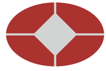

BANK FOR INTERNATIONAL SETTLEMENTS

Bail-in in the new bank resolution framework: is there an issue with the middle class?[1]

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Introduction

It is a privilege to participate in this conference organised by IADI, with which the FSI maintains a highly fruitful relationship. And it is of course a pleasure to visit Naples, one of Europe's most attractive cities.

The conference takes place at a crucial moment for the European resolution framework. The new rulebook – as spelled out in the Banking Recovery and Resolution Directive (BRRD) – is now in force throughout the European Union, and the Single Resolution Board (SRB) is up and running as the single resolution authority within the banking union.

At the same time, important debates and negotiations are taking place, with the twin aims of completing the banking union with the creation of a European Deposit Insurance Scheme and improving the single rulebook by adjusting both the prudential framework, as contained in the Capital Requirements Directive (CRD) and Regulation (CRR), and the resolution framework laid down in the BRRD.

More importantly, over the last year the new resolution framework has been tested in practice, in the context of the failure of a few significant institutions. That has obviously helped in assessing the effectiveness of the established procedures and also identifying possible deficiencies that need to be addressed.

These developments in the EU coincide, at the global level, with efforts in a number of jurisdictions to put in place a resolution framework that meets the new international standard set up by the Financial Stability Board (FSB) in its *Key attributes of effective resolution regimes for financial institutions* (the Key Attributes). Moreover, the recent publication by the US Treasury of a proposal to modify the US resolution and insolvency regimes for financial institutions makes a further important contribution to the current debate on how to best operationalise the Key Attributes.

In that context, let me share with you some reflections on the challenges faced in the current phase of implementing resolution frameworks in order to put in place effective procedures that will enable the management of banking crises with minimal involvement of taxpayers' money while preserving financial stability.

I will focus my remarks on the specific theme of the involvement of banks' creditors in resolving failing banks (or bail-in), as I believe that constitutes the key ingredient of the new framework but also

[1] I am grateful to Patrizia Baudino, Alberto Casillas and Ruth Walters for helpful comments. The views expressed are my own and do not necessarily reflect those of the BIS or the Basel-based committees.

possibly the one that entails more technical and political complexity, and the one which is likely to have a more significant impact on banks' business models and corporate strategies.

Let me, indeed, start by describing the most relevant challenges associated with the implementation of bail-in. I will then review some factual developments that help illustrate the relevance of those challenges. I will go on to analyse the specific European framework for bail-in and discuss its interaction with the structure of the industry.

The challenges

As I have already mentioned, the availability of bail-in powers is a fundamental and innovative component of the Key Attributes. It represents an essential tool to facilitate an effective resolution of systemic institutions – and, in particular, the preservation of their critical functions – without recourse to taxpayers' money. However, the implementation of bail-in is subject to a number of economic, technical and political challenges.

From an **economic** point of view, the main risk associated with bail-in is that the imposition of losses on specific classes of creditors could give rise to adverse systemic effects, particularly if activated in a period of generalised stress in the banking sector. Those effects could stem from the direct impact of bail-in on the solvency of affected creditors, such as institutional investors, and from a general deterioration in the market value of instruments similar to those subject to bail-in.

From a **technical** point of view, the effective execution of bail-in depends on a number of conditions being in place, including: accurate valuation procedures – that support the application of the no-creditor-worse-off safeguard; appropriate procedures in securities exchanges and depositories; an effective communication strategy; and a smooth process for adjusting rights of shareholders and creditors. That constitutes a set of complex operational arrangements that authorities and industry are still working to put in place.

From a more **political** perspective, the bail-in tool entails, at the end of the day, an administrative authority having the power, outside the regular insolvency procedures and without judicial intervention, to adjust the payoff profile of financial instruments issued by a financial institution with the purpose of ensuring sufficient absorption capacity. Therefore, it is perceived sometimes as a material deviation from the longstanding regular commercial law procedures that have applied in most jurisdictions. Moreover, for cross-border banks, resolution actions will often be taken by administrative authorities located outside the jurisdiction where the problems have been identified, and/or outside the jurisdiction where affected securities have been issued and/or outside jurisdictions where most investors in those securities may reside. All of this potentially entails significant political sensitivities.

