Which Protection for Bank Liabilities?

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1. A brief history of (de)regulation

History of (de)regulation

- Banking is risky (maturity transformation).
- Almost century-old 'cycling' between 3 objectives: productively efficient banking; financial stability (in particular, no bank runs); fighting moral hazard ('no bailouts').
- Until 1930's: sacrifice financial stability, but many bank runs, in particular in the Great Depression.
- From mid-1930's to early 1970's: sacrifice efficiency, with strict limits on competition (on entry, size, prices & activities); & introduce deposit insurance.
- No more bank runs & no bailouts but low productive efficiency in banking (e.g. overbranching) + development of nonbank competitors.

History of (de)regulation (2)

- As a result, gradual deregulation since 1970s, on prices and entry, & on size and set of activities.
- But deposit insurance maintained (against financial instability) and focus on (risk-based) bank solvency (against moral hazard): Basel I and II capital ratios.
- Impact: since 70s, very few runs, but many banking crises (147 worldwide (*Laeven-Valencia*, IMF, 2012)).
- Many linked to macro imbalances, but also to bank behavior (moral hazard), especially when undercapitalized and 'gamble for resurrection' (easier for banks than for regular firms: have access to 'safe' funding, just need to raise return on deposits).

History of (de)regulation (3)

- Interest rate and entry deregulation did benefit customers, but at times at expense of financial stability.
- Mixed picture at best w.r.t. innovation (e.g. ATMs versus very complex new financial products), and w.r.t. size and scope (are big (universal) banks profits and high management wages due to scale/ scope economies or to market power and 'too-big-to-fail' subsidy?).
- On the other hand, (Basel I/II) solvency (and liquidity) in 2008 clearly insufficient.
- Problem of both capital ratio level and banks' ability to 'manage' it (internal models, securitization, …).

Additional elements of the 2008 crisis

(see Dewatripont-Rochet-Tirole, Fahri-Tirole)

- Household overindebtness (especially in the USA).
- Securitization and therefore complexification of financial products.
- Role (and conflict of interest) of rating agencies.
- Extreme illiquidity for some banks, with massive recourse to (very unstable) wholesale funding.
- Race for higher and higher ‘return on equity’.
- Role of globalisation as an incentive to deregulate ('race to the bottom').

Responses to the 2008 crisis

- Crisis significantly worsened after fall of Lehman : first big-bank bankruptcy, that triggered « move to another equilibrium » (à la Diamond-Dybvig, but for wholesale funding).
- Double response:

  (i) « no more Lehmans », instead, significant rise of (retail) deposit insurance and massive bail-outs;

  (ii) re-regulation.

2. On the cost of bailouts

Banking crisis outcomes

(% of GDP; Source: *Laeven-Valencia*, 2012)

Area	(Gross) fiscal cost*	Increase in debt**	Output loss***
Japan (1997)	14.0	42	45
Sweden (1991)	3.6	36	31
USA (1988)	3.7	11	0
USA (2007)	4.5	24	31
Euro area (2008)	3.9	20	23

*: committed funds, to date (but (almost) fully re-paid in the case of Sweden, & USA 2007).

**: three years after the crisis; ***over 3 years, relative to trend.

Some lessons

- Crises typically lead to very low growth (with potential vicious circles). Exception: US S&L crisis (more 'regional').
- Gross fiscal cost of bailout is only a fraction of debt increase.
- Why was end outcome concerning this fiscal cost so much worse in Japan but also in S&L crisis than in the US in 2007 or in Sweden (where most of it got reimbursed)?

The Japanese crisis (1992-?)

- Familiar starting point: burst of real estate and stock market bubbles, then negative bank-real-economy link (see *Hoshi-Kashyap*, 2004).
- Key problem: insufficient recapitalization led banks to hide losses and favor loss-making existing corporate customers rather than more promising new borrowers. Such 'zombie lending' led to collapse of productivity (see *Caballero et al.*, 2008).

