematic, in our view, because of the multiple jurisdictions that would require even greater coordination to prevent loss-sharing issues.

We believe the most difficult challenge in global resolution planning is effective cross-border resolution arrangements, which are subject to different jurisdictional regimes, legal frameworks, time zones, timelines, and political imperatives. As institutions identify gaps and impediments, some remediation efforts may take longer to plan and implement, and international regulators may not act in coordination with the host country. Regulators from home and host countries need to cooperate and trust each other to have a global resolution plan that can be delivered effectively on a timely basis.

One good example of such cooperation is the joint statement of the U.S. Federal Deposit Insurance Corp. (FDIC) and the U.K. Financial Services Authority (the predecessor of the Prudential Regulation Authority). The FDIC is looking to expand its agreements with Switzerland, the EU, and Japan. The next stage--which will likely be more controversial and time-consuming--would be reciprocal agreements between countries in which host regulators commit not to intervene in resolutions managed by the home regulator under pre-set plans. Cross-border crisis management groups (CMGs) have been established under the FSB to bring together the main regulators of the G-SIBs, but their focus to date has been more on information sharing rather than effective resolution.

Other potential conflicts or disparities among national laws that have yet to be resolved relate to the following:

- Priority of creditor claims in liquidation for bail-in may not be the same across jurisdictions (for example, deposits and senior unsecured debt). The issue of fair outcomes across the various classes of creditors may become a key issue or may have to be accepted across jurisdictions.
- It may be difficult to apply a stay or suspension of actions against the debtor or its assets across borders, particularly on swaps and derivative financial products, repurchase agreements, or other types of collateralized financial instruments.
- Debt covenants may trigger early repayment or cross-default provisions, as well as cross guarantees within financial groups, especially when there is a holding company-operating subsidiary structure.

Progress to date on international coordination is varied, in our opinion. For example, implementation of new rules on OTC derivatives markets is moving forward in the U.S., Japan, and the EU. Also, in France, new resolution legislation adopted in 2013 says a debt restructuring that regulators mandate can't be considered an event of default in a derivatives contract. Similarly, the FSB is pushing the International Swaps and Derivatives Association (ISDA) to change standard contracts globally to make the entry into resolution not an event of default. Recently, the FDIC, the Bank of England, the German Federal Financial Supervisory Authority (BaFin), and the Swiss Financial Market Supervisory Authority (FINMA) together authored a joint letter to encourage the ISDA to adopt language in derivatives contracts to delay the early termination of those instruments in the event of the resolution of a G-SIB. The resolution authorities expressed support for the adoption of changes to ISDA's standard documentation to provide for short-term suspension of early termination rights and other remedies in the event of a G-SIB resolution. The adoption of such changes would allow derivatives contracts to remain in effect throughout the resolution process following the implementation of a number of potential resolution strategies. By minimizing the disorderly unwinding of such contracts, these changes would place resolution authorities in a better position to resolve G-SIBs in a manner that promotes financial stability while providing market certainty and transparency. The ISDA, in turn, responded that it would work with supervisors and regulators globally and may include an amendment to ISDA derivatives documentation to include a standard provision in which counterparties agree to a short-term suspension.

These rule changes, when adopted, will help to eliminate technical obstacles to resolution, although it is unclear whether they would lead to additional changes for debt instruments. Other rules, however, are moving more slowly, and some countries are even acting unilaterally. The Volcker Rule, a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) that prohibits proprietary trading, is an example of unilateral action in the U.S. Likewise, the U.K. government, working closely with the Bank of England, has announced it will not wait for statutory bail-in powers to come from the EU's Bank Recovery and Resolution Directive (BRRD). Instead it will legislate nationally sooner.

Effective execution of living wills and long-term resolution planning

Regulators are requiring G-SIBs to submit a resolution plan for their orderly liquidation if they become insolvent (a "living will"). However, these plans need to be integrated with long-term strategic planning of the larger risk framework of the organization because the information requirements during a time of stress are different from those needed on a day-to-day basis. Moreover, plans need to be flexible because the actual insolvency situation may be very different from the planned-for scenario. Creating a living will that will be useful in an unforeseeable crisis we believe is inherently difficult, and putting workable living wills in place may take years. Inevitably, some aspects will remain unknown and untested, making the initiation of large international bank resolutions a bold move. Although international colleges of regulators have mandates to review resolution plans of G-SIBs, the challenge associated with their presence in multiple countries and multiple jurisdictions will remain significant.

