Bank bail-in and bail-out from a civil society and public interest perspective

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Background

The era of “too big to fail” (1984-2008)

- Taxpayer-funded bail-outs as the de-facto standard policy response to the threat of large bank failures
- Effects:
  - Moral hazard
  - Failure of market discipline
  - Distorted competition
- In conjunction with financial market liberalisation:
  - Emergence of large international groups
  - High leverage, insufficiently capitalised
  - Tightly interconnected

⇒ Global Financial Crisis (2008)
⇒ EU Sovereign Debt Crisis (since 2009/10)

1984
“We have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank.”
Stewart McKinney
U.S. Congress
(at the Inquiry into Continental Illinois Corp. and Continental Illinois National Bank)

2009
“Global banks are international in life but national in death.”
Sir Mervyn King
ex-Governor, Bank of England
Responses

Policy objectives

- Improve financial system resilience
- Increase transparency, supervision
- Prevent build-up of systemic risk
- End “too big to fail” / Restore level playing field
- Improve loss absorption capacity / capitalisation
- Contain moral hazard / excessive risk-taking
- Shield taxpayers / Allocate losses to shareholders and creditors

Policy responses

- Capital adequacy
  - Basel III
- Recovery and resolution
  - FSB Key Attributes (2014)
- Banking structural reform
  - Vickers, Liikanen reports (2011/12)

⇒ Ongoing discussion about societal cost of bank business models

— CRR / CRD IV
— BRRD (2014)
— National bank separation laws
The idea that the penalty for failure can be shifted onto an institution, such as a bank, is incorrect. Ultimately all penalties, and similarly benefits, have to be absorbed by individuals, not inanimate institutions.

E. Avgouleas & C. Goodhart
Critical Reflections on Bank Bail-In
Bank for International Settlements, January 2015
New deal for taxpayers

The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions ...

FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October, 2014

Instead of bail-out, institutional and structural safeguard mechanisms:

- Industry-funded RFAs (SRF and national)
- Bail-in tool and “burden-sharing” clause (Art. 44/5 BRRD):

  The resolution financing arrangement may make a contribution [...] only where:

  (a) a contribution to loss absorption and recapitalisation equal to an amount not less than 8 % of the total liabilities including own funds [...] has been made by the shareholders, [... ], the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise;

  ➔ Delivery of promise to taxpayers depends critically on the success of the bail-in tool and, in due course, adequate funding of RFAs
Issues: Loss Absorption (I)

- Minimum levels of loss-absorbing capacity:
  - for G-SIBs: TLAC (FSB), (“Pillar 1”) MREL (EU: CRR/CRD IV, as proposed)
  - for other banks: (“Pillar 2”) MREL” (EU: CRR/CRD IV)
- So far no statutory (“Pillar 1”) MREL for “significant” and “other systemically important” (O-SII) banks
- Reference to Art. 44/5 BRRD omitted in the Delegated Act governing MREL – 8% “burden sharing” threshold to be applied by RA on a case-by-case basis only
- Subordination requirement for “Pillar 1” MREL only; proposed introduction of new class of eligible debt instruments (“senior non-preferred”)

Consistent definition and application, as well as adequate calibration of loss-absorbing debt and capital instruments, is essential for the credibility of bail-in
Issues: Loss Absorption (II)

Legacy issues highlighted in recent practice:
- ca. 20% of Eurozone bail-inable debt securities estimated to be held by retail investors (up to 50% in some Member States)
- Potentially numerous instances of mis-selling by captive financial advisers to unsuitable investors
- Investors faced with risk of bail-in loss or crystallising trading loss (sale before maturity)

Potential options
- precautionary recapitalisation (Art. 32/4 BRRD)
- ex-post compensation of investors

➤ Treatment of pre-BRRD securities held by retail investors uncertain and politically fraught
Issues: Loss Absorption (III)

Policy issues
- Fairness considerations:
  - Protection of savers
  - Sanctioning of faulty / biased advice
  - Prevention of moral hazard, conflicts of interest
- Financial stability considerations
  - Erosion of market confidence, contagion risk
  - Effective monitoring, realistic assessment and pricing of risk

Forward-looking solutions
- Bail-in able securities (incl. T3, AT1) held by sophisticated, preferably institutional investors
  - Standardised instruments, clear, comprehensive disclosure and risk warnings

Protection of retail investors likely to be key fora) feasibility and b) political acceptance of bail-in tool
Issues: Interconnectedness

- Banks continue to be the largest holders of bail-inable securities (ca. one-third)
  - Share declining (portfolio reallocations, pending regulatory disincentives)
  - Smaller banks relatively more exposed

- Other institutional investors account for ca. 40-50% of total holdings
  - ICPF s and IFs – representing a significant number of retail investors –largest holders of bail-inable debt securities in some MS (FR, NL)
  - Intermediation of retail investors by asset managers—professional monitoring, risk mitigation, diversification (but: cost, potential agency problem)
  - Overall exposures of institutional investors diversified but possible concentrations of risk at SII s, SI-NBNIs need to be monitored

→ Reliance on institutional investors for loss-absorption should go hand in hand with a robust macro-prudential framework for NBNIs
Issues: Resolvability

- Challenges posed by lack of relevant precedent
  - Resolutions strategies (SPE, MPE) unproven at scale
  - Cross-border co-operation (intra-EU, overseas)
- Challenges posed by complexity of bank corporate structures
  - Mapping of critical functions, distinction from core business lines
  - Maintenance / substitution of critical shared services in resolution
  - Maintenance of essential third-party contracts / services
  - Funding arrangements and liquidity management (internal LAC, cash pooling)
- Removing impediments to resolvability (Art. 17 BRRD)
  - Legal constraints: proportionality, necessity, appropriateness (Art. 18/2 BRRD)
  - Decision process (Art. 18 BRRD) cumbersome, time-consuming
  - Reliant on seamless co-operation with CA(s)

→ Resolvability cannot be taken for granted, could be lengthy, iterative process
Precautionary recapitalisation

- Art. 32/4 BRRD: For the purposes of point (a) of paragraph 1, an institution shall be deemed to be failing or likely to fail [...] :

  extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, [it] takes any of the following forms [...] :

  In each of the cases [...] the guarantee or equivalent measures referred to therein shall be confined to solvent institutions and shall be conditional on final approval under the Union State aid framework. Those measures shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the institution has incurred or is likely to incur in the near future.

  Support measures [...] shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises [...] .

→ Practice is still to be established and should be very restrictive
Conclusions

The BRRD marks progress towards the objective of sparing taxpayers from the fall-out of bank failure. However, some issues still need to be addressed:

- **Loss absorption**
  - Legacy holdings of bail-inable debt instruments by retail investors
  - Distribution of new bail-inable debt securities (in partic. to retail investors)
  - “Pillar 1 MREL” for “significant”/O-SII banks
  - Legal basis for consistent application of Art. 44/5 BRRD

- **Interconnectedness**
  - Bank holdings of bail-inable debt instruments (disincentives)
  - Holdings of bank securities and potential systemic risk of SII and SI-NBNI

- **Resolvability**
  - Structural measures – scope, co-ordination and enforcement
  - Prioritisation of public interest
Thank you!