The Implementation of the Bail-In Tool Requires Crucial Amendments

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One key lesson EU legislators have learned from the financial crisis of 2007/2008 and the ensuing sovereign debt crisis is that prudential regulation has to compel private sector loss-participation when banks fail. Private sector participation would enhance the risk sensitivity of investors as they can no longer rely on government bail-outs if an institution comes under financial stress. Hence, banks would be exposed to market discipline again and have to re-finance themselves on terms that better reflect their specific risk-profiles. This would dampen banks' appetite for risk and enhance the financial system's resilience. Moreover, making bank failures an essentially private event also cuts the link between banks and sovereigns and thus puts a halt to the mutually reenforcing downward spiral that can result from bail-outs in the financial sector. In this expertise we analyze whether the new European regulation on bail-in can live up to these objectives.

Bail-in instruments: not for everyone

Despite these elaborate regulatory precautions, the ability of the bail-in tool to perform as intended may still be inhibited if the demand-side preconditions for its functioning are neglected in the legal framework. First, investors in bail-inable instruments need to be able to understand the risk of bail-in, charge adequate risk premiums and thus exert meaningful market discipline on banks. Second, the same investors need to have sufficient loss-bearing capacity to incur a loss when their debt is bailed-in, i.e. written-down or converted into equity. Third, a bail-in shall not propagate risk from one financial institution to another and a bail-in of debt holders must not endanger the financial health of other financial institutions, triggering a systemic crisis.

Taken together, this implies that investors in bail-inable debt are ideally (1) sophisticated investors, (2) outside of the banking sector who (3) hold assets and liabilities that are matched with

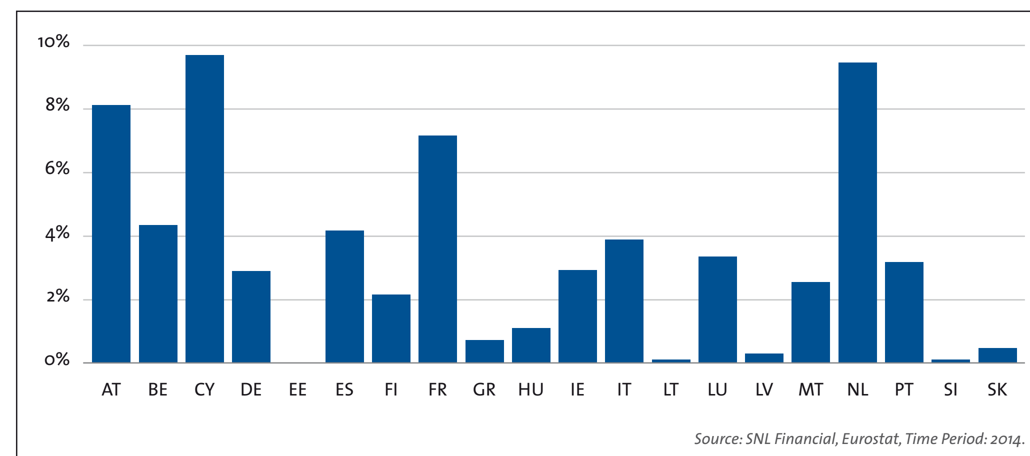

Figure 1: European banks' aggregate subordinated debt in proportion to their home countries GDP

regards to their maturity. In contrast, the sale of bail-in instruments to other banks or to unsophisticated retail investors would call the objective of this regulatory instrument fundamentally into question, and the efficiency of the bail-in tool would be compromised in all dimensions.

Meaningful restrictions missing

However, meaningful restrictions on the sale of banks' subordinated debt holdings are not established under the current legal framework: neither the BRRD nor any other prudential regulation effectively prevent banks from selling their bail-inable securities to unsophisticated (retail) investors; similarly, banks' holdings of bail-inable instruments can be limited only if they pose a risk for the holding institution's resolvability (BRRD, arts. 44(2) subpara. 5, 17(5)) or violate the large exposure limits under art. 395 CRR which allows only to remedy the most glaring deviations from the social optimum in this regard.

