Bank Resolution and Bail-in

Mathias Dewatripont
Solvay Brussels School and ECARES
Université Libre de Bruxelles

National Bank of Belgium Conference
Brussels – September 14, 2018
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* (e.g. through deposit insurance); (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’.*
The 2007-8 crisis and re-regulation

• Crisis fed by under-regulation; significantly worse-ned 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, liquidity ratios, recovery and resolution planning, macro-prudential regulation).
Assessment of reregulation

• Reform agenda makes sense given previous crisis, even if *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'.

• *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.
• Big concern however: cost of financial instability.
• Relevant both at FSB with TLAC and in the EU, with BRRD and MREL. Focus here on the latter.
Banking Recovery & Resolution Directive
(see EC 2014 and Dewatripont, 2014)

• 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.

• 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). But recent progress (see below).
Assessment

• Aversion to bailouts understandable: taxpayer money, moral hazard, ...

• Remember however cost of financial instability: the costliest bank failure for taxpayers in last 10 years was Lehman, despite lack of bail-out, while 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 ».

• Conclusion: in order to avoid bank runs (esp. with volatile wholesale deposits), need 8% junior long-term liabilities for all banks!
Example of bank liabilities

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secured + very short-term liabilities</td>
<td>25</td>
</tr>
<tr>
<td>Retail deposits</td>
<td>40</td>
</tr>
<tr>
<td>Bail-unable senior liabilities</td>
<td>30</td>
</tr>
<tr>
<td>Junior liabilities</td>
<td>1.5</td>
</tr>
<tr>
<td>Capital</td>
<td>3.5</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>100</td>
</tr>
</tbody>
</table>

• 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 (2)

• Useful national solutions, e.g. Germany: make senior bank bonds junior, retroactively; Italy: make depositors senior to bonds and derivatives, retroactively; France: same as Germany, but NOT retroactive, and more granular. Now in EU toolkit: ‘non-preferred seniors’.

• Tension today: unwillingness to renegotiate 8% rule but requiring 8% of long-term junior claims to re-assure senior claimholders this would imply a big shock to an already challenged EA banking sector.
Assessment (3)


• Challenge: ‘when bailout is out and bail-in is not in, denial is the only option left’ … And procrastination is very costly for growth and thus taxpayers.
References

• Admati, A. & M. Hellwig (2013), The bankers' new clothes: What's wrong with banking & what to do about it, Princeton UP.


References (2)

