Resolution in the banking union: completing the agenda

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The banking union: where do we stand?

- BU more successful on regulation and supervision (SSM) than in crisis management tools (evidence on bail-in and resolution so far points to problems) and no EDIS yet.
- What is the problem? the Eurozone is not a country, so reluctance to mutualize public funds (for a use which is never popular …).
- This creates at least two problems:

(i) priority given to bail-in in BRRD, but not done in a credible way so that resolution does not work;

(ii) fear by host countries, which tend to ring-fence liquidity and capital.

Banking union – goals in relation to the broad objectives?

- Protecting taxpayers: this requires a credible resolution regime as far as bail-ins are concerned – not yet there
- Ensuring financial stability: this requires that bail-ins do not destabilize the financial system through bank runs => clarify seniority ranking in MREL, EDIS, strengthening crisis management capability of SRB, liquidity in resolution - not yet there
- Promoting market integration to foster risk sharing and effectiveness of common monetary policy: this requires that ring-fencing is eliminated => need to find a solution to the home/host problem to ensure that host countries are not penalized by the absence of ring-fencing – not yet there

This paper – what we do and what we don't do

Discuss:

-- making bail-in more credible by improving MREL

-- reconcile the home/host country debate

-- (briefly) ideas for bail-in/bail-out in systemic crises

Don't discuss (although we think these are important topics):

-- Broaden the SRB power in resolution on the model of FDIC in the US [see also Scholz non paper and Reichlin and Vallee 2017]

-- liquidity in resolution

This paper

A. Resolution is key - although need policies to <u>both</u> reduce the probability of institutions' failure and the impact of those events

B. EDIS less of a priority in the sequencing of reform (ideal to do it as part of a package, but do not delay improvements on resolution just for this)

C. Connection between:
   (1) make bail-in credible (most important priority),
   (2) facilitate cross-border banking [given increasing returns, esp. for investment banking], and
   (3) create EDIS

There is a connection between these three priorities. If you do (1) and (2) well, then (3) is less of a priority

Moreover EDIS less quantitatively important than people (both those in favour and those against) assume, given the super seniority of retail deposits, and esp. their insured part, in BRRD

D. Individual institution's approach to prudential and resolution policies not sufficient in systemic crises but needs to limit discretion in bail-out

1. Making bail-in more credible

- Bail-in is potentially VERY costly if leads to financial instability.
- ***Lehman*** in September 2008 ***was bail-in***.
- Best metaphor is ***Diamond-Dybvig***.
- Reality involves a mix between ‘pure sunspot-like coordination’ and rational inference, especially given ***lack of transparency*** of bank balance sheets.

Experience so far with banks in difficulty

- Banco Popular Español: declared as failing or likely to fail by the SSM and existence of public interest assessed by SRB => resolved by the SRB, but with no bail-out => no application of the 8% bail-in rule

- Monte dei Paschi: not declared as failing or likely to fail => bail-out with no involvement of the SRB and, hence, no resolution and no bail-in

- Banca Popolare di Vicenza and Veneto Banca: declared as failing or likely to fail, but no existence of public interest => (national) insolvency procedure with bail-out

Hence: so far, no case of resolution with application of the 8% bail-in rule

Principle: concentrate the pain on claimholders whose money is ‘stuck’ in the bank

- Aversion to bailouts understandable: taxpayer money, moral hazard, …
- However the cost of financial instability: the *costliest* bank failure for taxpayers in last 10 years was Lehman, *despite lack of bail-out*, while for example TARP $428 billion bailout has *been fully repaid*.
- Remember also that ‘orderly’ resolution will not prevent depositors from running if they can and feel their money is at risk. Key is reaction of depositors of ***other banks***, not the bank under resolution.
- Not ‘mechanical interconnection’ (implicit focus of the law when it addresses bank systemicity), but ‘***informational interconnection***’ (e.g. what if a bank failure leads depositors or other claimholders to think the NPL problem is more serious than previously thought?).

Banking Recovery & Resolution Directive

- BRRD insisted on *8% (non RW) bail-in,* even under systemic stress, as of January 1, 2016, for access to common resolution fund or even national public money.
- Beyond secured liabilities, it *exempts very short-term interbank debt* (up to 7 days).
- It gives *priority to natural persons and SMEs* over other unsecured claims (and within those, priority to deposit insurance fund).

