Anne Le Lorier: Bailouts, bail-in and financial stability

Welcome address by Ms Anne Le Lorier, First Deputy Governor of the Bank of France, at the conference “Bailouts, bail-in and financial stability”, jointly organized by the Bank of France and the Toulouse School of Economics, Paris 28 November 2014.

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It is a great pleasure to welcome you here today at the Banque de France for this joint conference organized with the Toulouse School of Economics. It is the seventh conference jointly organized with TSE since the beginning of our partnership on financial stability issues. In the previous events, we tackled “Extreme events” in 2008, and then “Liquidity” in 2009, “the Future of Financial regulation” in 2010, “Debt crisis in the euro area” in 2011, “Banking models and banking structures” in 2012, and “Bank liquidity, transparency and regulation” last year.

Today’s topic is “Bailouts, bail-in and financial stability.” In the follow up to the last financial crisis, almost all regulatory initiatives have been motivated by the objective of ensuring no future public bailouts of banks or, in the language of economists and banking regulators, ending the Too-Big-Too-Fail problem.

This objective is to be reached for all systemically important financial institutions, be they banks, insurance companies, market infrastructures or entities belonging to the so called “shadow banking system” (asset managers, hedge funds and so on). Due to their unique role and concentration of positions, non-banks such as global insurers, global central counterparties and large asset managing entities undoubtedly entail systemic risks that have to be carefully monitored and mitigated. This is already acknowledged by standard setters (CPMI-IOSCO) and by the Financial Stability Board and would probably deserve a specific conference. What makes banks specific among systemic institutions is the presence of implicit subsidies and this feature is the main focus of today’s conference.

Allow me to elaborate a bit on the TBTF problem and the implicit subsidy

To prevent the collapse of the global financial system, governments in major jurisdictions stepped in by bailing out some financial institutions or by providing public guarantee to unsecured bank-debt holders. This use of tax-payers money for preventing private losses entailed sizeable direct costs for governments, in terms of both political support and fiscal implications. A more indirect, but equally important concern is that these interventions – aimed at stabilizing markets – may have reinforced market perceptions that some financial firms are too important-to-fail. When markets anticipate that some financial firms will benefit from future public support, their uninsured creditors have little incentives to charge a rate commensurate with the risk of their investment. These institutions thus enjoy a funding cost advantage – in essence an implicit public subsidy.

This implicit subsidy raises two important concerns for financial stability. First, it encourages risk-taking by the entities concerned, which are not subject to a proper creditors’ market discipline. Second, it can also provide perverse incentives for financial firms to grow bigger, more complex and more interconnected simply to secure public support and finally take on more risks.

To answer these concerns, the policy response has focused on the issue of ‘too- big- to- fail’ institutions. The Financial Stability Board (FSB) has proposed that global systemic financial institutions should be better capitalized and be submitted to higher capital surcharges, proportional to their contribution to systemic risk. It has also recommended a tighter supervision of these institutions, notably by setting up Crisis management groups in charge of monitoring that these institutions develop appropriate resolution and recovery plans.

It may be useful at this point to step back a little. The TBTF problem was not born with the crisis. The official recognition of a TBTF policy and the coinage of the term itself date back to 1984 during the testimony before Congress of the then US comptroller of the Currency on the government rescue of the bank Continental Illinois. Afterwards, a further 11 banks were identified as TBTF in an article in the Wall Street Journal. The fact that continental Illinois rescue led to a subsequent decrease in market discipline for these banks has been confirmed by several academic studies.

The last crisis however gave rise to two important developments in the TBTF problem. First, for the first time, taxpayer funded bailouts were extended to the uninsured creditors of non-deposit-taking entities (the names of Bears Stearns and AIG naturally come to mind) for fears that their failures would have severe negative externalities. Second, the list of globally systemically important banks is now set up and published by an official international body, the Financial Stability Board, on the basis of a mandate given by the G20. In itself, this simple fact could be interpreted by markets as a signal that public authorities will never allow the thirty firms belonging to the list of G-SIBs to fail. On the other hand, expectations of public support for too-systemic-to-fail institution are likely to have been reinforced by the market turmoil that followed the failure of Lehman Brothers.

