

# ***Bank Resolution and Bail-in***

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# Introductory remarks

- Why banks are special: (1) *fragility* linked to maturity transformation; (2) inability of most bank creditors/depositors to exercise usual *discipline* on their borrower (see *Dewatripont-Tirole* 1994, 2012).
- Implications: (1) address *financial instability* (by protecting deposits); (2) address moral hazard through *capital ratios* and *credible resolution*.
- Easier said than done, but leads to a key general rule: *concentrate the pain on investors whose funds are 'stuck in the bank'*.
- Remember also that most banks tend to be in trouble at the same time: *think in systemic terms*. 2

# The 2007-8 crisis and re-regulation

- Crisis fed by under-regulation; significantly worsened after fall of Lehman: first big-bank bankruptcy (i.e. *disorderly resolution*), that triggered « move to another equilibrium » (with *bank runs* à la *Diamond-Dybvig* 1983) but for *wholesale funding*).
- Double response:
  - (i) « no more Lehmans », instead, significant rise of (retail) deposit insurance and *massive bail-outs*;
  - (ii) *re-regulation* (more and better capital, plus new regulatory rules on liquidity, recovery and resolution planning, macro-prudential regulation, ... ).

# Assessment of reregulation

- Reform agenda makes sense given previous crisis, but impact of *new approaches still largely untested*.
- Debate continues on 'excessively low Basel III capital ratios' (e.g. *Admati-Hellwig*, 2013) versus 'difficulty of finding the money & risks to real-economy lending' (*currently winning* ...).
- *What to think about 'bail-in rather than bailout' trend*, in a European landscape plagued by overcapacity and a challenging environment?

# Bail-in

- Paradox of the crisis: (i) Basel III stresses quality of capital and micro/macroprudential distinction, while (ii) current « *bailout fatigue* » has now led to « *bail-in fashion* », with a desire to vastly enlarge set of bank claimholders meant to be « held responsible », and this *even under systemic stress*.
- Explanation: politicians (rightly) feel that Basel III doesn't require enough capital to protect taxpayers, and that R&R plans are complement but not substitute for more loss absorbency.
- Big concern however: *cost of financial instability*.
- Relevant both at FSB with TLAC and in the EU, with BRRD and MREL.

# TLAC

- Broadly, *pretty good idea*: since Basel III not that demanding on tier-1 capital, why not strengthen tier-2/ tier-3?
- *Reasonably modest*: (i) only for GSIBs; (ii) with significant transition; (iii) does not add explicit no-bailout clause (in US, Congress can always allow them in systemic crisis): constructive ambiguity.
- *Broadly rigorous*: Not as high-quality as CET1, but *remaining maturity of at least one and mostly subordinated* (but why up to 3.5%? This does not make sense (see below)).

# Banking Recovery & Resolution Directive

(see *EC 2014* and *Dewatripont, 2014a, b*)

- BRRD insists 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, and this *at point of failure*.
- 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*).
- As of today, *no hard targets yet for bail-inable securities* (MREL), at least for small and mid-size banks.<sub>7</sub>

## 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. Instead, *including senior claims in MREL does NOT protect other senior unsecured claimholders !*



# Assessment

- Aversion to bailouts understandable: taxpayer money, moral hazard, ...
- Remember 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: idea of « *informational contagion* », next to « *mechanical contagion* », so also a concern for small but 'representative' banks !

## Assessment (2)

- Several Member States have been aware of the problem, and have been trying to tackle it:
  1. Germany: *make senior bank bonds junior, retroactively* (also used for Greek banks in 2015).
  2. Italy: *make depositors senior* to bonds and derivatives, *retroactively*.
  3. France: same as Germany, but *NOT retroactive, and more granular*. Now part of EU toolkit: '*non-preferred seniors*'.
- Useful initiatives, but goal should be for all banks in Europe to have enough junior long-term claims *asap*. Instead, *BRRD* had '*wrong sequence*', committing against bailouts before imposing bail-inable buffers.

## Assessment (3)

- *Optimal rule: requiring  $x\%$  of bail-in before bailout should require  $x\%$  of long-term junior claims to absorb bail-in and reassure senior claimholders.*
- Problem: this would imply a *big shock* to an already challenged Euro-area banking sector.
- Other potential ideas: (i) go 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.
- Seems politically infeasible, so chosen 2017 route: *'precautionary recap' + compensation for retail subordinated claimholders*, or even *'national bankruptcy'* i.e. relying on 'BRRD loopholes'.

## Assessment (4)

- Current negotiations: unwillingness to renegotiate 8% rule; recognition of need to move towards more long-term junior loss-absorbency, but not all the way to 8% for all banks.
- 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’.
- Challenge: *‘when bailout is out and bail-in is not in, denial is the only option left’* ... And procrastination is also very costly for growth and thus taxpayers.

## Assessment (5)

- Most important idea: bailing-in deposits is probably the worst possible outcome for taxpayers in the end, the right way to limit moral hazard is to have enough long-term bail-inable funds (equity and junior debt).
- *If not done*, big risk *SRB* (and *SSM*) *will be blamed* in the future by politicians ... who are the ones who have put us in the current situation ...
- All this is much more important than EDIS.

## References

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