

## **Regulatory and resolution measures needed to foster market discipline**

SUERF and Bank of Finland Conference:  
Banking after Regulatory Reforms – Business as Usual?  
Jukka Vesala

# Policy objective: From “bail-outs” to “bail-ins”



- Current regulatory focus on effective resolution mechanisms and reducing the TBTF-problem is essential. However:
  - Resolution is by nature discretionary and many argue for substantial (national) flexibility
  - Europe has a history of bank bail-outs
  - *Debt holders may continue to assume that they will be paid-off*
  - *Weak market discipline on banks*
- What can make the policy shift more credible and support market discipline?
  - *As explicit and rules-based crisis management arrangements as possible (Gropp – Vesala)*
  - *Reduced scope for discretionary elements in resolution*
  - *Limits to systemic risks and increased credibility of imposing losses to private debt holders*

# Four additional avenues to support the policy objective



1. Build-up Loss-Absorption Capacity (LAC) via bail-in instruments also for the going concern state  
→ *Designated bail-in bonds, “two-stage bail-in regime”*
2. Reduce implicit and discretionary elements in crisis management arrangements  
→ *Preference for protected retail deposits, Single Resolution Mechanism, EBA’s standards (e.g. on resolution plans)*
3. Enhance transparency of asset values and ensure adequate provisions  
→ *Further disclosure, provisions that cover Expected Losses (EL)*
4. Reduce leverage and systemic risks (especially in trading activities)  
→ *Additional non-risk-based capital buffers, further reduced counterparty risks*

# “Two-stage bail-in regime”



- First stage: Designated debt instruments are used to absorb losses and to allow the bank to remain *going concern*
  - Equity conversion or write-down after an explicit trigger point above the resolution point
- Second stage: Extend bail-in to *all* debt instruments in the resolution process in accordance with the hierarchy of claims
  - Full ex ante clarity, limited discretion for resolution authorities
  - E.g. clear triggers for starting the resolution process
  - As limited bail-in exemptions as possible (preferential treatment of protected retail deposits only; no maturity-based exemptions)
- Several benefits:
  - Increase LAC for going concern → Systemic disruptions may be avoided
  - Contractual clarity and investor confidence
  - Reduced scope for discretionary resolution
  - Reduced risk for Deposit Guarantee Systems (DGS) and taxpayers

# Mandatory “bail-in bonds”



- Mandatory issuance of “bail-in bonds” (or CoCos)
  - A new “Tier 3” class of loss-absorbing capital
  - E.g. at least 5% of RWA
- Trigger point to activate equity conversion or write-down should be mandatory and contractual to avoid discretion by supervisors
  - A trigger based on regulatory capital ratios
  - E.g. 1-2-%-points above minimum CET1 –requirements
- In contrast to Admati and Hellwig (2013), debt instruments should be required (where possible) for the purpose of also promoting market discipline
- Require issuance of the bonds outside the banking sector to reduce systemic risks and increase the credibility of bail-in (Krahen)

# Depositor preference, but only for protected retail deposits



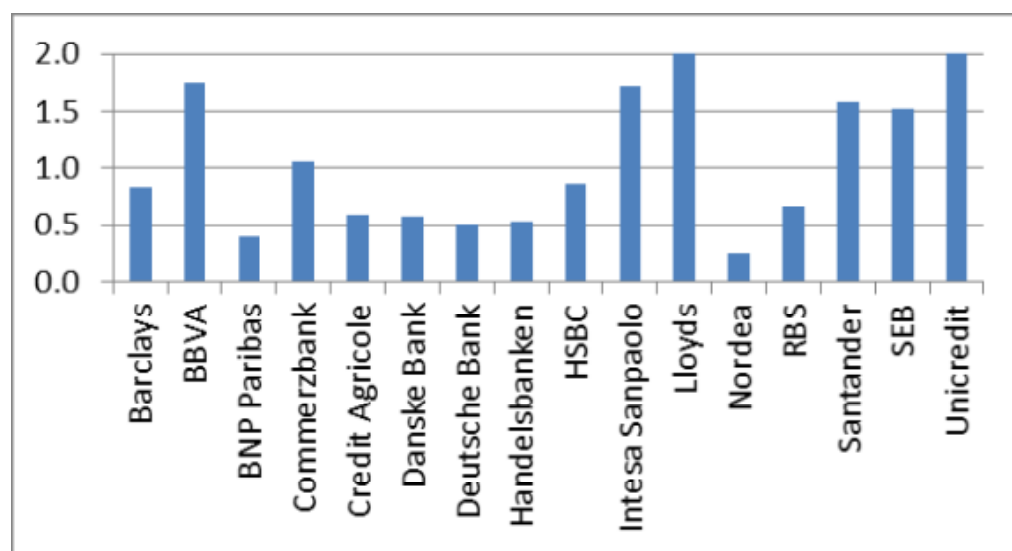
- Benefits of preference for protected deposits in resolution:
  - Less risk for DGS, easier to impose losses on private bondholders
  - More limited disruption to bank funding conditions
  - Easier to manage a bank in crisis (ref. handling of the Icelandic banking crisis)
  - *More credible bail-in*
  - *More effective market discipline*
- Full deposit preference could be dangerous and could lead to a shrinking of the senior bank bond market