BRRD was not well designed

- Problem of sequencing: it introduced a very rigid bail-in rule (8% of balance sheet) before banks built up ***long-term subordinated bail-inable claims*** (unlike TLAC which used the inverse sequencing)
- This explains why BRRD not fully implemented today. Downside: ***when bailout is out and bail-in is not in, denial is the only option left***.
- Why this contrast? Because the Euro-area is not a Nation. ***But procrastination is costly*** !
- No *hard targets for bail-inable securities* (MREL). But progress in BRRD2 in 2019

MREL and TLAC

Comparing TLAC and BRRD not straightforward :

On the one hand:

- TLAC only covers G-SIBs – MREL all banks
- TLAC has 6.75% unweighted ratio, BRRD 8% (but also has a weighted ratio, close to twice the Basel capital ratio).
- TLAC has a significant (2022) transition, BRRD introduced 8% rule on 1-1-2016.

But:

- TLAC prescribes minimum for all G-SIBs – MREL has a discretionary bank-by-bank approach
- TLAC goes for subordination ranking – MREL still unclear

Our view: 8% rule in the EU is too tough, so political compromise was to be (excessively) flexible in the definition of MREL, with as consequence that it has de facto prevented the implementation of this 8% rule until now, almost 4 years after its official introduction.

Key point

- To avoid bank runs (esp. with volatile wholesale deposits), it is important to have sufficiently large junior liabilities
- Including senior claims in MREL does NOT protect other senior unsecured claimholders

Example of bank liabilities

Secured + very short-term liabilities	25
Retail deposits	40
Bail-inable senior liabilities	30
Junior liabilities	1.5
Capital	3.5
Total liabilities	100

- Losses for senior liabilities before a bailout can be considered: (8 – 3.5 – 1.5)/30 = 3/30 = 10%.
- ***Conclusion***: to avoid bank runs (esp. with volatile wholesale deposits), better to increase junior liabilities to 4.5.

Good news: BRRD is getting better

- BRRD2 is good news (better late than never …) with:

(i) stricter subordinated MREL requirements for banks bigger than €100 billion balance sheet, and

(ii) the ability for NRAs to go below that number: crucial to avoid ‘informational contagion’ !

General idea: requiring x% of bail-in before bailout should require x% of long-term junior claims to absorb bail-in and reassure senior claimholders.

Our view/proposal: take opportunity offered by BRRD2 and make it compulsory also for all banks below €100 bn

- BRRD2: good that it recognizes the need to move towards more long-term junior loss-absorbency
- *If we take 8% for granted (no willingness to renegotiate it),* it is important to impose *equivalent* % of long-term subordinated claims, to avoid panic by depositors.
- Crucial, because 'no-bailout-before-8%-bail-in' rule probably *more credible/rigid*, even under extreme stress, in Euro-area context than in a 'normal country'.
- Caution: lots of discretion offered by BRRD in crisis on how to reach 8% but NOT on that threshold, even in a systemic crisis. Need more clarity on what exactly will be bail-inable. [This is the TLAC idea. BRRD2 better than BRRD1 but need to complete the job]

Transition

- Problem: this would imply a *big shock* to an already challenged EA banking sector.
- Other potential ideas for the transition: (i) allow temporarily for $x < 8\%$ (TLAC = 6.75% in 2022, and only for G-SIBs), at least for bailouts with *national money*; or (ii) *BRRD holiday* to clean up weak banks. But fix a date for the end of the transition (202?)
- Seems to have been politically infeasible so far, so resolution has been avoided so far and alternative routes have been used: *‘precautionary recap’ + compensation for retail subordinated claimholders;* or even *‘national bankruptcy’.* Not first-best but better than bailing-in depositors and risk bank runs.

Implication for EDIS

- Given super seniority of deposit insurance fund in BRRD (BRRD priorities: equity, junior debt, non-preferred senior debt, senior debt, non-insured retail deposits, and then insured retail deposits) EDIS for retailers does not seem very relevant here
- CAUTION: wholesale depositors penalized in the ranking in BRRD. As a consequence the risk of financial instability has increased. Therefore we need 8% junior for consistency - 8% only helps if it is junior.

➢ Conclusion: the creation of EDIS should NOT delay the needed improvements in MREL: we urgently need credible resolution.

2. Cross-border banks

- Increased push for cross-border mergers in the Eurozone (SSM, ECB, Commission, some Member States, not to mention big banks themselves).
- In principle, further integration is a good idea. It could reduce overcapacity (and accelerate restructuring) and it should help monetary transmission.

Cross-border M&As in Eurozone

- Limited: 9% of deals in 2016 (slightly more in 2017), 15% in 2011-2015.
- US: cross-state deals between 31 & 52% during 2000-2015 (versus between 5 & 19% in Euro-zone).
- Result: domestic credit institutions in 5 biggest countries (by banking assets) in Eurozone (DE, FR, IT, ES, NL) each amount to more than 90% of domestic assets.
- Note: Belgium is interesting exception: 6th country by size, and one where this number is only around 50%.

