Bail-in Debt: Will the Supervisors Pull the Trigger in Time?

Notes from the Vault

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The United States and the European Union (EU) plan to use funds from systemically important bank groups' creditors to protect taxpayers from losses.[1] These creditors, principally the unsecured bondholders, are to be bailed in at failing banking groups to absorb losses and recapitalize failing banks to allow their continued operation. This post first highlights the vital role of timely resolution if taxpayers are to be protected. It then considers the likelihood that the resolution will be timely under existing procedures.

Bail-in role in recapitalization
Title II of the Dodd-Frank Act gives the Federal Deposit Insurance Corporation (FDIC) new powers to resolve systemically important nonbank financial institutions, including the nonbank parent and affiliates of banks in a bank holding company. The FDIC has proposed to implement this authority through what it calls the Single Point of Entry (SPOE) strategy. This strategy would involve putting the parent of a failing nonbank financial firm into receivership. Under SPOE, the FDIC would first write down the equity of the parent holding company to reflect losses. It would then write down the value of the claims of the unsecured creditors of the parent to cover any remaining losses and convert to equity a sufficient amount of the remaining unsecured parent debt to recapitalize the group.

The FDIC faces limits on its resources, especially loss-absorbing resources, independent of the parent's unsecured creditors if it wants to continue the financial firm's operations. The agency will have access to an Orderly Liquidation Fund. However, the FDIC's SPOE proposal states that this fund may be used only for "liquidity purposes" and may not be used to provide capital support to the bridge(new) company.[2]

The European Parliament approved a package of three bank resolution measures in April 2014, including the EU Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) with the intent of minimizing taxpayer exposure to bank failures. Similar to the FDIC's SPOE resolution strategy, the BRRD envisions bailing in creditors of a failing bank to absorb losses as necessary and to provide for the recapitalization of the bank.

As with the FDIC, limited funds are available for the resolution of a systemically important failing EU bank, albeit the limitations take a different form. EU bank resolution funds could be used for the sole objective of funding bank resolution and its use is subject to a minimum bail in of 8 percent of banks' total liabilities, including own funds (capital) under the BRRD. However, bank resolution funds could be used only up to a maximum of 5 percent of banks' total liabilities.

Timely resolution
Whether the FDIC and EU resolution plans will accomplish their mission of ending bailouts and protecting taxpayers depends upon whether failing banks are put into resolution in a timely manner. Taxpayers will be protected if the bank is put into resolution while the bank still has sufficient bail-in debt to absorb any remaining losses and recapitalize the bank. However, taxpayers will remain exposed if resolution is delayed until full recapitalization is no longer possible and policymakers determine that the continued operation of the bank is critical to maintaining financial stability.

Importantly, if a bank is resolved in a timely manner, then other creditors (those not at risk of being bailed in) and other bank stakeholders would not be at risk from a resolution. As a result, most of these creditors and other stakeholders are likely to continue normal operations with the financial firm even if they anticipate it will be put into resolution in the near future. The willingness of these other parties to continue business as usual would greatly facilitate the reorganization of the failing firm into a new, viable operation.

If instead, losses have reached the point where the bail-in debt is inadequate, creditors who may be at risk of taking losses have an incentive to withdraw their funds and other stakeholders have an incentive to take their business to another financial firm. The result is that the failing firm may face urgent liquidity pressure prior to its resolution and lose many of the stakeholders needed to survive after resolution. In this situation, the resolution authorities will not have the luxury of contemplating when and how best to resolve the entity. Rather, if the authorities want the firm to continue operation, they will immediately have to supply the lost liquidity and may have to make open-ended guarantees to retain existing funding.

Difficulties in timely resolution
Although the importance of timely resolution is clear, implementing timely resolution in practice is likely to prove difficult, both because of the process for triggering resolution and the incentives of those involved in the process.

One possible "objective" measure of whether a bank should be resolved is its regulatory capital ratios, which are based on financial accounting rules. If the economic value of equity capital was accurately measured by accounting rules, one could confidently pick a regulatory capital ratio that automatically triggered resolution and also require the right amount of bail-in debt to recapitalize the bank adequately. However, equity is the residual between the value of the assets and the liabilities and so imports all the problems with using financial accounting values as measures of economic values. Moreover, the people responsible for producing the accounting numbers, the banks' managers, are also the ones with some of the strongest incentives to pick high-asset and low-liability values. The effect of these incentives was apparent during the financial crisis when book values of large banks' equity remained comfortably above regulatory minimums in almost all cases even while the stock prices of many of these banks collapsed, according to the Federal Reserve Bank of San Francisco's Fred Furlong, a group vice president in the economic research department, and Bank of England Executive Director Andrew G. Haldane.