To address these issues, we anticipate material changes to many banks' legal structures, funding approaches, and operating structures in the coming years to support the chosen resolution strategy for each institution (MPE or SPE). An SPE strategy, for example, envisages that losses are transferred from operating subsidiaries to the top company in each group's legal hierarchy, whose debt can be bailed-in to recapitalize the group. This process is more straightforward if the top company is a completely nonoperational holding company because this reduces the risk of complication from cross-default clauses, cross-guarantees, and the like. Holding companies are not common in most countries outside the U.S., and effective resolution planning may require some banks to create them and to concentrate their funding activities in those entities. Equally, banks may need to transfer information technology and other shared services into separate legal entities that could survive the resolution of the group.

The Removal Of Government Support In Our Ratings Is Likely To Be Gradual And Selective

Depending on the final regulatory plans for how to resolve a too-big-to-fail bank in different nations, we could change our thinking about sovereign support in times of financial stress. To do so in the context of our criteria, we could reclassify the country by its propensity to provide support, reclassify the specific bank's systemic importance, or widen the rating notching between the operating bank subsidiary and its holding company. In light of progress on implementing G-20 resolution key attributes, we have already removed systemic support from the ratings of many junior instruments, including nondeferrable junior debt in many countries such as some in Western Europe. As highlighted in recent failures and confirmed in European Commission State Aid rules issued in August 2013, the bail-in of equity and junior creditors is becoming a common practice in case of bank failure. We may begin to remove uplift in our ratings that reflects the potential of extraordinary government support for senior creditors if we believe a resolution regime in any one jurisdiction is credible and predictable enough to substantially eliminate concern about contagion. Furthermore, the removal of support from our ratings would likely be gradual rather than immediate, and it may vary across countries, depending on their resolution regimes.

In addition, we could lower our ratings on certain senior unsecured bank bonds depending on the scope of the proposed resolution regime (i.e., bail-in-able debt), the degree of policy flexibility that the government retains, and the level of sovereign support that we may already include in the ratings on such instruments. We might also change our views on the systemic classification of the financial institution under our criteria.

For instance, while we assess U.S. regulators' progress concerning the orderly resolution of G-SIBs, our outlooks on the nonoperating holding companies of the eight banks that we deem as having high systemic importance (Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo) already reflect the possibility that we may not continue to factor government support into the ratings (see "Various Outlook Actions Taken On Highly Systemically Important U.S. Banks; Ratings Affirmed," published June 11, 2013, on RatingsDirect). Our negative outlooks reflect the current progress and the political willingness to achieve effective resolution regimes for large complex groups. Although the U.S. is one of the countries most advanced in resolution, work remains to be done.

In the U.S., we believe clarity in rulemaking related to minimum levels of holding company debt, bail-ins, and globally consistent resolution mechanisms would be important milestones in building a credible resolution regime. Should we see progress toward some or all of these factors, we believe it would make an effective resolution under DFA's Title II more likely. Therefore, we could reduce or remove the extraordinary government support that we include in the ratings, which would lead us to lower the ratings on the eight U.S. bank holding companies, assuming no improvement in their stand-alone credit profiles. We continue to believe government support is likely to remain for the operating bank subsidiary.

While many governments are restricting their ability to bail out banks in the future and thereby attempting to reduce moral hazard, we are not convinced that they will always act differently if financial stability is again at risk and contagion risks start materializing. Effective resolution frameworks and multiple other regulatory initiatives aimed at reducing interconnectedness will eventually make bail-in and effective resolution more likely, but we believe a government bailout is unlikely to disappear completely in a number of jurisdictions. What form future extraordinary government support may take is anyone's guess. Despite what has been written in legislation, we believe when the time comes, decisions again may be made moment by moment--like they were during 2008-2009. Regulators and policymakers likely will adapt their response to the circumstances, not the other way around. Granted, government support is generally becoming less predictable.

