Resolvability Perceptions of U.S. Global Systemically Important Banks as Measured by Total Loss-Absorbing Capacity Eligible Debt

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Bank Resolution Planning

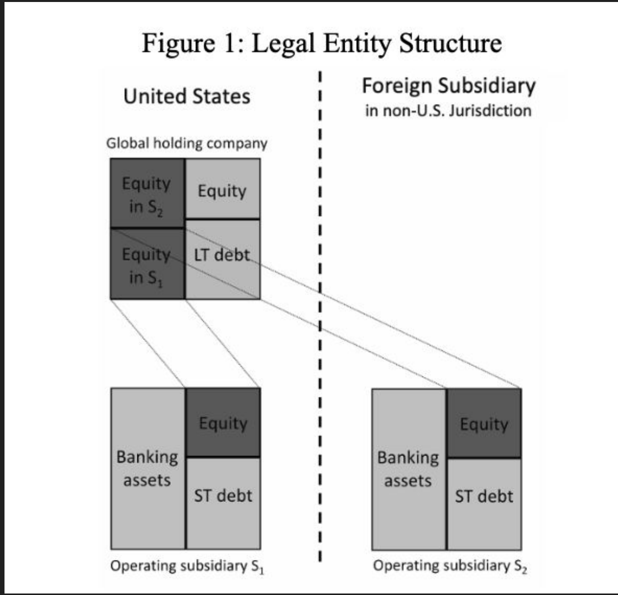
A resolution plan is a strategy for rapid and orderly wind down of a financial institution under the U.S. Bankruptcy Code in the event of material financial distress or failure

- A Dodd-Frank reform → end Too Big To Fail
- Public and private versions
- Fed and FDIC jointly review
- Key elements include governance, organizational structure, information systems, interconnections, and capital and liquidity resources

Key Concept

The parent entity of a financial firm in resolution suffers losses while the subsidiaries that perform critical economic functions continue to operate, limiting disruptions to financial stability

- Losses → parent creditors and shareholders
- Creditors are "bailed-in"
- Operating entities safe relative to parent
- Plans outline this process in depth

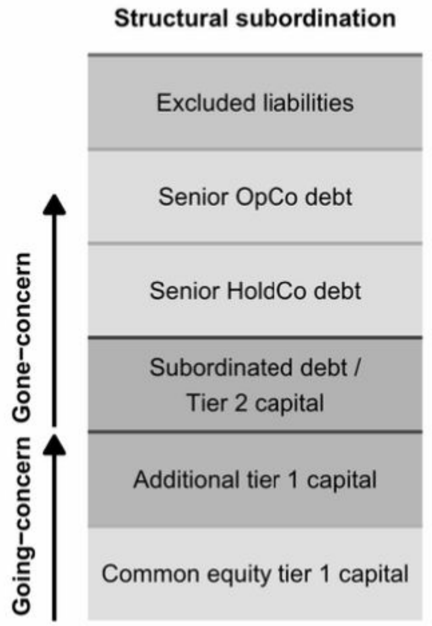


Total Loss Absorbing Capacity (TLAC)

TLAC is equity and bail-in eligible debt that can be used to absorb losses and recapitalize the banking group

- Minimum % of each required in U.S.
- TLAC eligible debt must fulfill maturity, issuer, seniority, and disclosure criteria
- U.S. TLAC rule adopted in 2017 with full compliance required by 2019