Let me now flag some of the questions/challenges that could be addressed today.

The first question that naturally comes to mind is the measure of the phenomenon, i.e.: “How big is the implicit subsidy?” A quick look at the literature shows that measuring the subsidy is difficult, since it is implicit and tied to market perceptions. In addition, differences in funding prices between large or systemic banks and small or non-systemic banks can be due to factors unrelated to potential government support, such as differences in economies of scale and scope, or differences in the size and liquidity of bonds issuance. Overlooking these alternative factors could lead to overestimate the size of the implicit public subsidy.

Second, one would also like to ascertain whether the presence of an implicit subsidy does lead to higher risk taking, and the quantitative importance of this effect.

The third question has to do with regulation, i.e.: “what can be done to address this issue?” It seems that there are three main approaches:

- Some regulatory measures try to eliminate possible symptoms of the implicit subsidy. For instance, proposals on restrictions on bank market activities have been justified by the objective of limiting the implicit subsidy to non-traditional banking activities.
- Another approach is to directly target the underlying cause of the problem, for instance by making easier the resolution of problems at large banks without resorting to taxpayer money. Some progress has been achieved in the US (through the Orderly Liquidation Authority), and in Europe (through the Recovery and Resolution Directive).
- A third approach, illustrated by the G-SIBs framework, is to offset the implicit subsidy with additional capital and bailinable debt requirements the so called TLAC or other regulatory measures.

Concluding remarks

To conclude, I would offer two remarks which you may want to keep in mind.

The first remark has to do with the comparative advantage of too-systemic-to-fail institutions, and in particular of global systemically important banks. In reaction to the crisis, many regulatory reforms have been put in place on capital and liquidity, credit exposure to counterparties, supervision, and trading activities.

These reforms will impose higher costs on systemic institutions compared to their non-systemic (smaller) peers. The logic makes perfect sense when one considers each reform separately, since the objective is to eliminate/compensate the competitive advantage that these institutions derive from expectations of public support. However, the result of adding up all measures may be to turn a gross competitive advantage into a net competitive disadvantage.

Although one might see this as a welcomed outcome, I see at least two reasons that could mitigate this view:

- First, this cumulative regulatory cost could lead banks to operate below the economically optimal scale and scope, and withdraw from the provision of activities important for international firms and globalized financial markets. I have no preference for big systemic banks. But I simply do not believe that these large financial institutions became large and complex simply to benefit from the implicit subsidy.
- Alternatively, this could lead to even more concentration among systemic institutions themselves, as some attempt to secure higher public support probabilities to compensate for the higher regulatory burden. Unless public authorities suddenly find a way to credibly commit to no bailouts whatsoever, we may well end up at some point with a world with fewer but more systemically important systemic players. And I am not convinced that a world with five G-SIBs instead of the current list of thirty would necessarily be more stable.

The second remark is that removing anticipations of state support/bailouts is a process that may take time and which must be handled with extreme care. The unexpected imposition of losses on some type of creditors to resolve problems in some banks can lead to shifts in expectations of public guarantee for other institutions, and create contagion and funding stress at other banks. The case of Cyprus was a perfect illustration of this. The difficulty is to guide the evolution in expectations over time, and avoid abrupt shifts that would increase financial instability and ultimately undermine the objective of the reforms. This 'transition problem' is in my view critical, and has been overlooked in many discussions.

This conference is organized so as to facilitate exchanges with the audience. Therefore, I encourage you to be fully involved in the discussions and wish you fruitful debates. I now leave the floor to Augustin Landier from Toulouse School of Economics, one of the organizers of this conference with Regis Breton and Laurent Clerc from the Banque de France Financial stability directorate, who will chair the first session of the conference.