Andreas Dombret: Systemic risk, too big to fail and resolution regimes

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Salzburg Global Seminar "Out of the shadows: should non-banking financial institutions be regulated?", Salzburg, 19 August 2013.

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1 Introduction

Good afternoon, ladies and gentlemen

It's a great pleasure to take part in this Salzburg Global Seminar. Many thanks for inviting me back. Over the next twenty minutes, I would like to share my views on how to deal with systemic risk and moral hazard.

While concepts have been developed to initiate regulatory reforms, it troubles me tremendously to have to state that the "too-big-to-fail" problem still remains unresolved. Market participants continue to anticipate that governments will rescue systemically important financial institutions – or SIFIs – in the event of their failure.

The resulting refinancing advantage is reflected in so-called rating "uplifts". Rating agencies usually calculate two different ratings for banks. One is a "stand-alone" rating that measures a bank's genuine creditworthiness. The other is the "all-in" rating which includes the likelihood and extent of external support available for the bank's debt.

The difference between these two ratings is the "uplift". It delivers a proxy for funding subsidies, which are benefiting SIFIs. Although these uplift factors have recently shrunk to some degree, they unfortunately remain substantial.[1] This could be taken as an indicator supporting my claim that the "too-big-to-fail" problem remains unresolved.

However, in this regard we need to achieve two objectives at the same time. First, taxpayers should not have to foot the bill for bank failures and, second, systemic disruptions must be avoided. The experiences following the Lehman collapse five years ago show how important financial stability is – and how fragile. So, what can we do about the "too-big-to-fail" problem?

2 Solving the "too-big-to-fail" problem

2.1 How to make bank failures less likely

I am convinced that overcoming the "too-big-to-fail" problem will require a multi-track approach. The main goal is to make SIFIs less likely to fail by increasing their loss-absorbing capacity. Basel III represents a landmark change in this respect. These rules are much more rigorous than any previous regulation, both in quantitative and qualitative terms. On top of this, global SIFIs face additional capital requirements, known as SIFI surcharges. Combined with other measures, such as more intensive supervision, these changes will enable banks to better cope with stress situations.

I am aware of a somewhat disconcerting discussion about the perceived shortcomings of the new capital standards. Some argue that they are still not rigorous enough. Others argue that they are too complex. Yet neither of these criticisms is convincing. Basel III substantially

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[1] OECD, S Schich and S Lindh, Implicit guarantees for bank debt – Where do we stand?, 2012. Schich and Lindh define "uplift" as the difference between the "all-in credit rating" (AICR) and the "stand-alone credit rating" (SACR).

raises capital requirements, and impact studies were carried out before the rules were finally endorsed.[2] Now we should let Basel III take effect.

Looking at the issue of complexity, it is true that risk measurement will never be perfect and that relying on internal models hampers comparability, among other things. However, simplicity can come at a cost, too, as it disregards the overarching need for risk sensitivity. Therefore, we need to strike a balance between risk sensitivity, simplicity and comparability.[3] But the spirit of the Basel rules, particularly regarding risk sensitivity, should not be compromised, nor must their full implementation be called into question.

2.2 How to make bank failures less systemic

While it is necessary to increase banks' resilience, that alone is not enough to solve the problem. There is a second broad goal which is now increasingly recognised: we have to ensure that SIFIs can be resolved without disrupting the financial markets.

But before discussing more specifically how to create effective resolution regimes, let me briefly touch on some suggestions for separating commercial from investment banking. As you know, the main argument in favour of such proposals is to avoid or restrict contagion.

Proponents of this approach believe that separating deposit-taking and lending from investment banking would prevent spill-over effects. The idea is to create a category of rather traditional banks whose customers would be protected by deposit insurance schemes. On the other hand, those banks engaged in riskier and more volatile business could not rely on deposits, nor would they be rescued at the taxpayers' expense. In addition, the separation could simplify group structures. This would facilitate risk management and supervisory scrutiny as well as resolution, if need be.

However, as the boundaries between various banking activities are fluid it is difficult to draw a clear line between them. Consequently, structural interventions in banks' business models must be carefully designed. They might help to solve the too-big-to-fail problem, but they are by no means a magic bullet.

3 How to resolve a SIFI

3.1 Key attributes of effective resolution regimes for financial institutions

Without any doubt, we need effective resolution regimes for financial institutions. Unfortunately, the crisis has revealed a significant lack of suitable resolution instruments, especially in a cross-border context. This is why the G20 leaders, back in 2011, endorsed the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions" as a reference point for national resolution regimes.

They set out core elements of national resolution regimes on a global level. For instance, in future every G20 country is to entrust restructuring and resolution functions to appointed authorities. Recovery and resolution planning will become mandatory in every resolution regime.

