Bail-in: an alternative to bail-outs of banks?

According to a recent European proposal by the European Commission (EC, 2012), bail-in is one of the instruments every EU member state should have at its disposal in order to deal effectively with banking crises. Briefly, bail-in means that the unsecured and uninsured claims of creditors of banks ('senior unsecured debt') can be written down or converted into equity if a bank is heading for bankruptcy. This Special Report discusses bail-in in more detail, as well as the related issues.

The rationale for bail-in

Experience from various banking crises has shown that normal insolvency procedures are not suitable in most cases involving banks, particularly if the bank in question has systemic importance. These procedures frequently take an unnecessary amount of time and do not take sufficient account of the negative consequences for other financial institutions (systemic risk) and the continuity of banking services that are essential for the economy and financial stability (such as the operation of payment systems, lending and deposit-taking). In the absence of a more effective crisis toolkit, governments in the past have seen themselves forced to 'save' the banks concerned. However the cost of these bail-outs, involving financial support or nationalisation, for governments and taxpayers can be substantial. In addition, this approach increases the potential for moral hazard among the banks and their investors. For these reasons, regulators think the time has come to develop alternatives to bail-outs (see Smolders, 2011).

Bail-in: one of the resolution tools

In addition to measures designed to *prevent* problems at banks and *early intervention* by the regulator as soon as problems occur, the EC (2012) is putting forward a number of *resolution tools* that should be available to every EU member state. These are measures such as the sale of all or part of the bank, the transfer of all or part of the bank to a public or semi-public bridge institution, and bail-in. These tools can be applied by the competent resolution authority when it determines that a bank is failing or likely to fail[1], there is no reasonable prospect of an alternative solution, and saving the bank is necessary in the public interest.[2] They can be used to restructure the bank so that it can continue as a going concern[3] or to wind up the distressed bank in an orderly manner (a 'gone concern'). In both situations, the goal is that essential banking operations continue, financial stability is safeguarded and public funds are not involved as far as possible.
Bail-in has a supporting role in this process. In a going-concern scenario, the objective of bail-in is to restore the bank's capital position so that it can continue to exist and regulatory authorities have the time to restructure the bank and replace the management. In a gone-

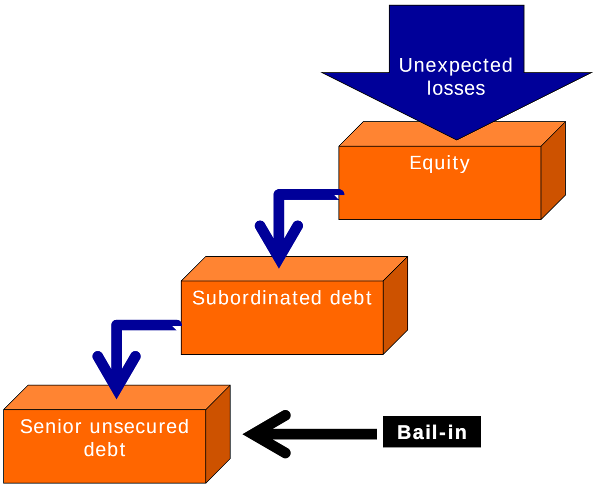
[1] According to the EC (2012), this applies when the bank in the near future no longer has sufficient capital, its assets are less than its liabilities, it can no longer meet its obligations or receives public financial support other than liquidity facilities.
2 The criteria for this are: a threat to financial stability or the continuity of essential banking operations and/or the security of deposits, client assets and public funds.
[3] However the exact meaning of 'going concern' in the proposals is not clear. If a bank in the resolution phase is restored and reinforced with the help of financial resources from other banks and is then able to resume competition with these same banks, this would be a form of unfair competition.

concern situation, bail-in can be applied when the distressed bank is split into a 'good bridge bank' that continues the essential banking functions of the bank and a 'bad' bank with bad assets that will be liquidated. In this case, bail-in is a means of capitalising the new bridge bank.

How bail-in works

If a resolution authority has decided to apply bail-in[4], the existing hierarchy of claims that applies in the case of insolvency is respected. This means that the bank's losses are first fully absorbed by equity. After this, the subordinated debt is written down in full. If the losses have not been fully compensated, the remaining part of the losses are for the account of the owners of (senior) unsecured debt: their claims are partly or fully written down or converted into equity. This last step is known as bail-in (see figure 1).

Figure 1: How bail-in works



Source: Rabobank

Bail-in in principle applies to all the institution's unsecured and uninsured debt. The proposal allows for only a limited number of exceptions: interbank or other debt with an original maturity of less than one month, secured debt, savings deposits covered by a deposit guarantee scheme[5], liabilities such as salaries, pensions and taxes, client assets and some derivative instruments. According to the EC, these debts have to be honoured in order to safeguard financial stability and the proper operation of the credit markets. Existing senior unsecured debt is *not* excepted, this will fall under a bail-in regime if this is implemented as planned on 1 January 2018.

Bail-in versus contingent capital

Like debt eligible for bail-in, contingent capital bonds can be written down or converted into equity at a certain future date. The important difference however is that this date in the case of contingent capital is determined according to an objective measure (usually a capital ratio) that is established in the financial contract between the investor and the bank. The possibility of conversion is embedded 'in the product' and conversion occurs automatically if the bank no longer meets the quantitative criterion. Bail-in on the other hand occurs after a more qualitative decision by the resolution authority. Furthermore, conversion of contingent capital is usually triggered well in advance of the time when bankruptcy occurs or is highly likely to occur. The actual objective of conversion of contingent capital is therefore to strengthen the bank's capital position so that it can continue as a going concern.

