The Banking Crisis and Its Regulatory Response in Europe

Mathias Dewatripont

National Bank of Belgium

and

Single Supervisory Mechanism

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Outline

- A brief history of (de)regulation
- Bailouts and reregulation
- The BRRD and financial stability

(see *Dewatripont* 2014a, 2014b)

A brief history of (de)regulation

Up to 1970's

- Banking is risky (maturity transformation).
- Almost century-old 'cycling' between 3 objectives: productively efficient banking; financial stability (no bank runs); fighting moral hazard ('no bailouts').
- Until 1930's: sacrifice financial stability, but many bank runs, in particular in the Great Depression.
- From mid-1930's to early 1970's: sacrifice efficien-cy, with strict limits on competition (on entry, size, prices & activities); & introduce deposit insurance.
- No more bank runs & no bailouts but low product-ive efficiency in banking (e.g. overbranching) + development of nonbank competitors.

Since 1970's

- As a result, gradual deregulation since 1970s, on prices and entry, & on size and set of activities.
- But deposit insurance maintained (against financial instability) and focus on (risk-based) bank solvency (against moral hazard): Basel I and II capital ratios.
- Impact: since 70s, very few runs, but many banking crises (147 worldwide (*Laeven-Valencia*, IMF, 2012)), many linked to macro imbalances, but also to bank behavior (moral hazard), especially when underca-pitalized (Basel I/II insufficient) and 'gamble for resurrection'.

Additional elements of the 2007-8 crisis

- Household overindebtness, subprime lending (especially in the USA).
- Securitization and therefore complexification of financial products, role (and conflict of interest) of rating agencies.
- Extreme illiquidity for some banks, with massive recourse to (very unstable) wholesale funding.
- Interconnectedness.
- Race for higher and higher return on equity.
- Role of globalisation as an incentive to deregulate ('race to the bottom‘, ‘light-touch regulation’).

Responses to the 2007-8 crisis

- Crisis significantly worsened after fall of Lehman: first big-bank bankruptcy, that triggered « move to another equilibrium » (à la *Diamond-Dybvig*, but for wholesale funding).
- Double response:

  (i) « no more Lehmans », instead, significant rise of (retail) deposit insurance and massive bail-outs;

  (ii) re-regulation.

Bailouts and reregulation

Stylized facts on bailouts

- Gross fiscal cost of bailout is only a fraction of debt increase (rest due to lower growth).
- Procrastination really costly (Japan, US S&L).
- Instead, swift bailout intervention may pay for taxpayer, possibly fully US 2007, Sweden 1991 (even if ex-post net-cost computations fail to take into account risk premia).
- Conclusion: Tradeoff current/future crisis: fighting moral hazard good, but NOT worth delaying restructuring, because lower GDP growth will raise final cost for taxpayer !
- See *Laeven-Valencia*, 2012

Reregulation: busy reform agenda

- Mix of (i) continuity (with recalibration) and (ii) change: (iia) back to regulation of what a bank may/should be; (iib) introduction of 'system regulation'.
- (i) More and better capital (and an additional, simpler, leverage ratio).
- (iia) Liquidity ratios, recovery & resolution plans, structural reforms. (Vickers, Volcker, Liikanen/ Barnier/…).
- (iib) Macroprudential instruments (Counter-cyclical Capital Buffer, systemic-bank sur-charges ...).

Recent developments in Basel

- Desire to ‘complete post-crisis reforms’.
- Next to calibration of leverage ratio and some fine-tuning, desire to reduce excessive influence of models: limit models to portfolios where modelling makes sense (does sound reasonable !)
- Such a ‘hybrid approach’ is a good idea because models were a clear source of unlevel-playing field, on top of leading to an aggregate reduction in the capitalization of the banking sector under Basel II.
- This being said, idea is to do this without raising aggregate Basel-III capital requirements further.

Assessment

- Reform agenda makes sense given previous crisis. Does involve a partial U-turn w.r.t. laisser-faire approach to banking activities.
- Impact of new approaches (liquidity, recovery & resolution, structural reforms, macroprudential / systemic approach to regulation) still untested.
- Debate continues on 'excessively low Basel III capital ratios' (e.g. *Admati-Hellwig*, 2013) vs 'difficulty of finding the money & risks to real-economy lending'.
- What to think about new trend: bail-in rather than bailout?