The facts

The international community and, in particular, the FSB, has worked effectively to provide guidance on how best to mitigate the obstacles – particularly those of a technical nature – and address the implementation challenges I have outlined.[2]

Yet the evidence so far is that, in practice, implementation of the bail-in tool is encountering serious obstacles.

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[2] See eg FSB, *Principles on bail-in execution*, November 2017.

First, according to the FSB surveys,[3] administrative powers to impose losses on creditors, or to convert their claims into capital, are only available – to different degrees – in about half of the FSB membership. That implies that this essential element of the new resolution frameworks, aiming at replacing bail-outs by private creditors' involvement in loss absorption and recapitalisation of failing systemic institutions, is not yet present in a large number of both advanced and emerging economies.

Second, despite the fact that the new EU resolution framework (contained in the BRRD), which follows the Key Attributes closely, entered into force in 2015, the bail-in tool has not yet been fully applied in any of the bank failures that have occurred since then. This poses doubts about the actual applicability of the bail-in powers. As Mark Branson, Chair of the FSB's Resolution Steering Group, said at a recent conference organised by IADI and the FSI, the credibility of the new resolution framework requires practical examples to show that the new arrangements, and in particular bail-in, actually work in practice.[4]

Therefore, recent experience in the EU may point to specific practical challenges that could in the future be relevant for other jurisdictions. Let me now turn to them.

Bail-in in the European Union

In the new framework, European banks which are declared as failing or likely to fail, for which no private solution is available and whose failure would have implications for the public interest, will be subject to resolution rather than to liquidation in accordance with the national insolvency regime.

However, the resolution framework in the EU, as set up in the BRRD, is quite stringent. It not only heavily restricts the availability of public funds to assist weak financial institutions, it also prescribes strict conditions under which the resources of the Single Resolution Fund (SRF) – funded exclusively by the industry and at present without any sort of public backstop – can be used in resolution procedures.

In particular, a minimum of 8% of total liabilities must be bailed in –as a necessary but not sufficient condition – before the SRF can start deploying the resources required to execute the resolution strategy. This condition for use of the resources of a resolution fund goes beyond the Key Attributes.

In order to make this stringent minimum bail-in requirement sufficiently credible, banks in the EU for which liquidation is not the preferred strategy may be required to hold on their balance sheets a minimum volume of liabilities that could be bailed in in the event of resolution. This the rationale behind provisions of the BRRD on minimum requirements for own funds and eligible liabilities (MREL).

Interestingly, MREL requirements, unlike the FSB's standard on total loss-absorbing capacity (TLAC), which applies only to global systemically important banks (G-SIBs), are specified in a relatively loose way in the BRRD.

In particular: (i) following a Pillar 2 logic, the required amount of MREL is set bank by bank; (ii) there is no general subordination requirement for MREL-eligible instruments; and (iii) there is no general deadline for banks to meet the MREL requirements.

As a consequence, much is left to resolution authorities to decide on specific features of MREL. In the banking union, the SRB therefore plays a crucial role in specifying MREL policy.

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3 See eg FSB, *Implementation and effects of the G20 financial regulatory reforms – third annual report*, July 2017.

4 See M Branson, "Opening remarks at FSI-IADI 8th Conference on Bank Resolution, Crisis Management and Deposit Insurance", Basel, 31 January 2018.

The issues with the "middle class"

The SRB has already hinted at the adoption of a relatively demanding approach. MREL requirements will apparently be set at close to twice regulatory capital,[5] which would normally imply around 25–27% of risk-weighted assets (RWA), on average, for institutions under the SRB's jurisdiction.[6] That will significantly exceed the TLAC requirements envisaged by the FSB for G-SIBs. Moreover, unlike TLAC, MREL requirements – as defined by the SRB – will be imposed on most if not all significant institutions in the banking union, and not only on those considered globally or domestically systemic.

