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Research Report

Implementing bail-in properly

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Implementing bail-in properly

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The G20 Summit of the leading industrial and emerging countries, this weekend (15/16 November 2014), is again concerned with the question of how the problem of “too big to fail” can be solved. During the financial crisis, systemically important financial institutions were rescued with taxpayer’s money because policy-makers and supervisory authorities considered a resolution too risky, fearing contagion effects: the default of one bank was expected to lead other banks into serious trouble.

The G20 member states will vote on a recent proposal by the Financial Stability Board (FSB) to require a new risk capital buffer for globally operating systemically important financial institutions. The suggested metric, “Total Loss Absorbing Capacity” (TLAC), is composed of Tier-1 capital and loss absorbing debt. In sum, TLAC would amount to about 16 to 20 percent of the risk-weighted assets of a systemically important bank.

The credibility of bail-in in the case of systemically important financial institutions hinges crucially on the design of TLAC and the requirements that will be placed on loss absorbing “bail-in-able” debt. In a crisis situation, “bail-in-able” debt is to be written down or converted into equity. If the supervisory authority continues to fear that a bail-in would seriously affect other important banks, it will shy away from practicing bail-in and, in the end, the taxpayer will again have to bear the costs. This would counteract the intentions of TLAC.

The issue of credible bail-in was addressed by the Liikanen Commission in 2012 and its proposal was recently affirmatively commented on also by the Deutsche Bundesbank. The Liikanen Commission argued that the fear of direct systemic consequences through bail-in could be overcome, if a holding ban were placed on the “bail-in-bonds” of financial institutions. The holding ban would stipulate that these bonds cannot be held by other institutions within the banking sector.

Of course, the question arises who could buy and hold these bonds. The debt holders should not themselves run the risk of refinancing difficulties in case of a bail-in. Thus, appropriate investors would be diversified investment companies with long-term contracts, restrictive cancellation rights and variable payment promises. These criteria are, for instance, fulfilled by life insurance companies and pension funds.

The objective of this endeavor is not to pass risks from one sector to the next. Rather, if designed correctly, the buyers of bail-in-bonds will receive an appropriate coupon for the risks they are taking. When an insurance company safeguards against a risk for a premium, it builds up reserves that can be used to settle any losses occurred. With investments into “bail-in-able debt”, it should act accordingly with the coupon received.

Ideally, the banking supervisory authority should know the identity of investors into bail-in bonds and their ability to absorb losses. It will need to oversee that investors do not transfer the default risk of this debt back into the banking sector, for example via Credit Default Swaps or similar instruments. In the end, only a well operating supervisory authority can build the confidence necessary to prevent systemic contagion in case a large bank gets into trouble.

For TLAC to make a successful contribution to decreasing the “too big to fail“-problem, a holding restriction for “bail-in-able debt” needs to be implemented. It is essential, that markets believe that loss-absorbing liabilities will, in fact, be bailed-in. This can only be achieved with transparency with regards to the investors. Therefore, requiring loss absorbing debt is a step in the right direction – but, without a holding restriction for banks, it is well-intentioned but not well-designed and would be ineffective.