

THE FUNDING OF RESOLUTION



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THE RESEARCH QUESTION

- **Who is likely to pay for bank resolution under the BRRD?**
- **Does this meet the objective of minimising the impact of bank failure on the real economy?**

THE PROBLEM

- There are almost no assessments of likely impact of failure resolution mechanisms
- The BRRD neither spells out what process of resolution will be used nor exactly how the choice is to be made
- While principles are quoted they do not entail a specific solution and trade-offs may be required

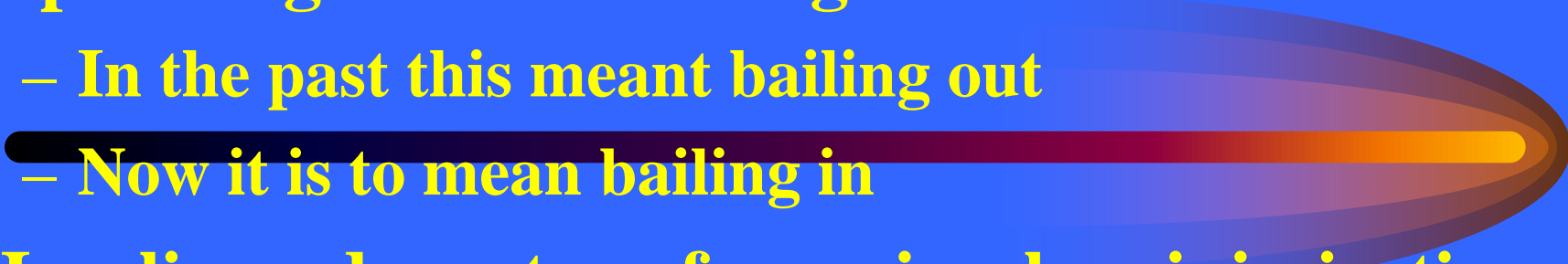
OUTLINE

- **Minimising direct costs**
- **Minimising costs to the economy**
- **An example from New Zealand**
- **Who pays under the BRRD**
- **Bailing in vs bailing out**
- **Conclusion**

MINIMISING DIRECT COSTS

- **Choice of methods (in rough order of cost)**
 - Raising new capital either from the existing shareholders or by a new issue on the market
 - Finding a buyer who takes over the functions that need to be continued
 - Obtaining guarantees that will stand in lieu of actual capital
 - Getting a capital injection from the government or some other outside agency – bailing out
 - Writing down the liabilities (bailing in)
 - Performing a debt for equity swap – bailing in
 - Restructuring the organization so that the banking part that needs to be saved remains solvent and keeping the losses in a part that goes into insolvency

MINIMISING DIRECT COSTS

- **But vital functions of SIFIs have to be kept operating to avoid contagion and crisis**
 - In the past this meant bailing out
 - Now it is to mean bailing in
 - **Implies a departure from simple minimisation of costs to the creditors**
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WIDER COSTS

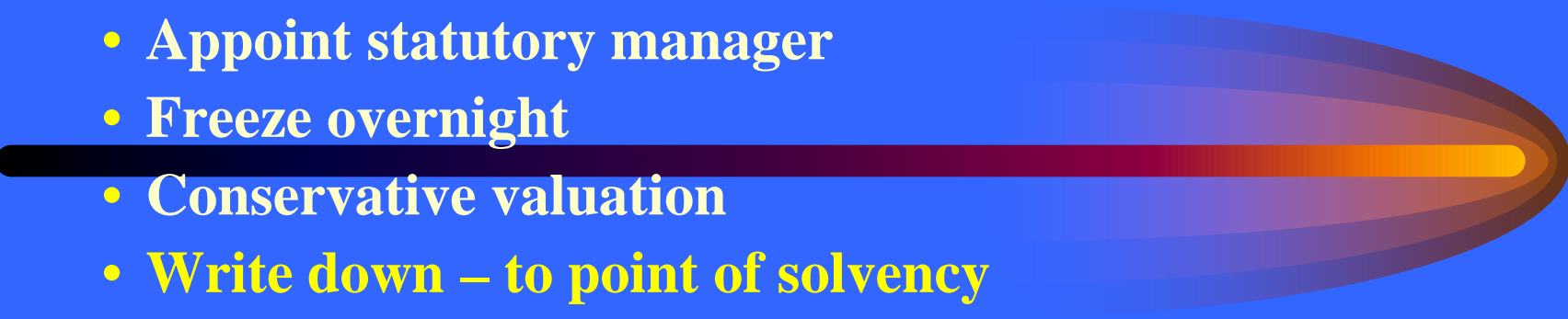
- **Economic costs (in terms of GDP)**
- **Fiscal costs (to the taxpayer)**
- **Costs to creditors**
- **Costs to bank stakeholders through deposit insurance and resolution funds**
- **Costs to banks**
- **Moral hazard**
- **Costs of avoidance and early action**

Some costs accrue without a failure, some are contingent, some can be assessed

THE NEW ZEALAND EXAMPLE

- **A note on Open Bank Resolution (OBR)**
- **Similar to BRRD as it relies on compulsory bail in**
 - **Unusual structure of banking system**
 - **All cross-border, Australian parents**
 - **RBNZ supervisor and resolution agency**
 - **All systemic retail banks must be locally incorporated and capable of running on their own overnight**
 - **Appoint statutory manager**
 - **Freeze overnight**
 - **Conservative valuation**
 - **Write down**