Figure 2: Capital Structure



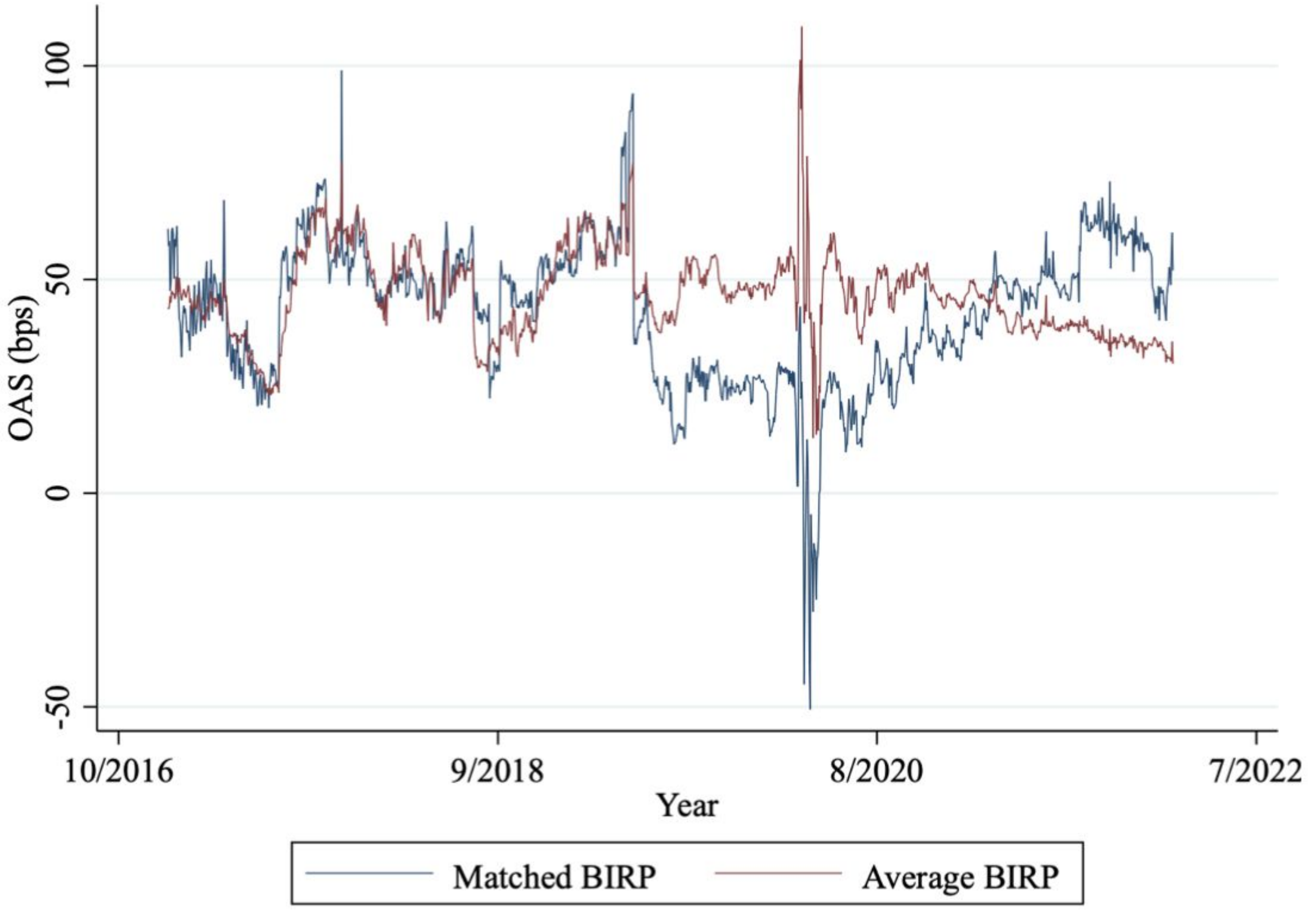
Three Measures of the Bail-In Risk Premium

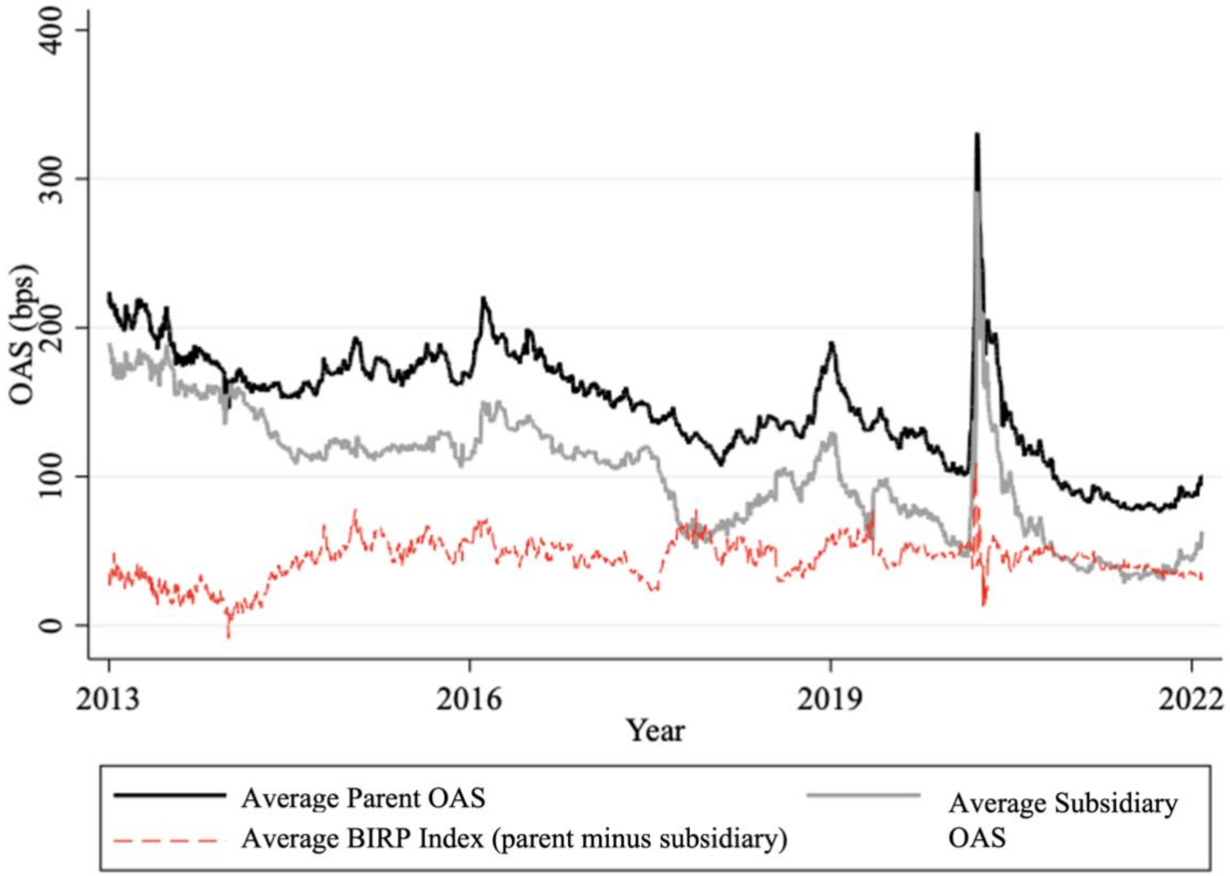
Bail-in applies to TLAC-eligible debt of the parent entity, not that of subsidiaries. The difference between yield of parent TLAC debt and similar non-TLAC subsidiary debt is the "bail-in risk premium."