Although U.S. and European regulators are working toward sharing the cost of bank failure among creditors, in Asia-Pacific, government officials will not necessarily change their stance toward senior unsecured creditors. This is likely because the large banks in those countries did not fail during the global financial crisis and the government owns some major banks. In Japan, for instance, the government has a tendency to avoid disruptions to the financial system and policymakers consider that in most instances a bailout will be less costly for taxpayers than a bail-in. Therefore, Standard & Poor's believes that when bailing out major financial institutions, the Japanese government remains more likely to opt to inject funds at an early stage before a failure than to provide financial aid after a failure (see "Japan Amends Deposit Insurance Law To Provide Support For Brokerages; Ratings On Nomura And Daiwa Incorporate Possible Government Support," published on June 21, 2013).

Last year, the Australian government released a consultation paper titled "Strengthening APRA's Crisis Management Powers," seeking market comment on a range of options to enhance Australia's financial sector, particularly around prudential regulation. The consultation paper highlights that options it canvassed include bringing Australia's regulatory framework in line with the FSB's paper "Key Attributes of Effective Resolution Regimes for Financial Institutions" (released in October 2011). Standard & Poor's assesses the Australian federal government as "highly supportive" to private-sector banks deemed to be systemically important under our bank rating methodology, and we don't believe the current developments around potentially greater resolution powers for the Australian Prudential Regulation Authority (APRA) have sufficiently weakened that assessment. That said, if Standard & Poor's believed the Australian government or APRA were likely to establish powers within a resolution process that could delay the repayment of creditor principal or interest, or if creditors were likely to take a financial loss as part of the execution of bail-in resolution powers, we could lessen the amount of uplift we factor into our bank ratings for government support in Australia. In that instance, we would potentially lower the issuer credit ratings of five of Australia's banks that we believe are systemically important by one notch. Ratings remain unchanged currently, however, until there is greater clarity concerning the appetite of the government and regulators toward embracing an alternate crisis management framework.

In Latin America, some countries already have resolution regimes in place, which may include government intervention. Furthermore, given that a foreign parent may own many of the domestic systemically important institutions, domestic ring fencing may in some instances protect domestic senior creditors from bail-in risk. This is the case in many Latin American countries where we expect the host country to isolate the domestic systematically important subsidiary in case of resolution of their foreign parent.

Appendix: Building Effective Resolution Regimes Remains A Work In Progress

Simply put, the main thrust in the global regulatory effort underway is to simplify individual bank structures and establish new mechanisms to resolve them. The aim of such actions is to ensure that resolutions are quick and predictable to prevent the sudden loss of confidence in the entire system. In 2011, the G-20's FSB adopted its Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) as a new international standard, and its leaders agreed to incorporate them into their domestic legislation. The FSB further established criteria for each KA to ensure the effective and orderly resolution of a systemically important bank, whether domestic or global. The FSB has issued guidance stating that resolution regimes should follow an SPE method for banks that operate as an integrated group, or an MPE method for banks that operate as a network of locally capitalized and locally funded subsidiaries.

We include some examples of banks' progress on resolution plans in different countries:

Table 1

Australia	
Relevant regulator/authority	The Australian Prudential Regulation Authority (APRA), in collaboration with other government and regulatory bodies, including The Reserve Bank of Australia and The Treasury of The Commonwealth of Australia.
Scope of application	Authorized deposit-taking institutions (ADIs), including licensed banks, currently numbering in excess of 160 financial institutions.
Relevant legislation	The Banking Act 1959 and as amended.
Capital standards	APRA's adaptation of Basel III capital standards became fully implemented and operational in Australia as of Jan. 1, 2013.
G-SIB capital surcharge	None proposed.
View on debtholder loss sharing	The current framework allows creditors to take losses through entity insolvency subject to the terms of the Banking Act, including those terms concerning protection of depositors in preference to other liabilities of issuing banks. Concerning senior creditors, Australian authorities currently have no statutory bail-in powers; these are only likely to come about from potential financial services sector reforms, which have not progressed beyond the market consultation phase at this stage. Consequently, our opinion currently remains that the Australian government is highly supportive of private-sector banks in the country. When there is further progress leading to a greater clarity from regulators and other government authorities concerning their appetite for bail-in powers, we would review whether systemically important institutions could be subject to downgrades.
Resolution strategy/tools	In the unlikely event that an Australian bank is unable to meet its obligations, according to the Banking Act, its assets must be available to meet specified liabilities (including most deposit liabilities) in preference to all other liabilities of the issuing bank. The current framework is largely untested, however, in the sense that there is a long-standing track record of depositors and other obligors of Australian banks having been paid in full, on time--i.e. there is no history in Australia of bank defaults. The potential transition to a new crisis management framework in Australia is only at the consultation phase, and there is uncertainty as to if and how it may progress. The Australian government, like many other governments, is contemplating further regulatory changes with a view to strengthening its financial system, including its ability to manage a financial crisis that may emerge in the future. Last year the Australian government released a consultation paper titled "Strengthening APRA's Crisis Management Powers," seeking market comment on a range of options to enhance Australia's financial sector, particularly around prudential regulation. The consultation paper highlights that options it canvassed include bringing Australia's regulatory framework in line with the FSB's paper "Key Attributes of Effective Resolution Regimes for Financial Institutions" (released in October 2011). There have been no material or concrete steps or developments toward a potential change in the government's current resolution powers, in our view, at this stage, beyond an interest by the government in proactively consulting with the industry on potential alternate options.
Trigger	Triggers for affirmative steps concerning liability holders are as defined in the Banking Act for institutions that are insolvent or at risk of insolvency. The regulator's role under the Banking Act is to exercise its powers and functions for the protection of the depositors and for the promotion of financial system stability. For hybrid capital instruments issued by Australian banks since Australia implemented Basel III, conversion to common equity is triggered if the regulator deems an issuer to be nonviable, and additionally in some cases if a hard ratio is triggered (for example, if the common equity Tier 1 ratio decreases to below 5.125%).
Living wills (resolution plans)	Starting with a pilot program in 2011, APRA has made progress developing contingency plans for some financial institutions. Six of Australia's largest ADIs had their recovery plans approved by APRA in mid-2012, and the program has been extended to establishing recovery plans for midsize ADIs and large insurers. The recovery plans consider a range of stress conditions and recovery actions that can be used in both idiosyncratic and market risk stress situations. APRA expects ADIs in a stressed event to recover to prudential minimums within six months. While this sets the minimum expectation, target recovery levels and timeframes are expected to change as the framework continues to evolve. While contingency recovery plans have the potential to support financial system stability in Australia, the initiative does not support the argument for factoring government support into bank ratings as the plans exclude any scenarios that require the provision of public financial support. We believe that the establishment of credible recovery plans for banks may help moderate the financial losses that might emerge at a bank experiencing financial stress but might not eliminate the prospect that government support could be required for averting repayment delay or loss for some creditors.
Debt conversion to equity	Under the current regulatory regime, instruments with specific clauses requiring conversion to common equity, such as Basel III hybrid capital instruments with nonviability contingent capital features, would convert to common equity in a stress scenario under their contractual terms. It's noteworthy that the bail-in of hybrid capital will not cause a cross-default on other debt obligations.

Table 1

Australia (cont.)	
Special feature	Australian regulators are currently working on a number of other key initiatives--including conglomerates policy, domestic systemically important banks, and the transition to the Basel III liquidity framework--which we believe have the potential to influence their ultimate appetite for implementing alternate arrangements for crisis management.
Extraordinary government support	Our current view is that the Australian government is one of 12 governments globally of the 86 banking systems where we assign bank ratings that is "highly supportive" to its domestic banking sector. The potential move by the Australian government toward an alternate resolution regime that embraces a concept of senior creditor bail-in could sit uncomfortably with our "highly supportive" designation. This could result in changing our views concerning government support, which, in turn, would likely be accompanied by downgrades of Australian banks that we currently view as "systemically important." Absent greater clarity concerning the government's appetite for a change in crisis management, we note the government's strong track record of support to the banking sector in both ordinary and extraordinary times, including via the current depositor-protection scheme (the Financial Claims Scheme, or FCS) and via the repo-eligibility of Australian mortgages and other collateral. With four large Australian retail commercial banks controlling about 80% of banking assets--and the remaining 20% of system assets shared between more than 160 other prudentially supervised institutions--and with the Australian banking sector reliant upon bond and other senior unsecured domestic and offshore funding sources, we believe that the Australian government is likely to have significant incentives to continue to support domestic systemically important banks and would likely carefully consider any change in crisis management given the structural underpinnings of the economy and banking sector.