THE NEW ZEALAND EXAMPLE

- **RBNZ supervisor and resolution agency**
 - All systemic retail banks must be locally incorporated and capable of running on their own overnight
 - Appoint statutory manager
 - Freeze overnight
 - Conservative valuation
 - Write down – to point of solvency
 - Separate into frozen and unfrozen parts of accounts – depositors
 - Unfreeze and complete transactions
 - Reopen in the morning with unfrozen accounts only
 - Recapitalise through private sector later
 - **Major points of difference from RRD**
 - Preconditions, no deposit insurance
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IMPACT ASSESSMENT

- **Compares economic cost (%GDP) with and without OBR under**
 - **Market recapitalisation**
 - **Bail out**
 - **Normal Statutory management**
 - **OBR**
- for a major failure**

Table 1: Crisis resolution options

<i>Outcome</i>	<i>Probability</i>	<i>GDP impact (%)</i>
No OBR		
Market recapitalization	0.30	12.5
Bailout (Good)	0.20	17.5
Bailout (Bad)	0.40	20
Statutory management	0.10	25
With OBR		
Market recapitalization	0.40	12.5
Bailout (Good)	0.15	17.5
Bailout (Bad)	0.10	20
OBR (Good)	0.275	20
OBR (Bad)	0.075	25

KEY INGREDIENTS

- **OBR not less costly than bailout or resolution without bail in.**
- **Gain comes from reduction in moral hazard and use of cheaper resolution methods – especially market solution**
 - **Incentive to behave more prudently and act early before public sector takes over**
- **Model unstated and estimates clearly fairly heroic**

IMPACT OF IMPLEMENTING OBR

(\$MN)

<i>factor</i>	<i>Status quo</i>	<i>OBR</i>	<i>difference</i>
Economic cost	5492	4764	728
Bailout cost	1703	693	1010
Government debt service cost	413	172	241
Bank funding cost	282	936	-653
Maintenance cost	0	10	-10
Build cost	0	20	-20
<i>Overall net present value</i>			<i>1295</i>

KEY INGREDIENTS

- While cost to economy and fiscal cost go down
- Cost to bank goes up
- Bank cost occurs without a failure so clear penalty from having the OBR (bail in regime)


THE PICTURE FOR BRRD

- **Ordering of losses – shareholders then creditors in order of priority**
- **No creditor worse off than in insolvency**
- **Uninterrupted access to deposits and payments transactions**
- **Depositor preference (super-preference for DGS)**
- **Minimise cost to taxpayers**
- **Return to adequate capitalisation**
- **Resolution funds – to bear costs not normally borne by creditors? (DGS share)**

RESOLUTION FUNDS NOT AVAILABLE TILL

- ‘losses totalling not less than 8% of total liabilities including own funds have already been bailed in, and the funding provided by the resolution fund is limited to the lower of 5% of total liabilities including own funds or the means available to the resolution fund and the amount that can be raised through ex post contributions within a period of three years.’ (73)

WHO PAYS FOR RESOLUTION FUNDS?

- **Depends on how the banks try to absorb contributions**
 - **Reduced dividends**
 - **Higher charges**
 - **Greater spreads**
 - **Lower costs**
 - **Costs borne by those dealing with banks but not especially the troubled bank so incentive weaker**
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WHO PAYS FOR RESOLUTION?

- **No mention of treatment of economic costs or costs to banks of preparation – which could include Liikanen report style separations**
- **Improved capital and liquidity buffers will reduce risk of failure**
- **Recovery plans will reduce need for intervention**
 - **But use of CoCos may advance pace of general crisis**
- **Earlier intervention powers will reduce potential losses**

COMMISSION ASSESSMENT

Cumulative impact (DGS deposit guarantee scheme, RF resolution fund)

	Basel III	DGS/RF	Bail-in	Sum
Costs (% of EU GDP annually)	0.16	0.04	0.14 - 0.42	0.34 - 0.62
Benefits (% of EU GDP annually)	0.30	0.32	0.76	1.38
Net Benefits (% of EU GDP annually)	0.14	0.28	0.34 - 0.62	0.76 - 1.04

Main gain from bail in

BAIL OUT VS BAIL IN

- Both keep vital functions operating
- Bail out spreads cost widely over time and over people – less concentrated than costs of economic downturn – some losses not borne by those who knowingly took risks (fairness)
- Bail in involves costs before and without failure
- Not spread out except by resolution and deposit insurance funds (fairness trade off)
- Only pension funds and hedge funds likely to find it easy to absorb – knock on for others
- But reduces moral hazard if credible

BAIL OUT VS BAIL IN

- **A good bail out makes a profit for the taxpayer**
- **Probability of bail in will alter structure of liabilities – pressure for seniority and collateralisation**
- **Will put more onus on depositors**
- **May require bail out of deposit insurance**
- **Time consistency problem for credibility**
 - **Small bail out preferable to concentrated bail in**
 - **Will bail in be politically possible – not in NZ?**

CONCLUDING REMARK

- Main gain from bail in is that it encourages greater prudence and cheaper market solutions
- Cross-border issues still to be resolved fully
 - Separability still to be agreed
- Will harm credibility and increase moral hazard
- Before SRM in place, use single point of entry resolution by home country of group or clear division into resolvable subsidiaries as in NZ?
- Does not deal with ‘Too Big to Save’
- Resolvability is the key and that is only a perception ex ante