

Dealing with solvency issues through bail-ins and bail-outs

discussion by

Alberto Franco Pozzolo
Università degli Studi del Molise

Managing financial crises: where do we stand?
Brussels – November 5-6, 2018

Bank restructuring and NPL (by JCR)

- NPLs are in this moment the major problem in the European banking landscape
- The paper is a very nice example of how **economic theory** can contribute to the **policy debate**
- The idea of **splitting a defaulting bank** between a good bank (GB) and a bad bank (BB) is not new...
...but the paper adds an interesting twist in proposing that the **BB gives a subsidy to the GB**
- A major critique of the banking industry is that the new regulations are causing **funding costs to rise...**
- ... but the paper shows that it is possible to **improve welfare** and reduce the underinvestment problem in case of crisis despite the higher ex-ante funding costs

Bail-ins, bail-outs, and MREL (by MD)

- The aversion to bail-outs is understandable, but it can create a risk of bank-runs through “**informational contagion**”
- Reassuring senior claimholders by **increasing the size of junior liabilities** may reduce the risk of runs
- In the trade-off between higher funding costs and lower risk of runs, requiring more junior debt can be **welfare improving**
- It is important to enhance **clarity** and European-level **harmonization** on:
 - the **structure of subordination**
 - the level of the **bail-in threshold** before bail-out is authorized

R&R: strategy, plans and suggestions

- Resolution procedures need to be **tailored** to bank characteristics (e.g., bank organisation, living wills)
- The banking union should be completed with **EDIS**
- Insolvency procedures should be **harmonized** across EU countries

- **Increasing the costs of bank funding** is often fully justified by the overall **welfare improvements**
- Better **coordination** at the European level is required on many issues

- In the background, lies the debate on **backstop facilities**

Additional issues (1): political economy

- There is a broad consensus on what would be an **optimal long-run equilibrium** for recovery and resolution procedures
- But **legacies** impose to consider what can be achieved in the **short to medium run**
- **Political economy** considerations are the **straightjacket** of any significant step ahead to solve issues still open:
 - EDIS
 - fiscal backstop
 - competition
 - harmonization of insolvency procedures
- If new legislation is difficult to pass, is there something that can be done with **actual rules**?
- Will **a crisis restore better EU-level cooperation**?

Additional issues (2): funding R&R

- Common funding of deposit insurance and recovery and resolution has many advantages...
... but creating such a fund at the European level requires **mutualisation**, that is difficult to envisage in the short-term, the more so if it includes a **fiscal back-stop**
- Without a European fiscal backstop and EDIS, and with a limited private backstop, a **country-level crisis** needs to be addressed differently
- **TARP** has been a successful story, worth considering for **single member countries** (controlling for the risks of doom-loops), if it is unfeasible at the European level
- Easier access to **ex-post market funding** and for private **acquisitions** should be considered

Additional issues (3): more MREL?

- In theory, mutualisation and cooperation are the best solutions...
... but in their absence it is better to **reduce** as much as possible the **risks of bank defaults**
- Political economy considerations might push the pendulum more in favor of **higher capital requirements** and a larger amount of subordinated liabilities
- Not as an ex-ante discipline device to reduce moral hazard, but as an **ex-post tool** to reduce the risk of insolvency

Additional issues (4): coordination

- The ability to contain moral hazard and to face a potential crisis would be enhanced by a **strengthened coordination among EU authorities**:
 - SSM (supervision and stress testing)
 - ECB (liquidity provision)
 - SRM (tailoring MREL requirements and R&R procedures)
 - DG-Competition (public interventions)

Are we now better at handling R&Rs?

- We have:
 - a better understanding of the mechanisms at play
 - better legislations
 - more tools
- ... but also
 - a stronger time-consistency problem for no-bail-out threats
 - a worse political environment