Table 2

Japan	
Relevant regulator/authority	Financial Service Agency (FSA).
Scope of application	Systemically important holding companies, deposit-taking institutions (banks, trust banks, cooperative banks), securities firms, and insurance companies.
Relevant legislation	Revised Deposit Insurance Corp. Law (2013).
Capital standards	Basel III implementation in March 2013.
G-SIB capital surcharge	Mitsubishi UFJ FG (1.5%); Mizuho FG and Sumitomo Mitsui FG (1%).
View on debtholder loss sharing	No statements about senior debt taking losses.
Resolution strategy/tools	(1) Capital injection for banks with weak but positive capital; (2) financial assistance for banks with negative net worth; and (3) taking full control of a troubled bank. This involves (1) taking the full control of the management and designation of the new managers; (2) exercising bail-in/write-down powers based on the contracts; (3) transferring assets to a bridge bank without approval of shareholders and debtholders; (4) cancelling loan collection; (5) cancelling/modifying contracts; and (6) the resolution authority should have the power to stop the early redemption of derivative contracts to ensure orderly resolution.
Trigger	The Financial Crisis Management Board, chaired by the prime minister, would decide upon the need of a bank resolution if a bank is not viable or has little prospect to recover. Banks are subject to Prompt Corrective Action (PCA) if they cannot meet the minimum capital ratio with some buffer. Regulators require management to take steps to increase capital ratios.
Living wills (resolution plans)	FSA requested all major banks (MUFG, Mizuho, SMFG, Sumitomo Mitsui Trust, Resona, Shinsei, and Aozora) to prepare and submit Recovery and Resolution Plans (RRPs). It is included in the bank inspection guideline in 2012.
Debt conversion to equity	Under Deposit Insurance Corp. (DIC) law article 102, banks' equity value will be zero if banks are nationalized. Under the Basel III rule, hybrid holders and subordinated debtholders would take losses or their debt will be converted into equity if banks become nonviable. If banks have negative net worth, it's possible unsecured debtholders would take a haircut. There is only one case where senior debtholders took losses. Although there is not yet a clear policy, market participants expect regulators will not require senior debtholders of large banks to share losses.
Special feature	FSA is discussing the needs to build the legislation, which could speed up the transfer of assets/liabilities of troubled banks. For example, the regulatory authority will be able to decide business transfer without the approval of shareholders.
Extraordinary government support	The proposed framework does not limit government support. In fact, DIC law clearly states that the government can inject capital if the bankruptcy of the bank may cause systemic risk in the particular prefecture or nationwide.

Table 3

Switzerland	
Relevant regulator/authority	Financial Market Supervisory Authority (FINMA).

Table 3

Switzerland (cont.)	
Scope of application	All banks (including cantonal banks that benefit from cantonal guarantee), securities dealers, and central mortgage bond institutions, including foreign assets held by these institutions.
Relevant legislation	Updated Swiss Bank Act as of 2011. Additional dedicated law on resolution regime since Nov 1, 2012.
Capital standards	The "Swiss finish" of Basel III with much enhanced capital requirements for all banks from 10.5% to 19%, depending on their size (e.g. UBS and CSG need to fulfill 19%), will be implemented in steps from January 2013 until 2019.
G-SIB capital surcharge	For both UBS and CSG (1.5%). However, based on the Swiss too-big-to-fail regime, both banks are required to fulfill 19%, which equals a surcharge of 8.5% above Basel III requirements.
View on debtholder loss sharing	Senior unsecured bondholders are subject to loss, as well as potentially depositors with their deposits above the insured minimum of Swiss Franc (CHF) 100,000.
Resolution strategy/tools	Significant and wide-reaching powers were introduced that allow a structured intervention of a failing institution and ensure either its recovery or orderly liquidation. This involves the transfer of all or part of a bank's property to a bridge bank, the possibility of a debt-to-equity conversion, or debt write-down.
Trigger	Swiss regulator FINMA decides upon the need of a bank resolution and the tools to be used and implemented. After the decision, all assets and liabilities will be frozen for 48 hours to implement a resolution regime.
Living wills (resolution plans)	There is a dedicated too-big-to-fail regime in place for the largest two banks, UBS and CSG, since January 2013, and ZKB (Zuericher Kantonalbank) since November 2013. Each bank needs to implement its own recovery and resolutions plans.
Debt conversion to equity	There is a prescribed cascade to convert bank debt to equity. First, the entire bank's equity and hybrid instruments would have to be completely reduced before any debt was converted into equity. In a second step, all subordinated debt would be converted into equity. Third, all unsecured debt issues would be swapped to equity. In cases where this might not be sufficient, the Swiss regulators are also in a position to convert any nonprivileged deposits that exceed the maximum limit of the enhanced Swiss deposit guarantee scheme of CHF100,000 per depositor. Only secured debt or other used for hedging is not subject to conversion.
Special feature	Only in case of the debt write-down feature, the regulator has the discretion to not follow the above waterfall. To proceed, the regulator can freeze counterparty contracts for a maximum of 48 hours.
Extraordinary government support	We currently view the Swiss government as "supportive." However, Swiss authorities have stated that they want to avoid putting taxpayer money behind failing banks in the future. In our view, the Swiss authorities, with the U.K. and U.S. authorities, are at the forefront of enhancing resolution powers and making banking groups more resolvable. These actions may make government capital support more of an option and less of a necessity for systemic banks. We already removed the likelihood of government support for subordinated debt, which does not receive any uplift in the ratings for potential extraordinary government support. We currently expect funding and liquidity support to be provided by the Swiss National Bank in times of stress, which we consider to be critical for any bank restructuring and which is not covered by the Swiss bank resolution regime.

