“By failing to prepare, you are preparing to fail”

BENJAMIN FRANKLIN
A STORY OF FAILED BANK FAILURES

It was Saturday, 15th September 2007 when John McFall, chairman of the UK’s Treasury Select Committee, was asked to comment on the small Newcastle-based lender Northern Rock. “The banking system in the United Kingdom is strong,” he said. “We’ve had 60 quarters of continued growth, the world economy has grown for the past five years. So it’s against a strong background. Don’t let’s predicate everything of doom and gloom on one small bank at that particular time. And I think it would serve us all well to stand back a little bit on this issue and give it time.”

There was one obvious problem with this assessment – customers were queuing outside Northern Rock branches to withdraw their funds, spooked by the provision of an emergency loan by the Bank of England. The UK took the advice to “give it time” – the result was a deposit flight over the following 3 months of close to 40% of the bank’s deposit base, the eventual collapse of the bank and a taxpayer funded split and bailout of the bank.

2007 and 2008 showcased several such costly attempts at resolving banks – IndyMac in the US in 2008 was another example – where the established rules of bank resolution (keep the problem quiet; find a private buyer; or failing that, have the regulatory authorities take over the bank over a weekend and efficiently resolve the bank) were forgotten or ignored by authorities.

Worse was to follow – a year later, US-based investment banking giant Lehman Brothers filed for bankruptcy. Policymakers worried about the moral hazard (and political damage) of bailing out a large Wall Street institution decided that as no private buyer was forthcoming, the bank would be allowed to fail. This turned out to be catastrophic, with the ensuing financial crisis as the web of financial contracts with which Lehman Brothers was involved was unwound, and the fears for the solvency of every bank in the industry resulted in a crippling credit crunch.

Large banks across the world began to fail, with authorities spooked by the Lehman crisis responding with an enormous array of financial support – distressed asset purchases, capital injections, liquidity relief, state-brokered acquisitions, and bank nationalization on an unprecedented scale.

By contrast, Asia Pacific emerged relatively unscathed from the Global Financial Crisis (GFC) which didn’t have the widespread bank failures that afflicted North America and EMEA. Yet the global regulatory response, which has seen a radical overhaul of almost every aspect of financial regulation, is also being adopted in Asia Pacific although with less urgency, especially in aspects such as stress testing, leverage ratio requirements and more technical elements such as model risk given the increased use of models in the US.
LEARNING FROM THE EXPERIENCES OF OTHERS

A key aspect of the global regulatory response has been development of an entirely new approach to **Recovery and Resolution Planning (RRP)**. This approach is designed to address the specific issues seen with bank failure, and we see this as key to systemic resilience.

Given the value to the system of such processes being formally established, we see seven key lessons that Asia Pacific can learn from international experience here:

1. **PLANNING IN ADVANCE FOR BANK FAILURE REDUCES THE COST OF THAT FAILURE**

Advance regulatory preparation of resolution plans – which involves rigorous ongoing monitoring, data collection, and background planning – is essential to smooth the resolution of commercial bank failures.

For example, the contrasting experience detailed above about Northern Rock and Banco Popular Espanol, which was resolved in 2017 through an arranged write-down and sale (for €1) to Banco Santander.

This is not a new lesson – similar approaches have been taken for decades – but were easily forgotten in the wake of a long period of growth and financial stability, like in Asia Pacific in 2017.

2. **RESOLUTION BY ACQUISITION NEEDS TO BE HANDLED WITH CARE TO AVOID CONTAGION TO THE ACQUIRER**

One interesting feature of the GFC is the number of cases where pre-crisis or crisis acquisitions contributed to the failure of the acquirer. Examples include RBS’ acquisition of ABN AMRO and Monte Paschi di Siena’s acquisition of Antonveneta, both of which were pre-crisis acquisitions that ultimately contributed to the failure of the parent banks. Lloyds TSB’s regulator-arranged acquisition of HBOS is also a clear example of the dangers of rushed acquisition as a means of achieving bank resolution.

By contrast, many of the US acquisitions did not lead to similar issues, often due to explicit support from the regulators, for example in the effective transfer of Washington Mutuals’ assets and deposits to JPM Chase.

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1. These comments are limited to recovery and resolution planning. The range of learnings from the crisis in totality is a much longer list.
3. BANKS HAD NOT ADEQUATELY PLANNED FOR THEIR OWN RECOVERY IN THE EVENT OF SEVERE STRESS

Large global banking groups have approaches to help them recover their capital or liquidity in times of stress, but these usually involve uncomfortable strategic compromises including sales of major subsidiaries, expensive fund-raising, liability-side actions at the expense of bondholders and draconian cost cutting. These actions can be effective, but only if taken early and decisively, which is only possible with extensive ex-ante planning.

This pre-planning lesson has prompted the global regulatory requirement for banks to create their own recovery plans. Regulators in Asia Pacific have followed, but stronger regulatory push is required if this is to be effective in creating a recoverable banking system.

