ASSET PRESERVATION ADVISORS

# Bail-In: The New Order of Risk

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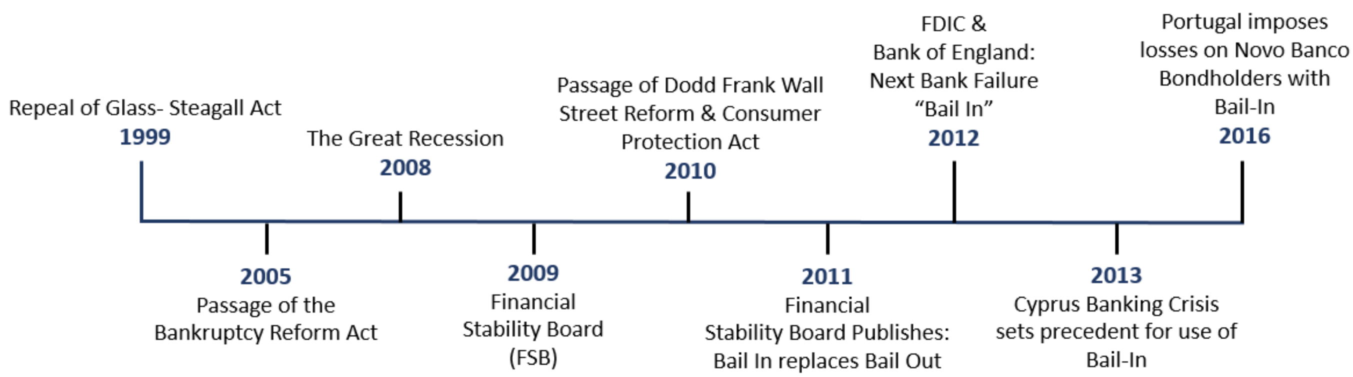
## What is a Bail-In?

In response to the worst global recession since World War II, policymakers around the globe set-out to enact laws aimed at protecting tax-payers from a systematic failure of large banking institutions. A “Bail-In” is meant to avoid both tax-payer bailout and systematic collapse of the banking industry, by allowing the distressed institution to recapitalize from within. In certain situations, it may be a more politically viable plan as it forces creditors to take the risk away from the taxpayer, by avoiding the need for a government bail-out of the institution, funded with taxpayer dollars. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010. This massive piece of legislation began as an 800-page document and swelled to a 23,000-page law to be implemented over a period of several years, and included a bail-in provision.

The colloquial term “too big to fail” has become synonymous with the Great Recession. During this time 462 commercial banks failed and Lehman Brothers, the fourth largest investment bank in the U.S. at the time, filed for bankruptcy.[1] Under Dodd-Frank, it is now the responsibility of the Financial Stability Oversight Council and the Orderly Liquidation Authority, two new government agencies established by this legislation, to monitor the financial stability of these institutions deemed “too big to fail.” The Orderly Liquidation Authority appointed the FDIC (Federal Deposit Insurance Corporation) to provide stability to the institutions and the overall economy by carrying out the liquidation and wind-up of large financial institutions that are close to failing.

The driving force behind the new banking laws is to avoid a domino effect of derivative contracts that financial institutions are obligated to fulfill. A default by one institution could put in place a chain reaction which could bring down the global financial system. During the Great Recession, governments provided the backstop to financial contagion or systemic risk. The bail-in clauses of the new law allows all bank creditors to be at risk including depositors.

## The Establishment of the Bail-In Provision




### *1999 – Repeal of Glass-Steagall Act*

After this repeal, banks were allowed to combine different business units (commercial, investment banking, etc.) which allowed the use of depositor’s money for their own investments.

### *2005 – Passage of Bankruptcy Reform Act*

Created a priority status for banks holding derivatives contracts. This means that when a financial institution is close to bankruptcy, any other bank or financial institution holding derivatives claims against it are given preference over all other creditors and customers for the remaining assets of the failing institution.

### *2008 – The Great Financial Crisis*

Derivatives, specifically credit default swaps (CDS), were one of the main reasons that investment banks like Lehman Brothers failed, leading to a subprime crisis and The Great Recession, with the potential for global financial meltdown.

### *2009 – Financial Stability Board (FSB)*

Following the financial meltdown, the G20 nations at their London summit formalized a new organization called the Financial Stability Board (FSB). The G20 nations also collectively agreed to be regulated by the newly formed FSB which is a sub-committee of the relatively unknown Bank of International Settlements (BIS). The BIS has become the central bank of central banks and is one of the most powerful financial organizations in the world.

### *2010- Passage of Dodd-Frank Wall Street Reform & Consumer Protection Act*

This massive piece of financial reform was established in response to the 2008 financial crisis. The act's numerous provisions, spelled out over thousands of pages, have established existing and new government agencies tasked with overseeing various components of the act. Even though the bill was signed in 2010, many parts of the bill will be enacted over time.