In order to assess the magnitude and severity of the problem we screened the amount of total outstanding subordinated debt levels of European banks licensed in the countries that participate in the Banking Union. Although the scope of the bail-in tool is much broader, we focus on subordinated debt because this represents the critical balance-sheet position subject to a bail-in.

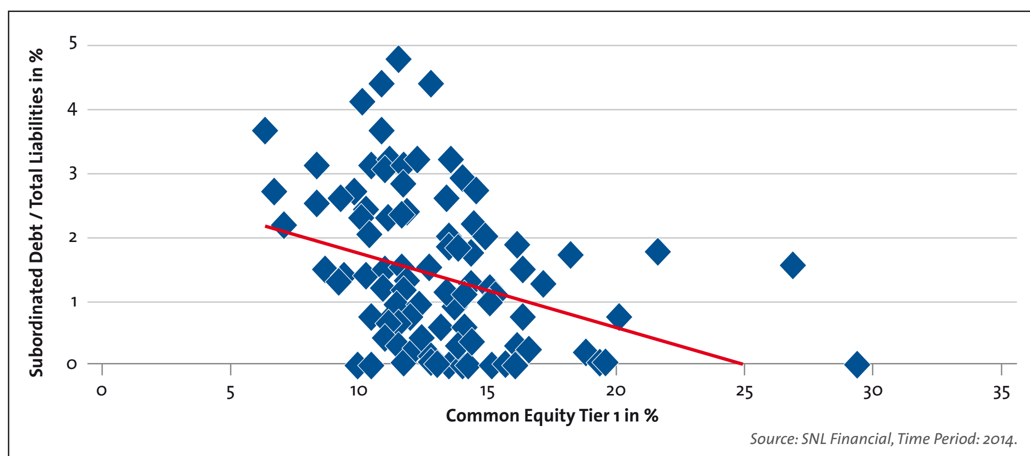

Figure 2: Relationship between subordinated bank debt (the critical balance-sheet position subject to a bail-in) in percent of total liabilities and Common Equity Tier 1

Banks with less equity issue more subordinated debt

We find that European banks rely to a large extent on subordinated debt financing with substantial heterogeneity among banks across Europe (see Figure 1). Furthermore, we observe that banks with less equity tend to finance themselves more with subordinated debt (Figure 2). As less equity may indicate that these banks are more fragile, this suggests that the subordinated debt of these banks is also more likely to be bailed in. Interestingly, banks issue about one third of their subordinated debt via affiliates, which adds a further level of complexity and makes it more difficult for investors to determine the likelihood of a subordinated bond to be bailed in.

Examining reports from systemically important institutions regarding their holdings of other financial institutions' subordinated debt suggests that some banks may be relatively large holders of these bail-inable bonds. Further empirical evidence on the investment behavior of retail investors across European countries suggests that households are also invested in banks' subordinated debt. To ensure the power of the bail-in tool it is important to examine whether the holdings of banks' subordinated debt by households and other banks is thus not too large.

Resolution authorities should monitor the placement of bail-in debt

We conclude by making the case that existing EU market regulation insufficiently addresses mis-selling of bail-in instruments to retail investors or their equally undesirable subscription by other banks. Private enforcement is generally inapt to effectively prevent mis-selling, which constitutes a major impediment to an effective functioning of the bail-in instrument. Public enforcement thus provides the superior option, also because it can counter detrimental acquisitions of bail-inable instruments by both retail investors and banks regardless of classical mis-selling. As a consequence, the relevant competences should not lie with market supervisors but with those authorities that administer the bail-in tool in all other dimensions and thus dispose of all relevant bank-level information needed to identify undesirable placements of bail-inable debt early, namely resolution authorities.

The full paper is available as SAFE Policy White Paper No. 35 at:
http://safe-frankfurt.de/implementation-of-bail-in