# High leverage still possible especially in trading activities



## Capital requirements for market risk for large EU banks

(2011, % of trading assets)



Source: Liikanen Report (2012)

- Basel Committee is reforming risk-based capital requirements on trading books
- Possibility of high leverage, model and operational risks are related to large trading volumes
  - *Risk-based capital requirements should be augmented by a non-risk-based capital buffer requirement*
  - *A buffer on top rather than a floor for model-based outcomes*
- Less leverage might also avoid the destabilizing consequences of marking-to-market highlighted in the academic literature
- Further limits to counterparty risks would seem justified to limit systemic risks

# Asset quality concerns still affect European banks



- Doubts about adequacy of provisions has been a major factor maintaining lack of market confidence in European banks
- Coverage Ratios for major EU banks currently range from below 20% to above 80% (average around 40%)
  - Coverage Ratio = Allowances for Loan Losses / Gross Impaired Loans
  - Problems of comparisons due to heterogeneous definitions
- Inconsistency of prudential and accounting approaches to provisions represents a major handicap
- Provisions should at all times cover Expected Losses (EL)
  - *A reform of IFRS standards is long overdue (provisions still based on incurred losses)*
- Credibility of capital ratios as indicators and triggers would be enhanced via ensuring adequate provisions



# In sum: As explicit and non-discretionary resolution as possible



- Resolution can be seen as “accelerated and substitute bankruptcy procedure” with several important benefits
  - Resolution authority determines, subject to a strict time constraint, losses of each claimholder
  - The fast processing saves bankruptcy costs (especially societal, those which stem from a break in the provision of financial services) and allows orderly restructuring or market exit
- However, just distribution of losses may be difficult to achieve given the strict time limit
  - *Potential for later lawsuits*
  - *Political pressures for bail-outs*
- To avoid negative effects on market discipline, pre-resolution point re-capitalization (“two-stage bail-in”) and well-defined and pre-determined rules on resolution are needed
- Supervision and resolution functions need to be closely connected (continuum of actions)

# Single Resolution Mechanism (SRM) would be needed to complement Single Supervisory Mechanism



- There is no binding resolution framework for cross-border groups in the Draft Resolution Directive
  - E.g. no compulsory coordination of crisis management and resolution measures before they are taken by home and host authorities
  - It is doubtful that a resolution college could effectively coordinate in time the necessary decisions and resolve the conflicts of interest
- Incentives for ring-fencing are embedded in the current framework
  - Both home and host authorities can exercise ring-fencing (at own discretion)
    - *No guarantee for adequate and timely information exchange*
    - *Burden-sharing (backstops) not agreed*
- Unless the SRM is established, the ECB would have to hand-off problem banks back to national authorities that can also produce conflicts of interest
- Resolution fund at the EU level should be separate from DGSs (which are currently quite heterogeneous across countries)

# Annex: Summary of key regulatory proposals



- Strengthen banks' loss absorption capacity by requiring significant banks to issue a mandatory amount of "bail-in bonds"
- Create a "two-stage bail-in regime" (both going and gone concern)
- Strengthen common rules for the resolution process to limit discretion
- Grant preference in resolution only to deposits protected by the deposit guarantee
- Increase capital requirements on especially trading book assets
- Create the SRM as a counterpart to the single European supervisor (separately from DGS)
- Enhance EBA's powers to develop strong pan-European criteria for the evaluation and approval of recovery and resolution plans
- Strengthen harmonized disclosure of problem assets and coverage by adequate (EL-based) provisioning



# Thank you!

[jukka.vesala@fiva.fi](mailto:jukka.vesala@fiva.fi)