Jurisdictions around the globe are currently contemplating their preferred resolution strategy for systemically important banks. Two stylized models have recently been set out by the Financial Stability Board: a Single Point of Entry- and a Multiple Point of Entry-strategy. The

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[2] FSB/BCBS, Macroeconomic Assessment Group: a) "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements", Dec 2010 and b) "Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks", Oct 2011

[3] BCBS, The regulatory framework: balancing risk sensitivity, simplicity and comparability – discussion paper, July 2013, http://www.bis.org/publ/bcbs258.htm

question behind these strategies is whether resolution tools will be applied by a single authority at the top level of a failing bank or whether they will be applied in a coordinated manner by more than one authority at the level of regional or national units of the bank.

Another matter of priority is that resolution instruments, including the bail-in tool, have to be codified in national laws.

The Key Attributes are quite a step forward. Implementing them will gradually align national resolution regimes. I am hopeful that this will significantly curtail the ability of financial institutions to hold taxpayers to ransom.

It is now up to governments to transpose the Key Attributes into national legislation. The Financial Stability Board is closely monitoring this process. A recent peer review by the Financial Stability Board[4] showed that implementation is still at an early stage in many G20 countries.

Implementation efforts therefore have to be treated as an urgent matter in all jurisdictions. We would have to pay dearly for any delay. To summarise, we cannot accept any excuse for deviations from timely implementation.

3.2 Europe's implementation of resolution rules: key issues

In Europe, the implementation of resolution rules has been carried out through ECOFIN's agreement of 27 June 2013.[5] The Council adopted its general approach on the draft directive for the recovery and resolution of credit institutions and investment firms.

I welcome the general thrust of the Recovery and Resolution Directive – or RRD. And I hope that the trilogue process with the European Parliament can be completed swiftly, as planned. Please allow me to look in more detail at three key issues relating to the RRD.

First, the bail-in tool: this enables resolution authorities to write down the claims of shareholders and write down, or convert into equity, the claims of creditors of institutions which are failing or likely to fail.

As predictability is crucial when it comes to allocating losses, I very much agree with the Council's general approach stipulating a clear pecking order. Shareholders will be the first in line to bear losses, followed by clearly defined classes of creditors. Very few classes of liabilities are permanently exempted from any bail-in, with covered deposits being the most important category.

I also broadly agree with the Council's list of permanent exemptions – with only one reservation. Excluding all inter-bank liabilities with an original maturity of fewer than seven days could have far-reaching consequences, as it may well foster an unwanted bias towards short-termism. I would therefore argue that these liabilities should be shifted from the permanent to the discretionary category of exemptions. In general, the bail-in tool should enter into force in parallel with the other resolution tools, that is, in 2015.

Second, I welcome the minimum requirement for own funds and so-called eligible liabilities. This will ensure that each institution has sufficient loss-absorbing capacity based on its size, risk and business model.

Third, I wish to comment on resolution funds. As a general rule, the draft RRD requires member states to set up resolution funds, which are to be funded ex-ante by banks. Within ten years they should reach a target level of 0.8% of covered deposits. For the sake of compromise, the draft directive contains an exemption to the mandatory creation of a

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[4] FSB, Thematic review on resolution regimes – Peer review report, April 2013; http://www.financialstabilityboard.org/publications/r_130411a.htm

[5] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf

separate resolution fund. In this case the member state would have to raise at least the same amount of financing from mandatory contributions and make it available to the resolution authority upon its request.

In my view, this mixing of public and private funds for resolution funding purposes is against the spirit of the RRD. Moreover, and to be frank, I wonder how this exemption can be applied in practice.

All in all, the draft RRD is quite close to striking a sound balance between the conflicting objectives of harmonisation and flexible rulemaking. A high degree of harmonisation is needed to ensure both predictability and a level playing field. However, a certain degree of flexibility is necessary in order to tailor resolution measures to the specific crisis situation.

Where do we go from here? On 10 July 2013, the European Commission presented its proposal for a single resolution mechanism for the banking union.

I firmly believe we should entrust a newly established European institution with resolution powers as laid out in the RRD. It must become a strong and independent body with full decision-making powers. If we agree this to be the objective, let's find constructive ways to bridge an interim period until this can be realised. A transitional phase is probably inevitable, so as to allow the SRM to become effective more or less in parallel with the Single Supervisory Mechanism. This is essential, as the SSM and the SRM will be highly intertwined and we should not launch the banking union half-heartedly.

4 Concluding remarks

In summary, effective resolution regimes which also work in cross-border crises are crucial for solving the still unresolved too-big-to-fail problem. This will require international cooperation and adherence to standards. The fragmentation of markets and regulation under protectionist pressure must be reversed. Although we have made some progress, especially conceptually, much more remains to be done, in particular in terms of implementation.

Incentives and expectations are mutually reinforcing. Markets must be convinced that even a large, internationally active bank that runs into trouble can and will be resolved should there be a need to do so. Markets must be convinced that shareholders, creditors and the banking industry will pick up the bill and not the taxpayer.

In short: the bail-in is "in" and the bail-out is "out"! I am aware that this is easier said than done. It will require firm political will. But it is very much worth the effort.

Thank you very much for your attention.