The Swedish crisis (1991-3)

- Fuelled by deregulation and real estate bubble.
- Dealt swiftly through nationalization of big banks (with shareholders wiped out). So, no lingering undercapitalization, thanks to availability of public money (repaid in the end).
- GDP significantly helped by international growth and depreciation of currency.
- See *Jonung* (2009).

Two contrasting US examples

- Savings and Loan crisis of the 1980s: much smaller than recent one to start with, but procrastination for many years. Accounting gimmicks instead of recapitalization (FSLIC without money at the time, Congress unwilling to help ...), while losses mounted due to gambling for resurrection by S&L's (see *Dewatripont-Tirole*, 1994).

Two contrasting US examples (2)

- Current worldwide crisis originated in the US, with subprime complex products.
- Still, US now in better shape than Europe.
- Key: TARP (Trouble Asset Relief Program) in 2009, at cost of $428 billion, but with net cost for the taxpayer today of ... only $21 billion, i.e. 0.1% of US GDP ! (*CBO estimate*, May 2013).

Euro area

- Two different crises since 2008: (i) ‘subprime-Lehman’ (trading book) crisis, which mainly affected Northern Europe; (ii) Euro (and Spanish housing) crisis, which mainly affects Southern Europe.
- First one dealt with ‘US-style’ (see Beck et al, Pisany-Ferry-Sapir), even if more gradually. Question: enough or not?
- Second one still a ‘moving target’, depending on GDP evolution.

Conclusion

- Procrastination really costly.
- Instead, swift intervention may pay for taxpayer (even if ex-post net-cost computations fail to take into account risk premia).
- Tradeoff current/future crisis: fighting moral hazard good, but NOT worth delaying restruc-turing, because lower GDP growth will raise final cost for taxpayer !

3. Reregulation

Reregulation: busy reform agenda

- Mix of (i) continuity (with recalibration) and (ii) change: (iia) back to regulation of what a bank may/should be; (iib) introduction of 'system regulation'.
- (i) More and better capital (and an additional, simpler, leverage ratio).
- (iia) Liquidity ratios, recovery & resolution plans, large-bank surcharges, structural reforms. (Vickers, Volcker, Liikanen/Barnier/…).
- (iib) Macroprudential instruments (Counter-cyclical Capital Buffer, ...).

Assessment

- Reform agenda makes sense given previous crisis. Does involve a partial U-turn w.r.t. laisser-faire approach to banking activities.
- Impact of new approaches (liquidity, recovery & resolution, structural reforms, systemic approach to regulation) still untested.
- Debate continues on 'excessively low Basel III capital ratios' (e.g. Admati-Hellwig, 2013) vs 'difficulty of finding the money & risks to real-economy lending'.
- What to think about new trend: bail-in rather than bailout?

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 and public at large do not feel that Basel III requires enough capital to protect taxpayers.
- Two concerns however: (i) cost of financial instability; (ii) who should bear risk?
- Relevant in particular in the EU, with BRRD (focus here, linked to FSB's TLAC).

4. The BRRD and financial stability

Banking Recovery & Resolution Directive

"Other tools (than bail-in) can be used to the extent that they conform to the principles and objectives of resolution set out under the BRRD. In circumstances of *very extraordinary systemic stress*, authorities may also provide *public support* instead of imposing losses in full on private creditors. The measures would nonetheless *only become available after the bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities* and would be subject to the applicable rules on State Aid." (FAQs on BRRD)

Banking Recovery & Resolution Directive

"Bail-in will potentially apply to any liabilities of the institution not backed by assets or collateral. It will *not apply* to *deposits protected* by a deposit guarantee scheme, short-term inter-bank lending or claims of clearing houses and payment and settlement systems (that have a remaining maturity of *seven days*), client assets, or liabilities such as salaries, pensions, or taxes. In *exceptional circumstances*, authorities *can choose to exclude* other liabilities on a case-by-case basis, if strictly necessary to ensure the continuity of critical services or to prevent widespread and disruptive *contagion* to other parts of the financial system, or if they cannot be bailed in in a reasonable timeframe." (FAQs on BRRD)

Banking Recovery & Resolution Directive

"The write down will follow the *ordinary allocation of losses and ranking in insolvency*. Equity has to absorb losses in full before any debt claim is subject to write-down. *After shares and other similar instruments, it will first, if necessary, impose losses evenly on holders of subordinated debt and then evenly on senior debt-holders.*"

"*Deposits from SMEs and natural persons*, including in excess of EUR 100,000, will be *preferred over senior creditors*."