Table 4

U.K.	
Relevant regulator/authority	The Bank of England (BOE), in consultation with the Prudential Regulatory Authority (PRA) and Treasury.
Scope of application	Currently covers only deposit-taking institutions (including holding companies), clearinghouses, and investment firms. Regulators are looking to broaden the scope as per FSB to include insurance companies (current powers allow wind-up, not restructuring) and non-central counterparties (CCP) financial market infrastructures (FMIs).
Relevant legislation	Current: Banking Act 2009, as amended by the Financial Services Act 2012. Future: Financial Services (Banking Reform) Bill (draft published that would cover ring-fencing) and implementing the EU Recovery and Resolution Directive.
Capital standards	Basel II.5 moving to Basel III (via the implementation of the Capital Requirements Directive IV [CRD IV]) on Jan. 1, 2014. The PRA retains the capacity to issue "individual guidance" to banks, which leads to differentiated requirements above the minimum set in the EU directive.
G-SIB capital surcharge	HSBC (2.5%), Barclays (2%), Royal Bank of Scotland (1.5%), and Standard Chartered (1%).
View on debtholder loss sharing	The current resolution regime allows any creditor to take losses through entity insolvency, but the BOE has no statutory bail-in powers. It is anticipated that these powers likely will come from the proposed Banking Reform Act, potentially supported by a requirement for some debt to have contractual bail-in clauses.

Table 4

U.K. (cont.)	
Resolution strategy/tools	Regulators can: (1) transfer all or part of a bank's business (its shares or property, i.e. assets and liabilities) to a private-sector purchaser; (2) transfer all or part of a bank's property to a bridge bank--a subsidiary of the BOE--pending a future sale; (3) place a bank into temporary public ownership (the Treasury's decision); (4) apply to put a bank into the Bank Insolvency Procedure (BIP), which is designed to allow for rapid payments to Financial Services Compensation Scheme (FSCS) insured depositors (or transfer of their accounts to a healthy bank); and (5) apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration.
Trigger	Defined as a bank failing, or likely to fail, to meet the "threshold conditions" for authorization as a deposit-taker under the Financial Services and Markets Act 2000. The Treasury would decide whether to put a bank into temporary public ownership, otherwise the BOE, in consultation with the other authorities, decides which of the tools to use and implements the resolution.
Living wills (resolution plans)	Under the Financial Services Act 2010, all U.K. deposit-takers are required to have RRPs in place. However, the final rules and full implementation that was expected in 2012 have been delayed owing to international developments in this area. Nevertheless, banks are required to put in place recovery plans and provide information for authorities to develop resolution plans. "Resolvability" is a condition for any new banking license.
Debt conversion to equity	Resolution authorities will be required to respect the hierarchy of claims, subject potentially to some senior unsecured classes being subject to statutory bail-in and some not. Conversion to equity is one potential outcome, but it is not mandated.
Special feature	The authorities are also working to implement a resolution buffer to ensure that systemically important banks have sufficient loss-absorbing capacity (beyond any minimum) to mitigate the impact of any remaining barriers to their resolvability. It is anticipated that the authorities will have the powers and mandate they need to do this via the CRD IV variable Pillar 2.
Extraordinary government support	We currently view the U.K. government as "supportive." The U.K. authorities have stated that they want to avoid putting taxpayer money behind failing banks in the future. In our view, the U.K. authorities, with the Swiss and U.S. authorities, are at the global forefront of enhancing resolution powers and making banking groups more resolvable. Over time, these actions may make government capital support more of an option and less of a necessity for systemic banks, certainly in an idiosyncratic stress. But it seems unlikely that the U.K. (or EU) will legislate to prohibit such government support.