As an immediate consequence of those stringent criteria, it is estimated that the European banking industry will need to make up a large shortfall of eligible liabilities. According to data provided by the SRB, corresponding to banks representing 80% of total assets of SRB banks as of 31 December 2016, that shortfall could exceed €117 billion. Other available calculations provide even higher estimates. For instance, the European Banking Authority (EBA) estimated that on the same date the shortfall for significant EU banks could be between €130 billion and €285 billion, depending on the final articulation of the MREL eligibility criteria.[7]

Moreover, to the extent that both covered and (most) uncovered deposits will not be eligible for MREL, the shortfall may be disproportionally high for significant (ie under the SRB remit) medium-sized institutions that follow a traditional business model mostly financed by capital and deposits and with limited recourse to capital market financing. In that regard, it is worth taking into account that around 70% of significant banks under direct supervision by the SSM are not listed, that 60% have never issued convertible instruments and that 25% have not issued subordinated debt either.[8]

To give a very simple example to illustrate the quantitative implications of the envisaged MREL requirements, consider a standard medium-sized commercial bank that is fully financed by capital and deposits and whose actual capital exceeds minimum regulatory requirements by, say, 25%. If MREL is set at twice regulatory capital, that bank will have to issue eligible, and preferably subordinated, instruments for an amount equal to at least 0.75 times its regulatory capital. On a conservative assumption that the required remuneration of the new subordinated liabilities is between half and two thirds of the return on equity of the firm, the MREL requirements will cost such a bank between 30 and 40% of its annual pre-tax profits. Naturally, the final impact on banks' profitability will depend on their ability to find new investment opportunities with a sufficiently high risk-adjusted return, for a bank with a traditional business model and minimal capital market activity.

It is clear that given the large magnitude of the shortfall and, particularly, the potential impact of the requirements on a relevant segment of the banking industry, a pragmatic approach by the SRB is of the essence. In particular, MREL requirements should always be fully justified by the need to make the specific resolution plans of the institutions sufficiently credible.

At the same time, it is also true that the SRB faces restrictions that constrain the flexibility that could reasonably be introduced in the MREL policy. Those restrictions are related to the specific resolution framework that the BRRD defines.

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5 In fact, the reference used by the SRB is twice the sum of Pillar 1 and Pillar 2 requirements plus the combined buffer requirements plus a market confidence charge. See SRB, *Minimum requirement for own funds and eligible liabilities (MREL): SRB policy for 2017 and next steps*, December 2017.

6 See D Laboureix, *Sixth industry dialogue: 2017 MREL policy*, Single Resolution Board, November 2017.

7 See EBA, *Quantitative update of the EBA MREL report*, December 2017.

8 Data extracted from SNL Financial.

First, as discussed, the BRRD envisages a Single Resolution Fund (SRF) with limited firepower and, more importantly, that can only deploy funds once a minimum bail-in has been already executed. Under those conditions, if authorities want to avoid subjecting uncovered deposits to bail-in, all banks that could eventually require support from the SRF should have issued a sufficient amount of eligible securities to meet the minimum bail-in-requirements.

Second, an excessive relaxation of subordination requirements for MREL is also a risky strategy. A smooth application of the bail-in-tool and, in particular, the need to minimise the impact on the rest of the financial system requires bail-in-able securities to be easily identified by investors as such. The need to respect the no-creditor-worse-off principle also restricts the extent to which instruments that are pari passu with deposits and operational liabilities in the creditor hierarchy can in practice be eligible for MREL. That suggests that securities that could eventually be bailed in should ideally be issued under clear contractual terms that include explicit conversion triggers and establish their subordination to non-eligible liabilities. In particular, experience shows that corporate fixed-term deposits are not suitable instruments even if the BRRD does not exclude them from being eligible.

And third, an excessively long transition period for meeting MREL requirements may also have unintended consequences. Arguably, smooth transitional arrangements could help banks to cover their MREL shortfall in an orderly way. In particular, it would facilitate the absorption by the market of the volume of new issues required for European banks to meet the new obligations. However, given that the minimum 8% bail-in requirement has been fully in force since 2015, a long period to meet MREL requirements could undermine the credibility of bail-in resolution strategies or make the resolution process particularly cumbersome during that transition. Indeed, if banks do not meet MREL requirements, access to the SRF during the transition may only be possible if unsecured deposits are subject to bail-in: an outcome that could be significantly destabilising and is likely to be politically unpalatable.