### *2011 – FSB – "Key Attributes of Effective Resolution Regimes for Financial Institutions"*

This was the first mention of the new concept of a "bail-in" to replace previous "bail-out" (i.e. tax-payer funded) resolutions of bank failure. This endorsed and became the international standard for bank failure resolution plans. Later, it was included in Dodd-Frank under Title II of the bill.

### *2012 - FDIC & Bank of England Publish "Resolving Globally Active, Systemically Important, Financial Institutions"*

Formally established that the next big bank failure will be resolved by the new "bail-in" policy. Specifically, paragraph 13 states, "An efficient path for returning the sound operations of the G-SIFI to the private sector would be provided by exchanging or converting a sufficient amount of the unsecured debt from the original creditors of the failed company into equity. In the U.S., the new equity would become capital in one or more newly formed operating entities…or the equity could be used to recapitalized the failing company itself".[2]

### *2013– Cyprus Banking Crisis Sets Precedent for use of Bail-In*

March 2013 – Cyprus announced it has reached a final 10 billion euro agreement with European Central Bank (ECB) and the International Monetary Fund (IMF). The agreement allows the bank to "bail-in" depositors of the bank per new Financial Stability Board (FSB) rules. Those depositors under the ECB insurance limit (100,000 euro) were spared. Those depositors, with deposits over the ECB limits will become shareholders to the tune of about 40% (Bank of Cypress), or as much as 60% (Bank of Laiki).

### *2016– Portugal Imposes Losses on Novo Banco Bondholders with Bail-In*

January 2016– Europe's new agreement for winding-up failing banks led to Portugal's imposition of losses on senior bondholders in Novo Banco which left bondholders footing the bill to shore up the banks deficits.

## FDIC: Coverage and Limitations

Most derivatives contracts are collateralized or have a pledge of the assets of the bank. As of October 2015, the FDIC announced it had adopted a proposal to increase the Deposit Insurance Fund (DIF) to a required minimum level of 1.35 percent of deposits (this does not include derivatives) by September 30, 2020 . The Deposit Insurance Fund at the FDIC in December of 2015 held about $72.6 billion. With the reserve ratio of 1.11%, this equates to total deposit coverage of approximately $9.1 trillion.[3] For perspective, the top five banks in the U.S. have derivative exposure of approximately 247 trillion.[4]

The FDIC, in their capacity as "trustee in receivership" is limited by the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which gives priority and special status to the large banks holding derivative contracts. The FDIC cannot actually intervene until the large banks holding derivatives contracts are repaid, despite the potential effect on depositor accounts. Globally, the notional value of all outstanding derivatives contracts is a staggering $552.9 trillion dollars according to the Bank of International Settlements.[5]

## APA Perspective

While we do not feel that bank failure is imminent in the US at the time of this publication, and that the likelihood of this is low, we believe that investors and bank depositors should fully understand their risks. It is our view that understanding risk is an important aspect of financial security, as is overall asset diversification. One should not forget that the Bank of Cyprus passed its stress test with flying colors shortly before it crashed, or that the effects of contagion contributed to many bank failures and the ultimate failure of Lehman Brothers in the US, during the Great Recession.

We suggest the following two part strategy in an effort to preserve liquidity and protect principal, customizable for the time horizon best suited to each individual client.

*Daily Deposits*: Liquid cash investors will need to be cognizant of keeping deposits under the FDIC limit of $250,000 or diversifying between FDIC sweep programs that internally diversify amongst banks.

*Short Duration Managed Portfolio*: Investors looking for additional yield and principal protection may want to consider a short duration municipal bond portfolio laddered to meet future cash needs. APA's Short Duration strategy provides an alternative approach for money market investors to seek enhanced returns, capital preservation, and a high level of liquidity. Short duration municipal bond portfolios generally offer investors higher yield than daily cash accounts and in a relatively low interest rate environment, every little bit helps.

For more information about Asset Preservation Advisors customized portfolio management, please contact:

ContactUs@AssetPreservationAdvisors.com, (404) 261-1333

[1] Bank for International Settlements; Commercial Bank Failures During the Great Recession: The Real (Estate) Story, November 2015, http://www.bis.org/publ/work530.pdf (accessed 4/1/2016)

[2] Bank of England; Resolving Globally Active, Systematically Important Financial Institutions, December 10, 2012, http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf (accessed 4/1/16)

[3] YCharts; US Total Savings Deposits at all Depository Institutions, https://ycharts.com/indicators/us_total_savings_deposits_at_all_depository_institutions (accessed 4/1/16)

[4] Office of the Comptroller of the Currency; OCC's Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2014, http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq414.pdf (accessed 4/1/16)

5 Bank for International Settlements; Global OTC derivatives market; H1 2015, http://www.bis.org/statistics/d5_1.pdf (accessed 4/1/16)

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