Table 5

U.S.	
Relevant regulator/authority	FDIC (in consultation with the Fed and U.S. Treasury).
Scope of application	DFA-covered banks and systemically important nonbanks (approximately 130 entities).
Relevant legislation	DFA 2010; specific rulemaking in progress at the Fed, Options Clearing Corp., the U.S. Commodity Futures Trading Commission, the SEC, and the FDIC. The New Financial Stability Oversight Council (FSOC) is mostly the coordinator.
Capital standards	Basel III is to be implemented by 2018. Fed rules establish higher regulatory minimums than Basel III standards. The supplementary leverage ratio is in a comment period--the proposal is 6% at a bank subsidiary and 5% at a consolidated holding company for large banks.
G-SIB capital surcharge	Proposed as follows: JPMorgan (2.5%); Citigroup (2%); Bank of America, Goldman Sachs, and Morgan Stanley (1.5%); Bank of NY Mellon, State Street, and Wells Fargo (1%).
View on debtholder loss sharing	There are strong views that unsecured creditors should share the loss as part of resolution, although there is no mandated haircut.
Resolution strategy/tools	Market solution is preferred, but debt-to-equity conversion under the Orderly Liquidation Authority (OLA) is the last resort; resolution plans should be mapped to legal entities. The FDIC is working on various strategies, but the preferred path is SPE. Non-systemically important subsidiaries would not be subject to OLA upon failure even if the parent and other subsidiaries are.
Trigger	Firm is in default or close to default and liquidation under the Bankruptcy Code would pose systemic risk. Banks are already subject to Prompt Corrective Action (PCA) if the health of the financial institution declines. Regulators can begin early remediation action as well.
Living wills (resolution plans)	The first wave filed on July 1, 2012, covered banks with more than $250 billion in nonbank assets; the second wave (with $100 billion to $250 billion in nonbank assets) filed July 1, 2013; and the third wave (between $50 billion and $100 billion in nonbank assets) is set to file Dec. 31, 2013.
Debt conversion to equity	Under one of several scenarios, senior unsecured creditors would receive a haircut depending on the loss estimate and exchange their claims for either or all of the following: new debt, convertible debt, and equity (preferred or common). Subordinated debt and equity holders could receive call options on financial instruments to be distributed to senior classes or warrants, or other contingent value rights.

Table 5

U.S. (cont.)	
Special feature	Fed Governor Daniel Tarullo has said G-SIBs need to have minimum long-term debt requirements so that there is enough long-term debt to absorb the original failed firm's losses. This is not yet a rule or policy. Also, the Fed has indicated it is considering tying minimum capital and liquidity standards together.
Extraordinary government support	We currently view the U.S. government as "supportive." In our view, the U.S. authorities, along with the Swiss and U.K. authorities, are at the global forefront of enhancing resolution powers and making banking groups more resolvable. In the U.S., support is explicitly prohibited in legislation for individual institutions. However, we are awaiting details about what we believe are the three key hurdles to implementing a credible resolution regime in the U.S. These are: clarity related to minimum levels of holding company debt, bail-in characteristics, and globally consistent resolution mechanisms. Should these hurdles be resolved, we still believe extraordinary government support likely will flow through to the operating entities, but it may not be available for holding company debtholders.

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011

Related Research

- Australia's Developing Crisis-Management Framework For Banks Could Moderate The Government Support Factored Into Ratings, Nov. 12, 2013
- The Evolution Of Government Support In U.S. Bank Ratings, Aug. 19, 2013
- An Update Of The Dodd-Frank Act's Building Blocks Three Years Later, July 16, 2013
- S&P Says Europe's Ring-Fencing Proposals Could Lower Risk Appetite, But Lead To Unintended Consequences, July 12, 2013
- How The Swiss Bank Resolution Regime Affects Government Support For Its Banks, Nov. 29, 2012