4. CLARITY AROUND SUPERVISORY GOVERNANCE IS ESSENTIAL TO EFFECTIVE CRISIS MANAGEMENT

Several countries were hampered in their crisis responses due to a disjointed regulatory regime where there are multiple sources of responsibility required to coordinate between various regulatory bodies, such as those of the US, UK and EU. These examples included cases where the Treasury/Ministry of Finances, Financial Regulators, Central Banks and Deposit Insurance corporations had to coordinate with each other, and at times across multiple countries at once. This mixed governance model, untested by practical experience and suffering from competing and often contradictory policy priorities, materially slowed and hampered the crisis response.

5. EARLY AND DECISIVE ACTION HAS A HIGHER IMMEDIATE COST — BUT MATERIALLY LOWER LONG-TERM COST

Whilst the financial crisis had a high cost (via direct expense and long-term economic output), the extent of that cost varied dramatically. The clear pattern that has emerged is that those countries which acted early and decisively, like the US, UK, Ireland, Iceland and Spain, enjoyed lower costs and better economic recovery than those such as Italy, Greece and Portugal where more incremental approaches were taken. For the US, this is true to the extent that the Troubled Asset Relief Program (TARP) scheme to purchase troubled assets which was established during the GFC, has ultimately been able to sell or hold to maturity the assets it acquired without making a loss to the US taxpayer.

Decisive action has led to a combined, coordinated effort of banking regulation, the legal framework around bank restructuring, fiscal efforts, transparency around asset valuation, balance sheet management, liquidity support and the buildup of bank capabilities.
6. THE LARGEST AND MOST COMPLEX INSTITUTIONS NEED A DIFFERENT RESOLUTION APPROACH

The failures of Northern Rock, Banco Popular and others largely required traditional resolution approaches managed well. However, the failure of Lehman Brothers was another matter altogether: the revelation was that the largest institutions, interconnected with the rest of the financial sector, could not be easily resolved because of the immediate contagion that this entailed. Essentially, the banks were “too big to fail”.

The response of international regulatory authorities has been varied – with the US requiring its largest banks to create their own resolution plans (under a very prescriptive regime), whilst European authorities have launched large-scale data collection exercises to enable more detailed resolution planning (“living wills”).

For Asian geographies, the resolution regimes need to be fit for purpose, and differ between:

- China and Japan (where 13 of the world’s 20 largest banks are located), should be considered alongside other countries where there are banks with large capital markets businesses
- For other Asian geographies, such as Australia, Singapore and Hong Kong, a number of banks are so embedded in the financial system that they may well pose systemic risk and hence resolution needs to be carefully considered

7. BALANCE SHEET STRUCTURE AND STATE SUPPORT WEAKENED MARKET DISCIPLINE

Pre-crisis hope that shareholders and bondholders would impose market discipline on bank management proved unfounded, not least because perceptions of implicit state support encouraged banks to take risk beyond regulatory risk appetite. This distorts the pricing of risk, and skews the competitive playing field in favour of larger banks. Pari passu treatment of bondholders with depositors in insolvency made it impossible to bail-in debtholders without imposing losses on depositors, and deposit insurance levels were widely inadequate.

The regulatory response to this – raising deposit insurance limits, adjusting bankruptcy laws and introducing bail-in capital requirements (such as TLAC) – have been substantial and should leave authorities better placed to deal with similar problems in the future when fully implemented.

Footnote:
2. The Financial Stability Board (FSB) issued the final minimum total loss-absorbing capacity (TLAC) standard in November 2015.
Full article: https://www.euromoney.com/article/b12697jn3mkg9/TLAC-what-you-should-know?copyrightInfo=true
For the full text “Total Loss-absorbing Capacity (TLAC) Term Sheet”, please refer to the Federal Reserve website:
THE STATE OF PLAY IN ASIA PACIFIC

The Asia Pacific Region (APR) has been slow to adopt global measures to create recovery and resolution plans, and has been largely focused on the introduction of recovery plans. We see material work to be done in APR countries to achieve confidence that the banking sector is both recoverable and resolvable. Some countries, where the banks are very active in US or European markets, such as the Japanese banks are more advanced than other jurisdictions.

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<td>AUSTRALIA</td>
<td>Recovery plans submitted by the four Domestic systemically important banks (D-SIBs) and lighter touch recovery plans needed for further 18 banks at least annually</td>
<td>As recommended by the 2014 Financial System Inquiry, crisis management teams and resolution framework need to be developed</td>
<td>Resolution powers partially implemented; further powers in development</td>
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<td>CHINA</td>
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<td>Resolution plans submitted by G-SIBs annually; no plans for D-SIBs</td>
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<td>HONG KONG</td>
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<td>Final consultation concluded in April 2017; involved in group resolution planning for foreign G-SIBs and some D-SIBs in the past</td>
<td>Final consultation concluded in April 2017 including all resolution powers</td>
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<td>INDIA</td>
<td>No requirements or plans implemented yet, but in development; early plans to introduce a resolution regime</td>
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<td>INDONESIA</td>
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<td>KOREA</td>
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<td>MALAYSIA</td>
<td>No formal framework in place, but “special resolution regimes” used in practice</td>
<td>Authorities have powers to intervene (e.g. remove senior officers and undertake recovery and resolution actions)</td>
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<td>NEW ZEALAND</td>
<td>Closely connected to the Australian market in terms of recovery and resolution planning (see above), so called “open banking resolution” for purely domestic banks, which also puts the authorities into the position to use a range of resolutions powers</td>
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<td>SINGAPORE</td>
<td>Recovery and resolution plans submitted by D-SIBs and other important banks at least annually</td>
<td>Resolution powers partially implemented with further legislative amendments planned</td>
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<td>THAILAND</td>
<td>Recovery plan Pilot Program conducted for six Financial Institutions with formal submission of Recovery Plans expected in 2018, Draft Resolution framework is under development.</td>
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LOCAL CHALLENGES TO ACHIEVE RECOVERABILITY AND RESOLVABILITY IN ASIA PACIFIC REGION (APR)