If timely resolution cannot be implemented through mechanical rules based on accounting values, the resolution decision will ultimately require some judgment calls on the part of the supervisors and/or financial market participants. If the supervisors fail to act in a timely manner, private creditors may perceive that they are at risk and force the bank's closure by denying it new funding.

The supervisors face two sets of problems in implementing timely resolution: (a) the standards and process for implementing resolution are not designed to facilitate timely action, and (b) the regulators face strong incentives to forbear from timely closure.

Section 203 of the Dodd-Frank Act requires that before a nonbank financial firm can be put into FDIC resolution, there must first be a determination by the U.S. Treasury, the Federal Reserve, and one other agency that the nonbank financial firm is about to fail and that sending it to the bankruptcy court would threaten financial stability.[3] Before authorizing FDIC resolution, Section 203 requires Treasury to determine that: (a) "the financial company is in default or in danger of default," and (b) the financial company's failure would have "serious adverse effects on financial stability in the United States." However, as we have seen, timely recapitalization best happens when a bank is not under immediate stress. Ideally, it would also take place before markets were disrupted by concerns about financial instability.

The EU process for triggering bank resolution contains a similar requirement that the bank have "no realistic prospects of recovery over an appropriate timeframe" but does not impose the financial stability requirement. Nevertheless, the EU process has a complicated approval structure. The European Central Bank, the Single Resolution Board, the European Commission, and, in some cases, the European Council are involved in the resolution decision, and the national regulatory authorities are then instructed to implement the resolution plan. The intent is that this process can be completed over a weekend, but the process also appears to create numerous opportunities to slow the decision to resolve a bank.

Moreover, the process in the United States and the EU will not occur in a vacuum. First, and arguably foremost, the resolution authorities know that their estimates of bank capital are just estimates subject to potentially large errors and that resolution will be risky. Perhaps the bank has adequate equity or, even if not, it might be able to recover if future economic conditions are stronger than currently forecast. Further, putting the bank into resolution is certain to impose some, possibly large, economic costs as the bank is reorganized—especially if the resolution does not go as planned. The risk of unanticipated, very high-cost problems is especially problematic for the United States as FDIC resolution can only be invoked when national financial stability is at risk. Thus, the FDIC cannot have the benefit of trying out its resolution process on a large, but not necessarily systemically important, bank when the financial system is otherwise in good condition. In contrast, the first time the EU process is invoked may involve a bank that while being important in its region, is not systemic to the overall EU.

Additionally, the managers, equity holders, and potentially the bail-in debt holders all have an incentive to work against resolution. The managers might work against resolution by assigning high value to the firm's assets and possibly engaging in (or appearing to engage in) attempts to recapitalize the bank. Managers and equity holders could lobby both political leaders and officials involved in the resolution process and seek to engage other stakeholders in similar lobbying. The effectiveness of these lobbying efforts will be enhanced by the fact that these institutions are some of the most important financial firms in their country and may, in some circles, be regarded as important national champions in the field of international finance.

Conclusion

Prompt supervisory action and timely resolution is required if bail-in debt is to serve its purpose of protecting taxpayers from losses while allowing systemically important firms to continue normal operation. Yet the standards and procedures for triggering timely resolution contain weaknesses that are likely to serve to discourage timely resolution. One alternative would be to develop market-based triggers for resolution. Financial market participants do not necessarily know more than the supervisors. However, it might be possible to incent market participants to use their information to help trigger resolution in a timelier manner. How best to structure these incentives is a topic I will leave for future consideration.

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[1] The large U.S. banking groups are all organized with a bank holding company as the parent that owns (directly or indirectly) the other group members. Many European banking groups are organized with the group's lead bank also serving as the parent.

[2]The FDIC also has a Deposit Insurance Fund, but this is only available for covering deposits at an insured bank and cannot be used to support the resolution of a nonbank financial firm.

[3]The procedure described in Section 203 first requires that the Federal Reserve Board and the FDIC make a written recommendation to the secretary of the Treasury as to whether the FDIC should be appointed receiver for a financial company. The procedure changes slightly if the firm is a broker, dealer, or insurance company. If the firm is a broker or dealer, the recommendation must come from the Securities and Exchange Commission (SEC) rather than the FDIC. If the firm is an insurance company, the recommendation must come from the director of the Federal Insurance Office rather than the FDIC. If the appropriate bodies recommend by a two-thirds vote (or the sole director of the Federal Insurance Office) that the FDIC be appointed receiver, the secretary of the Treasury (in consultation with the president) makes the final determination as to whether the FDIC should be appointed receiver.

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