Bail-in

- Paradox of the crisis: (i) Basel III stresses quality of capital and micro/macroprudential distinction, while (ii) current « *bailout fatigue* » has now led to « *bail-in fashion* », with a desire to vastly enlarge set of bank claimholders meant to be « held respon-sible », and this even under systemic stress.
- Explanation: politicians and public at large do not feel that Basel III requires enough capital to protect taxpayers. But further raising equity seems difficult.
- Two concerns however: (i) cost of financial instabi-lity; (ii) who should bear risk?
- Relevant in particular in the EU, with BRRD (focus here, linked to FSB's TLAC).

The BRRD and financial stability

Banking Recovery & Resolution Directive

“Other tools (than bail-in) can be used to the extent that they conform to the principles and objectives of resolution set out under the BRRD. In circum-stances of *very extraordinary systemic stress*, authorities may also provide *public support* instead of imposing losses in full on private creditors. The measures would nonetheless *only become avail-able after the bank’s shareholders and creditors bear losses equivalent to 8% of the bank’s liabi-lities* and would be subject to the applicable rules on State Aid.” (FAQs on BRRD)

Banking Recovery & Resolution Directive

"Bail-in will potentially apply to any liabilities of the institution not backed by assets or collateral. It will *not apply* to *deposits protected* by a deposit guarantee scheme, short-term inter-bank lending or claims of clearing houses and payment and settlement systems (that have a remaining maturity of *seven days*), client assets, or liabilities such as salaries, pensions, or taxes. In *exceptional circumstances*, authorities *can choose to exclude* other liabilities on a case-by-case basis, if strictly necessary to ensure the continuity of critical services or to prevent widespread and disruptive *contagion* to other parts of the financial system, or if they cannot be bailed in in a reasonable timeframe." (FAQs on BRRD)

Banking Recovery & Resolution Directive

"The write down will follow the *ordinary allocation of losses and ranking in insolvency*. Equity has to absorb losses in full before any debt claim is subject to write-down. *After shares and other similar instruments, it will first, if necessary, impose losses evenly on holders of subordinated debt and then evenly on senior debt-holders.*"

"*Deposits from SMEs and natural persons*, including in excess of EUR 100,000, will be *preferred over senior creditors*."

(FAQs on BRRD)

Banking Recovery & Resolution Directive

"By definition, this will depend on the systemic footprint of different institutions. *Depending on their risk profile, complexity, size, interconnected-ness, etc., all banks should maintain (subject to on-going verification by authorities), a percentage of their liabilities in the form of shares, contingent capital and other unsecured liabilities not explicitly excluded from bail-in.* The Commission, upon a review by EBA, could specify further criteria to ensure similar banks are subject to the same standards." (FAQs on BRRD)

Comments

- BRRD insists on 8% bail-in even under systemic stress, as of January 1, 2016.
- Beyond secured liabilities, it exempts very short-term debt (up to 7 days).
- It gives priority to natural persons and SMEs.
- At this point, it does not impose hard targets for bail-inable securities (« MREL »).
- Suggestion: think of requiring a minimum of *8% of long-run junior liabilities* (equity, hybrids and *junior* debt, or an « *extended leverage ratio* ») in order to foster financial stability.

Example of bank liabilities

Secured + very short-term liabilities	25
Retail deposits	40
Bail-inable senior liabilities	30
Junior liabilities	1.5
Capital	3.5
Total liabilities	100

- Losses for senior liabilities before a bailout can be considered: (8 – 3.5 – 1.5)/30 = 3/30 = 10%.
- ***Conclusion***: to avoid bank runs (esp. with volatile wholesale deposits), better to increase junior liabilities to 4.5. Instead, *including senior claims in MREL does NOT protect other claimholders* !

Conclusion

- Aversion to bailouts understandable: taxpayer money, moral hazard, …
- Remember however the cost of financial instabi-lity: the *costliest* bank failure for taxpayers in last 10 years was Lehman, *despite lack of bail-out*, while TARP bailout has *almost been fully repaid* (*CBO* 2013: more than 400 Billion $ out of 428).
- Remember also that « orderly » resolution will not prevent depositors from running if they can and feel their money is at risk.
- This requires sufficient long-term junior claims to absorb bail-in and reassure senior claimholders.

Conclusion (2)

- Several Member States aware of the problem, and are trying to tackle it.
- Germany: make senior bank bonds junior, retroactively (also used for Greek banks in 2015).
- Italy and Spain: make corporate deposits senior to senior bank bonds and derivatives, retroacti-vely (note that BRRD was also retroactive).
- France: same as Germany, but NOT retroactive, and more granular.
- Conclusion: useful initiatives, but would be better to have a 'European solution'. And the key is to have 8% junior long-term claims for all banks as soon as possible !

References

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