

Bail-ins, Bank Resolution, and Financial Stability

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'Laws,' says that illustrious rhymers Mr John Godfrey Saxe, 'like sausages, cease to inspire respect in proportion as we know how they are made.'

The Daily Cleveland Herald, Mar. 29, 1869

The evolution of financial regulation

- ▶ Financial regulations are developed in haste following a crisis and economic theory tries to catch up
- ▶ The Great Depression brought us the SEC, Glass Steagall, Fannie Mae, a reformed Federal Reserve System
- ▶ The financial crisis of 2007-2008 brought us the DFA and Basel III
- ▶ The pressure is on politicians and regulators to “do something” :

“We had no theory. We were asked to do something to make the banking system more resilient and we did ‘something’.”

— Member of a Basel III working group

Welfare analysis

- ▶ Optimal regulation can only be based on some kind of *welfare analysis*
- ▶ Identify sources of *market failure* (incomplete markets, asymmetric information, imperfect competition, etc.)
- ▶ Identify conditions for (incentive) *efficiency*
- ▶ Consider *structural remedies* (introduce markets, promote transparency, break up the SIFs, etc.)
- ▶ Then consider welfare-improving policy *intervention*
- ▶ *Worthwhile* as a thought experiment for economists and regulators, even if *politically* impractical

“There is a difference between thinking about a problem and not thinking about it.”

— FH Hahn

The argument in a nutshell

- ▶ Financial crises are enormously costly
- ▶ SIFIs are bailed out because their failure would damage the economy
- ▶ Bailouts encourage moral hazard and make financial crises more likely
- ▶ Therefore, SIFIs should be made *failsafe*
- ▶ In the event of failure, equity should be wiped out and *creditors should take a (serious) haircut* (bail-in), assets are transferred to a bridge bank which continues to function while claims on the bankrupt entity are settled
- ▶ This will discourage moral hazard and allow orderly resolution without damage to the economy.

Total Loss Absorbancy Capacity

- ▶ “16 – 20% of Risk-Weighted Assets and at least twice the Basel 3 Tier 1 leverage ratio requirement”
- ▶ “Debt capital instruments . . . will constitute an amount equal to or greater than 33% of the Minimum Pillar 1 TLAC requirement”
- ▶ “Liabilities that are not eligible TLAC or that are not included in a G-SIB’s TLAC remain subject to potential exposure to loss in resolution”
- ▶ “Liabilities that qualify as Minimum TLAC should be stable, long term claims that cannot be called at short notice”

— FSB Consultative Document

Will it work?

- ▶ TLAC is an advance on earlier plans for bail-in, such as the DFA and BRRD, insofar as it calls for a mandatory minimum amount of bail-in-able debt
- ▶ Nonetheless, there remains the threat of a haircut on debt that is not TLAC-eligible that may be destabilizing
- ▶ Bail-in may work when a single bank fails for idiosyncratic reasons, e.g., fraud
- ▶ It is less likely to work in a *systemic* crisis
- ▶ The market freezes we saw in 2007-2008 can wipe out even very substantial capital buffers
- ▶ Bail-ins may simply provoke a death spiral

Incentives to issue and hold debt

- ▶ Will banks have incentives to issue sufficient bail-in-able debt? If properly priced, it will be expensive.
- ▶ Who will hold it? Pension funds and insurance companies are natural holders of long-term debt, but are not appropriate holders of risk assets and also not well suited to the role as monitors
- ▶ Short-term holders of fixed income securities, such as hedge funds, are more likely to end up holding debt
- ▶ Their short-term horizon also makes them unlikely to monitor banks
- ▶ They will try to get out at the first sign of trouble and the resulting fire sale will cause further disruptions in the financial sector

- ▶ *Self-fulfilling prophecies*: Anticipation of bail-in may lead to a run on the bank: even creditors holding non-eligible debt have a reason to fear illiquidity
- ▶ *Contagious beliefs (the Lehman effect)*: Imposition of a bail-in at one bank will lead to expectations of bail-ins at others
- ▶ *Reputational damage*: The reputation of a BHC and its subsidiaries may be irreparably damaged, making it difficult for some or all to continue business as usual
- ▶ *Contagion*: Non-bank holders of bail-in-able debt are also part of the financial system; their attempts to unload debt may cause a fire sale, leading to marginal calls and portfolio adjustments that lead to further disruption

Insolvency or illiquidity?

- ▶ Whether a firm is insolvent or illiquid may be hard to determine in the time frame required
- ▶ Bail-in policies do not distinguish adequately between liquidity support and a 'bailout' in the narrow sense of the word
- ▶ When markets freeze, mark-to-market accounting can wipe out large bank capital buffers
- ▶ Liquidity support may be necessary to prevent a systemic crisis
- ▶ Failure to provide timely liquidity support created a global financial crisis in 2007-2008
- ▶ Restraints on liquidity provision in the DFA will simply aggravate the next crisis

The present situation

- ▶ We now have a class that of G-SIBs that are bigger than ever as a result of takeovers of failed institutions and the absorption of assets from the shadow banking system
- ▶ To increase capital buffers and increase lending to industry, particularly SMEs, it is essential to find a home for the securities held by the G-SIBs
- ▶ The obvious answer is to revive the shadow banking system, but in a more efficient and stable form
- ▶ The model for the new shadow banking system is found in the experience of the Sigma Finance Corporation

A better alternative is structural reform

- ▶ Efficiency and stability require transparency
- ▶ A narrow bank is a Limited Purpose Financial Company (LPFC) designed to hold high quality securities.
- ▶ Traditional banks are opaque and risky. Their return on equity is high but uncertain.
- ▶ By contrast, narrow banks are designed to be safe and transparent.
- ▶ Traditional banks are casinos; narrow banks are utilities.

The Gordian Knot proposal

- ▶ The target returns to capital providers are low, but stable.
- ▶ The activities that the Narrow Bank can engage in (e.g., the type of securities held) must be fully defined by a charter that is transparent to capital and debt investors and to regulators.
- ▶ The capital structure must be responsive to
 - ▶ (i) the credit quality of the portfolio;
 - ▶ (ii) the maturity of the assets;
 - ▶ (iii) the diversification of the portfolio; and
 - ▶ (iv) the asset-liability maturity gap.

The Gordian Knot proposal (II)

- ▶ No off-balance-sheet exposures or contingent risk exposures would be allowed.
- ▶ There would be no proprietary trading and most assets would be held to maturity.
- ▶ Interest rate and currency exposure would be fully hedged.
- ▶ Risk management would be consistent with “best practice;” in particular, asset quality evaluation would be based on in-house research and would not rely on rating agencies.
- ▶ Most importantly, the Narrow Bank would be regulated by the FRS and would have access to central bank liquidity facilities.

Coda: What's wrong with bailouts?

- ▶ Papers presented during the morning session of the conference provided estimates of the 'cost' of the implicit guarantee provided by central banks
- ▶ The methodology assumes that the value of the implicit guarantee to the G-SIB, as represented by the reduced funding cost, equals the expected cost to the taxpayer
- ▶ This is true only if there are no costs of bankruptcy, as the the Merton model assumes
- ▶ With bankruptcy costs the value of the implicit guarantee may be greater than the expected cost of a bailout
- ▶ If private costs are greater than social costs, e.g., because fire sales constitute a transfer and not a social cost, an implicit guarantee can be Pareto-improving