How much debt is bail-inable?

To prevent banks from funding themselves only with debt instruments that are excluded from bail-in, the EC is proposing the following regarding the amount of bail-inable debt that European banks have to hold. The amount of bail-inable debt plus the amount of equity and

[4] In the proposal, and contrary for instance to the measures in the Dutch Intervention Act [*Interventiewet*], this decision is not subject to judicial review ex ante.

[5] Deposit guarantee schemes themselves do come under bail-in. The question is whether this is politically feasible (see HSBC, 2012).

subordinated debt, designated by the EC as the 'loss-absorbing capacity' (or LAC), must be greater than x% of the bank's total debt (excluding equity). The minimum LAC (x%) that banks must have may be decided by the individual member states, but the EC recommends 10% and that this should apply to each individual licensed entity of a bank.
In theory, it would be possible for the banks to fully fund their LACs with capital, but since this is based on non-risk weighted assets this would in practice lead to very high and uneconomic capital ratios. Most banks will therefore hold bail-inable debt. A notable effect of this is that traditional banks (funded by savings only) will effectively be forced to use the institutional funding market. The collective shortfall of bail-inable debt instruments at European banks is estimated to be EUR 1,100 billion (HSBC, 2012) and EUR 708 billion at the top 50 European banks (Goldman Sachs International, 2012).

Many questions surrounding bail-in

Senior unsecured bank funding will be more expensive ...

The already higher costs of funding for banks will increase further as a result of the introduction of bail-in. Investors in senior unsecured bank debt will demand additional compensation for the increased risk they will incur of having to meet losses. Since bail-in is a discretionary power of the supervisor, this risk is very difficult for investors to assess and to price in. The more opaque and subjective the trigger is, the higher the compensation they will demand will be. Funding costs could also rise because the credit ratings of some banks could be negatively affected by the introduction of bail-in.
The higher funding costs as a result of bail-in are usually justified on the basis of the view that this is the price banks must pay for the removal of the implicit bail-out guarantee. This however does not change the fact that higher funding costs (for which estimates range from a 0.05% increase in total funding costs (EC, 2012) to a 1.5% premium on bail-inable debt (HSBC, 2012)) could also have consequences for clients and for the real economy in the form of more expensive credit.

... and (even) more difficult to get

In addition to the effects on the price of unsecured funding, there are serious concerns regarding the appetite of investors to continue investing in senior unsecured debt of European banks if bail-in is introduced. Due to the European debt crisis, it is already very difficult or even impossible for many banks to raise unsecured funding, and with a bail-in regime this will become more difficult. Even though bail-in will possibly not be introduced until 2018, professional investors will anticipate this. They will probably prefer to invest their money in non-financial businesses or banks in regions where a bail-in regime does not apply (Switzerland or Asia for instance), or will wish to invest only a small part of their portfolios in bail-inable debt. Indeed, some large investors have already indicated that they will no longer invest in European financial institutions if the bail-in proposal goes ahead (HSBC, 2012).

Hold more capital, or ... contract the balance sheet

For banks that cannot raise sufficient senior unsecured debt (or wish to meet the minimum required LAC by other means), there are basically two options: holding more equity and/or subordinated debt, or contract their balance sheet. The advantage of the first option is that losses will initially be borne by other capital providers, so that senior unsecured creditors will be better protected against a possible bail-in and higher funding costs can to some extent be limited. On the other hand, the cost of capital will rise, and raising or building additional capital is a very difficult exercise for many banks in the current market conditions, since profits are under pressure as a result of the accumulation of new legislation and regulation. Thus, there will also be banks that are forced to reduce their balance sheets (the second option) to meet the LAC requirement. The resultant deleveraging will have negative consequences for the availability of credit and the economic recovery.

More or less financial stability?

Finally, there are concerns regarding the effectiveness of this relatively new resolution tool. In practice, it could lead to less rather than more financial stability. The concern is that as soon as professional investors, other banks and large depositors become aware that a bank has problems they will no longer wish to fund the bank in order to escape a possible future bail-in. This will only exacerbate the bank's problemsand moreover could lead to other banks experiencing funding problems and even a systemic crisis. There is also the question of whether bail-in will work when it is actually applied: if clients and market participants have no confidence in the effectiveness of bail-in and other resolution tools, they will pull out. The bail-in proposal in the Vickers Report prepared in the UK exempts unsecured debt with a maturity of up to one year from bail-in. The EC, which has set the limit at one month, should consider adopting the British bail-in proposal on this point. This would at any rate reduce the chance that short-term funding (less than one year) for a bank experiencing difficulties would dry up rapidly.

Conclusion

The idea behind bail-in is right: if a bank looks like failing, the costs should as far as possible be borne by its owners and investors so that the use of public money can be limited and market discipline will be increased. The introduction of a bail-in tool in EU member states could however have significant effects on the availability and cost of funding for European banks and these effects will also work through to the real economy. It is moreover not certain how effective bail-in will be in practice, or whether bail-in will have unintended adverse effects on financial stability. This raises the question of whether the time is ripe for bail-in. Regulators and supervisors could decide to focus initially on successful implementation of the stricter capital and liquidity requirements of Basel 3 and preventive measures to avoid banks encountering serious problems.

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