Cross-border banks and home bias

- Advantages go further than just home sovereign bias and ‘doom loop’.
- Home sovereign bias indeed a problem (sovereign concentration, without capital requirements (‘0 risk weight’) tolerated from the start by Basel: ‘original sin’)
- But note that home sovereign bias not the only problem: home economy bias problematic too (and if sovereign risks defaulting, home economy will tank too, which makes it rational for sovereign home bias to rise in times of sovereign stress).
- Cross-border banking can address both home biases.

Facilitating cross-border banks

- To facilitate cross-border banks we need coherence in case of resolution.
- We want to have creditors of subsidiaries to be senior to those of the holdings (people calling the shot must be the one bearing the risks. Different ways to do it: branches, intra-group support agreements, holding with structural subordination).
- The current situation is suboptimal : banks could get around the problem by going for branches. However, a good system should be neutral concerning branches versus subsidiaries

Need to address the home/host debate

- As long as the BU is not complete, it is not unreasonable for host countries to be nervous, even if the risk to their DG system is in general limited.
- Indeed, there is also the risk to private claimholders in bail-in, which is meant to be the norm and not the exception in BRRD. Can host countries be confident that their subsidiaries will be treated fairly in crisis time if the CEO of the group faces 'gentle pressure' from home country authorities ? Currently such confidence does not exist, which is why host countries keep their options & national discretions (ONDs) on liquidity and intra-group exposures.
- Of course, one can expect the SRB to try and ensure fairness. But the devil will be in the details, so better to improve the rules of the game to leave less room for discretion and potential bias.

Proposal: transform the Banking Union from a perceived 'home country club' to a genuine EZ construction

General idea: take a fully EZ-wide approach to resolution of cross-border banks.

The goal is to avoid the suspicion, valid or not, that European authorities (Commission, SSM-ECB, SRB) will not be completely unbiased in the resolution process and that will end up favouring some (large) headquarter/home countries over (small) host countries.

Simplest solution: have resolution focused on burden-sharing at the holding structure

- In this way we would ensure that we have not only resolution through a single point of entry but also a “fair” resolution, i.e. which is not biased in favour of home and powerful countries.
- This would reassure host countries because losses would occur ‘at the top’.
- This is moreover the efficient thing to do : the decision-maker should be the residual claimant (this is the whole idea of prudential regulation, solvency ratios and no bailouts ; and thus this principle goes much beyond a cross-border setting).
- It follows ideas developed at the FSB by the architects of resolution recommendations (see Tucker, 2018).

3. Dealing with systemic crises

- A paradox of BRRD is that it largely ignores one important innovation of post-Lehman regulation, the distinction between micro- and macroprudential approaches. Indeed, the 8% bail-in must be respected 'even in a systemic crisis'.
- We therefore suggest further strengthening the BU by introducing 'automatic stabilizers' (just like they exist in fiscal policy) to protect what is a sector which is 'macroeconomically fragile', since bank failures often happen with (economically- or politically-induced) macro crises.
- Two ideas worth exploring: (1) 'capital insurance' (Kashyap, Rajan & Stein, 2008) and (2) 'equity recourse notes' (Bulow & Klemperer, 2015).

1. Capital insurance – dealing with common shocks

- Ask banks to pay insurance premia in order to automatically receive fresh capital in hard economic times. In order to avoid moral hazard, such capital injection would be contingent on the state of the economy and NOT on the state of the individual bank.
- Note that this would be a ‘prefunded bailout/backstop’, but if the crisis is deep enough, the insurance fund would be empty, and one would have to move to a ‘post-funded bailout/backstop’.
- Historical evidence on ‘well-designed’ State intervention (TARP, Swedish crisis, …) indicates this can be done at a limited (and possibly 0) cost for the taxpayer, even without considering its positive effect on GDP growth and thus public finances.

2. Equity recourse notes – dealing with common and idiosyncratic shocks

- The idea is to automatically beef up bank capital in difficult times
- This idea takes a very different route, by asking banks to have as part of their loss-absorption debt claims whose interest payments are automatically replaced by payments in shares of the bank when the declining stock price hits a given threshold.
- This idea is helpful both for macro and for idiosyncratic shocks, but it shares with the Kashyap et al. idea the automaticity. And note that, in contrast with some other CoCo's, this one does not 'suffer' from discontinuous triggers.
- Whatever route is taken, our feeling is that such automatic stabilizers are very complementary to the attributes of a well-functioning BU, in that resolution is much easier if the banking sector as a whole is healthier.

Conclusions

- Much progress can be achieved in making bail-in credible - and therefore decreasing probability of financial instability in crises and decreasing probability of bail-out – by improving incrementally on existing rules
- A coherent package can do this and help cross-border banking by solving home/host conflict
- EDIS is important, but quantitatively probably less than some assume or fear
- More work must be done on building rules for systemic crises