(FAQs on BRRD)

Banking Recovery & Resolution Directive

"By definition, this will depend on the systemic footprint of different institutions. *Depending on their risk profile, complexity, size, interconnected-ness, etc., all banks should maintain (subject to on-going verification by authorities), a percentage of their liabilities in the form of shares, contingent capital and other unsecured liabilities not explicitly excluded from bail-in.* The Commission, upon a review by EBA, could specify further criteria to ensure similar banks are subject to the same standards." (FAQs on BRRD)

Comments

- BRRD insists on 8% bail-in even under systemic stress, as of January 1, 2016.
- Beyond secured liabilities, it exempts very short-term debt (up to 7 days).
- It gives priority to natural persons and SMEs.
- At this point, it does not impose hard targets for bail-inable securities (« GLAC », « MREL »).
- Suggestion: think of requiring a minimum of *8% of long-run junior liabilities* (equity, hybrids and *junior* debt, or an « *extended leverage ratio* ») in order to foster financial stability.

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 claimholders* !

Conclusion

- 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 TARP bailout has *almost been fully repaid* (more than 400 Billion $ out of 428).
- Remember also that « orderly » resolution will not prevent depositors from running if they can and feel their money is at risk.
- This requires sufficient long-term junior claims to absorb bail-in and reassure senior claimholders.

5. Trading off insurance and incentives (Dewatripont-Tirole 1994a, 1994b, 2012)

Regulation as an incentive scheme

- Idea: when firm performance bad, risk for management that control switches from (nicer) equityholders to (tougher) debtholders.
- Representation hypothesis: in banks, debtholders unable to exert control, so see bank regulation as a way to replicate role of capital structure in nonfinancial corporations.
- In a sense, Basel regulation does achieve this, provided that control switch is credible (resolution question),

Regulation as an incentive scheme (2)

- Key issue however: which performance?
- Answer: idiosyncratic performance, not performance linked to aggregate shocks (Holmstrom) !
- This issue was ignored by Basel I and Basel II.
- Addressed to some extent by Basel III: counter-cyclical capital buffer (similar to Spanish dynamic provisioning).
- One problem though: this is only 'self-insurance', which works provided bad shock 'follows' good one, so that there is a buffer to be released !

Regulation as an incentive scheme (3)

- Better to introduce capital insurance (à la Kashyap-Rajan-Stein), probably State-provided, or automatic stabilizers (e.g. through deposit insurance premia indexed on the business cycle).
- Based on the idea of the State as insurer of last resort (classical in economics).
- Instead, BRRD seems to be based on ‘protecting the taxpayer as much as possible’: OK for idio-syncratic shocks, NOT for macro shocks !

Regulation as an incentive scheme (4)

- Private insurance of course potentially adequate (provided it is credible: loss absorbency rather than runs, and no resource constraints (AIG …).
- One way to make BRRD consistent with this micro/macro distinction: have banks issue CoCos whose triggers would distinguish between idio-syncratic and macroeconomic events, so as to appropriately discipline bank management.
- Not easy to design though. Why not complement it with additional insurance mechanisms?

6. Conclusion

- Search for optimal tradeoff between productive efficiency, financial stability and fight against moral hazard continues.
- At this point, ‘protecting taxpayers’ is given priority.
- Don’t forget however the cost of financial instability, while there have been successful bailout experiences in case of macro crises.
- Therefore, do design bail-in a way that will not trigger bank runs.
- Do complement it with capital insurance against macro risks and/or automatic stabilizers.

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