(1) <u>Matched spread</u>: same issuer, +/- 6 month remaining maturity window
(2) <u>Average spread</u>: difference the average of TLAC and non-TLAC bonds
(3) <u>Dummy spread</u>: panel regression coefficient corresponding to the parent or subsidiary status of the issuing entity

Sample of 890 active bonds, issued by all 8 U.S. GSIBs, sourced from Bloomberg

Figure 4: Matched and Average BIRP Indexes





400
300
200
100
0
OAS (bps)
2013
2016
2019
2022
Year
Average Parent OAS
Average BIRP Index (parent minus subsidiary)
Average Subsidiary OAS

Methodology

Is the bail-in risk premium positive and significant? What firm, market, and regulatory factors influence it?

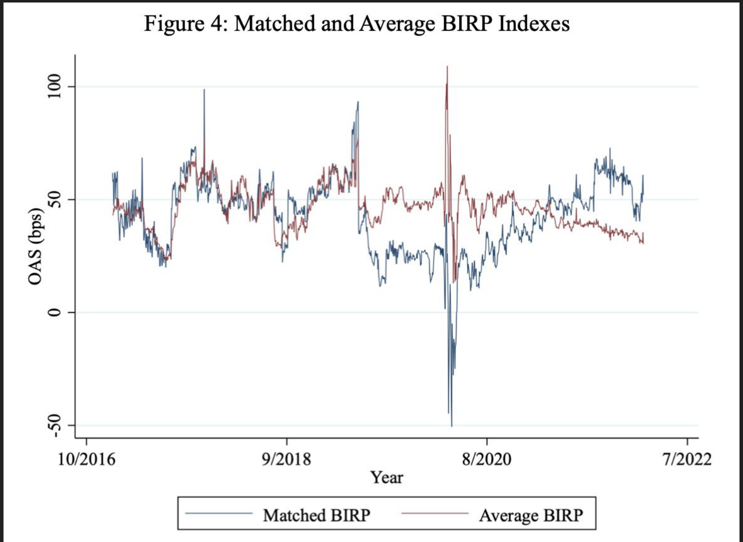
(1) Construct a panel dataset of bonds
  - Daily measures of bond yields
  - Quarterly accounting measures (Debt, BV, CET1…)
  - Daily risk variables (CDS, VIX, Treasury Spreads…)

(2) Run a panel regression with firm fixed effects, clustered standard errors, and variables associated with firm, market, and bond risk factors

(3) Perform an event study analysis to identify impact of resolution news updates on the spread indexes

Is there a statistically significant positive BIRP?

- Yes: 24 to 44 basis points
  - Consistent with prior research with a range of 14 to 70 basis points



What factors drive influence it?

- Parent/subsidiary credit notch differential
- High frequency market risk factors
  - Quarterly metrics less predictive
- COVID “dash for cash” ⟶ non-bail-in debt sell-off > bail-in debt sell-off
  - Contradicts resolution theory
- Public plan release and Agency feedback ⟶ no significant change

Policy Implications

- The bail-in risk premium ⟶ firms internalize some resolution costs
    - Success from the policymaker perspective
- COVID: the first real stress event since the Financial Crisis
    - Governmental support ⟶ resolution regimes remain untested
- Agencies should continue to promote orderly resolution
    - Review plans, supervising/implementation rules

Unfortunately, a real resolution event will be the only way of knowing the robustness of resolution planning and TLAC measures