Public support for bank resolution[1]

Executive summary

Credible bank resolution crucially requires appropriate means to preserve failing banks' critical functions. To that end, resolution policies work in two directions. First, they require banks to have internal resources that could facilitate the continuation of a bank's main functions by itself or by a suitable acquirer. Second, they mobilise resources that are external to the failing bank to help close remaining mismatches, for example by providing support to an acquirer. In many jurisdictions, such external resources can be made available from industry-sourced funds such as deposit insurance funds or dedicated resolution funds.

Banks' internal resources and those of industry-sourced funds are finite, and public resources may therefore be needed to enhance them. Both banks' internal resources and those of industry-sourced funds may not always be sufficient, they may not be available within the requisite time, or they cannot be called upon without defeating the very objectives of resolution. In such circumstances, if resolution is to preserve financial stability, and considering that financial stability is a key public good, using public resources as a last resort to enhance funding capacities appears only natural.

Yet public support for resolution action poses obvious risks. If funds are used on a temporary basis, for example as loans, immediate risks pertain to recouping those outlays over time. More generally, using public resources to fund resolution, even if only on a temporary basis, comes at the expense of other public tasks and may jeopardise the credibility of resolution policies and, eventually, erode social confidence. Lastly, expectations that resolution will be publicly funded are likely to lead to moral hazard and distort market discipline. These risks are exacerbated if public resources are committed without predetermined duration, for example as capital. Resolution policy needs to mitigate these risks.

The simplest way to organise public support for resolution action is through a loan to industry-sourced funds. This enhances the resources of industry-sourced funds and strengthens their capacity to fund resolution actions. Such an arrangement has various advantages. The lending terms can reflect proper burden-sharing across funding sources, reinforcing the last resort principle. Moreover, public loans are repaid from fees and levies imposed on fund constituencies, ensuring that public expenses are recouped and loans do not permanently burden the public purse. Lastly, as loans are repaid through fees and levies, the cost of failure is contained within and mutualised across the financial system as the primary beneficiary of resolution action, rather than imposed on the taxpayer.

Residual risks to public finances remain but can be managed by remuneration policies. Where public support for resolution is provided as a loan to industry-sourced funds, punitive interest rates may help set incentives that reduce the exposure of public funds, similar to lender of last resort policies, and further mitigate moral hazard risks. If public support is deployed directly, for example through publicly funded recapitalisations or guarantees, setting such incentives is more challenging and requires negotiating bespoke terms into the relevant instruments.

While flexibility is a key feature of effective arrangements for public support, it needs to incorporate safeguards. If required, public support needs to be deployed quickly and provided in sufficient amounts. Overly constraining caps as well as overly demanding thresholds, while potentially mitigating public exposure, tend to reduce the scope of action and ultimately may harm the credibility of resolution frameworks. Arrangements should therefore be sufficiently flexible while incorporating

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safeguards to ensure that public support is provided as and when needed to preserve financial stability, alternative suitable solutions are unavailable, adequate conditionality applies and recoupment is effective.

Resolution frameworks should integrate well-defined public support arrangements that enhance financial stability and contain adverse social costs. Integrating public support into resolution frameworks has various benefits. It clearly ties public support to the public interest by identifying the considerations to be taken and processes to be followed, if and when authorities deem financial stability is at stake. It then underpins these decisions with governance arrangements, safeguards and conditionality that help to preserve social legitimacy.