To be sure, the introduction of minimum bail-in requirements to obtain external support in resolution will only be effective in meeting the resolution objectives if those minimum requirements are met with suitable securities. That suggests appropriate constraints not only on the quantitative TLAC/MREL-type requirements but also on the eligibility criteria for those instruments and on the transitional arrangements envisaged for the full implementation of both the minimum bail-in and the MREL requirements. Those constraints are likely to have an impact on the structure of the banking industry.

The structure of the industry

Thus, as I have argued earlier, if minimum bail-in conditions – and the associated TLAC/MREL requirements – are as stringent as currently envisaged, those conditions could well become a binding constraint on the sustainability of banks' business models. In particular, they may not be feasible for banks whose business models do not easily allow them to tap capital markets to issue subordinated or convertible liabilities to meet requirements for a sufficient amount of bail-in-able debt.

As a consequence, it may be the case that relevant elements of the new resolution framework – which relies on the principle of bail-in – can only be effectively applied to those institutions that not only meet the public interest condition for the use of resolution powers, but whose size and business models also allow for a sufficiently large issuance of subordinated liabilities that could be bailed in in resolution without undue risk of negative impacts. As the alternative to resolution is the application of regular insolvency procedures, authorities will need to be satisfied that the failure of those institutions that are unable to comply with TLAC/MREL requirements would not meet the public interest threshold, which justifies the application of resolution. Or, put differently, authorities will need to be confident that the regular insolvency procedures could be applied to them without jeopardising financial stability.

It seems therefore that the effectiveness of the new resolution framework could require the banking system to be organised into two well defined segments. The first one would be composed of

systemic financial institutions with active participation in capital markets that would be subject to the resolution procedures, including bail-in, in case of failure. The second segment would be composed of truly unsystemic institutions that would be subject to regular insolvency procedures. There is therefore no clear room for a "middle class" of institutions whose failure – and eventual liquidation – could be considered systemic but whose business model appears incompatible with the satisfaction of stringent MREL requirements, as imposed by the resolution framework. Under the bail-in and MREL regime that is currently contemplated, authorities may need to facilitate an organisation of the industry along the lines suggested.

The need to improve insolvency procedures

In any event, in order to preserve the principle of no-bail-out in a context in which not all banks could be subject to effective bail-in under a resolution framework, it is natural to expect that in the future a higher proportion of failing banks will be subject to insolvency procedures. That suggests – as is already being done in several jurisdictions – working on developing specific procedures for failing financial institutions that, by taking due account of the specificities of this type of firms, could help insolvency processes to become swifter and more able to preserve the remaining value of the institutions and, therefore, better protect the interests of creditors. In doing that, those specialised procedures may help mitigate the risk of adverse impacts of banks' failures.

The quest for specialised insolvency procedures is already incorporated in the *Core principles for effective deposit insurance systems*, developed by IADI in 2014. I believe, however, that at present they are not available in most jurisdictions.

In this regard, the recent proposal by the US Treasury to develop a new Chapter 14 of the US bankruptcy code[9] for financial institutions that meet a set of specific criteria merits consideration.

In the EU the need to develop a specific insolvency regime for financial institutions is even more pressing, given the difficult compatibility of a common resolution framework, operated by a European authority, with a constellation of highly heterogeneous insolvency rules applied at the domestic level.

Unlike in the US Treasury proposal, a harmonised specialised insolvency regime in the EU should not be confined to the failure of large complex banks but, rather, be designed to facilitate the orderly management of the crises of small and medium-sized institutions which do not meet the conditions for the application of the common resolution framework.

That improved regime would normally help enlarge the set of institutions that could be subject to insolvency procedures without generating excessive systemic stress, thereby mitigating the likely impact of the new resolution framework on business models and the structure of the banking industry.

Thank you for your attention.

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[9] See US Department of the Treasury, Orderly liquidation authority and bankruptcy reform, February 2018.