EXECUTION DISCIPLINE

While a highly useful and important exercise, resolution planning is, by definition, of little value to the banks themselves but of very high value to authorities.

As such, it is incumbent on regulators to enforce execution discipline in recovery planning, which should involve:

- Providing a high level of detail to recovery planning requirements on the banks. We see most recovery planning efforts in APR have been lacking sufficient detail or realism, allowing too much scope for low quality completion. Setting minimum standards around analysis, stress testing, valuation, options assessment, governance and process is important to getting high quality plans from the banks.

- Building up regulatory capabilities. Regulators should provide robust Quality Assurance of banks’ plans to ensure quality and consistency. This requires regulators to have sufficient resources of their own, including people, models and access to the relevant data.

- Regulatory capabilities are needed for ongoing monitoring against trigger levels and not only in the initial effort to create recovery plans.

- Plans need to have “teeth” – i.e. regulators need credible punishments that they can impose on banks in the event that plans are of poor quality. Here the Federal Reserve has taken the lead, with liquidity and capital requirements driven directly by recovery and resolution plans, affecting dividend disbursement; whilst bankruptcy proceedings are also directly linked to the state of resolution plans. This is a challenge for APR regulators, many of which take a less intrusive approach to regulation than EMEA and North American peers.
MORE LIMITED RECOVERY OPTIONS IN THE EMERGING MARKETS CONTEXT

A key consideration for many regulators implementing RRP in Asia is that the envelope of potential options to consider in a recovery or resolution situation are more limited in less developed markets.

This is particularly true for recovery plans, which in more developed markets often include capital-raising actions such as asset sales or corporate debt issuance. Such markets are much more limited in many Asian countries. As a result, local regulators need to carefully consider the degree to which the potential to tap into longer-term state support in response to a crisis – over and above access to a liquidity window – can be included in a recovery plan. This would differ markedly from more developed countries, where recovery plans are designed specifically to limit the dependence on state support.

In the case of resolution plans, the impact is less pronounced, although the local legal enforceability of bankruptcy needs careful consideration given the national context, especially when there is overlap between private and state ownership in the banking sector.

MANAGING STATE-OWNED BANKS

In most emerging markets in APR (notably China, India, Indonesia, Thailand, and Vietnam), the largest banks in the market are state-owned. This creates particular challenges for recovery and resolution planning, as bail-in quickly becomes another form of bail-out. Resolving this problem requires consideration of the state’s appetite for diluting its stake, ex-ante planning for restructuring of the banking sector in a crisis, and detailed consideration of governance, at a minimum.

BALANCE SHEET STRUCTURE IN SHALLOW FINANCIAL MARKETS

Adding a layer of bail-in capital for the purposes of resolution is challenging in markets without depth of financial markets. Whereas for Europe and North America this has largely involved repurposing wholesale funding as bail-in capital, for many APR markets this would involve creating new wholesale markets.

Similarly, authorities need to think through the implications of a withdrawal of financial services by the banks as a recovery action to the provision of financial services in underserved markets. Whereas North American and EMEA authorities can usually rely on withdrawal of individual banks being taken up by capacity elsewhere in the market, this may not automatically be the case in underbanked pockets of emerging APR, such as Thailand.
PUTTING REGULATORY GOVERNANCE AND POWERS IN PLACE

Ensuring coordinated governance – particularly where this involves Ministry of Finance, State Owned Enterprises, Financial Regulators and Central banks – is a key challenge to achieving efficient recoverability and resolvability in APR banking markets.

Similarly, we see considerable work to be done in putting essential laws and powers in place to facilitate recovery and resolution – including establishing the legal power to intervene; reassessing deposit insurance schemes, levels and fees; creating bridge bank powers; revising bankruptcy law; and ensuring that funding is in place (either through bank balance sheet structure, deposit insurance or other specific resolution funds).

CONCLUSION – TIME TO ACT

The experience of North America and EMEA suggests that pre-emptive recovery and resolution plan can help materially reduce the cost of financial crisis and provide an effective safety net. While we don’t necessarily foresee a repeat of the GFC happening in APR happening anytime soon, the region needs to act now and set up the capabilities to have recoverable banks to save from the high cost experienced in other markets. There are also unique challenges in APR that will require fresh thinking and – crucially – execution discipline. Despite this need and urgency, progress has been slow and we see most APR countries as significantly behind international peers. The time to act is now before it ends up being an equally costly mistake.
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